EUROPE IN FOCUS

INTERNATIONAL ECONOMIC ANALYSIS

BREXIT:
REGULATORY EQUIVALENCE AND SINGLE MARKET ACCESS FOR THE FINANCIAL SERVICES INDUSTRY

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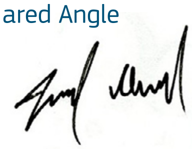
EXECUTIVE SUMMARY

As a supporter of closer European integration and as a close follower of global economic trends, I was deeply concerned by the United Kingdom's June 2016 decision to leave the European Union. To some, Brexit is a reclamation of British sovereignty from the collective intergovernmental forum embodied by the European Union's member states and its bureaucratic institutions. Others see the effects of the referendum as reaching far beyond the borders of the European Union, triggering a major shift in the global financial services industry as investment firms and other financial services providers attempt to navigate obstacles to cross-border business and seek new opportunities within the European Union and in major financial centers around the globe.

This report focuses on three primary subjects which may be of interest to a variety of individuals, including contingency planners in the financial services industry, consultants seeking to broaden their knowledge on contemporary issues in the industry, and members of academia. First, it provides an overview of the regulations that provide for cross-border financial services trade and mutual recognition of foreign companies within the European Union. Second, it identifies the specific characteristics that make cities attractive to financial services firms and subsequently examines a number of European cities to assess their suitability for large-scale relocations of financial services firms, activities, and workers. Finally, this paper describes the potential post-Brexit relationships that the United Kingdom could have with the European Union and evaluates their effect on the country's access to the European single market where financial services are concerned. This paper ultimately finds that while London will likely remain Europe's largest financial center, a portion of firms, activities, and employees currently located in London will disperse across several European cities to pursue greater certainty of their continued access to the European Union's single market.

My hope is that the insights gained from reading this report will provide readers with a deeper understanding of the challenges that businesses, global investment professionals, and European regulators are faced with. Furthermore, I hope that the recipients of this report will take my findings as an opportunity to engage with their colleagues and debate the merits (and risks) of European financial centers and find new opportunities for economic growth.

Jared Angle



OVERVIEW

The United Kingdom's June 23, 2016, referendum on European Union membership marks an inflection point in British and European politics, with the United Kingdom laying the groundwork for a new path forward as an independent international actor and the European Union continuing to evolve as its member states struggle with their own identities. For the financial services industry, however, the uncertainty surrounding the United Kingdom's future relationship with the European Union poses new threats, new opportunities, and new questions as cities gear up to claim potential benefits and firms debate their next move.

At the crux of the matter is the question of whether the United Kingdom will remain in the European Union's single market after its departure from the 28-member bloc, through which its massive financial sector is able to offer services to some 445 million people, excluding residents of the United Kingdom itself.[1] This access to the European Union market occurs through "passporting," or the mutual recognition of financial services regulations between the exporting and importing countries, which allows firms to offer financial services in other member states of the European Union without establishing separate subsidiaries in those member states.

17.4 million Britons voted Leave and 16.1 million voted Remain, for a total of 51.9 percent and 48.1 percent of the vote, respectively, with a turnout of 72.2 percent.

In other words, passporting is a "mechanism whereby an authorisation to issue securities in one jurisdiction would apply in all jurisdictions within the European Union," meaning that the successful regulatory approval of an issue of a particular security or a particular financial services activity in one member state constitutes approval in all member states.[2] While many British financial services firms access clients in other European Union member states via London and vice versa, London also serves as a key access point for non-EU firms, including numerous American and Asian firms that have established subsidiaries in the city and "use it as a gateway to the EU market."[3] If London-based financial institutions are denied access to the single market, the change could potentially be reciprocal.

With significant uncertainty surrounding the likely course of future European regulatory measures and their impact on access to the European market via London, some international financial services firms have suggested that they intend to curtail their activities in London.[4] Faced with a two-year negotiation window between the triggering of exit proceedings[5] and the United Kingdom's eventual exit from the European Union, all players in the global financial services industry have been searching for a safe haven to ensure the best path forward for their business.

This is not to suggest that London's financial sector developed as a result of the European Union and the Single Market, as its development was hundreds of years in the making, but rather that the industry continued to evolve alongside the European Union's regulatory framework during the formation of the Single Market and became considerably integrated with continental markets, adapting to European rules (which it had a hand in creating) and specializing in serving European clients. Now that London-based institutions play such a large role in European-oriented financial services, it is in London's interest to maintain as strong a role as possible in this market.

These issues pose two questions, which this paper explores in depth. First, can the European Union restrict the passporting rights that facilitate Single Market access for British firms? Second, what new trends will unfold in the European financial services sector in terms of market access, employment, and commercial establishment, provided that restrictions are indeed implemented or are assumed to be a credible future threat by relevant actors in the industry? The answer to the former depends upon the United Kingdom's future relationship with the European Union, which will be informed by the ongoing negotiations between the two parties, as well as which regulatory means the European Union might utilize to restrict British access to the Single Market. The answer to the latter is more definitive. London's loss will not be an equal gain for the greater European Union; although some financial centers in Europe stand to gain from firm reallocations, the broader European financial services sector will be negatively impacted as market efficiency declines and certain activities are lost to extra-European financial centers.

LONDON'S FINANCIAL SECTOR: DYNAMIC BUT THREATENED

Size and scope of London's financial sector

The financial services industry in London hosts a wide variety of companies and organizations, including traditional banks, private equity firms, stock exchanges, insurance companies, hedge funds and other asset managers. These institutions are in turn served by a large number of auxiliary service providers that handle the sector's legal, accounting, and information technology needs.

The industry is a critical component of the United Kingdom's economy, both domestically and abroad. The sector's total output, taking into account both financial services firms and ancillary industry, has been estimated at $300 billion annually.[6] Total financial service exports to all trading partners were valued at roughly $104.5 billion in 2015, or as much as 3.7 percent of the United Kingdom's gross domestic product.[7] The European Union is a key export market for firms operating out of London, receiving roughly "one-third of the UK's financial and insurance service exports and one-half of its cross-border bank lending" by one estimate,[8] or around 40 percent according to another estimate.[9] These percentages correspond to somewhere between $34.5 billion and $41.8 billion in financial services exports to the European Union in 2015.[10]

The United Kingdom's financial sector is not only large in terms of revenue, but is also heavily concentrated in terms of employment, number of firms, and value of assets. Estimates of total financial services employment in London vary depending on the which specific activities are included in the estimate, ranging from "350,000-plus finance jobs"[11] to 2.2 million jobs in financial services, insurance, and ancillary industries. A survey by London-based lobbying group TheCityUK reported 729,600 "financial and related professional services [jobs]" in June 2015,[12] while asset manager BlackRock states that the industry for the United Kingdom as a whole employs 1.1 million workers or 3.4 percent of the labor force, with the financial services sector and related fields representing nearly 12 percent of GDP.[13] With London alone having in excess of 6 percent of all financial services and insurance jobs in the European Union, the United Kingdom's share of these jobs "[reflects] the high geographic concentration and tradability of these services."[14]

Some of the most heavily-concentrated financial services activities in London include asset management,

The British financial services industry employs between several hundred thousand and a few million employees, by varying estimates.

foreign exchange trading, and derivatives clearing. Despite representing slightly less than one-fifth of the bloc's gross domestic product, the United Kingdom holds roughly $466 billion in hedge fund assets (excluding overseas territories and Crown dependencies)[15] and a similarly large amount of private equity fund assets thanks to passporting privileges under the Alternative Investment Fund Managers Directive (AIFMD), representing 78.5 percent[16] and 64 percent[17] of the European Union total, respectively.

In terms of trading volume, London processed roughly $2.2 trillion in foreign currency exchange trades per day in mid-2015, accounting for 41 percent of global volume in 2015[18] and 37 percent of global volume in 2016.[19] As of 2013, its daily volume in euro-denominated derivatives trading was equivalent in value to $927.8 billion, dwarfing France and Germany, whose trading volumes were valued at $141.2 billion and $88.1 billion, respectively.[20] The clearing of these derivatives trades is of central importance to the debate over the United Kingdom's future access to the single market through the passporting framework; central counterparties (CCPs), which reduce risk by acting as a buffer between buyers and sellers and ensuring the successful completion of each of these trades, would be negatively affected if their ability to provide cross-border clearing services was curtailed.

Across many measures, including foreign currency exchange and derivatives trading, London is the world's largest financial center.

Wholesale banking services performed for EU clients (other than domestic British clients) accounted for €1.7 trillion in assets ($1.8 trillion), or 17 percent of total banking assets held within the UK; of these assets, British banks accounted for 15.5 percent, EU27 banks operating in London and serving EU27 clients accounted for 28.8 percent, and other global banks (to include US banks, banks from other non-EU European countries, and those from all other territories) accounted for a combined 55.7 percent.[21] While the firms carrying out one-quarter of EU-oriented wholesale banking may be less significantly affected as they already maintain headquarters within the Eurozone or the broader EU, the British and third-country firms representing roughly three-quarters of this market segment may find that they will have to shift their European operations significantly.

History of London as a global financial center

The development of London's financial sector spans several hundred years, owing to the city's importance in both ancient and modern times as a center of regional and global commerce. While this paper briefly outlines London's historical development, its core analysis emphasizes the period following the Second World War, with a particular focus on developments occurring between 1973 and 2017, during which London's financial sector evolved concurrently with European Union regulations.[22]

Development from the 17th century to mid-20th century

Early modern banking in London began to take shape in the mid-1600s as goldsmiths began to offer interest-paying deposit accounts and interest-earning loans to the public, as well as rudimentary banknotes and checks.[23] London consolidated its role as a leader in global finance in the early 1800s as Dutch competitiveness in global finance receded and as the country served as a net creditor and key financer of international trade.[24] Shortly after the beginning of the 20th century, the United Kingdom was surpassed by a rapidly-growing United States as the dollar became the leading currency of international trade and finance.[25] Despite this, London retained its competitive position due to the inward-looking United States' failure to "promote American financial institutions in the international sphere."[26] More specifically, the United States "introduced regulations and restrictions whose effect was to drive US depositors and borrowers offshore," often to London's benefit.[27]

The postwar acceleration of London's financial sector was driven by both endogenous and exogenous factors, with excessive regulation abroad ultimately expanding London's competitive advantage vis-à-vis New York and competing European markets. One key example can be seen in a discriminatory 15 percent tax enacted by the United States in 1964 that targeted American earnings from European-issued securities in an attempt to reduce capital outflows.[28] Foreign residents who had been selling dollar-denominated bonds to American customers were significantly affected by the tax and needed to locate a new market for the bonds. With continental European markets still recovering from the Second World War and thus suffering from limited capital-raising capacity, investment bankers instead issued new dollar-denominated bonds in London, bypassing the tax "as long as [the bonds] were not sold to US residents."[29]

In essence, strict regulations affecting the American financial sector "[drove] US depositors and borrowers [offshore]" to London, whose "open-door policy for foreign banks" and lack of foreign exchange controls made it an ideal location for business denominated in foreign currencies.[30] Other competitive factors such as the prevalence of English, ample availability of skilled workers, and a favorable legal framework further increased London's attractiveness to "continental Europeans … and big international institutions."[31]

Continental European investors would soon build upon the so-called "Yankee bond" market through the issuance of Eurobonds in the London marketplace.[32] The first such instrument was introduced in 1963, a year prior to the American tax on Yankee bonds; by 1964, 76 Eurobonds had been issued with a combined initial value of more than $1 billion.[33] The Eurobond market continued its rapid growth into the 1980s, quintupling between 1980 and the mid-1980s.[34] Light regulations in the United Kingdom also attracted international lenders, "as British banking regulations did not apply to foreign banks lending in foreign currencies,"[35] and the United Kingdom's decision in 1979 to abolish all remaining restrictions on capital flows further facilitated cross-border investment, predating the European Union's Single Market by 14 years.[36]

The "Big Bang"

Despite its competitive position in the global financial system, the London Stock Exchange continued to struggle with low liquidity, drawing concern from the Bank of England.[37] On October 27, 1986, the British government passed the Financial Services Act, instituting sweeping regulatory reforms that boosted competitiveness for the British financial sector.[38] These changes included the "elimination of fixed commissions, [a] marked increase in the number of market participants, [and a] change in the structure and ownership of trading firms."[39] With regard to derivatives and clearing activities, the Financial Services Act "made all financial derivatives […] legally enforceable in the UK" and accordingly left New York-based traders "at a potential competitive disadvantage."[40] These changes "opened up the London Stock Exchange to international competition and allowed a broader range of activities, including proprietary trading."[41] Greater international competition after deregulation "resulted in many mergers among financial services firms and acquisitions by foreign investment banks and produced large-scale universal banks for the first time." [42] This date and the associated deregulation would come to be known as the "Big Bang."

During the years immediately following the Big Bang, derivatives trading and clearing in London began to reach a critical mass, facilitated by passporting privileges that spared firms in the industry from otherwise having to secure "regulatory permissions for each location where they operate."[43] As a result of deregulation and increased concentration of international financial services institutions, London became an agglomeration of "creative, regulatory, legislative, funding and technology centers" that fosters "greater competition, greater innovation [and cost reduction]."[44] The Big Bang gave London a significant competitive advantage over other European financial centers, whose stock exchanges were plagued by illiquidity and settlement issues. Traders in Stockholm, for example, moved a significant number of securities to the London exchange, as liquidity for highly-demanded stocks was five times higher than in Stockholm.[45]

Central bank independence in the 1990s

Following on the coattails of the Big Bang and other key deregulatory and liberalizing measures, the role of central bank independence was critical in improving the United Kingdom's financial services ecosystem and advancing London's position as a European financial center. In 1997, then-Prime Minister Gordon Brown granted the Bank of England independence from the government, allowing it to set interest rates without outside influence.[46] This increased stability and certainty of interest rates, as decisions to adjust rates were no longer politicized. Prior to 1997, "governments would 'reward themselves' with a rate cut," while national elections "influenced the nature and timing of decisions on interest rates."[47] Prior to independence, political influence over the Bank of England could potentially lead to "inflationary bias," and the Bank was not protected from "unsustainable politically motivated monetary policy decisions."[48]

London, the euro, and the passporting framework

European financial regulatory regimes and contemporary passporting rules

In order to fully understand the significance of the aforementioned passporting framework and the impact that reduced UK access to the Single Market would have on London-based firms, the concepts of passporting and mutual recognition must be explained in further detail. In the contemporary sense, passporting is defined as the right or privilege of a financial services provider established in and approved by the regulatory bodies of one European Union member states to operate in or provide services to clients in another member state without the need to establish additional legal entities or gain additional regulatory approval.

Deregulation was the catalyst for London's success. Brexit may be the catalyst for its undoing.

The policy rationale behind passporting is rooted in the concept of mutual recognition, a core element of the European Union regulatory framework. Mutual recognition is performed in the interest of retaining an element of sovereignty, rather than dissolving individual member states into a "genuinely single market" where the European Union is the sole legal entity; member state governments and the EU institutions thus decided that "there should be a mechanism whereby an authorisation to issue securities in one jurisdiction would apply in all [EU] jurisdictions," a concept dubbed "single license" by some and "passporting" by others.[49] Today, passporting privileges are applied to a variety of financial services, including retail banking services, wholesale investment banking, and "specialized financial services like operating trading platforms [...] and acting as central counterparties."[50]

The First Banking Directive, enacted in 1977, made initial steps toward harmonizing the licensing and regulation of cross-border banking activities, "[removing] obstacles to the provision of services and establishment of branches across the borders of EU member states."[51] Mutual recognition in the context of the European financial services industry means that the regulatory authorities in a country hosting a foreign bank trust that the regulations of the bank's home country are sufficiently rigorous and equivalent to their own regulations; they will thus allow cross-border banks to operate under the regulations of their home country (known as home country control) and waive the requirement to separately follow host country regulations.[52]

Mutual recognition of regulatory compliance among cross-border banks became less ambiguous with the introduction of the Second Banking Directive, enacted in 1989, which established the "single passport" that the industry is familiar with today.[53] The benefits of the passporting regime notwithstanding, the Second Banking Directive made significant steps to improve the ability of banks to engage in cross-border activities, specifically with regard to the harmonization of capital requirements and the introduction of a positive list system that determined the types of financial services for which the single passport would guarantee cross-border rights across all European Union member states.[54]

Perhaps one of the greatest benefits of the directive in terms of reducing the cost of entering new markets was its suggestion that branch-level capital requirements be replaced with bank-level capital requirements.[55] This change facilitated the cross-border expansion of larger banks by harmonizing a diverse range of national capital requirements, allowing the home offices of cross-border banks to maintain the necessary capital reserves to bail out national branches should they experience difficulty, rather than requiring branches in each member state to maintain capital reserves specific to that country's requirements to ensure their stability in a self-sufficient manner.[56]

No single regulation governs the financial services industry in the European Union. A large compendium of legislation spanning the past several decades governs the regulation and daily functioning of these firms.

Due to the difficulty of achieving convergence between European Union member states with significantly different banking regulations (which were in turn influenced by the unique characteristics of their national banking systems), a significant amount of European financial regulation came not from within the European Commission, but rather from the Commission's application of international banking regulations envisioned in the Basel Accords. The Second Banking Directive was accompanied in the same year by the Own Funds Directive and the Solvency Directive, which built upon Basel I and formally instituted the capital requirements proposed in the Second Banking Directive.[57]

Capital requirements were applied to investment firms soon afterward with the Capital Adequacy Directive in 1993; this regulation was unique in that it mandated the separation of investment banking activities from commercial and retail banking activities,[58] mirroring a similar mandate set forth in the 1933 Glass-Steagall Act in the United States, which forced banks to separate their commercial banking activities from their investment banking activities. This additional regulation arguably had greater significance for continental banks due to their combination of consumer banking services and business lending with investment banking, while the impact on the British market would have been subdued as London hosts a far larger number of specialist investment firms that do not engage in consumer retail banking.

The Capital Adequacy Directive was accompanied in the same year by the Investment Services Directive, which resembles the Second Banking Directive in that it provides for mutual recognition for specialist investment firms instead of traditional banks covered under the banking directives that may or may not also engage in investment activities.[59] The directive specifically extends passporting privileges to firms engaged in "brokerage, dealing, portfolio management, [the] execution of investor orders, underwriting and securities placement."[60]

Building on early achievements at the European level between the 1970s and 1990s, financial regulation in the European Union accelerated significantly in the 2000s and continues to take shape today. In 2001, the European institutions initiated the Lamfalussy process, an approach designed to foster regulatory and supervisory convergence within the European Union's single market where the financial services industry is concerned.[61] This process resulted in the adoption of four noteworthy directives,[62] popularly known as the Lamfalussy directives: the Markets in Financial Instruments Directive, the Market Abuse Directive, the Prospectus Directive, and the Transparency Directive.[63]

MiFID, entered into force in 2007,[64] is the most significant of the Lamfalussy directives where single market access is concerned and was designed to replace and improve upon the Investment Services Directive.[65] The directive expanded the European financial regulatory framework to cover activities undertaken by "electronic exchanges, multi-lateral trading platforms, and … investment firms," improving on existing regulations that covered traditional stock exchanges such as those located in London and Frankfurt.[66] Whereas the Investment Services Directive "focused on the official central regulated markets," MiFID introduced new measures to regulate "multilateral trading facilities [and systemic internalizers]," with the former referring to off-exchange trading platforms or networks for third-party buyers and sellers and the latter referring to investment firms that "[execute] client orders outside a regulated market or an MTF" on a regular basis.[67]

The MiFID framework also added several new service categories to the list of regulated activities, including investment advisory services, foreign exchange trading, investment research services, mergers and acquisitions advisory services, and trading on margin.[68] Finally, the regulation covers specific financial instruments, including traditional securities and numerous types of derivatives relating to commodities, credit risk, currency exchange, interest rates, emission credits, inflation rates, and "other official economic statistics."[69]

According to Alastair Hudson, "MiFID enhanced the regime for passporting regulatory approvals around the European Union, such that approval in one jurisdiction can be relied upon in another jurisdiction." The directive explicitly states that "an investment firm authorised in its home Member State should be entitled to provide investment services or perform investment activities through the [EU]" without the need for additional authorization from other member states.[70]

Hudson goes on to note that MiFID prevents European Union member states from "rely[ing] on further regulatory hurdles unique to their own jurisdiction to impede issuers and others who have regulatory approval in another Member State."[71] Not only is MiFID "crucial for UK capital markets and investment firms selling or advising funds in the EU," but the loss of equivalence under MiFID could also mean that "EU investors accessing global markets through the UK would have to take their business elsewhere."[72] This suggests that withholding equivalence would constitute a net loss for all parties involved, as both British and EU-based investors and firms would face increased hurdles with regard to all forms of cross-border investing.

Many regulations, such as MiFID and the Banking Directives, are already in place. New changes, in the form of the MiFID II and MiFIR regulations, will coincide with the UK's exit from the European Union.

Critical forthcoming regulations include a revised MiFID and the Markets in Financial Instruments Regulation (MiFIR), which are scheduled to be implemented on January 3, 2018.[73] MiFID II, proposed by the European Commission in September 2011, seeks to improve the MiFID framework as it applies to investment firms, with an emphasis on addressing "powers to intervene in overly-large derivatives positions."[74] The revised directive's reference to excessive derivatives positions poses several questions, including what constitutes an "overly-large" position and whether enforcement would be targeted at the national level or toward individual clearing houses. The directive "allows individual member states to continue applying their existing national regulatory regimes," and provides for the ability of (but does not explicitly require) member states to force non-EU financial services firms to establish local operations "in order to provide [investment services to retail clients and 'elective' professional clients]."[75]

Vincenzo Scarpetta and Stephen Booth argue that the majority of investment activities taking place across borders are institutional investors, including "credit institutions, investment firms, insurance companies, pension funds [...] national and regional governments, central banks and international institutions."[76] These are considered "professional investors" under MiFID II, and are thus eligible for the access afforded under MiFIR under equivalence regulations set forth by the European Union.[77] The financial services firms targeting retail investors would be left on a more uncertain footing than those serving institutional investors, but they are arguably less significant because, as the authors declare, "retail financial services are very rarely provided across borders."[78] This difference in access nevertheless suggests that relocating retail-oriented activities to the remaining member states will be necessary for many firms, while institutional-oriented activities likely face less risk.

MiFIR, proposed soon after MiFID II in October 2011, addresses investment services for "eligible counterparties and professional clients," and stipulates that "if equivalence is granted, firms can operate anywhere in the EU without establishing a branch."[79] MiFIR thus leaves a passport-like option open for institutional and professional investing, while the language of MiFID II poses greater uncertainty, with firms that offer services to smaller investors potentially losing the ability to conduct cross-border transactions depending on the decisions of the member states where their clients reside. Article 24 of MiFIR stipulates that derivatives trading must take place via physical exchanges, multilateral trading facilities (MTFs), or organized trading facilities (OTFs).[80] This regulation would effectively discourage private parties within the European Union from trading over-the-counter derivatives outside of a regulated setting.[81] Private parties in the United Kingdom would also be covered under MiFIR or an equivalent regulation implemented by the British government, depending upon whether the United Kingdom falls under the scope of MiFIR under an association agreement such as European Economic Area membership or unilaterally applies EU regulations to maintain regulatory equivalence with the EU in the interest of retaining third-country passporting privileges.

Article 2 of EMIR defines a central counterparty (CCP) as "an entity that legally [interposes] itself between the counterparties to the contracts traded within one or more financial markets, becoming the buyer to every seller and the seller to every buyer and which is responsible for the operation of a clearing system."[82] EMIR, the "proposed OTC derivatives clearing and trade repository regulation," stipulates that CCPs must be authorized by the regulatory authority in the member state, with such authorization being subsequently confirmed or denied by the European Securities and Markets Authority (ESMA).[83] According to Hudson, the EMIR framework devolves authority for CCP supervision to the member states where they reside but does not specifically state how this supervision should be performed, thus leaving "the precise supervision of CCPs" as "a matter for regulators to identify" in an ad hoc manner.[84]

London's role in clearing and other financial activities

Due to the presence of favorable tax policies and regulations, derivatives clearing "developed naturally" for the same reasons that other activities became concentrated in London before and after the Big Bang.[85] With London already trading securities denominated in dollars and other major currencies, the introduction of the euro on January 1, 1999, provided an opportunity for the city's financial sector to expand the scope of its services. Roughly 1,000 people work in London-based clearing houses and banks involved in clearing activities, with clearing houses "[acting] as firewalls against defaulting derivatives traders by holding collateral and monitoring risks," a role that has become increasingly important following the 2008 financial crisis.[86] In September 2016, "[the London Stock Exchange's] infrastructure, which includes clearing, freed up $25 billion in capital that financial companies could invest in the broader global economy."[87] If clearing operations were dispersed across Europe, some of these efficiency gains would effectively be erased.

Conflict with the European Central Bank

In exercising its role as the European Union's central monetary authority and a key element of the European banking and financial services regulatory system, the European Central Bank (ECB) has demonstrated greater scrutiny of banking and investment activities taking place in or pertaining to the Eurozone in the years following the 2008 financial crisis and the ensuing economic malaise that crippled European growth and financial market stability. The ECB previously wanted to assert greater control over euro-denominated clearing even before the Brexit vote, because it believed that "in times of crisis, it should have oversight over clearing in its own currency."[88]

While some of this scrutiny has been targeted toward the United Kingdom in part after the financial crisis (but more especially in the two years preceding the Brexit referendum and in the months since), the ECB's desire to see the domiciliation of at least a sizeable share of euro-denominated clearing within the Eurozone has its roots in policy objectives set out at the euro's introduction in 1999, when the ECB sought to reduce dependence on New York-based central counterparties.[89] In 2011, the ECB introduced a new policy requiring that CCPs "[handling] large volumes of euros to be located in Eurozone countries so it could better monitor trades and provide liquidity in a crisis."[90] However, this policy drew significant controversy, as it suggests that the financial sectors of other non-Eurozone countries could be curtailed, despite their good standing within the European Union.

A renewed attempt by the ECB to curtail or prohibit extra-Eurozone derivatives clearing or other euro-denominated activities that require passporting to service Eurozone customers could negatively impact non-Eurozone financial centers that are still within the European Union. If euro derivatives clearing and other activities were made exclusive to the Eurozone, the financial services industries in Stockholm, Warsaw, Copenhagen, Prague, and Budapest could be negatively impacted. Likewise, Brexit's impact expands beyond London. Glasgow and Edinburgh, while far behind London in terms of the scale of their industries, host banks whose cross-border activities could suffer under such an arrangement. While restricting the ability of these countries to engage in euro-denominated activities would not necessarily lead to a substantial economic impact due to the smaller role of such activities in these countries relative to the current scale of such activities in London, it would nonetheless suggest that these countries are politically inferior to Eurozone member states and could lead to a renewed legal challenge against the ECB within the European Court of Justice (ECJ), with the latter possibly ruling against the ECB just as it did in the United Kingdom's favor in 2015 regarding the legality of forcibly relocating clearing operations to the Eurozone.

To avoid such a legal challenge from other member states, such a policy would need to be very explicitly and carefully worded to avoid significant legal and diplomatic challenges. An overly-broad policy would affect European Union member states that possess their own sovereign currencies, including the Nordic countries and much of Eastern Europe. A policy that specifically targets non-EU countries would impact the passporting privileges of financial centers in North America and Asia as well, spurring a strong negative reaction from protectionism-averse institutions. Finally, if a discriminatory passporting regulation were to solely target the United Kingdom, relations between the European Union and the United Kingdom would further erode. This possibility has led some people to question whether European regulators could potentially extend clearing restrictions beyond London to other centers such as New York, Singapore, and Hong Kong "to avoid appearing vindictive."[91]

Brexit's impact would offer a boost to continental financial centers while hindering London and other British centers in England and Scotland.

The United Kingdom's legal victory against the European Central Bank

In 2015, the United Kingdom challenged the ECB's policy before the European Court of Justice, which ruled that the United Kingdom "could host such clearing houses, which process about $1 trillion of euro-based trades per day.[92] Although the ECB's first attempt to curtail euro-denominated derivatives clearing in London failed to hold up to legal scrutiny, the bank will likely try to reinstate the policy after the United Kingdom's exit from the EU, possibly with success and without further legal challenges.[93] One British lawmaker has reached the same conclusion, suggesting after the ruling that "the win wouldn't have been possible were the country outside the EU."[94] A report by the financial services advisory practice of accounting firm KPMG also supports this idea, arguing that the possibility of the ECB initiating a new challenge to London's role as a host to clearing houses remains a real threat, as numerous other parties have begun expressing a desire for euro-denominated derivatives clearing to be repatriated to the Eurozone for the sake of "effective oversight and regulation."[95] According to Karl Whelan, the ECJ's 2015 decision in the United Kingdom's favor will no longer apply upon its exit from the European Union in March 2019, leaving London-based clearing firms vulnerable to a renewed attempt to repatriate these services to the Eurozone.[96]

The UK's 2015 victory against the ECB before the judges of the ECJ could prove to be short-lived.

In a display of hostility in the weeks immediately following the referendum, outgoing French President François Hollande argued that clearing houses situated within London would lose their passporting privileges upon the United Kingdom's exit from the European Union.[97] Other sources are also pessimistic regarding the United Kingdom's chances of retaining passporting privileges. Charles Grant argues that "to leave the single market means to lose the passport."[98] Former Bank of England official Charlie Bean testified before the British Parliament that the loss of passporting privileges is a certainty rather than a possibility,[99] while the KPMG report directly states that a so-called "hard Brexit" without the retention of EEA membership would cause the current passporting arrangement to "automatically lapse."[100]

Being considered a third country, location requirements concerning euro-denominated transactions could be enacted to London's detriment, a scenario which Niamh Moloney describes as a "particularly likely outcome with respect to critical market infrastructures, such as stock exchanges and central clearing counterparties, in relation to which rescue/resolution responses involving ECB/euro area liquidity support might be needed."[101] Moloney's assessment seems to suggest that the ECB or another regulatory body such as the European Securities and Markets Authority (ESMA) will likely make a renewed attempt to repatriate clearing activities to the Eurozone, with the United Kingdom being at a disadvantage compared to its position in 2015 when the ECJ ruled in its favor.

London's victory was not unprecedented, as past attempts have been made at restricting the cross-border flow of financial services in favor of requiring commercial presence. Germany previously attempted to require insurance firms to establish local operations inside the country in order to provide services to German residents, but this regulation was struck down by the European Court of Justice.[102] However, the Court held that "host country controls were permissible in the public interest."[103] The Court's ruling on permanent local establishment requirements is likely applicable to other financial services outside of insurance, "including banking and, to a lesser extent, to investment services that require similar investor protection measures."[104]

Citing Article 127 of TFEU, the ECJ held in March 2015 that the European Central Bank "lacks the competence necessary to regulate the activity of securities clearing systems as its competence is limited to payment systems alone."[105] The question here is whether the ECJ will continue to maintain this opinion for non-EU members, or if this will become a precedent in EU case law regardless of the target country's relationship with the EU. In the case of non-Eurozone countries remaining in the EU, such as Sweden, Denmark, and much of Central and Eastern Europe, such a discriminatory policy would likely remain prohibited under the ECJ ruling unless a revised ECB policy prohibits non-EU countries from carrying out euro-denominated clearing activities, rather than non-Eurozone countries.

According to Philip Alexander, the UK's eventual exit from the EU would have no bearing on the ruling's effect, meaning that for the ECB to make a second attempt at curtailing extra-Eurozone clearing activities would require either a revision of the EU treaty, an amendment of the European Market Infrastructure Regulation (EMIR) by the European Commission with the consent of the Council of Ministers and the European Parliament, or through separate regulation by the European Securities and Markets Authority.[106] Regardless of the means used to restrict London-based CCPs, the UK would have legal recourse to protest discriminatory regulations before the

ECJ if it enters the European Economic Area upon its exit from the European Union, as it would retain single market access.[107] Taking these issues into consideration, it becomes clear that claims by figures such as President Hollande that London will unequivocally lose the right to clear euro-denominated derivatives in March 2019 are essentially acts of political grandstanding rather than serious policy proposals. While Hollande could be right, London's future access to passporting-dependent activities will be dictated by the specific terms of the United Kingdom's future relationship with the European Union, as negotiated between the two parties.

As a treaty change would require the remaining European Union members to negotiate the revised terms and unanimously agree upon them, it is likely that non-Eurozone countries will veto such an attempt. Sweden, which advocated for the United Kingdom during its case against the European Central Bank, would likely be one of the vetoing parties, as Stockholm hosts its own central counterparty, Nasdaq OMX Clearing.[108] According to Alexander, clearing restrictions could pave the way for discriminatory reciprocity if regulators in non-Eurozone countries enacted similar restrictions against Eurozone CCPs clearing their national currencies.[109] Furthermore, EU-based firms will not want to lose the ability to clear dollar-denominated derivatives, an activity which is also carried out in large volumes in London.[110] The United Kingdom could also respond to the revocation of passporting privileges by restricting EU-based firms from accessing London, forcing them to establish London-based subsidiaries.[111] At a minimum, the implementation of such a policy would risk turning non-Eurozone countries into second-class member states, which is likely not the "multi-speed Europe" that European Commission President Jean-Claude Juncker has envisioned.

Differences in the passporting framework for member states and third countries

Article 56 of the Lisbon Treaty stipulates that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited," but the treaty goes on to provide for the ability of the Council to "[adopt] measures on free movement of capital relating specifically to 'the provision of financial services or the admission of securities to capital markets' by qualified majority voting."[112]

The ECB could potentially be opposed to offering third-country equivalence to the United Kingdom. This stems from the ECB's belief that "third-country branches and broker-dealer licenses could pose [regulatory] arbitrage opportunities" for British financial services providers operating outside the reach of ECB supervision.[113] Such examples would include expedited approval of third-country licenses without an appropriate level of due diligence on the part of the approving authorities and the relaxation of risk management requirements for locally-established subsidiaries or branches.[114] In doing so, banks and other financial services firms could cut their approval times by several months to as much as a year compared to the timeline associated with ECB accreditation.[115] In response to the risk of "regulatory and supervisory arbitrage," the ECB has proposed a requirement for firms to establish ECB-supervised intermediate holding companies."[116] These revelations suggest that the ECB must make significant improvements to its regulatory capacity if it wishes to ensure that systemic risk in the financial services sector is adequately managed during a migration of this magnitude.

Third-country passporting is specifically avoided by a number of firms, hence their decision to create London-based subsidiaries to "access the single market and avoid the complexities, opacities, and uncertainties of third country access arrangements."[117] After the financial crisis, "[hedge funds] focused their lobbying on the issue of equivalence between EU and US rules, third-country access, and international harmonization," while the U.S. Department of the Treasury raised concerns regarding perceived protectionism and "the risk of retaliatory action" in third-country passporting provisions."[118]

Regardless of these challenges, the European Commission declared in October 2012 that financial services regulation in the United States, Canada, and Australia was equivalent to European Union standards.[119] Around the same time, the Channel Islands established diplomatic missions to Brussels to voice their concerns regarding regulation of the hedge fund industry, as these overseas territories operate independently of the United Kingdom as third countries (in terms of their relationship with the European Union where financial services regulation is concerned), and thus demand clarity regarding market access.[120]

The UK could secure a level of equivelance for financial services that would preserve its current market access. Then again, its competitors could score the same deals.

It must thus be reemphasized that third-country passporting and regulatory equivalence are sub-optimal because they are much less formal than member state passporting provisions. Whereas passporting represents a right of access for EU member states, equivalence represents a privilege of access for third countries.

This privilege can be modified or revoked, and countries relying on it must implement policies to maintain equivalence. This is precisely the kind of uncertainty to which financial services firms are averse; these firms demand predictability of market outcomes and of government decisions affecting conditions of market access to overall market functionality from a regulatory perspective.

Changes to the passporting framework

According to Jim Brunsden, the European Commission believes that “Brexit also allows Brussels to revisit [financial sector regulatory] ideas” that were previously unable to be implemented while the United Kingdom was a voting member and significant constituent of the European Union.[121] The Commission is considering “[giving ESMA] powers to directly supervise clearing houses,” thus bypassing the original legal issue concerning the ECB’s jurisdiction over clearing activities, and expanding ESMA’s ability to oversee transnational investment activities.[122] Currently, ESMA can recognize third-country CCPs after receiving “an equivalence decision by the [European Commission].”[123] According to the aforementioned article, enhanced EU regulation of clearing houses “was part of Brussels’ 2009 blueprint for the [European Supervisory Authorities].”[124]

New approaches to financial sector regulation could give the European Union new tools to keep critical portions of the financial services industry close to home.

New developments in European financial regulation could have varied effects for UK-based firms hoping to retain passporting or equivalence privileges. With the MiFID II and MiFIR regulations set to take effect in January 2018, wholesalers of financial instruments believe they may benefit from “third-country provisions” introduced in both laws. However, “equivalence will be harder to get for institutions wishing to provide services such as lending, deposit-taking or pretty much any financial service to retail clients.”[125]

In terms of retaining equivalence, it is likely that the United Kingdom will reach a satisfactory agreement with the European Union and secure third-country passporting privileges for the financial service sector, largely due to the realities of how global financial services regulations are negotiated and administered. More specifically, as the current bout of political grandstanding subsides, the European Union can be confident that financial services regulations in the UK will not significantly deviate from European standards. According to Moloney, this is because financial services regulation is largely driven by international standard setting bodies (ISSBs), whose standards are typically transcribed, whether verbatim or with minor modifications, into national law.[126]

However, the United Kingdom’s voice within these institutions will be diminished upon its eventual exit from the European Union, curbing its ability to influence regulatory policy. This is because in addition to its individual seat in these institutions, from which it can “directly advocate for [its] interests,” it was doubly-represented because it had the ability to influence the EU’s position before the ISSBs, effectively giving it two seats at these institutions. Furthermore, the UK retains the ability to further influence the incorporation of global standards into EU legislation by virtue of its seats on the European Commission and the Council of Ministers, and it similarly can exert influence on the EU’s supervisory and regulatory agencies.[127] Presently, the UK’s bargaining position is significantly diminished as the EU is keen on ensuring that the UK does not have the ability to influence long-term policies on its way out the door. Upon its exit in March 2019, it will permanently lose the ability to directly influence EU financial regulations and will see its negotiating power diminished at the international level because it will be speaking from one seat, rather than two.[128]

It will be important for the United Kingdom to secure an agreement with the European Union that maintains passporting privileges under the MiFID framework, which currently allows financial services firms to conduct business in EU and EEA member states “via a branch, a subsidiary or on a cross-border basis” through entities established in the United Kingdom.[129] The loss of access under MiFID would constitute “a severe blow to an entity’s own derivatives business [and] that of its derivatives counterparties.”[130] The United Kingdom also faces the prospect of being excluded MiFID II and MiFIR, which “provide for cross-border access to trading venues, clearing and settlement systems.”[131] The effects of the loss of passporting would be far-reaching. Some 2,250 firms established in the United Kingdom access the EU market through passporting privileges, while 988 firms located in other EU and EEA member states use passporting to access the British market.[132]

General impact analysis of the loss of euro privileges

Forcing London to forfeit its role in euro-denominated derivatives clearing and a host of other financial services as a result of the withdrawal of passporting privileges would considerably disrupt London’s concentrated and highly-specialized financial sector.[133] These changes will likely result in cross-border flows of financial services jobs, the relocation of certain European Union institutions, job losses within London, and economic impacts for both the United Kingdom and the European Union. Furthermore, passporting increases the liquidity of securities within the EU because the ability to market securities across national borders expands the number of buyers to whom sellers can issue securities and accordingly expands the number of securities available to prospective buyers.[134] In short, this means that a particular financial instrument issued by a firm in one member state can be "offered to the public in any member state in the European Union."[135] The revocation of passporting privileges would reverse these improvements in market liquidity.

Potential flows of jobs and institutions

Brussels-based think tank Bruegel estimates that London-based banking activities accounting for up to €1.8 trillion in assets, or roughly 35 percent of London wholesale banking, could be forced to relocate as a result of the potential loss of passporting or equivalency.[136] This could cause the relocation of as many as 3,300 employees of American banks that use London as their gateway to the European market, or as many as 10,000 employees of all banks offering services to EU27 clients via the financial services passport.[137] A different Bruegel estimate predicts that "10,000 banking jobs and 20,000 financial-services positions" could leave London.[138] The scale of this potential reallocation is the result of the fact that without the guarantee of passporting or another form of regulatory equivalency, banks will be forced to establish separate subsidiaries inside the European Union in order to satisfy ECB and ESMA regulations.[139] These subsidiaries would be required to have their own autonomous board of directors, as well as "full senior management teams, senior account managers and traders," and other critical positions.[140] Although back office employees need not relocate to the European Union because they do not trade securities with institutional or retail clients,[141] some companies are considering relocating these personnel anyway.[142]

The Bruegel report predicts that Brexit will result in a decline in the United Kingdom's share of the European wholesale banking market from 90 percent to 60 percent.[143] This implies that other current European Union member states currently account for 10 percent of wholesale banking within Europe, and that the loss of 30 percent of the British market share represents the migration of wholesale banking services that are specifically intended for EU27 customers. In the scenario described in the report, the United Kingdom's retention of 60 percent of the European market is likely due to the fact that the remaining activities are carried out on the behalf of global clients who will continue to leverage the resources and capacity available in London as their gateway to the rest of the world, if not the European Union.

The situation is less clear where the exact number of job losses in London is concerned, as estimates vary significantly between sources and contingency plans continue to evolve. From an investment bank perspective, several banks suggest that they will move between 25 and 30 percent of their employees to the European Union. Senior leadership at New York-based investment bank JP Morgan Chase announced that up to one-quarter of the bank's 16,000 London-based employees could be moved to new locations in continental Europe, with other New York-based banks with London operations also indicating that they were searching for suitable office space in Frankfurt and Dublin.[144] Swiss bank UBS has reportedly considered moving a larger share of its total business, with some 1,500 of its 5,000 London-based employees potentially relocating.[145]

Reports by government agencies and independent accounting and advisory firms show a broader picture. According to a November 2016 report by the European Commission, some 83,000 jobs in London's financial sector could be lost between 2017 and 2023 if the city fails to retain clearing privileges for euro-denominated securities and derivatives.[146] A more recent article in The Guardian, a London-based newspaper, states that of some "350,000-plus finance jobs" in the city, between 35,000 and 70,000 could leave London if the United Kingdom's passporting privileges are revoked.[147] Global accounting and advisory firm PwC has reported that London could lose some 100,000 finance jobs by 2020,[148] or close to 10.5 percent of total UK-wide job losses (for all industries) that PwC believes will occur, although it expects the majority of finance jobs to return by 2030 as the industry continues to grow.[149]

Depending on the severity of job losses and relocations, Brexit could lead to a loss of between half a percent and 1.1 percent of London's population if all affected employees relocate to the continent.

Some subsectors are expected to be safe, however. Charles Bean suggests that the retention of passporting privileges may be less of an issue for firms that mainly deal in wholesale financial services for cross-border clients.[150] The regulatory challenge is more relevant for firms connecting with consumers of retail services such as personal banking or personal investing, as this would require these firms to establish "physical operations in those member states."[151] Attorneys and financial services employees specializing in mergers and acquisitions (M&A) advisory may also be unaffected, as their work "does not usually require a passport."[152]

The final component of London's financial sector that must be considered is the European Banking Authority, one of the European Union's regulatory bodies for financial services. Described as "one of the main cogs of the system," it will almost certainly move from London to another location in the European Union, according to Valdis Dombrovskis, the European Commissioner with acting responsibility for the financial services portfolio.[153] The 159-employee agency could also potentially be merged into the European Insurance and Occupational Pensions Authority, which is located in Frankfurt.[154] This would serve to further expand Frankfurt's competitive advantage, as the city already hosts the European Central Bank and is favored to be a key beneficiary of the United Kingdom's departure.

Potential economic impact on London

London-based bankers are high earners. Losing bankers to the European Union wouldn't just mean the loss of certain financial services activities such as derivatives clearing, but also the loss of tax revenues to communities where these bankers live.

Losing certain financial services activities to the European Union or third countries would erode the United Kingdom's surplus of trade in services, valued at roughly £95.2 billion between July 2015 and July 2016 and of which roughly 45 percent comprised trade in financial services.[155] Combined with other potential economic losses associated with Brexit, a loss of access to the single market could further deteriorate the United Kingdom's current account balance, which stood at -5.4 percent of GDP in 2015.[156] In total, economic estimates of the loss in GDP for the United Kingdom and the European Union indicate either an equal loss (in euro terms) for both parties, or a loss for the United Kingdom of double that of the European Union; these projections place the UK's losses at between €20 and €200 billion and EU losses at between €10 and €100 billion.[157]

A report by asset manager BlackRock suggests that while Brexit won't necessarily trigger capital flight, it will nonetheless serve to cap growth for the sector within the United Kingdom, with an unfavorable outcome in terms of continued single market access after March 2019 likely limiting London's appeal as a target for foreign direct investment in the financial services sector.[158] Tax revenues in the United Kingdom would also be impacted in accordance with the eventual scale of the reallocation of financial activities and their associated employees to the Eurozone, hindering the government's financial position and potentially depressing London's economy.[159]

While much of the media attention and boardroom strategy debates have centered on the ability of financial services firms to negotiate the European regulatory framework and ensure the continued operation of their business, the impact of firm relocation on British public finances is also important to consider. Citing a report by accounting firm PwC, asset manager BlackRock estimates that the British financial services industry paid £66.5 billion in taxes in 2015, including £30bn for employment taxes alone, making up 11 percent of total UK tax revenue.[160] Losing just 10 percent of these workers, according to BlackRock, would result in the loss of more than £3 billion in tax revenue, to say nothing of the foregone tax revenue associated with the services that these departed workers would have otherwise been performing.[161]

Individuals engaged in planning for potential relocation of financial services activities fear that as much as $570 billion in euro-denominated derivatives clearing volume could be off-limits to London-based clearing houses; as such, clearing house employees "will be among the first moved to the continent once Brexit is triggered." [162] Brussels-based consultancy Cambre Associates argues that "much of the logic behind basing trading operations and so many staff in Britain will be undermined" if passporting privileges or regulatory equivalence are denied to the United Kingdom.[163]

Simon Puleston Jones argues that the euro should be "freely tradeable and clearable anywhere in the world" due to its status as the foremost reserve currency after the US dollar.[164] "Forcibly moving trading [and] clearing of euro-denominated derivatives into the euro zone," according to Jones, "is likely to fragment liquidity by currency, with a detrimental effect to EU end users and wholesale market counterparties."[165] Jones' argument is interesting because it conflicts with the ECB's rationale for withholding clearing from third countries; while the ECB argues that allowing euro-denominated derivatives clearing to take place outside the Eurozone raises the possibility that it could be unable to distribute funds to an illiquid CCP, Jones seems to argue that placing clearing activities physically closer to the ECB reduces liquidity because clearing houses will be foregoing London's more efficient market infrastructure.

Hypothetical flows of London-based firms and activities to other EU hubs

Characteristics that attract financial services firms

European cities hoping to attract large outflows of financial activity and personnel from London must determine how they can offer the necessary amenities and financial incentives that make relocation logical for companies from an economic perspective and for workers from a quality-of-living perspective. London is a true cosmopolitan "global city" with a mix of strong governance, low corruption, vibrant culture, a large population, efficient infrastructure, and strong economic fundamentals. Few European cities can boast all of these characteristics, perhaps with the exception of Paris. From a more technical perspective, London is an "industry 'cluster,'" characterized by "groups of interlinked firms that share knowledge, are close to clients, can access specialized labor and services inputs, and benefit from economies of scale."[166] To have the strongest chance of attracting financial services firms as they leave London, recipient cities should embody these characteristics or be able to do so in relatively short order.

Industry insiders have cited a variety of factors that would make other cities attractive for relocation. From the company perspective, these include favorable financial and employment regulations, strong local use of English, "excellent transportation and communications infrastructure," and available office space.[167] Where worker preferences are concerned, attractive qualities include the presence of high-end residential real estate, a strong educational system, and cultural amenities.[168]

The prevalence of English as a first language or proficient second language varies significantly across the member states, and could weigh heavily on the viability of certain cities as a potential choice for relocation. Local tax and employment regulations are also varied, with some member states having low corporate tax rates and flexible employment policies and others having very high taxes and regulations that are unaccommodating to the industry's need to hire and fire as business circumstances evolve. For most financial services firms, favorable tax policies are "a vital issue for firms looking to relocate."[169] In terms of transportation, London will be challenging to match; with two international airports and a world-class bus and commuter rail network, few European cities have comparable transportation options save for Paris and Berlin. Outside of Europe, other competing financial centers such as New York and Hong Kong boast the same capabilities.

The availability of property is critical for firms that are considering relocating major operations to a new city. In London alone, financial services firms have occupied as much as one-quarter of commercial real estate.[170] Cities that wish to attract larger companies will need ample commercial space to facilitate the relocation of hundreds or thousands of employees, while smaller cities with less available real estate may be better suited to small boutique firms or asset managers that have dozens of employees or fewer. Finally, financial services firms must generally be collocated with numerous ancillary service providers, including law firms, regulatory and tax specialists, accounting firms, and information technology specialists, as these services are essential to the continued functioning of the industry.

James Stewart states that some executives believe that London will eventually be eclipsed by another European city that can host the financial services firms currently based in London, citing evidence that London wasn't always the cosmopolitan city that it is today, and that other cities can replicate the current environment in due time.[171] Others, however, disagree. Tim Worstall argues that London's importance today has nothing to do with market access, but rather is a product of agglomeration in the financial services industry, with firms continuing to pool where liquidity is ample.[172] This argument is noteworthy because the level of agglomeration present in London is missing from other cities.

Efficiency and contingency

Despite potential gains for the recipient cities, splitting up euro-denominated derivatives clearing across various financial centers in the European Union would be economically inefficient. Derivatives clearing is more cost-effective when trades are kept within a single clearing house, according to Philip Stafford and Roger Blitz, who note that this cost advantage "would erode should clearing houses split between a UK and EU jurisdiction."[173] This notion is supported by the fact that "clearing executives at European banks that could benefit from the move say they have little desire to move their portfolios to countries in the EU."[174]

Because the concentration of clearing in a single venue significantly reduces transaction costs, any potential relocation of clearing would need to be done en masse if it were to retain this efficiency, with the entirety or at least a vast majority of London-based operations moving to another European financial center and being fully integrated with the local and EU-wide financial services sector. However, for reasons stated later in this section, most other European cities simply lack the capacity to host large amounts of financial services activities, let alone the entirety of the European clearing network.

With 8.7 million residents, London is the largest city in the European Union. At double to triple the size of its neaest competitors, other would-be financial centers have significant work to do if they wish to match London's scale.

A large amount of the contingency planning undertaken by major financial service firms will rely upon the status of the Article 50 proceedings and will depend on whether the United Kingdom and European Union agree to a transition period, during which London-based firms would retain their access to the single market, as well as the length of time that the transition period will be in effect. However, many firms are still eager to begin the relocation process due to the uncertainty surrounding future access to the single market. American investment bank Goldman Sachs, for example, is reportedly not taking the possibility of a transition period for granted and is pushing forward with relocation planning.[175]

Dispersion or aggregation?

Opinions differ significantly on whether certain activities will leave the UK. One source cited by the September 2016 Global Financial Centres Index (GFCI), a semi-annual survey produced by London-based consultancy Z/Yen that tracks "business environment, infrastructure, financial sector development, human capital, and reputational factors,"[176] argued that Brexit would not necessarily mean that banks and other financial institutions would flee London outright because "commercial and retail banks will remain where their customers are."[177] A great deal of debate following the Brexit referendum has centered on whether financial services firms will move en masse to a major Eurozone finance hub or if they will become fragmented across a broad range of cities.

The British Parliament has acknowledged that it would be "difficult to identify another individual smaller financial centre in Europe that has anything like the sort of advantages that London has."[178] Instead, banks are focusing on expanding their existing operations within the European Union, rather than establishing new headquarters at a higher cost.[179] Most sources seem to indicate that dispersion across many cities, rather than concentration in a single city, a London 2.0 so to speak, will characterize the post-Brexit landscape. A report from BlackRock supports this idea, arguing that an outright “exodus of capital” is unlikely in the case of Brexit due to the continued presence of “strong institutions and flexible markets,” which are the primary draw for London.[180] This suggests that any restructuring of financial services activities in Europe will take shape in the form of a partial reallocation of investment firm resources rather than a complete upheaval in pursuit of a new corporate headquarters.

A report by Bruegel asserts that “financial services in Europe will be split between several centres,” including such Eurozone cities as Frankfurt, Luxembourg, and Dublin, as well as non-EU cities such as Zurich.[181] The authors describe the post-Brexit status of the European wholesale banking market as following one of two paths. The first such path, dubbed integration, implies that further EU27 integration in the form of Capital Markets Union and Banking Union will harmonize policies governing cross-border finance, with “consistent rules and enforcement [guaranteeing] equal conditions” and making it relatively easy to have operations dispersed across multiple European cities while still being able to communicate effectively and execute transactions. The second path, fragmentation, implies that inefficiencies will exist as institutions, banks, trading venues, and individual investors contend with “diverging local requirements” that are specific to both the member state that they reside in and the member state in which their clients reside.[182]

Europe’s smaller financial hubs would see massive gains that correspond to considerable, yet proportionately small, losses in London.

Under both models described in the report, the potential gains in market share for wholesale banking could be enormous for the European financial hubs that stand ready to host the businesses and financial activities that would leave London under the report’s assumption that the UK will lose passporting rights. Frankfurt and Paris would see their share of the European wholesale banking market grow nine-fold and eight-fold, respectively, while Amsterdam and Dublin could see their shares quadruple and triple, respectively.[183] Smaller financial centers such as Luxembourg, Rome, and Madrid would see incremental gains, with such gains likely concentrated in the specific sectors in which they specialize.[184]

The European Central Bank is concerned that financial services firms leaving London could focus their operations in countries that are offering relocation incentives that would allow them to quickly regain access to the single market and allegedly skirt the European regulatory framework that would otherwise more closely scrutinize their activities.[185] Luxembourg and Ireland have been criticized in the past by the European Commission for their very low corporate tax rates, drawing accusations that they may be engaged in “’regulatory arbitrage’ in a bid to attract business from London.”[186] This fear is not entirely unfounded considering the LuxLeaks scandal and the recent European Commission ruling on Ireland’s tax deal with Apple.[187]

Net loss from migration to extra-EU locations

One of the key challenges for London and other would-be European finance hubs is the fact that London’s size and unique characteristics are currently unmatched in Europe. A report produced by the House of Lords states that New York shares the same “economies of scale, scope, information-sharing and ancillary services” seen in London and admits that other European cities are unlikely to replicate this business-friendly environment; the contributors concede that if financial services firms choose New York over Europe in the pursuit of policy certainty and economies of scale, Brexit will constitute a net loss for both the United Kingdom and for the European Union.[188]

Some financial services firms that are exploring the possibility of relocating operations will view a second-best European option as unacceptable, and will likely instead seek out space in New York and other global financial centers that are directly competitive with London, such as Hong Kong or Singapore.[189] Statements by leading financial services institutions and think tanks support the net loss hypothesis. Respondents to the GFCI survey ranked Hong Kong as being among the “[most] likely to become more significant” relative to more than 100 other leading financial centers featured in the index.[190] BlackRock argues that while “Dublin, Paris and Frankfurt could benefit to some extent,” the loss of regulatory equivalence (and thus passporting privileges) for British financial services firms would constitute a net loss for Europe as financial activities are diverted to financial centers in the United States and in Asian countries.[191] Experts at Bruegel reached a similar conclusion, stating that at least a portion of euro-denominated derivatives clearing could migrate to New York.[192]

Shifts in financial services competitiveness among European financial centers

As referenced throughout this paper, significant attention has been devoted to the idea of Paris, Frankfurt, and Dublin becoming the likely beneficiaries of expected shifts in the European financial services landscape. However, these choices should be scrutinized and justified by measuring the tangible characteristics that would allow them to successfully attract business leaving London; similarly, cities that have otherwise been overlooked should be considered on their merits.

The September 2016 edition of GFCI shows significant shifts in the competitive position of many European Union financial centers relative to London, which has held the top position for most years the survey has been administered.[193] Despite the importance and scale of their financial sectors, Frankfurt and certain Swiss cities have edged downward in the GFCI as other cities have made significant gains.[194] Paris has edged upward slightly, and remains only a few positions behind Frankfurt, while Dublin, oft-mentioned as one of the financial centers best positioned to reap the rewards of Brexit, rose by 8 places between 2015 and 2016.[195] In fact, every Eurozone financial center within the top 50 spots in the index, with the exception of Frankfurt and Munich, has seen its ranking improve over the previous year.[196]

Eurozone-based financial centers have gained in competitiveness, while non-Eurozone centers seems to be falling behind.

Among non-Eurozone financial centers and those within the Eurozone but outside of the top 50 positions in the index, rankings have declined modestly to dramatically.[197] Stockholm lost 7 places, Copenhagen lost 11 places, and Brussels lost 10 places, while Prague and Helskini faced the largest backslide, at 15 and 21 places, respectively.[198] Some European financial services regulators have argued that Eastern Europe is becoming less favorable where corruption and rule of law are concerned.[199] (*For a more detailed analysis of the competitive factors of individual Eurozone financial centers and potential outcomes for these cities, please see the appendices at the end of this report.*)

Potenial post-Brexit arrangements with the EU

With the United Kingdom's departure from the European Union slated to occur in March 2019, London-based financial services institutions will at the very least seek a transition period that allows them to maintain passporting privileges through 2021 to allow them to wind down existing contracts and avoid legal uncertainty.[200] Beyond that date, all options available to the United Kingdom are unfavorable ones, as the UK's pre-referendum status as an equal member of the European Union provided it with the greatest amount of rights and benefits. Potential post-Brexit relationships such as EEA or EFTA membership, or other models of association resembling the Canadian, Turkish, or Swiss agreements, are suboptimal because they either offer reduced benefits to the financial services industry or cross the UK's non-negotiable red lines, such as contribution to the EU budget or the free movement of people. The United Kingdom will want to carefully explore which option has the least negative impact on the industry while also meeting other core UK objectives, such as opting out of the aforementioned migration and budget responsibilities.

If the United Kingdom is able to secure entry into the European Economic Area, it will retain the right of free movement of capital and services, which would implicitly include passporting rights. However, it would also retain free movement of people, which was one of the core motivations behind the referendum and has been considered off-limits by the United Kingdom's negotiators.[201] Other forms of EU association such as the European Free Trade Association (which does not provide full passporting privileges for Switzerland) or a free trade agreement (in which passporting or equivalency rights for financial services would need to be negotiated as part of the agreement) would be equally incapable of providing the necessary assurance that the British financial services sector would retain the level of access to the European market that it currently enjoys.[202]

In light of these facts, it appears necessary for the United Kingdom and the European Union to negotiate a bespoke agreement for financial services access as part of the divorce proceedings. Alternatively, there is a slim possibility that the snap elections scheduled for June 8, 2017, play out in Labour's favor, opening up the possibility for Parliament and the prime minister to change their position on free movement of people and agree to an EEA relationship with the EU, or perhaps even back out of Article 50 proceedings altogether. For the sake of realism, however, it should be acknowledged that the Conservatives are expected to expand their majority and push for one of the aforementioned post-Brexit relationships. Regardless of these hypothetical scenarios, the European Union's negotiating position as of May 1, 2017, does not provide for a transition period.[203]

European Economic Area model

Remaining within the European Economic Area would allow the United Kingdom to retain its existing passporting rights, but would pose a number of conflicts with regard to issues important to the Leave campaigners, including the lack of a British vote on EU laws and the requirement to continue permitting the free movement of persons, which directly conflicts with British anti-immigrant sentiment.[204] EEA membership provides for the free movement of goods, services and capital, which would allow the UK to retain passporting privileges, but also entails contribution to the EU budget and the free movement of persons, both of which are red lines for the UK.[205]

With certain exceptions for sensitive subjects, EU legislation is automatically "integrated into the national legislation" of EEA members; therefore, EU financial services legislation would continue to apply in the United Kingdom if it enters the EEA.[206] Central Bank of Iceland official Sigridur Benediktsdottir and her colleagues state that EEA membership confers many of the same benefits of EU membership, "including full participation in the European passport."[207] As such, passporting privileges allowed Icelandic banks to establish operations in the European Union and offer services to customers without the need to establish a separate legal entity in the European Union, with the passporting arrangement operating "on the explicit assumption that [Icelandic] regulators were exercising adequate controls."[208] Such a scenario would also apply to the UK under these circumstances.

One challenge with the EEA model is that "several significant pieces of EU legislation" pertaining to financial services have not been integrated into the EEA framework, such as EMIR.[209] According to law firm Shearman and Sterling, the full integration of EMIR into the EEA framework would allow London-based CCPs to "provide services in the EU" under a national treatment system, rather than under third-country equivalence rules.[210] Other challenges also exist. Despite having to apply EU legislation as a member of the EEA and having to accept freedom of movement and other policies that are controversial within the UK, the UK will be reverted to observer status within the European Banking Authority, reducing its influence on European financial regulation despite being obligated to apply virtually every aspect of EU law.[211] The political realities of EEA and EFTA membership, including the aforementioned red lines, make EEA membership a challenging proposition for British politicians whose Brexit mandate is to meet the demands of British citizens who voted leave in the referendum with the intention of securing the United Kingdom's exemption from these exact measures.[212]

Free trade agreement, WTO model, Swiss model, or Turkish model?

The EU-Canada Comprehensive Economic and Trade Agreement does not provide single market access in the same manner as EEA membership, and it also excludes automatic regulatory equivalence under the passporting framework.[213] The Turkish customs union model is even less comprehensive, as it contains no provisions for financial services passporting and would not allow for the United Kingdom to influence EU policy; however, tariff-free access would be retained, as would the common external tariff.[214] Because of its narrow focus on eliminating internal tariffs, a Turkish-style agreement is likewise irrelevant to the United Kingdom's economic goals for a post-Brexit relationship as it excludes services.[215]

A report by Cambre Associates notes that British lobbyists are seeking "a beefed-up EU-Swiss style relationship for the UK, allowing for some sectors to benefit from access to the single market in return for maintaining a certain level of regulatory equivalence."[216] However, the Swiss association agreement with the United Kingdom does not automatically grant passporting privileges to banks, requires contribution to the EU budget, and "[necessitates] commercial treaties with each EU member state."[217] In essence, it is a limited-capacity version of EEA membership.

Likewise, replicating Switzerland's ad hoc relationship with the European Union would prove inadequate and difficult to accomplish due to the arrangement's exclusion of financial services equivalence, the undue burden of having to negotiate a broad range of bilateral agreements on individual issues, and the fact that such an agreement would involve contributing to the EU budget as a condition.[218] However, Karel Lannoo argues that "the UK could strive to negotiate a bilateral agreement for market access with the EU on financial services, pending a more comprehensive trade deal."[219] If EEA membership remains taboo for the United Kingdom's negotiators, the second-most favorable type of post-Brexit agreement would be one that provides for "some level of tailored access."[220] According to Cambre Associates, financial services firms in London have "given up hope of full access to the single market, and [are] instead hoping for a bespoke agreement, leveraging London's status as a global powerhouse in finance."[221] Considering the aforementioned fact that EEA membership crosses red lines such as immigration policy and budget contribution, the prospect of maintaining a sort of proto-single market access exclusive to financial services in exchange for non-immigration and non-budgetary concessions is certainly a possibility. Finally, all of these models would limit the applicability of ECJ decisions to issues concerning the United Kingdom's access to the single market where financial services are involved, as "dispute settlement mechanisms lean on WTO practice, with less total reliance on the European Court of Justice."[222]

In the absence of EEA membership or a Swiss-style

EEA membership is the next-best status for the United Kingdom. Other options could be more complex, or less comprehensive.

agreement, the United Kingdom's future access to the European market would involve third-country passporting via "some sort of equivalence arrangement."[223] Having thoroughly applied European Union financial services regulations, equivalence is likely to be granted without an unusual amount of difficulty; however, the ability of Parliament to satisfactorily apply future EU regulations, which it will lack direct influence over, adds complexity to the regulatory framework and calls into question how seamless third-country passporting will truly be.[224] Furthermore, third-country passporting privileges come not as a single agreement, but rather as a patchwork of agreements, with regulatory approval coming from the European Commission for certain financial services activities and from individual member states for other activities.[225] It is precisely this type of complexity and uncertainty that financial services firms are likely to shy away from, and which may influence their decision to relocate services and personnel to other EU member states without waiting for a political agreement or relying on assurances from the European Commission or the British government.

Conclusion

The analysis of the regulatory and intergovernmental issues explored in this paper provides strong clues regarding future trends in the European financial sector as well as the United Kingdom's ability to maintain passporting privileges. The European Union's ability to restrict the United Kingdom's single market access for cross-border financial services is contingent upon the exact type of relationship or association agreement that both parties agree to during withdrawal negotiations and upon the use of the appropriate regulatory body to implement such restrictions.

As discussed earlier, the United Kingdom will maintain significant legal rights safeguarding its access to free movement of capital and services provided that it remains in the EEA; the protections afforded to the United Kingdom's financial sector under a lesser form of association will be far less robust, and such treaties can lack the permanence expected of membership in a supranational grouping such as the EU or the EEA. Furthermore, if the United Kingdom remains in the EEA after March 2019 and the EU decides to restrict its passporting privileges for financial services despite such membership, the EU will likely remain bound by the ECJ's 2015 decision and must ensure that the regulatory body enforcing the restriction is empowered to do so by its respective mandate. In this case, such a policy would likely need to be implemented by ESMA or the Commission, rather than by the ECB. The likely scenario is that the European Union will possess some ability to curb London's access, but the potential effect will be significantly more muted than some member states would prefer because the United Kingdom will maintain regulations compatible with those of its European counterparts due to the globally-driven nature of financial services regulation.

In terms of future trends in the European financial services sector, nearly all parties close to the matter believe that London will lose at least some of its core financial activities to other member states and more specifically to the Eurozone. Due to the potential for the EU to restrict single market access, the more risk-averse firms in London will be keen to scale up their European operations before March 2019, as some have already done. If Brexit negotiations deliver a negative outcome for the United Kingdom, more firms will certainly follow. While several European cities stand to be major beneficiaries, Brexit will not precipitate an exodus of financial services activity from London, which will maintain a competitive position as a global financial center despite its reduced ability to serve European clients. More importantly, the European financial centers benefitting from Brexit will evolve considerably in terms of employment, economic growth, and global relevance as they assume a greater role in the international financial industry.

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[26] Plender, 42.
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[31] Ibid.
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FRANKFURT

As the host of the Deutsche Börse, the European Central Bank, and numerous German and international banks, Frankfurt is well positioned to continue building its well-established financial sector. Frankfurt could attract as many as 10,000 new jobs over the next five years,[1] with up to 4,000 of them potentially being sourced from Deutsche Bank's 9,000 London-based employees despite the lack of an official announcement.[2] Swiss investment bank UBS established new operations in Frankfurt in 2016 and has suggested that 1,000 of its London-based jobs are at risk from potential changes to the passporting framework between the UK and EU.[3] This move suggests that additional positions may shift from London to Frankfurt and also reinforces the idea that a Swiss-style relationship between the UK and the EU is not suitable for banks with regard to passporting, as they would simply be operating out of Switzerland if that were the case. New York-based Citibank currently employs 370 people in Frankfurt and is looking to expand its operations there due to the presence of a skilled workforce.[4]

Aside from the city's current residents, there are signs that other firms are exploring the idea of moving to Frankfurt, as financial news network Bloomberg reports that additional financial services institutions have approached realtors to reserve office space.[5] According to the Bruegel report, Frankfurt will represent between 35 and 45 percent of the EU27 wholesale banking market after the conclusion of Brexit, contingent upon the accuracy of the *integration* and *fragmentation* models, respectively.[6]

In terms of economies of scale, Frankfurt hosts the Deutsche Börse, the Eurex derivatives hub, key regulatory institutions, and an agglomeration of major German and international financial services firms,[7] including "the biggest European operations of the US investment banks outside London," making it a strong choice for further bank relocation.[8] This suggests that just as London today represents a strong economy of scale in terms of possessing the existing market infrastructure that attracts new entrants, Frankfurt would be the next logical choice

choice as it is presently the largest Eurozone financial center and would thus have the most to offer to those seeking to relocate into a new environment where the existing market infrastructure can cater to their needs. Aside from market infrastructure advantages, many leading global banks are attracted to the idea of moving some of their operations to Frankfurt due to the presence of both the ECB and BaFin, the German financial markets regulator.[9]

The city also has ample office space suitable for financial services firms, as well as a lower cost of living than other Western European cities, with combined annual office and residential leasing costing half of what firms would pay in Paris on a per-employee basis.[10] Frankfurt is cheaper still than London, which has among the highest office leasing costs of all European Union financial centers, at just over one-third of the cost.[11] However, Germany's "strict employment laws and high taxes" could present an obstacle to firms more accustomed to London, and Frankfurt is ill-favored among expatriates as a consequence of having a "staid culture and little night life."[12] Other cities preferred by expatriates, including Berlin and Munich, have stronger cultural offerings but lack the same scale as Frankfurt's financial services industry.

AMSTERDAM

Amsterdam has long aspired to attract international investment banks and key EU institutions, having previously been a candidate location for the European Central Bank, a prize that would later go to Frankfurt.[13] Individuals affiliated with Amsterdam-based banks in the early 1990s felt that hosting the ECB would prompt third-country banks to locate their European headquarters in the city, a move that would be akin to the benefit that hosting the EU's executive and legislative institutions has afforded to Brussels.[14] According to the Bruegel report, Amsterdam will host 10 percent of the market under the *fragmentation* model and 12 percent under the *integration* model.[15] The Dutch foreign investment and business development agency has ramped up recruiting efforts, expanding its London office to increase outreach to prospective banks that might relocate.[16] Japanese bank Mitsubishi UFJ is one likely contender, as it has been considering an expansion of its existing offices in Amsterdam.[17]

Amsterdam has a long history in capital markets, with the Dutch having "a strong Anglo-Saxon as well as international business orientation."[18] The city also boasts excellent rail connections to the rest of Europe and strong global air connections.[19] Amsterdam is also appealing because the vast majority of Dutch residents are proficient in English, meaning that it will be relatively easy for bankers and their families to be transplanted into the city.[20] However, Amsterdam is less competitive in other areas. The city's financial sector is less developed than those of Frankfurt and Paris, international schools and housing are in short supply, and regulations currently cap bonuses at 20 percent of an individual's salary.[21]

The 20 percent cap on bonuses is concerning for those in the financial services sector because it reduces incentives for top banking employees.[22] However, where derivatives clearing alone is concerned, officials in Amsterdam believe that the country's 20 percent cap on bonuses will not deter clearinghouses interested in relocating to the city because of differences in their incentive structure relative to traditional investment bankers and other financial sector employees.[23] For segments of the industry where larger bonuses are the norm, the restriction on bonuses may not necessarily have a significant impact as the regulation applies only to Dutch nationals, potentially leaving the door open for bankers relocating from London.[24]

DUBLIN

After Frankfurt and Paris, the Irish capital of Dublin is often mentioned as a potential destination for London-based financial services jobs. Ireland is perceived as very business-friendly, and London-based financial services workers will feel at home in Dublin due to the ubiquity of English. According to French newspaper Le Monde, many banks are looking toward Dublin due to the presence of "favorable regulations and the cultural and linguistic community."[25] Credit Suisse is actively planning to move its hedge fund operations to Dublin, using the city as a hub to serve European clients.[26] According to the Bruegel report, Dublin will host 15 percent of the industry under the *fragmentation* model and 18 percent under the *integration* model.[27]

Because many firms already have back-office and support operations located in Dublin, moving over additional operations would simply build onto existing capacity; Ireland is campaigning for many of these businesses to continue congregating in Dublin.[28] The country has already attracted some of the highest levels of foreign capital among European Union member states, the UK notwithstanding.[29] Finally, Ireland's 12.5 percent

corporate tax rate is favorable to businesses, although it has also drawn scrutiny from the European Commission. Businesses must also consider the expenses of their employees. Ireland's high personal income tax rate poses an obstacle to financial services employees who plan to relocate to Dublin.[30] However, Ireland introduced the "Special Assignee Relief Programme (SARP)," which "[provides] a more attractive income tax regime for foreign employees assigned to Ireland."[31] Despite the existing scale of the industry, there is doubt as to whether the Irish government has sufficient capacity to host a large influx of foreign financial services firms beyond that which already exists in Dublin. Office space in the city is in short supply,[32] and regulators are worried about expanding too quickly. With the sovereign debt crisis in recent memory, Irish central bank officials "are worried about whether they have the right expertise to regulate [complex trading]," and would prefer if the influx of banking and investment activities were relatively limited and manageable. Finally, the city's transportation links could prove inadequate, with major roads potentially being unable to handle the added traffic caused by an expansion in business activity.[33]

PARIS

According to the Bruegel report, Paris could host as much as 20 percent of the EU27 wholesale banking market under the integration and fragmentation scenarios.[34] This is due to multiple factors including the scale of the existing industry, the presence of EU institutions, and cultural factors. In the months since the referendum, London-based bank HSBC has considered relocating numerous positions to Paris to maintain access to the single market.[35]

Paris boasts the unique status of being the European Union's only "global city" outside of London itself.[36] The city is a major cultural attraction, with vibrant nightlife, high-end restaurants, and ample fine arts, music, and other entertainment options; in this sense, Paris competes with London in a way that Frankfurt is unable. Aside from being a cultural center, it is also the core of French business. The La Défense business district in the city's outskirts hosts numerous financial services firms, positioning Paris as a strong rival to Frankfurt in terms of its capacity to host a significant number of firms relocating from London. Paris also hosts the European Securities and Markets Authority (ESMA).[37] Despite these favorable characteristics, many firms relocating from London will find the corporate tax rate unfavorable, the labor regulations overbearing, and the language barrier unconducive to an industry characterized by a high volume of communication between firms and clients. In France, where some jobs leaving London are expected to migrate, the corporate tax rate is 33.3 percent, compared to the United Kingdom's 20 percent rate.[38] However, the rate is scheduled to drop to 28 percent over the next three years.[39] To further mitigate aversion to French tax policies, the country has extended a program that provides tax breaks to high earners who are repatriating to France after extended residence abroad; this tax break will now last for eight years, instead the previously-allotted five years.[40]

Despite promises to relax labor regulations as they apply to the financial sector, executives of global investment banks remain skeptical. In a conversation with former French President François Hollande, JP Morgan Chase CEO James Dimon stated that that banks were unlikely to move jobs from London to Paris unless "[France] softens its strict labor laws."[41] Despite the strict nature of French labor laws, the French government has privately explored options to "[allow] banks to easily fire employees that fall into certain European Banking Authority classifications" in an attempt to attract business from London that is otherwise regulation-averse; however, several prominent politicians at the center and on the political fringe have opposed such an approach.[42]

LUXEMBOURG

Private equity firms and ancillary services, including legal and accounting firms, are planning to shift operations to headquarters in Luxembourg's capital. Some firms include MJ Hudson, which is shifting ten percent of its employees, the Carlyle Group, Oaktree Capital, which opened a new office prior to the referendum, and the Blackstone Group, which is "hiring staff in finance, accounting, risk and compliance in the principality."[43] For some of these firms, the move is a catch-22, as relocating to Luxembourg ensures that passporting rights are retained but also increases operating costs as operations are split across multiple offices.

Luxembourg has significant experience catering to asset managers, but in recent months it has also attracted major insurance companies. New York-based insurer AIG announced plans to establish a new office in Luxembourg,[44] and London-based insurance market Lloyd's and American private equity firms Blackstone and Carlyle (American private equity) "reportedly favour Luxembourg for their EU home."[45] Many large Chinese banks also use Luxembourg as their gateway to Europe, unlike Western banks, which have historically used London as their hub.[46]

Luxembourg already demonstrates a strong concentration of financial services activity relative to its size, with the highest level of banking assets per employee among European Union member states and roughly one banking employee for every 18 residents as of 2007.[47] Luxembourg has attracted some of the highest levels of foreign capital among European Union member states, the UK notwithstanding.[48] Luxembourg ranks highest among all Eurozone cities in the GFCI index, with respondents ranking it as being among the most likely to increase in significance.[49] Luxembourg's proximity to France, Germany, and Belgium means that some 150,000 people easily commute into the country each day for work.[50] While not necessarily a 'global city' to the extent that London or Paris are, Luxembourg nevertheless attracts expatriates, with some 40 percent of its residents being foreign-born.[51] Luxembourg is also a remarkably multilingual country, with more than half of the population proficient in English and more than four-fifths being proficient in two or more languages.[52]

The city's financial sector specializes in asset management, surpassing even the United Kingdom in total hedge fund assets; with as many as 100 banks managing more than 800 billion euros in private banking assets, which represent a significant share of the country's more than 3 trillion euros in assets under management, Luxembourg is the "the biggest center for investment funds in Europe and the second in the world, just behind the United States."[53] As such, it is a strong candidate to further expand its market share by attracting London-based asset managers who wish to diversify their operations or relocate to the Eurozone entirely. Luxembourg is also home to the European Investment Bank, which will likely attract international financial services firms that are attracted by the presence of major European financial and regulatory institutions, similar to the desire of banks to collocate with the ECB in Frankfurt and ESMA in Paris. The city also hosts a large range of companies that are complementary to the financial services sector, including consulting firms and law firms, and has favorable tax policies which, although under recent scrutiny, are even more competitive than those offered in Ireland.

There is concern among some government authorities in Europe that Luxembourg could gain an unfair advantage over other EU member states by offering special incentives to financial services companies seeking to relocate in the EU27, such as offering single market access without capital requirements for EU27 affiliates of foreign-based banks.[54] For Luxembourg in particular, the availability of such incentives could make the country an ideal base for the European operations of global banks, although it is unclear as to the scale of operations that could feasibly be located there. On the other hand, there exists the potential for strong resistance to such relocations, both in the form of increased scrutiny from European regulators and in the form of negative public opinion.

The latter poses a perception-based risk to firms operating in Luxembourg due to the the fallout of the so-called "Lux Leaks" scandal, in which tens of thousands of documents leaked by employees of consulting firm PwC revealed a large-scale tax avoidance scheme, abetted by Luxembourg's government, with hundreds of global companies among its participants.[55] Firms operating out of Luxembourg could potentially face investigation for tax avoidance in their home countries; this could prompt investors to seek out other service providers seen as more compliant with international tax policies and industry norms.

As with Frankfurt, financial services employees accustomed to living and working in London might find Luxembourg dull as a result of its very small size, both in terms of geography and population, although this is mitigated by a high quality of life and high-end dining options.[56] Due to its size, there is also likely to be limited housing available for a large migration of London-based employees; fortunately, hedge funds are smaller than large banks, so the impact should be relatively light if this influx remains specific to the country's specialties. Finally, despite the city's close proximity to the national airport, connections are regarded as poor.[57] International connections are very limited due to the country's proximity to major airports in Paris and Brussels, so many travelers may find that they will need to fly into a larger regional airport and travel to Luxembourg by train or automobile.

OTHER LOCATIONS

Some financial services firms have explored the idea of moving jobs to Madrid, including Swiss investment bank UBS, which has discussed shifting some of its 1,000 London-based clearing jobs to the Spanish capital.[58] The Madrid government is establishing special incentives for financial services firms, including a two-month fast-track approval system and the provision of English-speaking coaches to help workers understand applicable Spanish regulations.[59] Madrid also has low cost of living compared to London and other major European cities, an educated workforce, three top-ranked business schools, significant connections to investment opportunities in Latin America, and cheaper real estate than Paris and Frankfurt, at more than 50 percent less than former and 33 percent less than latter.[60]

Other firms have looked eastward toward Central and Eastern Europe and the Baltic states.[61] The Polish government has met with London-based financial services firms to promote the possibility of "moving middle-office and back-office operations to Poland,"[62] with an emphasis on "risk management and information technology."[63] It is offering these firms "financial incentives to relocate [to Warsaw] such as grants for training new employees [and] tailoring university degree programmes to the IT and finance skills required by foreign banks."[64] The country's "comparatively low wages, high level of university education and EU market access" facilitate this, with various international banks already employing more than 50,000 people in Poland prior to the referendum.[65] One Polish official believes that the United Kingdom's withdrawal from the European Union will cause as many as 30,000 more jobs to migrate to the country.[66] In addition to the incentives offered by the Polish government, Warsaw has low cost of living and flexible labor regulations may prove to be especially attractive to London-based financial services firms.[67]

Eurozone newcomers Estonia, Latvia, and Lithuania also demonstrate the potential to attract at least some jobs from London, with Vilnius and Riga looking to attract financial technology (fintech)[68] and back-office functions.[69] According to the GFCI survey, Tallinn and Riga lead Eurozone countries in terms of improvement in their financial sectors, having gained by 28 and 19 places, respectively. Vilnius is specifically working to attract fintech firms and in-house cybersecurity teams for banks such as Barclays, and the country's regulators may also potentially offer fast-track licensing for new firms.[70]

However, a major drawback for all three Baltic countries is their small size. Estonia, Latvia, and Lithuania have 1.3 million, 2 million, and 2.9 million residents, respectively, thus limiting their overall capacity to handle a large influx of foreign workers in a similar manner to other small European states such as Luxembourg.[71] All three countries are also in a precarious position as a result of ongoing geopolitical tensions between the European Union and the Russian Federation. Estonia, for example, has previously been a target of cyber attacks originating from Russia, and such attacks in recent years have increasingly targeted financial infrastructure.[72] As a result, London-based firms may be hesitant to put financial data at risk in these countries, as they could face large financial losses if critical systems were taken offline or if account data were compromised.

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