

# THE IMPACT OF BREXIT ON THE UK FINANCIAL SECTOR

Marc Ibáñez Díaz

Professor: Patricia García Duran

Economics EUS, University of Barcelona, June 2016

## ABSTRACT

The objective of this project is to establish whether an exit of the United Kingdom (UK) from the European Union (EU), dubbed as Brexit, would have a negative impact on the financial sector of the UK. First, it explains that the Single European Market (SEM) has resulted in a reduction of barriers to trade between banking markets in the EU. Then, it exposes how any Brexit scenario would result in increased barriers to trade. On the basis of these facts, it argues that by analysing if the UK financial sector has benefited from European integration, it can be induced whether the increase in barriers to trade generated by Brexit will have a negative impact on the UK financial sector. This is carried out through a qualitative study in the form of a content analysis of documents produced by the UK banking sector and press articles regarding the impact of the SEM on the UK financial sector. The conclusion is that the financial sector of the UK has been positively impacted by the EU and therefore any Brexit scenario would be negative for this sector.

Key words: Brexit, European Union, Single European Market, Banking, City of London, Finance, Free movement of Capital

L'objectiu d'aquest treball de final de grau és analitzar si una sortida del Regne Unit de la Unió Europea (UE), l'anomenat Brexit, tindria un impacte negatiu en el sector financer del Regne Unit. En primer lloc, s'explica que el mercat únic europeu (SEM) ha donat lloc a una reducció de les barreres comercials entre els mercats bancaris de la UE. A continuació, s'exposa que qualsevol escenari posterior al Brexit es tradueix en un augment de les barreres al comerç. A partir d'aquests fets, s'argumenta que al generar un increment en les barreres comercials, si el sector financer del Regne Unit s'ha beneficiat de la integració europea, es pot concloure que el Brexit tindrà un impacte negatiu en aquest sector. Això s'estudia qualitativament a través d'una anàlisi de contingut de documents escrits pel sector bancari del Regne Unit i articles de premsa sobre l'impacte de la SEM en el sector financer del Regne Unit. La conclusió és que el sector financer del Regne Unit s'ha vist afectada positivament per la UE i per tant qualsevol escenari Brexit seria negatiu per a aquest sector.

Paraules Clau: Brexit, Unió Europea, Mercat Únic Europeu, Sector Bancari, City de Londres, Finances, Lliure moviment de capital

CONTENTS

- INTRODUCTION ..... 4
- I. THE EUROPEAN UNION & THE SINGLE MARKET FOR BANKS..... 6
  - 1.1 European Union overview ..... 6
  - 1.2 The Single European Market for banks ..... 8
    - 1.2.1 Types of banking..... 8
    - 1.2.2. Banking expansion..... 9
    - 1.2.3 The Single European Market in Banking ..... 9
  - 1.3. Concluding Remarks ..... 14
- II. EXITING THE EUROPEAN UNION: POSSIBLE CASE SCENARIOS..... 15
  - 2.1 UK position – why Brexit? ..... 15
  - 2.2 Brexit Legal Bases ..... 16
  - 2.3 Brexit scenarios ..... 17
    - 2.3.1 Scenario 1: General WTO rules – Most Favoured Nation (MFN) ..... 17
    - 2.3.2 Scenario 2: Free Trade Agreement (FTA) ..... 18
    - 2.3.3 Scenario 3: European Free Trade Association (EFTA) ..... 19
    - 2.3.4 Scenario 4: Bilateral Agreements- The case of Switzerland ..... 20
    - 2.3.5 Scenario 5: European Economic Area (EEA) ..... 21
    - 2.3.6 Scenario 6: Custom Union (CU) ..... 22
    - 2.3.7 Scenario7: Customized relationship..... 22
  - 2.4 Concluding remarks..... 24
- III. METHODOLOGY..... 25
  - 3.1 Methodology contextualization ..... 25
  - 3.2 Content Analysis..... 26
  - 3.3 Concluding remarks..... 30

IV. CONTENT ANALYSIS RESULTS.....	31
4.1 Results from analysing the Balance of competences.....	31
4.2 Results from analyzing the Financial Times (FT) articles.....	35
4.2 Concluding Remarks.....	38
V. CONCLUSION.....	39
BIBLIOGRAPHY.....	41
APPENDIX 1 .....	44
APPENDIX 2 .....	45

## INTRODUCTION

The aim of this project is to examine whether leaving the European Union (EU) would have a negative or positive impact on the financial sector of the United Kingdom of Great Britain and Northern Ireland (UK). The motivation for this project comes due to the fact that one of the UK's main industries is the financial sector, which contributes to more than 10% of the British GDP. At the outset of the project, the UK financial sector was mentioned in the Stay and Leave campaigns but without solid arguments, based mainly in rhetorical arguments. Also, there was a lack of academic journal articles on the impact of Brexit into the UK financial industry. This project tries to increase the amount of literature on the impact of Brexit on the UK's main economic sector.

As the Brexit referendum approached, the campaign started to shift to more technical arguments and the impact of the Single European Market (SEM) on the UK financial services industry started to be debated. The free movement of capital and passporting started to arise as key topics during the referendum's campaign. This project addresses these issues to determine if they have helped develop the City of London. It tries to take an objective view without taking any sides in the political debate.

The hypothesis of this project is the following: Leaving the EU would have a negative impact on the UK as a financial centre. To test the hypothesis, the research looks at whether the EU has contributed to the development of the City. If it has contributed, since Brexit would raise barriers to trade with the rest of the EU it would negatively affect the UK financial industry. Thus, analysing the impact of the EU on the City is the way used to test the hypothesis. Furthermore, in order to establish whether the City has been positively or negatively affected by the EU, a content analysis methodology is employed. The content analysis studies documents authored by financial institutions and press articles to understand the impact of the SEM on the City of London.

The work has been structured in 4 chapters. The first chapter is dedicated to an overview of the EU and Banking. After explaining what is the European Union, it focuses on how the SEM for financial services has evolved to what it is today. The second chapter explains the possible

post-Brexit scenarios. Each scenario is presented with the barriers to trade that the UK would face if it exited the EU. The third chapter presents and justifies the methodology used to test the hypothesis. Chapter four presents the results obtained in the content analysis and chapter five concludes the project.

## I. THE EUROPEAN UNION & THE SINGLE MARKET FOR BANKS

This chapter presents an introduction to the European Union and its evolution from the Treaty of Rome to the Banking Union, making an emphasis in economic integration. It also includes an overview on what banking is and its' different types, as a building block to explain how European integration may have impacted the banking sector.

### 1.1 European Union overview<sup>1</sup>

The European Union (EU) is an international governmental organization trying to achieve regional economic integration. With the aim of creating a Common Market, the Treaty of Rome, in 1957, established the European Economic Community (EEC), which is the origin of the EU. This Treaty was signed by Germany, France, Italy, Luxembourg, Netherlands and Belgium. Today, the EU is composed of 28 European countries, including the UK which became member in 1973.

The Common Market is an advanced stage of economic integration (defined in Balassa (1961)). Basic economic integration is comprised of Free Trade Agreements (FTA) which imply the reduction to zero of most tariff barriers for the trade in goods. As a result, any good complying with the safety and origin norms<sup>2</sup> can flow free of tariffs between the agreeing countries. Nowadays, FTA's are evolving into Deep and Comprehensive Trade Agreements (DCTA) which include measures to liberalize trade in services. The second degree is a Customs Union (CU) (which goes on top of an FTA), whereby members agree to have the same commercial policy in front of third countries.

The third step in economic integration is the Common Market, where besides a Customs Union, countries start to reduce non-tariff barriers. These are the barriers that have to do with access and safety. A Common Market focuses on access norms and includes the free movement of goods and services as well as measures to promote higher movement of factors

---

<sup>1</sup> This chapter is largely based on professor Patricia Garcia Duran fall 2014 course on International Economic Organization at the University of Barcelona

<sup>2</sup> Origin norms regulate that a certain percentage of the added value of the good has been produced in one of the agreeing countries

of production, labour and capital. The Treaty of Rome laid the foundations of a Common Market in the EEC. It implied that Goods, Services, Capital and Labour could freely move throughout participating countries. Although, there were still internal border controls inside the EEC to ensure that products complied with the regulations of the destination country. The Common Market was achieved in Europe in 1970.

The end of the seventies and beginning of the eighties was a time of crisis and stagnation for the European economy. In order to boost the economy and commit to further integration, it was decided to create a Single European Market (SEM). The SEM was designed in the 1986 Single European Act and was implemented in January 1993. It aimed at further completing the process of economic integration by reducing barriers to trade, especially normative disparities within the market. Therefore, facilitating the exchange of People, Goods, Services and Capital. The most visible thing that the SEM has done is to eliminate all custom controls between EEC countries, eliminating the need to check the safety of goods at the internal borders. As a result, the safety of goods produced or entering the EEC (now EU) need to have similar requirements.

The EU establishes harmonized rules through its institutions, the European Commission (EC), the European Council and the European Parliament (EP). These bodies provide the regulations and directives that set up the minimum standards that are necessary for mutual recognition between countries. Mutual recognition implies that unless proven different laws in all countries are assumed to have the same requirements (Springford, 2014). The SEM led in 1998 to the abolition of controls on capital and payment transfers between member states.

European integration deepened, in 1992, through the Treaty of Maastricht. This Treaty changed the name of European Community to the European Union (EU). Moreover, it wanted to achieve further integration by setting out the road to the Monetary Union with the Euro. The Euro would be the common currency to all EU member states with the aim to achieve higher European trade and improve the free movement of capital. The Eurozone was created in 1999 and the Euro was introduced in 2001. The new currency was adopted by most advanced economies in the EU and initially the UK was bound to join the Euro. The transition process was made through fluctuation bands between currencies (European Exchange Rate Mechanism (ERM)). However, during the crisis of the 1990s, turmoil in the financial markets,



led to most countries having to exit the ERM and the UK decided finally not to join the Euro. With the introduction of the Euro, the European Central Bank (ECB) was created in order to set monetary policy for the single currency. However, the ECB did not become the supervisor of EU banks.

## 1.2 The Single European Market for banks

The aim of this section is to introduce the different types of banking in order to better understand the impact of the SEM in the sector. Afterwards, the different ways of banking expansion are explained, for a better understanding of regulatory implications at EU level. Finally, this section explains how is the SEM for banks in terms of the free movement of services and also capital.

### 1.2.1 Types of banking

There are different types of banking:

- Retail banking – gathers savings from customers in the form deposits, to whom it pays an interest, and lends it to other individuals, obtaining an interest. Retail banking is directed to individuals or Small and Medium Enterprises (SME's).
- Wholesale banking – is the lending or deposit taking from large corporations or other financial institutions.
- Investment banking – offers corporate clients a wide range of services, mainly assistance in complicated financial transactions. Services include Merger & Acquisition advisory, raising capital and syndicated loans amongst others.
- Asset Management – includes the management of assets, ranging from hedge funds, pension funds, private equity and investment management.
- Private banking – is a hybrid between asset management and retail banking to affluent customers.

- Clearing houses – Clearing houses are the intermediary between two parties that settles the trade. It is used by banks as an intermediary to settle, clear and compensate debts between banks. Moreover, it also acts as a market for Over the Counter securities (OTC), these are securities exchanged outside of the market.

### *1.2.2. Banking expansion*

When a bank wants to expand to other regions it has different legal ways to expand its business (Banco de España, 2016)

- Representative office – can offer general advice on investment, legislation, risks, but cannot gather deposits or give credit, although they can divert it towards the bank they represent.
- Branch – it is considered as an extension of the parent company but in a foreign country. It is allowed to give credit and take deposits but with certain limits and usually only to businesses. It is regulated both by the home authorities and those of the country it operates in.
- Subsidiary – a subsidiary is a new legal entity, owned (totally or partially) by the parent company but it works as a standalone bank, reporting to the local authorities, of where the subsidiary is operated, although it can also report to the authorities of the parent country.

### *1.2.3 The Single European Market in Banking*

The free movement of capital was introduced in the EU with the Treaty of Rome. It established that the EEC should abolish capital restrictions "to the extent necessary to ensure the proper functioning of the common market". However, few restrictions were abolished, prior to 1994, as some countries required authorization to conduct transactions within the EEC, commonly known as "exchange controls" (EU, 2015).

The liberalization of the movement of capital at European level was done in 1988 through a directive removing “exchange controls”. The Maastricht Treaty made the free movement of capital a fundamental pillar of the internal market. Also in 1994, the EU unilaterally abolished capital restrictions with third countries.

The free movement of capital implies that countries cannot put any restrictions to the exiting or entrance of Foreign Direct Investment, Real Estate Investment, Securities Investments, Loan Granting and other operations with financial institutions. Although there still exist some cases in which countries can establish safeguards limiting the free movement of capital. It also implies that any bank in the EU can provide banking and financial services to any client in the EU, without the need to establish a branch or open a subsidiary where the client is located (EU, 2015).

The key impact of the SEM programme in the financial area was the establishment of the single banking licence. This allowed for any bank established in any EU country to open a branch and provide cross border services to any country within the EU needing only the supervision of their home regulator. This eliminated any red tape<sup>3</sup> that might have been in place before. The only requirement is that the home regulator agrees with the expansion. This is known as the “single passport” (Passporting) because any EU bank gains passports to operate throughout the EU (without need for further control by the authorities of the destination country). As a result, passporting reduces the cost of expanding overseas as it only requires to fulfil one capital requirement and to be under one supervisor. That was very attractive to foreign banks as they only needed to open a subsidiary in one EU country and then they could branch their way throughout the EU<sup>4</sup> or even provide cross-border services without need of opening a branch.

In order to prevent the single banking license from creating a race to the bottom in banking regulation, all EU countries agreed on a minimum harmonized prudential regulation. Yet, the

---

<sup>3</sup> Red Tape is the use of excessive regulation by governments, leading to the impossibility of taking decisions by companies

<sup>4</sup> Under MIFID 2 there are additional requirements

impact was largely deregulatory as countries feared that financial institutions would move where the legislation was more deregulatory (Springford et al, 2014).

The free movement of capital also allows clearing houses to locate anywhere within the EU. As a result, most clearing houses of Euro denominated bonds, OTC derivatives and other financial instruments payable in Euros are settled in the UK. It might seem contradictory that although the UK is not in the Eurozone, London is the place with most trade in Euros. In order to change this, the ECB legislated to bring these institutions back under its supervision. But the European Court of Justice, struck down the decision under the Free Movement of Capital. Many commentators believe that if the UK were to leave the EU, then the ECB would bring clearing-houses back to the EU (O'Donnell et al, 2016).

Another step of further integration in financial services was taken with the “Financial services action plan” (1999) which led to directives aiming to reduce money laundering, improve capital allocation and a more efficient intermediation. The directives were all inspired by a British style regulation (Europe Economics, 2014).

British thinking in financial regulation was also introduced with the Markets in Financial Instruments Directive (MIFID) adopted in 2004 and effective in 2007. MIFID sets out the guidelines under which countries have to regulate their financial services. The aim of MIFID was to harmonize regulation, increase competition, efficiency and transparency whilst ensuring a better protection of investors.

During the financial crisis, the UK has led the forefront of prudential regulation, especially after the detection of bad practices such as miss-selling or LIBOR manipulation. These practices coupled with the financial crisis have brought about a certain rejection of the “Anglo-Saxon” model of finance in Europe (Springford et al, 2014). Although, the British perspective on financial regulation has now completely changed. Previously, the Bank of England (BoE) was required to consider the competitiveness of London as a financial Hub (The City) when drafting regulation, this is no longer so. Moreover, British regulators required banks to raise capital standards, draw up resolution plans and ring-fence their retail operations from the investment ones. All these measures were taken much before the EU took any action. EU countries have

been slower in increasing bank's capital. Furthermore, the EU decided on common regulatory standards in 2013, after most UK rules had already been changed. European rules have taken the essence of British rules (Springford et al, 2014). In addition, 2 years after the UK approved ring-fencing, the EU decided to implement it. This represents that the UK is at the forefront of EU regulation.

The EU has striven to restore financial stability during the 2007 financial crisis. Between 2009 and 2014 the European Commission has presented more than 40 legislative actions to improve the financial sector. The most known of the financial directives is MIFID 2. This update to MIFID sets out much more stricter rules to passporting to non EU financial institutions. Once it enters into effect passporting will no longer be automatic and EU institutions will have to grant permission for the provision of cross-border financial services (*see Chapter 2*). Other measures such as the cap on bankers bonus which cannot double their annual salary has risen a lot of controversy, especially in the UK where it is said to damage competitiveness.

The crisis made it clear that the EU needed further integration in the banking sector. As a result, European leaders decided to adopt the Single Rulebook which is a harmonization of prudential regulation and banking supervision procedures. These rules relate to capital requirements and deposit guarantees amongst others. It also exposes how to proceed in the event of bank resolution. The agencies in charge of supervision and the drafting of the Single Rulebook are the European Supervisory Authorities (ESA) made up of European Banking Authority (EBA), European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA). These institutions are charged with micro prudential regulation for all the EU.

At macro level, prudential regulation is in the hands of the European Systemic Risk Board (ESRB). This agency is charged with studying and assessing potential macroeconomic impacts to the financial sector and ensuring the financial stability of the system.

Together the ESA's and the ESRB constitute the European System of Financial Supervision (ESFS) and apply to all EU countries as a whole. The ESFS was approved in 2009 and operational in 2011. Nevertheless, after these agencies had been approved the European debt crisis

started. European leaders took another step forward starting a Banking Union which became effective in the end of 2014. The UK opted out from the Banking Union.

The Banking Union is composed of two legs, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). These institutions apply only to Euro area countries, however membership is open to all countries wishing to join. To complete the Banking Union the Deposit Insurance Scheme is going to be common amongst Eurozone countries and paid by banks in the Euroarea.

The SSM is under the umbrella of the ECB. The SSM is in charge of the supervision of all banks in the Euro area. The ECB directly supervises the largest banks in the EU whilst national central banks supervise smaller banks (the ultimate responsibility falling on the ECB). The SSM checks that banks comply with the EU banking regulations and fines banks if they do not comply with the rules. The SRM applies only to banks under the supervision of the SSM. If a bank is bound to fail the SRM mechanism takes the lead in effectively managing the bank. Through the Single Resolution Fund, it ensures an orderly resolution of failing banks.

The UK wanted to maintain supervisory sovereignty over its banks, but hoped for a stronger Banking Union which would mitigate further risks (Springford et al, 2014). The procedures for the SRM are complicated and the ECB only has direct supervision of 130 banks out of the 6,000 in the Eurozone. Nevertheless, the UK is in a delicate position because most of the supervisory power is now in the hands of the ECB which will have considerable influence in the making of prudential regulation. As a result, the UK fears that prudential rules will be done to satisfy the requirements of the Eurozone and not the EU as a whole. Although, the UK ensured a double majority in the board of the ESA.

### 1.3. Concluding Remarks

The EU is a process of regional economic integration that has led to the creation of the Single European Market (SEM). The SEM includes the free movement of capital and of financial services, allowing any EU financial firm to provide financial services to any country within the market. For financial services this has implied a large reduction in barriers to trade. The financial crisis has led to an increase in integration due to the creation of a Banking Union and the adoption of new regulations.

## II. EXITING THE EUROPEAN UNION: POSSIBLE CASE SCENARIOS

This chapter aims to define Brexit scenarios. It is structured in three sections. After introducing the reasons for Brexit, it revises its legal bases and the seven possible scenarios that may follow.

### 2.1 UK position – why Brexit?

The UK has always been one of the most Eurosceptic countries of the EU. This Euroscepticism is what brought the UK not to join the EEC in 1957 in the first place.

It was also made clear in 1975, because only two years after joining the EU, membership was put to a referendum. At that time, the option to stay in the EU, which was supported by the main parties, had a clear victory. After the first EU referendum Euroscepticism did not disappear in the UK and now British citizens have been called to a new referendum on leaving the EU that has been set to take place on June 23<sup>rd</sup> 2016. The UK possible exit from the EU has been dubbed as Brexit.

Today Eurosceptics hold some of the following arguments in order to defend Brexit (Booth et al., 2015):

- Regain parliamentary sovereignty in law making.
- Possibility to increase competition and deregulate the economy aiming to achieve more competitiveness without EU influence.
- Limit the flows of immigration.
- Conduct a trade policy that makes sense in the framework of UK exports and imports, to gain better market access to other countries.
- Eliminate UK involvement in Common Agricultural/Fisheries Policy, justice, home affairs, climate change by replacing EU legislation with national legislation.



- Reduce the burden of contributing to the EU budget.

Prime Minister (PM) David Cameron said he would campaign for the UK to stay in the EU if he could renegotiate the relationship with the EU. The deal he got from the EU which he considered satisfactory is as follows (The Economist, 2016):

- Promise of more Free Trade Agreements.
- Support from 55% of the national parliaments can block any EU legislation.
- Britain has an opt out from the clause of an ever closer union.
- Obtained observer member status in the Eurozone meetings.
- Requirement of a double majority voting for financial services regulation (between Euro and non-Euro countries).
- A clause to stop benefits to new migrants.

Although the PM got these concessions from the EU council, polls in the UK do not envisage a clear result. If the UK wants to leave the EU it must follow the official procedures in the Treaty of the European Union (TEU) which foresees the possibility to exit the EU in its article 50.

## 2.2 Brexit Legal Bases

Article 50 of the TEU sets out the procedure to follow when a country wishes to withdraw from EU membership. The first step in the procedure is to inform the European Commission of the decision to exit. After this formal notification the EU and the UK, would have a period of two years to negotiate a withdrawal agreement laying the foundations of their future relationship.

Most observers consider that it would be difficult to stick to this time frame because trade negotiations are always lengthy and there is no definite interpretation of the article since it has not been used before. The EU and the UK would have to negotiate their relationship but

would not necessarily have to conclude a trade agreement. Moreover, due to lack of precedent, it is unclear whether the withdrawal agreement should include the future relationship or this should be established in a separate treaty (TheCityUK, 2016a). This is important because each agreement requires different majorities in EU institutions. Even if packed together, various parts of the treaty would require different voting systems. This implies that unanimity will be required in order to conclude an agreement.

Since the exact nature of the future relationship between the UK and the EU is not known, it is a necessary step to explore the seven possible case scenarios of future relation between the EU and the UK, and how they would impact the trade relations.

## 2.3 Brexit scenarios<sup>5</sup>

During these negotiations the EU and the UK will try to find the fit for their prospective relationship. The negotiations will revolve around various case scenarios based on the different commercial relationships that the EU has with various third countries. So far, the EU has 6 different types of relations with third countries: World Trade Organization (WTO) rules, Free Trade Agreements (FTAs), the European Free Trade Agreement (EFTA), the Swiss Bilateral Agreements, the European Economic Area (EEA) and a Customs Union. Since the EU and the UK are in a deep process of economic integration it is possible that they would want to retain this high degree of integration by achieving a customized relationship which is the seventh possible scenario.

### *2.3.1 Scenario 1: General WTO rules – Most Favoured Nation (MFN)*

Unless an agreement is reached between the EU and the UK in the two year period established in article 50 of the Treaty of the EU, UK products access into the SEM would be regulated by WTO norms under Most Favoured Nation (MFN) terms, which is the Common External Tariff (CET). The MFN implies that the CET applies to all countries in the WTO with whom the EU does not have a preferential trade agreement. As a result, British goods and services would

---

<sup>5</sup> The following section is mainly extracted from Piris (2016), TheCityUK (2016a) and Credit Suisse (2016)

have no preferential treatment for entry into the EU than those coming from any other country.

Financial access into the EU would be limited by the General Agreement on Trade in Services (GATS) and by EU regulation. As a result, under GATS to avoid discrimination, UK banks would have to open subsidiaries within the EU and this should theoretically concede passporting rights. However, GATS allow “prudential carve-outs”. This means that for justified prudential regulatory purposes the countries can discriminate against foreign financial service providers. This gives ample hand to the EU to discriminate against foreign financial service providers, as it does in MiFID 2.

MiFID 2 establishes that foreign financial services firms that want to establish themselves in the EU can do so if there is a cooperation agreement between ESMA and the third country regulatory authorities, there is a tax agreement in place with the third country and the third country regulator agrees to supervise the subsidiary in the EU. However, this does not confer passporting rights. To operate all over the EU, the firm must open branches in all countries, in order to be able to have European wide operations.

Furthermore, under MiFID 2, foreign financial firms can only gain passporting rights if there is an equivalence regime and further cooperation arrangements between regulators. An equivalence regime implies that the regulatory framework of the third country must be deemed equal to that of the EU by the EU council under the advice of ESMA. In other words, it is as much a technical as a political decision. In addition, the subsidiaries opened in the EU will need to be larger, this implies that higher capital and separate capitalization will be required. In consequence, it will be a burdensome process for foreign financial services firms to obtain access into the SEM, supposing an increase in barriers to trade.

### *2.3.2 Scenario 2: Free Trade Agreement (FTA)*

Another possible relation between the EU and the UK is that of an FTA. FTAs provide duty free access to third country exporters into the single market if their products have had a minimum degree of added value in the exporting country (norms of origin) and if the exports comply with national regulation. As a result, only UK exporters would have to comply with EU

regulation. But an FTA still allows for a lot of red tape and there are still on the border controls, so it does not grant automatic access into the single market, such as the UK has at the moment.

In addition, most FTA's only cover goods not services, regulatory convergence nor public procurement. However, a new type of FTA's, called Deep and Comprehensive Trade Agreements (DCTA) are arising such as the one concluded between the EU and Canada (CETA) or the Transatlantic Trade and Investment Partnership (TTIP) between the US and EU, still under negotiation. These FTA's aim to reduce non-tariff barriers such as differences in technical regulations. Hence, these agreements lead to lower restrictions in the cross border offering of services. Nevertheless, no previous FTA or DCTA (of the EU) has ever covered rights of establishment or passporting so they have not even come close to replicating the current degree of access that the UK has into the Single European Market (SEM). In any case, for an FTA/DCETA to resemble the degree of market access that the UK has at the moment, the EU would require the UK to keep applying all future EU laws.

### *2.3.3 Scenario 3: European Free Trade Association (EFTA)*

EFTA is an intergovernmental organization which promotes free trade between its member states. It was established as a way of obtaining EEC benefits without being a member of the EEC, given that it is considered to be a more politically driven organization. Nowadays, EFTA members are Norway, Switzerland, Liechtenstein and Iceland. Initially it was formed by more countries which have now joined the EU, amongst them the UK.

EFTA countries began in 1960 to reduce tariffs between them and afterwards they signed bilateral Free Trade Agreements with the EEC. As a result, it is not EFTA, but its members who have an FTA with the EU. Thus, entrance into EFTA does not imply that the UK will have tariff-free access to European markets. The relationship between EFTA countries and the EU has not been developed under EFTA but under the EEA or bilateral agreements (*see following sections*).

#### *2.3.4 Scenario 4: Bilateral Agreements- The case of Switzerland*

Switzerland's trade relation with the EU is set through bilateral treaties. More than 100 treaties have been concluded since the 1950s (Thorp, 2011). The bilateral agreements go from FTA's in goods up to the Free Movement of People. Through these agreements Switzerland gains access into the SEM, in the areas covered in each agreement, which is not the whole economy. Moreover, Switzerland also contributes to the EU Budget. It makes an approximate contribution of £53 per citizen whereas the UK makes one of £128 (Miller, 2013).

Bilateral agreements are usually static, whereas EU law is evolving (amendments and case law). As a result, agreements and new protocols must be renegotiated quite often between the two parties. Since, it is costly to organize such a relationship, the EU is reluctant to conduct economic relations with other states in such a manner. At the moment the EU is trying to change its relationship with Switzerland so that Switzerland has stricter legal obligations.

Switzerland's access into the single market is derived from bilateral agreements, yet, it is not fully inside the single market. This theoretically allows the Swiss government to adopt any regulation it wants in the sectors where there is no agreement with the EU. However, if Swiss businesses want to export to the EU they have to comply with EU regulation. The situation of Swiss exporters and for the economic areas in which Switzerland is inside the SEM is analogous to EEA EFTA states (*see next section*). The Swiss model allows Switzerland to have more regulatory sovereignty than EEA states, in some areas of the economy. But Switzerland always ends up adopting EU regulation even in areas in which it has no formal agreements with the EU (Booth et al., 2015). Switzerland can refuse to adopt EU law, but this can lead to the suspension of access into the SEM and retaliation by the EU. As a result, if the UK chose this model it would still have to follow EU regulations.

Moreover, Switzerland has not signed any agreement relating to services, including financial services, due to the reservations of the Swiss financial Sector (University of Kent, 2013). Therefore, access of the financial sector into the EU single market is ruled by the GATS (*see section 2.3.1*). The impact on Swiss banks is that they have to open larger subsidiaries in the EU, with higher capital and personnel. MIFID 2 regulation is making it increasingly difficult for

Swiss financial firms, especially smaller ones, to conduct business in the EU. As a result, the situation of Switzerland represents a large increase in barriers to trade in financial services with respect to EU membership because no agreement has been reached in this area.

#### *2.3.5 Scenario 5: European Economic Area (EEA)*

EEA is an agreement, which entered into force in 1994, extending the SEM four freedoms to Norway, Iceland and Liechtenstein. As it does not imply a custom union, nor covers agricultural products, there are still border controls between EEA countries and the EU, to ensure trade complies with rules of origin.

Since these countries are to a certain extent part of the SEM, they are affected by most of the regulations set by the EU institutions. Although, none of these countries has a say in the setting of the regulations. EEA countries have had to adopt 93 out of the 100 EU costliest policies. As a result, leaving the EU to enter the EEA does not imply significant competitive gains. Moreover, access into the SEM comes at the price of making a financial contribution to the EU budget. In 2013 Norway's contribution to the EU budget was of £106 whereas that of the UK was of £128 (per person) (Miller, 2013).

The adoption of EU legislation by the EEA countries is done through a series of joint committees. EEA countries also have the right to veto (refuse to implement in their jurisdiction) any legislation they think inappropriate. But, if they veto any legislation regarding product standards, then they cannot continue exporting that product to the EU with the old rules. Moreover, when you veto an agreement in a determined area, you are de facto betting a whole area of legislation. As a result, if you veto bankers bonus cap you can get locked out of financial services single market altogether (Booth, 2015).

Since the EEA countries are within the single market, and adopt all EU regulation, there is a free trade of financial services. Therefore, any bank in the EEA can branch in any other country within the EU as well as offer cross-border services, without any problem. In short, EEA banks have passporting rights. Thus, if the UK were to leave the EU, but be in the EEA, financial institutions would still have access into the EU market. Although, at the moment EEA market access in financial services and passporting is restricted since these countries have not applied

post-financial crisis directives. This is because the EU directives are in conflict with some EEA states constitutions, as a result EU and EEA states are trying to find a way to get around these constitutional limitations.

In short, EEA countries have a high degree of market access if they adopt European legislation, but lack regulatory sovereignty. If European legislation is not adopted then they are prevented from accessing the single market. As a result, the case of the EEA also results in an increase in barriers to trade.

#### *2.3.6 Scenario 6: Custom Union (CU)*

Another possible scenario after Brexit is a CU between the UK and the EU. The EU currently has in place various CU, the most important of which is the one with Turkey. A CU implies that there is free trade between members and that those members apply the same tariffs to third countries.

When agreeing to a CU, the EU partner has to apply the same tariffs as the EU. Hence, in a CU the EU partner has no sovereignty on tariffs. Moreover, when the EU is granted a preferential trade agreement, it does not imply that its CU partner would automatically get the same or even a reduction in tariffs from that country. Nevertheless, the CU partner would have to lower tariffs in front of that third country (Piris, 2016). In other words, the CU partner of the EU has to apply a tariff reduction without getting any market access in return.

So far, all EU customs unions only cover goods, not services. Hence, there is no market access in financial services and GATS rules apply. This scenario would imply raising trade barriers in the financial services area.

#### *2.3.7 Scenario 7: Customized relationship*

The last possible relation between the UK and the EU is a customized relation, which does not fall into any of the prior categories. Not much is known about this possible customized relationship, since it will mainly depend on the negotiating abilities of the EU and the UK government.

However, existing EU relations with third countries indicate that that if the UK wants access into the SEM, it would have to comply with European regulations (without having a say on it) and make a contribution to the EU budget. Moreover, access into the SEM comes at the price of accepting the four freedoms, and the UK rejects free movement of people.

It is possible the EU relationship with the UK would be a hybrid between the EEA and the new relationship it is trying to establish with Switzerland. Even in this case, the financial sector would face higher barriers than in the present situation.



## 2.4 Concluding remarks

Brexit refers to the possibility that Britain leaves the EU as a result of the referendum that has been called by its PM on June 23<sup>rd</sup> 2016. The situation that will arise after an exit from the EU is unclear as the EU has never had to deal with such a situation. Observers consider seven possible scenarios, summarized in figure 1 (*see Appendix I*). All scenarios present a common trait: they all raise barriers to trade when compared to the present situation, especially to financial services.

### III. METHODOLOGY

This chapter addresses the methodology which has been used in order to test the hypothesis that Brexit will have negative implications for the City of London. In order to explain the methodology, the chapter is divided in 2 sections. A first section justifies the method selection by explaining the development of the financial sector in the UK and why its development might have been impacted by European integration. The second section explains the methodology used and justifies the data selection criteria and the requirements to prove the hypothesis.

#### 3.1 Methodology contextualization<sup>6</sup>

The City of London started developing as a financial centre in the 1960s, when New York was the world's biggest financial hub. The United States had a very advantageous stock market regulation, whereas the UK had a very strict regulation on the stock exchange that made it highly unattractive for trading securities. But, the USA was not an attractive location for short term deposits because of strict banking regulation, materializing in interest rate ceilings. As monitoring by the Bank of England was less strict, International finance moved to London. Thus, by the 1970s there were two financial hubs: one in New York based on securities trading and one in London oriented towards banking and foreign exchange. London was also chosen as a financial hub because of the language, culture, stable regulation, talented people and a good time zone location.

The biggest change to the UK's position as a leading financial centre came in 1986, with the "Big-Bang". It was a set of deregulatory policies applied to the UK stock exchange market which led to a large growth in the international securities trade and was also the beginning of investment banking in London.

After nearly 10 years of great development, in the early 1990s, recession broke out and the City jobs were lost, making prospects for the City look frail. But the City was able to overcome

---

<sup>6</sup> This section is mainly based on The Economist (2006)

these obstacles and emerge as a stronger financial centre. This second period of growth for the City coincided with the introduction of the SEM and the Euro.

Nowadays, London is the main financial exporter of the world. It has a worldwide market share of 37% in foreign exchange and 36% in over-the-counter (OTC) derivatives. In terms of EU market shares the City accounts for most foreign exchange trading, 85% of hedge fund assets and 70% of OTC derivatives (Springford, 2014). In terms of its trade balance with the EU, the UK has a large trade surplus (74bn£) in financial services. The City of London accounts for 11.8% of the UK's GDP (The City, 2016b).

London is home to more than 250 foreign banks that through passporting can operate in the EU. In addition, there is also a broader range of services related to financial services (legal, advising, IT ...) that have developed in the UK because of the existence of the City. The whole financial sector and related industries employ 2.2 million people (The City 2016b). Of these, 360,000 work in the City of London, of which 22% are from foreign nations, split in half between EU and non-EU citizens (Jenkins et al, 2016).

The hypothesis of this project is that leaving the EU would have a negative impact for the UK as a financial centre. As exposed before, an exit from the EU would result in increased barriers to trade in financial services, making it harder for the City of London to operate with the EU. If the EU has had a positive impact in the development of the City, then the increase in barriers to trade implied by an exit from the EU would have a negative impact in the UK. As a result, if the financial services industry in the UK has benefited from integration into the EU that demonstrates that exiting the EU would be damaging for the City of London. However, this rationale would not work if European integration had had a negative or at least not positive impact in the UK financial sector.

### 3.2 Content Analysis

In order to determine if EU integration has resulted in a positive impact for the UK financial industry a content analysis procedure is used. Content analysis is an objective methodology in order to make inferences of the message contained in one or various document by analysing them (Colorado State University, 2016). The documents are analysed looking for concepts or

keywords. Then, according to the number of times that the concepts or keywords are mentioned an inference can be made of their importance in the context.

In this project a content analysis should serve to look for evidence of which has been the impact of European integration in the UK financial sector and whether it has been positive or negative. If the impact has been positive then the hypothesis shall be accepted and if it is negative rejected. The degree of integration analysed is the SEM. References to the internal market or Single European Act as well as free movement of capital will be considered as equivalent to a reference to the SEM. References can be made explicitly or implicitly (when mentioning European regulation). The hypothesis will be considered valid only if, at least, 60% of the evidence indicates that the SEM has had a positive impact on the development of the financial services industry in the UK.

A key challenge presented in a content analysis is the selection of bibliography. In this case a selection method was followed. As the objective was to get the opinions of experts (i.e. people or organizations with specialized knowledge in the field), data was gathered from declarations of the financial services industry, as well as searched in specialized media and academic journals.

Public declarations from the financial services industry were available through calls for evidence done by Governmental organizations. In such submissions, financial institutions and related parties can present their point of view on the topic asked. Recently, there have been two calls for evidence on financial services.

The first one is the Balance of Competences carried out in 2014 by the UK government. It audited what the EU had done and how it affected the UK. A part of it was focused on the Financial Services Industry. In the Balance of Competences, interested parties explain how they think the EU has affected their industry, offering a first-hand perspective from the interested parties. Hence, submissions to the Balance of Competences are a good source of evidence that shall be used in the content analysis. Submissions to the Balance of Competences can be broadly grouped in 3 categories, financial institutions, financial associations and individuals. As financial institutions and financial associations represent the

perspectives of the sector, these are the declarations that have been used rather than those of individuals.

The second call for evidence was the one on EU regulatory framework for financial services, carried out in early 2016. In this call for evidence the EU wanted to have feedback as to how rules on the financial services are affecting economic growth and whether there are duplicities in regulation. Nevertheless, this call for submissions will not be used in this analysis as it is out of the scope this project. It focuses on the impact of specific regulation and how it is perceived by interested parties, whereas this project covers the impact of the EU as a whole rather than on specific regulation.

Another source of information of the impact of the SEM on the City can be found in specialized economic media such as the *Financial Times* (FT) and *The Economist*. The FT has published 1,489 articles relating to Brexit (as of April 16, 2016) and *The Economist* 236,000<sup>7</sup>. Such large amounts of data are out of the scope of this project as they are too large to handle. As a result, a filtering criteria was needed in order to bring down the number of hits obtaining to a representative sample.

The interface of the FT allows to introduce a search criteria and then, within that subset, to filter for additional criteria. The first filter applied to the FT was “Brexit City of London Banks”, because most articles in which an assessment of the EU-UK relationship is made are published preparing for the Brexit referendum. Therefore, they are prone to contain the word Brexit. The other keyword used is City of London which is the name given to London’s financial hub. Finally, the word “banks” was added, as they are a key element in the ecosystem of financial institutions. Hence, any article that verses on the impact of the EU for the UK financial system is bound to make a point of the impact on banks. This filters reduces the results to 105. Still too lengthy and many articles do not address the topic at hand.

As a result, two additional filters provided by the FT are added, these filters are region which we filter by the “City of London” and by topic “UK’s EU referendum”. These two filters reduce

---

<sup>7</sup> The searcher from *The Economist* is powered by Google and that probably explains the large amount of results arising in *The Economist*

the number of hits to a total of 21, which is an appropriate number for our analysis. Of these only articles have been selected, discarding other types of posts (i.e. videos, blogs...). The selected 17 articles have been then used for the content analysis.

*The Economist* interface does not provide the possibility to filter the results to the same extent as the FT. The maximum segmentation it offers is to use a criteria such as “impact european EU integration banks City of London Brexit”, and it returns 399 hits. Since there is no satisfactory way to filter the results to obtain an analysable quantity, *The Economist* was not included in the content analysis.

Last but not least, academic articles were also searched as a source of information. But, Brexit is such a recent thing that there are few academic articles exploring the issue. As a result, the focus of the search was on articles explaining the reasons behind the City of London growth. Using the databases of the University of Barcelona keywords introduced in the “recercador” are “Finance City London reasons” obtaining 3 hits, none of which approached the subject of factors impacting the growth of the City of London. Introducing other keywords such as “London reasons” or “finance London drivers” returned few and all non-relevant papers. Inserting the criteria “Finance City of London growth” led to 74 responses only 1 of which was relevant<sup>8</sup>. The document was discarded as it might lead to bias as it does not have contrasting opinions.

---

<sup>8</sup> The relevant document is a paper by Sir Nicholas Godison, TSB Chairman in 1991 titled “London: European City of Finance”.

### 3.3 Concluding remarks

A way to test the hypothesis that Brexit would be damaging for the UK financial industry is to prove that European integration has been positive for the industry. In that case, leaving the EU must have a negative impact on the financial sector because the seven possible Brexit scenarios imply limiting the access of the UK financial industry to the SEM.

To test the hypothesis, a content analysis procedure is proposed. The content analysis draws on the submissions to the Balance of Competences and articles from the *Financial Times* (FT) (see *Appendix II for a complete list of bibliography used in the content analysis*). The search relates to the impact of the SEM and whether it is mentioned in positive or negative terms. The hypothesis would only be validated if at least 60% of the evidence implies that the EU has had a positive impact on the financial sector in the UK.

## IV. CONTENT ANALYSIS RESULTS

This chapter exposes the results of the content analysis, methodology used to test the hypothesis that the UK will be negatively affected by an exit from the single market. Since any exit from the EU implies an increase in barriers to trade, if the City has benefited from the SEM, then Brexit will have a negative impact on UK financial services. Therefore, evidence that the City has been positively impacted by the Single European Market (SEM) is searched. The chapter is divided in 2 sections, the first one presents the results obtained from analysing the Balance of Competences, carried out in 2014 by the UK government, and the second one, those obtained from the analysis of *Financial Times* (FT) articles.

### 4.1 Results from analysing the Balance of competences

The Balance of Competences (BoC) has a total of 170 paragraphs making references to the SEM, out of approximately 720. Of these references, 62% state or imply that the SEM has had a positive impact in the financial sector. Furthermore, 22% of the evidence is neutral not being either positive or negative and the remaining 16% is in the direction that the EU has had a negative impact on the financial sector.

Out of 57 responses to the BoC, 20 clearly state that the SEM in financial services has benefited the UK and their businesses, with statements such as this one made by the British Bankers Association (BBA):

*"The Single Market for financial services is a significant factor in the success of the UK as a financial centre and therefore of considerable value to the UK economy"*

This statement is echoed through statements by the British Chamber of Commerce for Luxembourg, Confederation British Industry (CBI), Centre for European Reform, Franco-British Chamber of Commerce, Citi, European Movement, FCA Practitioners Panels, Glaxo Smith Klein, HSBC, Insurance Industry Roundtable, Investment Managers Association, IRSG, JP Morgan, Law society of England, Wales and Scotland, Lloyd's, Nomura, RSA, Standard life, The Royal Bank of Scotland (RBS) and TheCityUK.



The international bank Citi states that it chose to base its operations in London because the UK is part of the SEM:

*"Citi has chosen the UK base from which to head these operations for many reasons two of the most significant being: (1) London's position as a global financial centre; and (2) the UK's access to the EU's single Market. We believe that (1) is in no small part a function of (2)"*

In a similar line as established by Citi, HSBC states the following of the SEM:

*"We believe that UK based financial institutions such as HSBC benefit from the EU single Market in financial services. This is shown by the UK's large trade surplus in financial services with the rest of the EU (...). London in particular prospered as a financial centre not just as a result of deregulation in the 1980s but also as a result of the extension of the single market. This has allowed significant concentration of financial groups in the UK. This includes, those headquartered outside the EU which can then branch freely throughout the EU, (...)"*

The BBA, as a speaker on behalf of the financial sector, replicates the statement above in the following way:

*"The members of the BBA believe the Single Market for wholesale financial services to be a key factor in the attractiveness of the UK as a global financial centre and a significant asset for the EU as a whole."*

Moreover, the SEM not only has a positive impact in the UK because of the ability to trade freely with the rest of Europe, but also because of the strong negotiation power it confers to European institutions derived from the world's largest single market. The following has been extracted from the submission of the European Movement:

*"The bargaining power that flows from having the world's largest single market should not be underestimated. The UK as a stand-alone negotiator would have little chance of achieving anything once the US congress has decided the rules that will apply to any entity that does business with US firms anywhere in their global operations"*

The BBA echoes this position by mentioning the agreements already reached with the USA. To sum up, for most respondents the fact that the UK is part of the SEM is an asset, and has influenced their decisions to set up a branch in the UK. They all acknowledge that the EU has

had a positive impact on the development of the City of London. Nevertheless, opinions diverge on whether the UK would retain its financial sector importance after a Brexit. Some banks state that they would relocate to the EU, whereas other institutions, believe that the EU is only one of the many markets for UK financial exports.

The two strongest opinions on the negative impact of the EU on the UK financial industry are Business for Britain and Fresh Start. These two submitters are not financial institutions but lobbies. Their arguments are not based on the new possibilities opened up by Europe in transnational transactions, but rather on SEM regulation. According to Business for Britain:

*"56% of financial services professionals think that, on balance, the costs of EU financial regulation currently outweigh the benefits of the Single Market to the City, while 31% disagree. Over the next five years, 62% expect the costs of EU regulation to outweigh the benefits of the Single Market, while only 24% disagree." ComRes/Open Europe poll of 500 financial services professionals (manager level and above) in London. Conducted November 2011."*

For Fresh Start:

*"The financial services industry are critically important for the UK and the EU is by no means their only market. The EU must not be allowed to strangle them with red tape. Nor impose crippling costs on them, nor dissuade financial companies and workers from locating or staying in the UK."*

The argument that European regulation goes against the interests of the financial industry are widely discussed in the call for evidence. Most submissions consider that EU regulation is in line with international financial regulation and is agreed in international forums such as the G20. Thus, they believe that if the UK were to apply its own regulation it would not differ significantly from that of the EU. The Royal Bank of Scotland (RBS) states the matter as follows:

*"It is difficult to quantify how different rules would be if the UK was solely responsible for them; (...) the agenda for much of the recent EU regulatory reform is set at the global level by institutions where the UK is already very well represented. As such, the broad thrust of rules may not significantly differ under national rules when compared to EU equivalents. (...) RBS notes that much recent EU regulatory reform has been driven by global standard-setters and that the UK has been at the forefront of debate in these fora."*

The British Chamber of Commerce for Luxembourg goes even further, stating that most European legislation is based on British legislation giving the example of MIFID. Regardless of where the legislation originates it is a widespread opinion amongst respondents that European regulations do not differ greatly from those agreed at international fora.

The issue for most submitters is how European law is written. Financial institutions believe that European legislation is written giving way to multiple interpretations. They also criticize the European Commission for using too many regulations rather than directives, which give countries less leeway in implementation. Also a common complaint is that even if the UK has the right to decide how to implement legislation it usually chooses to gold-plate legislation (legislate more harshly than the EU). The following is extracted from HSBC's response:

*"In conclusion we would reiterate that the UK benefits from the EU single market including from harmonized financial sector rules to the extent that these are well-crafted and proportionate. Risks to the UK competitiveness stem not only from the potential for badly conceived and executed EU rules but also from the UK's propensity to gold-plate EU rules and to produce distinctive rules of its own with competitive consequences such as the Bank Levy, which adds significantly to the cost of basing a multinational banking group UK and Vickers ring-fencing proposal. This type of impact is unlikely to be resolved were the UK to leave the EU. Moreover, engagement in Brussels by the UK with its more Pro-market, pro-competition, approach is often beneficial, it can help deliver better outcomes for the EU consumers and businesses"*

As a result, the problem for financial institutions is not in European legislation, but rather how British regulators apply it in the UK. Although, they emphasize that British influence in the EU leads to better rule-making, due to the UK's outlook on the economy. Albeit, financial institutions complain that the UK has forgone the opportunity to lead the European agenda, pressing for the completion of the SEM. One such example is the fact that the UK is underrepresented by staff in European institutions, which implies there is a lack of transmittance of the UK perspective in most of the European regulations and directives.

Some submitters state the UK does not have enough power at EU level, as it cannot ensure that legislation safeguards the interests of the City. Many refer to the so called "Luxembourg compromise", of 1966. Through this compromise the requests of any state with a high stake in the matter under discussion will be taken into consideration, but financial institutions

complain that this is only a compromise and has no firm standing in European legislation. Therefore, some submitters believe that the government has done a good job ensuring a double majority in the Banking Union, but it still has no way to ensure that its points of view are approved by the European Council or Parliament. In addition, these submitters believe that the UK should lead the completion of the SEM, in the aspects where Europe still lacks integration.

In short, most of the evidence presented in the Balance of Competences goes in the line that the SEM has had a positive impact in the City and has allowed the UK to become a financial hub. Although there is still criticism, not to regulations, but rather to the way that regulations are applied by UK authorities. There is little evidence that the SEM has hampered the progress of the City of London, it mainly comes from two institutions which are not financial services firms. On the basis of these results a Brexit that does not ensure the free movement of financial services would negatively affect the City.

#### 4.2 Results from analyzing the Financial Times (FT) articles

The selected FT articles mention the single market in 24 paragraphs. Out of these, 21 (88%) are in a positive context and 3 (18%) in a negative context.

The favourable opinions can be summarized in the fact that the UK has benefited from its' membership of the SEM. The following has been extracted from "Bankers sound alarm bells over Brexit consequences" by Martin Arnold (FT, January 6<sup>th</sup> 2016):

*"[Citing James Chew, HSBC head of Strategy] "Opening access to the single market through London has enhanced those hub effects." He added that some of London's intrinsic advantages as a financial centre — such as its location, language and legal system — were being eroded over time, but access to the EU single market had helped to offset that. "The hub things that have made London great are not eternal and the advantages that have been granted by access to the single market have bolstered that and have made it stronger."*

Patrick Jenkins and Harriet Agnew in the article: "What the City stands to lose and gain from Brexit" (FT, February 23<sup>rd</sup> 2016), believe it to be easy to tell which parts of the financial sector have benefited from the SEM:

*“But if pinning down how Brexit would help or hinder the City is elusive, it is relatively straightforward to identify the sectors of the financial services industry that have prospered to date, at least in part thanks to their single market access to the rest of the EU. These include foreign currency trading, particularly in the euro; Investment banking; insurance; And cross border sales of securities”*

According to these authors London has always been prominent in currency trading. However, trading has accelerated since the UK entered the SEM and especially with the creation of the Euro. Investment banking and insurance has prospered in London due to its ability to passport all over the EU. This has led to large cost reductions as it is unnecessary to set up infrastructure in other countries. The SEM has also helped create a deep talent pool in London as it can easily import talent from all over the EU.

Another article by the aforementioned authors: “What would Brexit mean for the City of London” (FT, February 23<sup>rd</sup> 2016), exposes also the negative impact that the SEM has had for the UK. Mainly through specific regulation, such as MIFID 2 which is considered to be over bureaucratic as it requires brokers to fill more paperwork. In addition, it also states the wide rejection existent to bankers bonus cap, established by the EU in the aftermath of the financial crisis:

*“Brokers complain about Mifid 2, a sweeping new European regulation intended to make financial markets more transparent by “unbundling” the research and trading fees that brokers charge their asset management clients. Such grievances tap into a more general resentment of the EU’s limit on bonuses, which is so overwhelmingly unpopular in the City that it could trump more general worries about stability.”*

Criticism to the SEM can also be found in the transcript of “For the City to thrive must the UK stay in Europe?” (FT, December 1<sup>st</sup> 2014). In this unsigned article in the FT a series of managers of financial firms in the UK express their opinions. One of them is Helena Morrissey, Chairman of the Investment Management Association:

*“Meanwhile let’s be honest in this debate about the downsides to the EU, too. The Eurozone economic difficulties are well known and not unrelated to the political construct. The one size fits all and undemocratic law making process makes it hard for Europe to compete with more flexible economies. (...)The EU law and regulation making process is convoluted, undemocratic and*

*timewasting – time that could be put to more productive use. The UK is currently unable to negotiate trade terms with say India or China – we simply don't have a seat at the table, except through the EU"*

Although saying this, she also argues that access to the SEM has been crucial for the investment management industry and that even though there might be a Brexit, the UK has to ensure it retains access to the single market.

The Director of the CBI, John Cridland, seems to encompass the main opinions shared by most of the sector. On the one hand, he believes that in the advent of Brexit the City of London would not completely disappear but it would lessen its standing. On the other hand, the benefits of being in the SEM have positively impacted the City.

*"(Either) talking about the City or the country as a whole, the benefits of membership significantly outweigh the costs. Going it alone will leave us on the outside with less influence. The 'Norway option' would reduce the UK to a halfway house on the margins of Europe with little say over the market rules (...) which we operate on the continent."*

In short, the FT articles do not seem to put in doubt that the development of the City has been positively impacted by the SEM. The main complaints to the SEM go against the new regulation emanating from the financial crisis, such as bonus caps. However, there is no agreement on whether, in the near future, benefits provided by the EU will outweigh the costs imposed by new regulation. In any case, the results indicate that the SEM has had a positive impact on the UK and therefore a Brexit would be negative for the financial services industry.

## 4.2 Concluding Remarks

This chapter has presented the evidence retrieved during the content analysis procedure. It has reviewed which are the most common arguments on the impact of the SEM on the City of London.

Most of the evidence gathered has been in favour of the fact that the UK has been positively impacted by the SEM. Most of the complaints are due to recent legislation adopted by the EU. It seems to be of common agreement that the EU has greatly benefited the financial services industry in the UK. The only question remaining is whether the EU is going to continue helping the growth of the City in the light of the new legislation.

It was established that the hypothesis would be accepted if at least 60% of the references to the SEM were positive, in both the Balance of Competences and *Financial Times* articles. In both cases the evidence has gone beyond this threshold which leads to the hypothesis being accepted. Since, the EU has had a positive impact for the financial services industry in the UK, leaving the EU would have a negative impact on the City of London.

## V. CONCLUSION

The objective of this research was to establish whether an exit of the UK from the EU (Brexit) would negatively impact the UK financial sector. The results indicate that this will be the case.

European integration has led to the creation of the SEM, which has brought a reduction in trade barriers both physical and technical. For financial services, the SEM has created the possibility of passporting, allowing EU financial services companies to branch or provide services in other member states. This has led to a large cost reduction and integration of financial markets.

The exit of the UK from the EU will lead to seven possible scenarios of relationship between them. A WTO scenario where MFN tariffs are applied. A FTA, Customs Union or EFTA scenarios, granting tariff free access into the single market. There is also the possibility that the UK might join the EEA or reach a bilateral agreement with the EU in which case under certain conditions access into the SEM can be granted. A final scenario is a customized relationship, which would arise as a result of negotiations. The common feature of all these scenarios is that they all result in an increase in barriers to trade, especially for financial services, which would see their access into the SEM largely restricted.

It is clear that an exit from the EU would reduce the UK's financial services degree of market access. As a result, if it is proven that the EU has had a positive impact in the development of the UK financial sector, then it is also clear that the UK financial industry will see its position worsened upon exiting the EU. That is why this project has been focused on determining if the UK financial industry has been positively affected by the SEM.

A content analysis procedure has been used in order to test the impact of the European Union in the British financial sector. It has been applied to the submissions presented in the 2014 Balance of Competences and *Financial Times* (FT) articles. The hypothesis was only to be validated if at least 60% of the references to the EU establish a positive impact of the SEM in the City.



Results indicate that more than 60% of the experts believe that this is the case, which validates the hypothesis. In the Balance of Competences more than 20 out of 57 respondents state outright that the EU has been determinant for their success. More submitter's also state it but with reservations. The FT articles indicate that the sectors that have benefited the most from financial integration are foreign currency, investment banking, insurance and securities.

The research has led to the conclusion that most analysts consider that historically the UK financial industry has benefited from the EU. Although, the Brexit position argues that the increase in costs, when all post-crisis regulation is implemented, will outweigh the benefits of being part of the EU. The arguments for staying in the EU support that most financial regulation is inspired in UK regulation and also that the costs of leaving the EU would be larger than the benefits of staying. On the basis of these findings, if the financial services sector had a vote in the referendum it would probably vote to remain in the EU.

## BIBLIOGRAPHY

Balassa, B. (1961) "The Theory of Economic Integration" Homewood

Baldoni, E. (2003) "The Free Movement of Persons in the European Union: A Legal-historical Overview" Pioneur

Banco de España (2016) "Oficinas de representación de entidades de crédito extranjeras". Available at: "[http://www.bde.es/clientebanca/es/areas/Entidades/Entidades\\_que\\_no/Oficinas\\_de\\_rep\\_34e44c7f9edc941.html](http://www.bde.es/clientebanca/es/areas/Entidades/Entidades_que_no/Oficinas_de_rep_34e44c7f9edc941.html)" (Last accessed 10/6/2016)

Booth S., Howarth C., Persson M. & Scarpetta V. (2011) "Continental Shift: Safeguarding the UK's Financial trade in a changing Europe" Open Europe

Booth S., Howarth C., Persson M., Ruperal R. & Swidlicki P. (2015) "What if ...? The consequences, Challenges & Opportunities facing Britain outside the EU" Open Europe

Clements B. (2014) "Britain Outside the European Union" IEA Brexit Prize

Clifford Chance (2014) "A Legal Assessment of the UK's relationship with the EU: A financial services perspective" ThecityUK

Colorado State University (2016) "Content Analysis". Available at "<http://writing.colostate.edu/guides/pdfs/guide61.pdf>"

Credit Suisse (2016) "Brexit: Breaking up never easy or cheap"

Europe Economics (2014) "EU financial regulation: A report for Business for Britain"

European Banking Authority (2016) "The Single rulebook". Available at: "<http://www.eba.europa.eu/regulation-and-policy/single-rulebook>" (Last accessed: 11/6/2016)

European Central Bank (2016) "Single Supervisory Mechanism". Available at: <https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html> (Last accessed 6/11/2016)

European Commission (2015), Press release. Available at: "[http://europa.eu/rapid/press-release\\_IP-92-1058\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-92-1058_en.htm?locale=en)"

European Commission (2015) "Free movement of Capital: Overview"; Available at "[http://ec.europa.eu/finance/capital/overview\\_en.htm#when](http://ec.europa.eu/finance/capital/overview_en.htm#when)"

European Commission (2016) "Banking Union". Available at: "[http://ec.europa.eu/finance/general-policy/banking-union/index\\_en.htm](http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm)"

European Parliament (2015) "European System of Financial Supervision". Available at: "[http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuld=FTU\\_3.2.5.html](http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuld=FTU_3.2.5.html)"

European Union (2016)

A. "One market without borders". Available at: "[http://europa.eu/pol/singl/index\\_en.htm](http://europa.eu/pol/singl/index_en.htm)"

B. "The History of the European Union". Available at: "[http://europa.eu/about-eu/eu-history/index\\_en.htm](http://europa.eu/about-eu/eu-history/index_en.htm)"

Her Majesty's Government (HMG) (2014) "Review of the Balance of Competences between the United Kingdom and the European Union. The Single Market: Financial Services and the Free movement of Capital"

Jenkins, P. & Agnew H. (2016) "What the City stands to lose and Gain from Brexit" Financial Times

Lang A. (2013) "Norway's relationship with the EU", House of Commons Library

Miller V. (2013) "Leaving the EU", House of Commons Library

O'Donnell J., Jones H. & Geddie J. (2016) "Brexit risks taking multi-trillion euro trading from London" Reuters

Piris J. (2016) "If The UK votes to leave: Alternatives to EU membership", Centre for European Reform

Sherman & Sterling LLP (2014) "Extraterritoriality revisited: Access to the European Markets by Financial Institutions, Funds and others from outside Europe"

Springford J. & Whyte P. (2014) "The Consequences of Brexit for the City of London", Centre for European Reform

Springford J., Whyte P. & Tilford, S. (2014) "The economic Consequences of leaving the EU"; Centre for European Reform

The Economist; "The Brexit Delusion"; February 27, 2016

The Economist; "Capital City: London as a Financial Centre"; October 19, 2006

TheCityUK (2016)

A. "A Practitioner's Guide to Brexit"

B. "Key facts: About the UK financial and related professional services"

University of Kent (2013) "Switzerland's Approach to EU enlargement: A financial services perspective"

Wilson S. (2014) "Britain and the EU: A long and rocky relationship" BBC

## APPENDIX 1

Table summarizing the market access of the seven possible Brexit scenarios

	Tariffs	Full access to the SEM	Independent trade policy	Influence on EU regulation	Regulatory sovereignty	Independent Immigration Policy	Contribution to Budget
<b>WTO</b>	Yes	No	Yes	No	Yes	Yes	No
<b>FTA</b>	No	No	Yes	No	Yes, theoretically, but regulations must be consistent with EU norms to access the single market	Yes	No
<b>EFTA</b>	Yes	No	Yes	No	Yes	Yes	No
<b>Bilateral Agreements</b>	No	No. FTA in goods but not in services (access limited by bilateral agreements)	Yes	No	No	Uncertain (Switzerland does not have the freedom to restrict immigration)	Yes, but smaller
<b>EEA</b>	No	Yes	Yes	Engagement in construction of regulation but no voting rights	Yes, theoretically, but regulations must be consistent with EU norms to access the single market	No, there is Free movement of Labour	Yes, but smaller
<b>Custom Union</b>	No	No	No	No	Yes, theoretically, but regulations must be consistent with EU norms to access the single market	Yes	No
<b>Customized Relationship</b>	Unknown						

Source: Own elaboration based on Credit Suisse (2016)

## APPENDIX 2

### List of Documents used in the content analysis:

Submissions to the Balance of Competences: Single Market - Financial Services and the Free Movement of Capital:

AIG

All party parliamentary Group on modern languages

Association of British Insurers

Association of Corporate Treasurers

Association of Foreign Banks

Association of International Life Offices

Association of Professional Financial Advisors

Bank of America Merrill Lynch

Barclays

BATS Chi-X Europe

British Bankers Association

British Chamber of Commerce for Luxembourg

British Insurers Brokers association

British Private Equity and Venture Capital Association

British Property Federation

British Standards Institution

Building Societies Association

Business for Britain

CBI

Centre for European Reform

Citi

City of London Law Society Regulatory Law Committee

Consumer Council Northern Ireland

Equity Release Council

European Movement Council

FCA Financial Services Practitioners Panel

FCA Smaller Business Practitioners Panel

Financial Services Consumer Panel

Franco-British Chamber of Commerce workshop

Fresh Start

General Council of the Bar of England and Wales

GlaxoSmithKline

HSBC

Institute of Chartered Accountants in England and Wales

Insurance Industry Roundtable

International Regulatory Strategy Group

International Underwriting Association of London

Investment and Life Assurance Group

Investment Management Association

JP Morgan

Law Society of England Wales and Law Society of Scotland

Legal & General

Lloyds of London

London Metal Exchange

Moody's

National Association of Pension Funds

Nomura  
Payments Council  
Royal Bank of Scotland Group  
RSA Insurance Group  
Scottish Government  
Standard Life  
TheCityUK  
UK Crown Dependencies  
Wealth Management Association  
Welsh Government  
Wholesale Markets Brokers Association

List of Financial Times articles used in the content analysis:

Arnold M., (2015) "Deutsche Bank fires warning shot over UK vote on EU exit" Financial Times

Arnold M. (2016) "Bankers sound alarm bells over Brexit consequences" Financial Times

Arnold M., Parker G. & Jenkins P. (2015) "UK bank levy and ringfence head list of City of London grievances" Financial Times

Arnold M., Dunkley E. & Shotter J. (2016) "City status as a financial hub at risk from Brexit vote says Cryan" Financial Times

Barker, A., (2015) "UK pushed for "emergency brake" on EU policy votes" Financial Times

Barker A., Brunsden J., Chassany A. & Parker G. (2016) "Cameron tried to win over critics of the City "safeguards"" Financial Times

Barker A., Brunsden J. & Stothard M. (2016) "Brexit — an existential problem for London and Paris" Financial Times

Fortado L. (2016) "Law firms hire from Westminster to prepare for Brexit" Financial Times



Guthrie J. (2013) "The City needs its own referendum" Financial Times

Jenkins, P. (2014) "IMA head dismisses bank threats to quit UK after "Brexit"" Financial Times

Jenkins P. (2016) "Brexit is the last thing City banks need" Financial Times

Jenkins P. & Agnew H. (2016) "What the city stands to lose and gain from Brexit" Financial Times

Jenkins P. & Agnew H. (2016) "What would Brexit mean for the City of London" Financial Times

Parker, G. (2015) "Financial Services would be hit hardest by Brexit" Financial Times

Pickard J. & Noonan L. (2016) "Boris Johnson hits out at pro-EU stance of City" Financial Times

Sullivan C. & Parker G. (2016) "Brexit takes central stage in London's Mayoral race" Financial Times

Unsigned (2014) "Transcript: For the City to thrive must the UK stay in Europe" Financial Times