EUROPEAN CAPITAL MARKETS INSTITUTE

Post-Brexit, ‘Plus ça change’ for the City of London

Karel Lannoo*

The clearest result of Brexit, as seen from a financial markets perspective seven years on from the fateful June 2016 referendum, is that nobody in Europe won. A classic case of a lose-lose situation, as was to be expected. Yet the big outflow of banking jobs from London did not happen, nor did any EU-based financial centre clearly emerge as the winner, and nor did any big boost to London materialise, as some Brexiteers had hoped.

Rather, Europe as a whole lost, as liquidity has become even more clearly concentrated in the US, in many different sectors. As both, the EU and UK are slowly converging again, and with a big political shift expected in the UK next year, prospects for the European financial marketplace are improving. But a decade will have been lost, with EU projects such as banking and capital markets union also clearly impacted.

When discussing Brexit’s impact on financial markets, a distinction needs to be made between the local financial markets in the UK and the City of London as a global financial centre. The former have clearly been negatively affected by the UK’s EU exit and by the political upheaval the country has gone through over the last few years. Two elements stand out: the decline in UK stock markets, and the crisis in UK pensions, as was well documented in a recent study. The number of listed UK companies has virtually halved over the last 25 years, new issue volumes have collapsed, valuations have stagnated, and the UK’s share of global markets has fallen. A deep reform of the UK pension system, an important building block for the local capital market, is therefore needed, including an increase in contributions, reducing fragmentation, and improving asset allocation.

In contrast, the City’s position as the second biggest or most important global financial centre has not been so affected. The number of banks active in the UK, as authorised by the Prudential Regulation Authority (PRA) has continued to grow over the last five years by 4 % to 375 in 2023, an all time high. Revenues have continued to increase, while the total number of banking employees is only slightly down. The UK is still home to the largest European bank, HSBC, and the total assets of the five largest banks have increased steadily since 2018.

* ***Karel Lannoo*** *is General Manager of ECMI and CEO of CEPS.*

International banks are active in the City not because of domestic business, but to participate in international activities centred in London. Agglomeration effects continue to play an important role in financial centres and have remained resistant in London's case to the negative effects of Brexit and the ensuing political instability. According to the latest international rankings, London remains predominant as a financial centre, second only to New York. No other European centre even makes it into the top ten with the exception of Geneva.

Business in international financial centres is uniquely focused on a few activities that cannot easily be displaced. They depend not only on financial institutions, but also on solid infrastructure, the abundance of highly specialised law firms, consultants, regulators, and an attractive international environment. For London, it concerns international lending and issuing and trading of international bonds, asset management and the related brokerage, specialised insurance, foreign exchange, and central counterparty clearing in derivative markets – all activities where it is far ahead of other European and regional financial centres.

Why did the UK's departure from the EU not have a larger impact? Regulation and the rules allowing for the cross-border provision of services with a single licence in the EU are only one of the additional elements that have contributed to London's rise. Firms can easily set up another separately licensed EU-based entity and process transactions through to their main European entity. Even if this creates an additional cost, it does not weigh up against the advantage of being able to serve the EU market from one large financial centre. And with the EU-UK Windsor framework agreed on 27 February 2023, gone is the frosty relationship that characterised Boris Johnson's time in office. A long-awaited MoU between supervisory authorities on both sides can be concluded, as a first step towards more equivalence agreements to facilitate market access.

Regulation-wise, although it was expected the UK would use the opportunity to diverge from the EU, this has not happened. In banking, obviously, the room for manoeuvre is limited, as EU rules implement the internationally agreed Basel standards, and the long shadow of the 2008-09 financial crisis is still high on many Brits' minds. Additionally, the UK had already diverged somewhat, even as an EU member, specifically in its rules separating retail from wholesale banking, and the rules on resolution. But both are certainly not examples of tweaking regulatory standards to race to the bottom, and in the aftermath of the SVB collapse in the US, this is certainly not on the agenda.

The big question, however, are the rules for capital market activities, as contained in MiFID. Post-Brexit, the UK has retained any national legislation and regulation that implemented the parts of MiFID that had to be transposed into national law. Hence, the UK had its own MiFID II, through which it has 'onshored' the parts of MiFID that applied directly when the UK was an EU Member State (see Latham&Watkins). It only made minor amendments to ensure that the regime operates effectively in a UK-only context (for example, moving ESMA's functions to the Financial Conduct Authority). However, none of these amendments were intended as policy changes. The result was that post-Brexit we immediately ended up with two separate but parallel, regimes — the EU MiFID and the UK MiFID (which is the same as EU MiFID, but with some minor changes).

But rest assured, more divergence is coming. As part of the Wholesale Markets Review, and the Financial Services and Markets Act (FSMA), the UK now intends to develop a smarter regulatory framework and is beginning to alter rules in UK MiFID that it does not think are appropriate for the UK market. Revocation of on-shored EU financial services regulation is on the agenda but this is easier said than done. The legal consequences of revocation are mindboggling – what would be revoked and what not? Investigations or enforcement actions may still be ongoing under onshored pieces of legislation, or interactions with other pieces may be overlooked. Hence "the 'FSMAification' of EU-derived law is going to be a long and arduous journey. For those of us hoping that Big Bang 2.0 will result in a less complicated patchwork of legislation and regulation in this area, we remain cautious for now. We will all also need to carefully engage in every consultation around each revocation proposal to consider the potential unintended consequences", according to Allan & Overy.

More in general, the UK's attempt to move back towards a principles-based system, laudable as it may be, raises questions about accountability and control. The primary responsibility for regulation is delegated to the UK regulatory authorities, subject to Parliament's oversight, which is a lesser system of control and oversight than that of the EU.

Hence, more than seven years after the Brexit vote, the expected big shift of business from the City of London to the EU has not materialised, nor has an EU centre emerged as a clear competitor. This indicates that other elements matter and not just access to the single market, elements such as critical mass and reputation, the availability of talent, and flexible labour market rules. Time thus to converge once again and to truly realise European financial objectives together.

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