



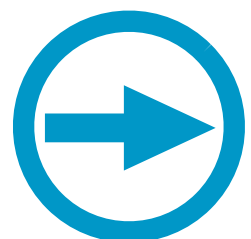
THE POTENTIAL IMPACT OF BREXIT ON EUROPEAN CAPITAL MARKETS

A QUALITATIVE SURVEY OF MARKET PARTICIPANTS

April 2016

by William Wright

> Brexit would cause significant disruption and uncertainty for European capital markets, investors and issuers – at a time when Europe needs bigger and better capital markets more than ever



The potential impact of Brexit on capital markets in Europe

On 23rd June the UK will hold a referendum on whether to remain a member of the European Union or to leave. This report is about the practical implications of a potential Brexit on capital markets in Europe, and the potential knock-on effects on investors, issuers and other customers.

New Financial believes that Europe needs bigger and better capital markets to help drive its recovery and growth. One of the clear messages that emerges from this report is that the current efforts across the EU to encourage the development of capital markets and reduce the dependence of the European economy on bank lending could be significantly disrupted if the UK votes to leave the EU.

The report does not explore the politics of the debate: that is a question for the British people and the respective campaigns advocating Remain and Leave. The report does not try to boil down the benefits or consequences of either outcome to a single number, and does not focus on the impact on London as a financial centre. It aims to be accessible and as jargon-free as possible.

The report addresses some of the following questions:

- What specific aspects of the single market do participants in the capital markets consider to be most beneficial to them and their customers?
- How interconnected are capital markets in the UK with the EU?
- What are the potential benefits of the capital markets union initiative? And what could happen to it in the event of Brexit?
- What are the main criticisms of EU-wide financial regulation and how could it be improved?
- What could happen to financial regulation in the UK in the event of Brexit?
- What practical steps might market participants take in the event of Brexit?
- What could be the potential benefits of Brexit from a capital markets perspective?
- And what sort of future relationship between the UK and the rest of the EU would market participants like to see in future in the event of Brexit?

Sample and methodology:

The report is based on 25 responses (mainly through in-depth structured interviews) from different market participants across Europe and different sectors of the capital markets to a detailed questionnaire. The full questionnaire, with a selection of anonymous responses, is available at www.newfinancial.eu. We invited 100 different organisations to take part, and deliberately sought responses from across the spectrum of the debate. Given the sensitivity of the subject, we assured all participants of complete anonymity.

One note on terminology: throughout this report we use 'EU27' to denote the EU excluding the UK.

Acknowledgements:

I would like to thank all of the participants for the significant amount of time they dedicated to this report, and to Esther Spaarwater and the team at New Financial for their diligent work. Any errors are entirely my own.

New Financial is a think tank and forum that believes Europe needs bigger and better capital markets to help drive its recovery and growth.

We think this presents a huge opportunity for the industry and its customers to embrace change and rethink how capital markets work.

We are a social enterprise that launched in September 2014. We are funded by institutional membership

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The potential impact of Brexit on European capital markets

Here is a 10-point summary of what respondents to our survey thought were the main benefits of the single market to them and their customers, and the main risks in event of Brexit:

1. The current efforts in the EU to encourage the development of deeper and more efficient capital markets and to reduce the dependence of the European economy on bank lending could be significantly disrupted if the UK votes to leave the EU - with big implications for markets participants, investors, issuers and the economy in the UK and the rest of the EU.
2. UK and European capital markets are highly interconnected with the UK the dominant party. For example, more than three quarters of all capital markets business in the EU27 is conducted out of the UK. Unpicking this interdependence could be a complex, lengthy and costly process.
3. By a wide margin respondents said that passporting was the biggest benefit to their business and to their customers of being in the single market, and that losing passporting rights was the biggest risk of Brexit. UK-based firms and their customers benefit disproportionately from passporting, accounting for three quarters of all passporting in the EU.
4. The other main benefits cited by respondents were the economies of scale of the single market that enable them to offer a wider range of services to more clients at lower cost; the broadly consistent regulatory framework across the EU that reduces cost and complexity; and the free movement of labour that opens up a wider pool of talent.
5. The UK could miss out on the potential benefits of the capital markets union project. Respondents said CMU marked an important shift in mindset by European policymakers in recognising the need for deeper capital markets in Europe - and that capital markets could be part of the solution. But they warned that in the event of Brexit it would either grind to a halt or become a more inward-looking project for the rest of the EU excluding the UK.
6. While it is often easy to criticise EU financial regulation it is unlikely that there would be any bonfire of EU regulations in the UK on the other side of Brexit. In order to retain access to the single market as a 'third country', much regulation may have to be retained. Respondents feared that over time regulation in the UK and EU would diverge, increasing costs and potentially raising questions over future UK access to the single market.
7. The UK could lose influence over the future direction of the capital markets on its doorstep, which represent the biggest market for many firms based in the UK. Without a seat at the table it would not be able to influence future regulation (but may have to implement it). As one respondent said: "God knows what Mifid III and CRD V would look like without the UK".
8. The majority of respondents made a strong case for the UK to remain in the EU and said they had identified no benefits - or only marginal ones - of Brexit to their business and clients. A very small number said Brexit could benefit capital markets in the UK.
9. A vote to leave the EU could cause an initial period of significant dislocation and uncertainty in markets and across the industry, leading to lower activity and less cross-border investment. The only two certainties are that lawyers would have a field day, and the cost of disruption would be passed on to customers. Many respondents said they could over time be forced to relocate some staff from the UK.
10. In the event of Brexit, most of our respondents said they would like to see the UK negotiate an agreement with the EU similar to the Norwegian model (with access to the single market) - but they thought this would be politically untenable and that the UK would end up with a more complex arrangement closer to the Swiss model or WTO framework.

HOW INTERCONNECTED ARE UK & EU CAPITAL MARKETS?

Unpicking 25 years of integration

This section looks at the high level of interdependence between capital markets in the UK and the rest of the EU. Figure 1 shows a range of different ways of measuring this. Unpicking them from each other could cause uncertainty and potential disruption for capital markets on both sides.

Capital markets in the UK and the rest of the EU are deeply intertwined with each other in three main ways.

- **Trade and investment:** the high level of trade between the UK and the EU means that there are high levels of investment in each other's economies. For example, 48% of the stock of foreign direct investment in the UK comes from the EU, and than one third of all acquisitions of UK companies by overseas buyers over the past five years have involved EU acquirers.

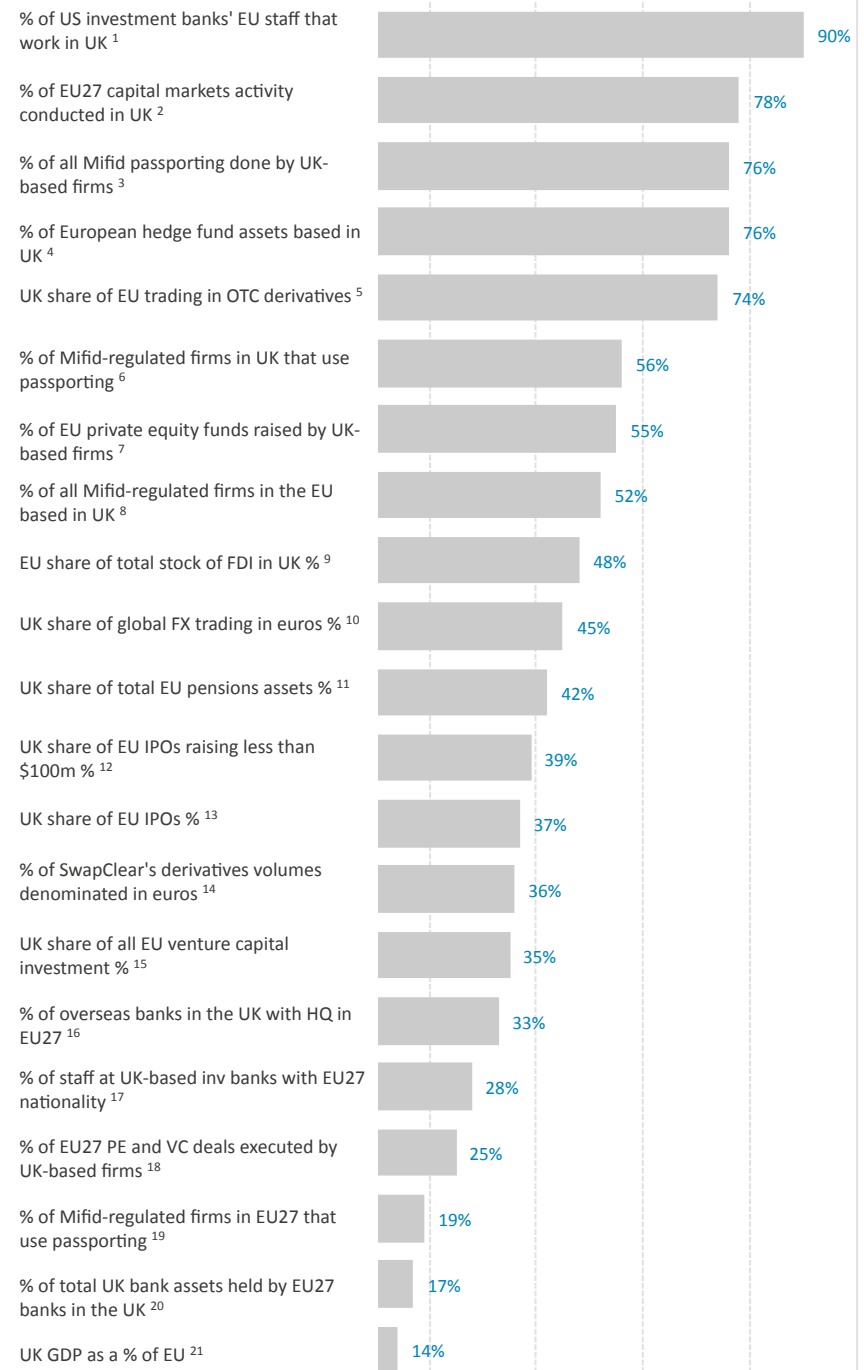
- **Punching above its weight:** the UK has much deeper capital markets than the rest of the EU, and plays a bigger part in overall levels of activity. On average, UK capital markets are nearly twice as developed relative to GDP as the rest of the EU, and the UK nearly accounts for between 25% and 75% of activity in most sectors of EU capital markets despite having only 14% of EU GDP.

While the UK's markets are often viewed with suspicion by other countries, the UK's expertise in capital markets means it has a valuable role to play in shaping the capital markets union project (see page 10) to help boost growth across the EU.

- **The European financial centre:** the EU's single market enables firms to base many of their capital markets activities and conduct much of their EU-wide business from the UK. More than three-quarters of all of the firms in the EU that use passporting under Mifid are based in the UK, and nearly 80% of capital markets activity in the EU 27 countries is managed and conducted out of the UK.

1) How interconnected are UK and EU capital markets?

A selection of measures of the high level of interdependence between the UK and EU capital markets



Sources: 1. Bruegel 2. Oliver Wyman 3. EBA 4. AIMA 5. BIS 6. EBA 7. Invest Europe 8. EBA 9. ONS 10. BIS 11. New Financial 12. New Financial 13. New Financial 14. SwapClear 15. New Financial 16. Bank of England 17. eFinancialCareers 18. Preqin 19. EBA 20. Bank of England 21. IMF

WHAT ARE THE MAIN BENEFITS OF THE SINGLE MARKET? (I)

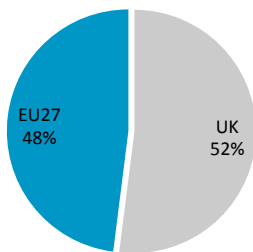
Which aspects of the single market do market participants most value?

We asked market participants in five sectors – asset managers, banks and investment banks, hedge funds, private equity and venture capital, and trading and market infrastructure – what they considered to be the most important benefits of the single market to them and to their clients.

The flipside of this question is what they would most fear losing in the event of Brexit and what they would most want to see as part of a negotiated settlement. This section looks at these benefits, starting with passporting – which was cited by respondents as the most valuable aspect of the single market by a wide margin.

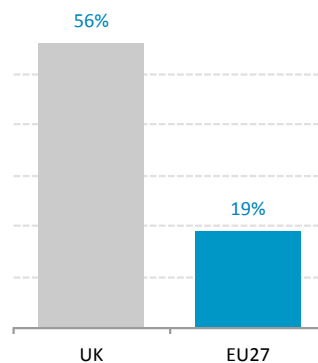
2) How UK-based firms and their customers across the EU benefit from passporting

1) Location of firms operating under Mifid in the EU %

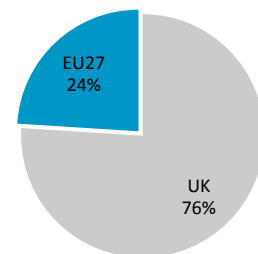


Source: EBA

2) % of Mifid-regulated firms in EU that use passporting



3) Where companies that use passporting under Mifid are based - 2015 %



1) PASSPORTING

- Under EU passporting rules, a firm that is authorised and incorporated in one EU state has a right to set up branches or conduct cross-border business across the EU without the need for additional local authorisation.
- UK-based firms are by far the most active in using these passporting rights. Just over half of all firms in the EU regulated under Mifid are based in the UK, and 56% of these 3,700 firms take advantage of passporting to trade or access their clients in the rest of the EU (compared with just one fifth of all firms in the EU 27). Between them, UK-based firms account for three quarters of all passporting activity in the EU (see Figure 2).
- Passporting works in both directions. Many of these UK-based firms using passports are branches of EU-owned banks, investment banks or asset management firms that have taken advantage of the single market to set up business in the UK. One third of all overseas banks operating in the UK are headquartered in the rest of the EU (representing more than a fifth of all banks in the UK), and more than 70 banks incorporated in the European Economic Area (EEA) use passports to access the UK market to the benefit of UK customers.

What happens in the event of Brexit?

- The main fear expressed by respondents was that they could lose their automatic passporting rights in the event of Brexit. The volume of passporting activity from the UK shows that this could cause significant disruption to UK-based market participants and their customers. However, while it is tempting for people in the UK to focus on the impact on UK capital markets, several respondents warned that clients and counterparties in the rest of the EU could also face uncertainty and disruption if firms based in the UK lost the automatic right to do business with them. >>>>>

WHAT ARE THE MAIN BENEFITS OF THE SINGLE MARKET? (2)

Jargon:

It is almost impossible to write about capital markets in the EU without using some of the jargon of financial regulation. Here is a quick summary of the main acronyms:

AIFMD:

The Alternative Investment Fund Managers Directive

CRD:

Capital Requirements Directive

EMIR:

European Market Infrastructure Regulation

Mifid:

Markets in Financial Instruments Directive

UCITS:

Undertakings for the collective investment in transferable securities

I. PASSPORTING (cont.)

Here is a summary of what respondents in different sectors said about the benefits of passporting:

- **Banks / investment banks:** banks are able to operate across the EU under a CRD or prudential passport, which is effectively a single EU-wide banking licence. This single point of entry significantly reduces the complexity and cost of their cross-border business. Investment banks operate on a similar model under Mifid passports and can trade and market to clients across the EU from one location, which reduces their costs and provides easier market access for their clients.

In the event of Brexit, banks in the UK may have to set up separately-capitalised subsidiaries inside the EU, and investment banks may have to set up separate broker dealers in the EU in order to retain this automatic access.

- **Asset managers:** EU regulations such as AIFMD, Mifid and UCITS enable asset managers to access clients across the EU without having a physical presence in each country. This increases the range of investment funds available to customers across the EU and reduces costs. Several respondents said they valued access to the UCITS brand itself: UCITS has built a global brand over the past 30 years with nearly €10 trillion of assets in UCITS funds in the EU and distributed across Europe, the Americas and Asia.

In the event of Brexit, asset managers' biggest concern is that they could lose their automatic passporting rights, and nearly €1 trillion of UCITS funds domiciled in the UK could lose their UCITS status unless they moved their domicile to inside the EU. On the other hand, asset managers based in the UK but with funds already domiciled in the rest of the EU (Luxembourg and Ireland account for 54% of all UCITS funds by domicile) should still be able to manage those funds on behalf of clients.

- **Trading and market infrastructure:** trading and market infrastructure firms can operate across the EU under a wide range of EU regulations including Mifid and EMIR. It means that an exchange, central counterparty or trading platform has a right to provide services to other market infrastructure firms or clients across the EU, and a right to access local market infrastructure firms across the EU.

This has helped boost competition in trading and clearing across the EU, which has increased liquidity and lowered the cost of trading. In the event of Brexit, trading platforms and market infrastructure may have to set up a physical presence inside the EU to retain the same level of access.

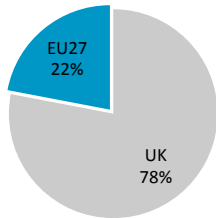
- **Private equity and venture capital:** passporting under AIFMD, Mifid and European venture capital regulations enables private equity and venture capital firms to raise funds and market to investors across the EU. It also provides easier access to non-EU funds for EU-based investors if the manager is based inside the EU. Outside of the EU, private equity firms in the UK may have to raise funds from EU investors under separate national private placement regimes.

- **Hedge funds:** hedge funds said that passporting under UCITS, which is usually associated with more traditional asset management, was more important than passporting under AIFMD. Continental European investors are more comfortable with the UCITS structure and brand, and 28% of all hedge fund assets in the UK are held in UCITS structures, mainly domiciled in Ireland and Luxembourg.

WHAT ARE THE MAIN BENEFITS OF THE SINGLE MARKET? (3)

3) Scalability

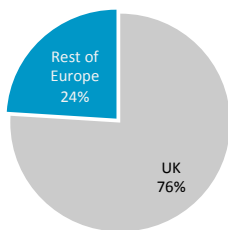
Where EU27 capital markets activity is conducted - 2013 %



Source: Oliver Wyman

4) Concentration

Distribution of hedge fund assets in the EU %



Source: AIMA

2) ECONOMIES OF SCALE

The second main benefit of the EU single market cited by respondents was the economies of scale that passporting enables. Firms across all sectors can concentrate their activities in one location and manage their business across the EU at much lower cost than if they were based separately in each country. This reduces complexity and helps reduce costs for customers.

The main concern expressed was that Brexit could increase the cost and complexity of doing business and increase frictional costs of doing business – such as liquidity and trading costs. Many respondents highlighted the risk that the network effect of different market participants such as investors, investment banks and lawyers and being concentrated in one location could be undermined.

Here is a selection of what respondents in different sectors said about how economies of scale benefit them and their customers:

- **Banks / investment banks:** banking has high barriers to entry and high fixed costs which can be significantly reduced by concentrating operations in one place. The industry also generates high network benefits, such as more liquidity and lower frictional costs of trading. By removing the need to manage local subsidiaries across the EU, banks and investment banks can operate less complex businesses, manage their capital and risk more effectively, and provide a single access point to all 28 EU markets for their clients.
- **Asset managers:** access to the single market enables asset managers to offer a wider range of more sophisticated investment funds at a lower cost to a wider range of customers than would be possible if they had to domicile, manage and administer funds separately in each country. This helps explain why more than 40% of all EU assets under management are based in the UK, and why UK-based firms account for three-quarters of all firms using passports in the EU. There is still some way to go in terms of the economies of scale and benefits to customers: the average UCITS fund has assets of around €200m, compared to €1.6bn for the average mutual fund in the US, and fees for retail investors are significantly higher in Europe than the US.
- **Trading and market infrastructure:** in a high fixed cost business such as market infrastructure, the single market enables the development of critical mass in different products and markets. A single trading platform open to customers across the EU can concentrate liquidity at lower cost for clients than multiple platforms across the EU. The single market is an important part of the open-access approach to infrastructure, whereby a clearing house in one country can offer services to an exchange or market participants in another. The economics of some trading platforms may not add up without access to the single market. For example, more than 40% of trading in EU27 stock markets is executed on platforms in the UK with very few staff in the EU27.
- **Private equity and VC:** the economics of private equity and VC firms are sensitive to fixed costs so the ability of firms to concentrate their operations in a one or a handful of locations was seen as a significant benefit by respondents. Big US private equity firms have as much as 90% of their EU-wide staff in the UK, and more than 25% of all EU 27 private equity and venture capital deal activity is conducted by UK-based firms.
- **Hedge funds:** hedge funds tend to be relatively small operations and the single market enables them to centralise investment, risk and trading functions in one location to reduce their costs and maximise returns. Three quarters of European hedge fund assets are based in the UK, and most hedge funds in the UK have only a small number of staff in the rest of the EU, mainly support staff in Ireland or Luxembourg.

>>> *“The functioning of the single market is not perfect - but it is cheaper, less complex, and more efficient than dealing with 28 different rulebooks – or a separate rulebook for the UK and Europe”*
Investment Bank

3) REGULATORY FRAMEWORK

The broadly consistent regulatory framework across the EU was cited by most respondents as an important benefit in reducing the complexity and cost of doing business, even if they also expressed frustration with specific regulations and the EU regulatory process (see page 12). This framework provided them and their clients with confidence, clarity, and certainty over regulation when dealing in countries they are not familiar with and where they are not based.

The main concern expressed by respondents was that in the event of Brexit there could be a gradual divergence in regulation between the UK and the rest of the EU, which could raise costs and have longer-term implications for whether UK-based firms would continue to have automatic access to clients and markets in the rest of the EU (and vice versa).

- **Banks / investment banks:** the high level of harmonisation of regulation across the EU enables banks and investment banks to concentrate their activities in one financial centre while retaining access to clients in the 27 other member states. Respondents in banking shared the view of other sectors in saying that while the functioning of the single market was not always perfect it was cheaper, less complex, and more efficient than dealing with 28 different rulebooks – or dealing with a separate UK and EU 27 rulebook.

Several respondents also said the main problem with EU regulation was less the regulation itself but the way in which was interpreted and applied by national regulators. In the event of Brexit respondents feared that there could be less effort across the EU to ensure that there was a level playing field in regulation in individual countries.

- **Asset managers:** while respondents in the asset management sector said the common regulatory framework was a significant benefit in reducing cost and complexity, they expressed concern that different approaches to marketing and distribution rules and the notification requirements with local regulators can often undermine the single market. One estimate is that a UK-based asset manager marketing and distributing a fund across all 28 member states plus Switzerland would face initial start-up costs of around €1.5m and annual costs of a similar amount as a result.

- **Trading and market infrastructure:** Mifid and Mifid II, which is due to be introduced in 2018, provide a detailed framework for trading and market infrastructure providers. Respondents said the non-discriminatory access to market infrastructure across the EU under current regulations was an key part of their business - and several respondents pointed out that their business would not exist without the regulatory efforts to open up competition in trading and clearing across Europe over the past decade.

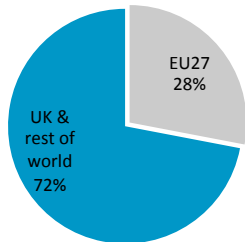
- **Private equity and VC:** AIFMD provides an increasingly harmonised rulebook across the EU for the private equity industry. While AIFMD improves access across the EU for larger firms, some elements of it were criticised for being unnecessarily costly, particularly for smaller or purely domestic firms. Smaller investors have also struggled to access certain funds because the firm has chosen not to market them under AIFMD.

- **Hedge funds:** respondents said that the impact of the EU-wide framework on the efficiency of markets and in reducing the frictional cost of trading was more of a benefit than hedge fund-specific regulation. For example, competition between trading venues in equity markets has increased liquidity and reduced fees and spreads. While AIFMD creates a common structure for marketing funds, it does not yet offer full access for EU investors to offshore funds, and some elements – such as requiring a designated depositary – can involve more cost than benefit. Hedge funds are able to market funds under private placement regimes, but these operate on different national rules.

WHAT ARE THE MAIN BENEFITS OF THE SINGLE MARKET? (5)

5) International staff

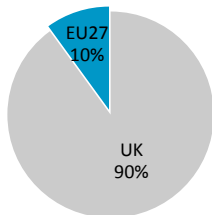
Nationality of workforce at investment banks in the UK %



Source: eFinancialCareers

6) Concentration of staff

Where EU staff at big five US investment banks are based %



Source: Bruegel

4) FREE MOVEMENT OF LABOUR

Many of the respondents to our survey cited the four main freedoms of the EU single market (the free movement of goods, capital, people and services) as an important part of the benefits to them and their customers. Every respondent mentioned the importance of the free movement of labour and their ability to employ staff from across the EU regardless of their nationality and location. Many said this access to a wider pool of talent without the need for visas or work permits improved their performance and outcomes for clients and minimised their costs.

Respondents expressed concern that in the event of Brexit the future status of EU nationals living in the UK could be unclear. There is no talk of deportation and most respondents believed that EU nationals working in the UK would retain their right to live there in future. However, it was not clear whether they would automatically retain that right if they were to change jobs or lose their job in future.

- **Banks / investment banks / asset managers:** investment banks benefit more than most from the free movement of labour. An estimated 28% of staff working at investment banks in the UK are non-UK EU nationals, representing tens of thousands of staff. Many EU-based firms have significant investment banking or asset management operations in the UK and are able to move staff freely from their home country to the UK.

- **Hedge funds and private equity:** hedge funds in the UK employ a high number of French and Italians, and an unusually high proportion of staff in the private equity industry across Europe are German. Both sectors could face uncertainty around their staffing in the event of Brexit.

5) OTHER BENEFITS

Respondents cited a wide range of other benefits of the single market, including:

- **A global perspective:** in addition to the specific benefits to running their business in the EU, several respondents said that membership of the single market gave their business or sector additional influence on the global stage, particularly given that competition is often global and the direction of regulation is set at a global level. They feared this influence could be diminished in the event of Brexit.

- **The wider economy:** many respondents raised the benefit to the wider economy and companies they invest in of the single market, such as more efficient supply chains and lower barriers to cross-border business. Several private equity firms said the single market in Europe was essential to the operation of their portfolio companies, which can find it easier to invest and grow across borders as a result.

- **Employment law and management:** several smaller firms based in the UK but operating across the EU said the single market enabled them to have a much simpler management structure than if they had to employ staff under different employment regimes. Several larger firms also said that the EU provided a simpler framework for employment law and data protection across different countries.

- **Access to EU funding:** smaller private equity and VC firms have direct access to EU-backed funding from the European Investment Fund, part of the European Investment Bank. The EU plans to increase the availability of this funding to help kickstart European venture capital investment. This can be a significant source of funds for smaller firms which could be cut off in the event of Brexit.

THE POTENTIAL BENEFITS OF CAPITAL MARKETS UNION

Capital markets union (or CMU), is the initiative launched by the European Commission in 2014 to reduce barriers to cross-border investment in the EU, increase the range of available funding for companies, and recalibrate the post-crisis regulatory framework. Respondents to our survey said capital markets union could have a significant positive impact on European markets in three main ways.

- **A philosophical shift:** instead of viewing CMU as an operational programme of reform, respondents said the main benefit is that it is a welcome shift in mindset among European policymakers. The project recognises that the bank-centric model in the EU cannot provide the level and diversity of funding that the European economy needs and - that capital markets can be part of the solution instead of part of the problem.

- **Pulling down barriers:** by setting out to remove obstacles to the efficient functioning of markets, particularly across national borders, CMU should increase competition and reduce frictional costs for market participants, which should increase choice for customers and issuers, and reduce costs.

- **A pause for thought:** a big part of CMU is the move by the European Commission to review the cumulative impact of the flurry of post-crisis financial reform and adjust reforms if there is clear evidence of unintended consequences for the real economy.

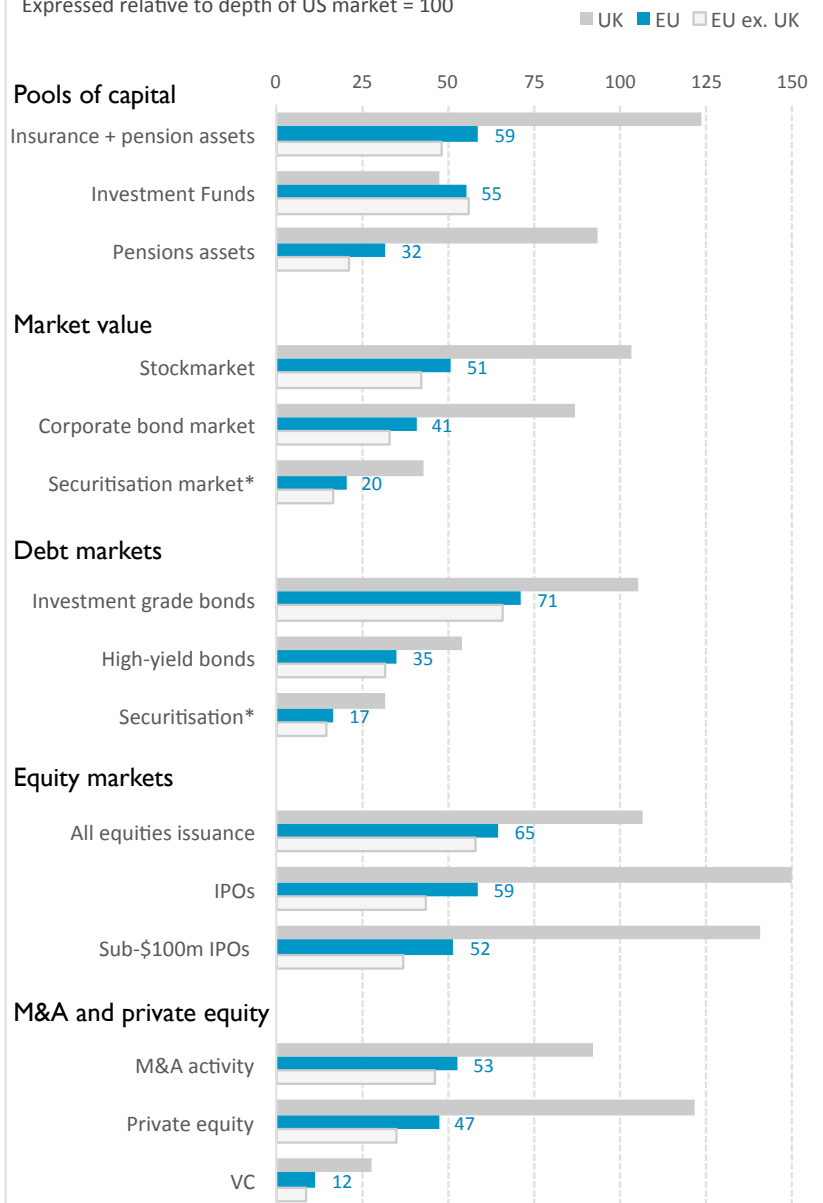
Our research shows CMU could help unlock hundreds of billions of euros in additional funding for European companies, significantly reduce dependence on bank lending and increase the range of investment opportunities and reduce costs for clients. (Figure 7 highlights this potential by showing how developed UK and EU capital markets are relative to the US across a range of sectors).

Specific potential benefits of CMU that were mentioned included measures to encourage cross-border VC, the rehabilitation of the securitisation market, and the attempt to tackle the patchwork of insolvency laws.

Respondents sounded two main warnings: first, that CMU must not become an inward looking initiative and should embrace investment from outside the EU. And second, that some countries in the EU see the logical conclusion of more harmonised capital markets as a single market regulator.

7) The depth of UK and EU capital markets vs the US

Average depth of capital markets relative to GDP 2010-2014
Expressed relative to depth of US market = 100



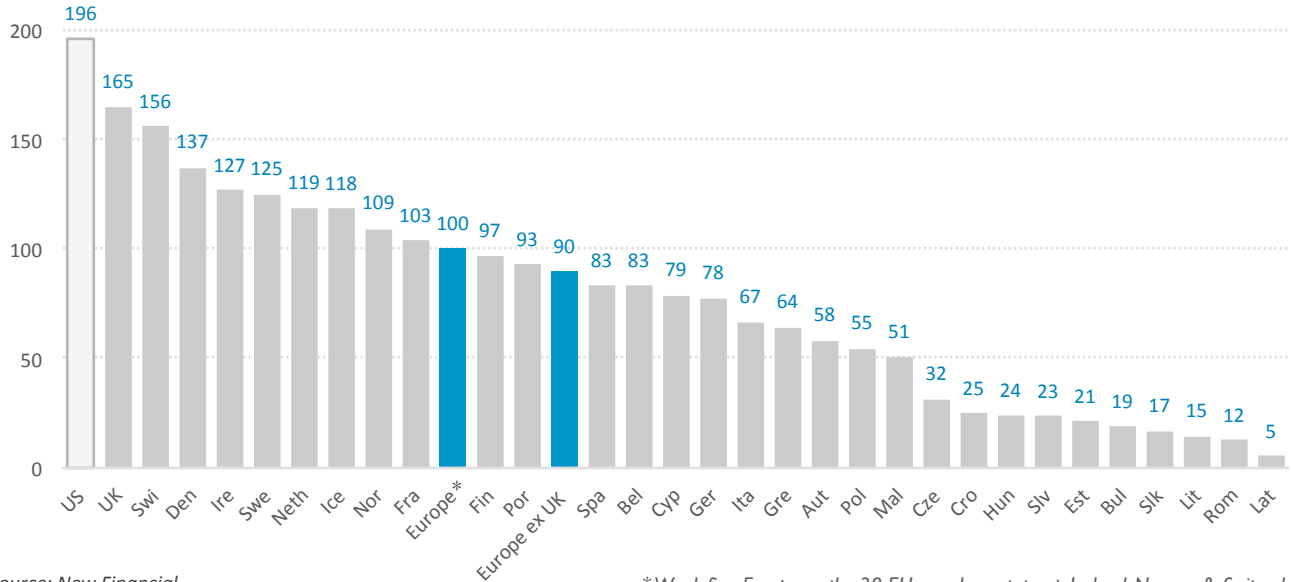
* Using Europe average (includes Iceland, Norway & Switzerland)

Source: New Financial analysis of publicly available data from the ECB & IMF, and of information provided by a range of consulting firms, data providers, and trade associations

WHAT HAPPENS TO CMU IN THE EVENT OF BREXIT?

8) Capital markets disunion?

Relative depth of capital markets in different countries across 23 metrics over the past five years
Rebased to Europe = 100



Source: New Financial

*We define Europe as the 28 EU members states + Iceland, Norway & Switzerland

At a crossroads

In the event of Brexit, respondents were equally split between three main scenarios for capital markets union.

- Accelerate:** the remaining members of the EU would accelerate the CMU project with a particular focus on faster and deeper integration of trading, exchanges and clearing, with more emphasis on supervisory and regulatory integration. There may be less focus on market-based finance and perhaps a more inward-looking and less liberal CMU that excluded the UK. This could increase barriers between UK and EU 27 capital markets.
- Change course:** with the departure of the biggest capital market in the EU and the loss of the main intellectual driver behind the project, CMU could change course and gradually run out of steam. While the European Commission is invested in the project and the need for CMU would still exist, it would cease to be a political priority.
- An abrupt halt:** many countries in the EU consider CMU as an olive branch to the UK, and never really bought into a project that they saw as more of a slogan. With the departure of the UK, the project could grind to an abrupt halt.
- In all three scenarios, the UK could stand to lose influence over the future direction of the capital markets on its doorstep, and it is unlikely CMU would deliver the maximum potential benefits of choice, competition and cost for customers and companies across the EU. Our research shows there is a wide range in the depth and development of capital markets in different countries within the EU (see Figure 8). While some member states believe the UK would be the biggest beneficiary of CMU, we believe that the countries with the least developed capital markets potentially have most to gain from it.
- If the UK voted to leave the EU, several respondents said it could raise difficult questions over Lord Hill's position as Commissioner for EU financial stability, financial services and CMU. The European Commission may have to reshuffle its portfolios, and Hill – who has built up a lot of trust across Europe in his role – could be deployed as part of the UK's post-Brexit negotiations.

>>> “EU financial regulation can help protect the UK from the regulatory zeal of the FCA”

Asset manager

Getting regulation right

It is not difficult to find critics of EU financial regulation. But most respondents said regulation was a necessary if unwelcome cost of doing business – and that it is hard to see a radical shift in the overall burden of financial regulation in the UK in the event of Brexit.

The main criticisms of EU financial regulation from respondents divided into thematic issues and specific regulations:

Thematic issues:

- the sheer **volume of regulation** and the distraction of resources that it has required, combined with the often **slow process** in finalising the rules
- the **uncertainty** around the future regulatory environment and frequent the **inconsistency** between different regulations that can occur (for example, capital markets union is an attempt to promote investment in Europe, while elements of Solvency II seem to do the opposite)
- the difference between a **prescriptive rules-based approach** in the EU with a more principles-based approach in the UK
- the **proportionality and calibration** of regulation, and the frequent unwillingness to differentiate between different sectors or between large and small firms
- the **political nature of regulation** (for example AIFMD and the putative financial transactions tax)
- the **inward-looking** nature of regulation, with not enough regard paid to international **competitiveness**

Specific issues:

Concerns over specific regulations depended on the respondent's sector:

- **hedge funds and private equity firms** flagged up the disconnect between the costs and benefits of some elements of AIFMD and short-selling regulations
- **asset managers** worried about reforms to research and commissions, and certain reporting rules under Solvency II, and Mifid II transparency
- **banks** would like to see capital requirements tweaked and structural reform
- **trading platforms and exchanges** wanted to see some technical elements of Mifid II rewritten
- **nobody** liked the rules on remuneration (such as the bonus cap and the regulation of deferred bonuses) of the FTT (which looks like it has quietly gone away)

A light touch future?

We found little support for the view that in the event of Brexit UK markets would be able to break free from EU regulation and write their own rules. While a few respondents said the UK may take a softer line on the bonus cap (for example, it has declined to apply it to smaller firms) and may consider some tweaks to AIFMD and Mifid II for smaller firms, no-one expected there to be a bonfire of EU regulations in the event of Brexit.

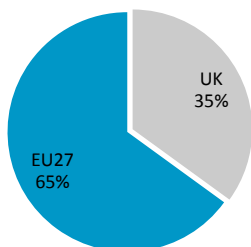
First, much of what is criticised as EU regulation is often the EU's implementation of global regulation. Second, it is hard to see a government of whatever political colour repealing the bonus cap. Third, in order to retain access to the EU's single market the UK may have to maintain broadly equivalent regulation as the EU to qualify under 'third country rules'.

And fourth, many people said the UK is often tougher than the EU, particularly around supervision. One person said the EU 'protects us from the regulatory zeal of the FCA'.

WHAT COULD BE THE BENEFITS OF BREXIT?

9) Overweight UK

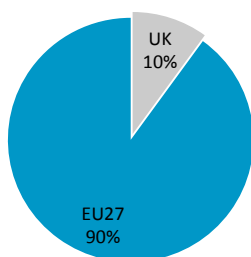
Share of wholesale finance industry in the EU %



Source: TheCityUK

10) Underweight UK

Distribution of MEPs %



Source: European Parliament

The potential benefits of Leaving the EU

The majority of respondents to our survey made the case for the UK to remain in the EU and said they had identified no benefits to their business or for their clients if the UK were to leave (or that any marginal benefits would be more than offset by negative consequences).

A handful of respondents said Brexit could have a positive effect on UK capital markets on the grounds of democracy, over-regulation, the UK's global outlook, and its strong negotiating position. Here is a summary of their case:

- **Democracy:** since the UK last held a referendum on membership of the European Economic Community in 1975, the EU has become a more political project that challenges the rights of individual member states to control their own affairs. The UK's influence in the regulation of European capital markets has declined over time – the UK share of MEPs has fallen from 19% in 1986 to 10% now – and smaller countries with less experience of capital markets have a disproportionate voice on EU-wide regulatory bodies on how UK capital markets are run.
- **Over-regulation:** since the official launch of the single market in 1992 the UK financial services industry has been subjected to a barrage of often unnecessary, politicised and prescriptive regulation. Brexit would allow the UK to develop a more competitive regulatory framework that was more in line with global rules and more appropriate to the UK's traditional strength in finance, while retaining enough equivalence to retain a high level of access to the single market as a third country.
- **Adaptability:** concerns over uncertainty and volatility post-Brexit and of the potential impact on the City of London are over-blown. Over hundreds of years the City has demonstrated its ability to adapt to change and to often adverse conditions. People in the capital markets want to trade with each other. On the other side of Brexit, there would be a brief pause and some uncertainty, before everyone got back to business.
- **Global outlook:** the UK has a global outlook when it comes to capital markets. Financial markets are largely geographically insensitive and the UK has developed a strong track record as a hub for money, trading and investment from all over the world. Brexit would enable the UK to expand its global business and cement its role as a global financial centre.
- **A strong hand:** The UK would have very strong hand to play in post-Brexit negotiations because of its inherent advantage of expertise, language, legal system and time-zone, its dominance of EU financial markets, and the need for many big issuers and investors in the rest of the EU to retain access to them.

Minority report: it should be stressed that this was very much a minority view in our sample. The vast majority of respondents from different countries and different sectors of the capital markets were clear that Brexit could - at the very least - cause a significant amount of disruption and uncertainty to market participants and their customers across the EU, and in the longer term could increase costs and complexity and could undermine the UK's leading role in EU capital markets.

>>> *“Lots of firms would want to be first in the queue at the Bundesbank, or the Central Bank of Ireland to ask for their advice and consider their options - and every sector in the UK would want priority treatment from the government”*
Investment bank

The practical details

There were five main areas of concern that respondents expressed about the potential immediate practical implications of a vote for Brexit, and they mainly involved significant increases in costs for market participants and their clients.

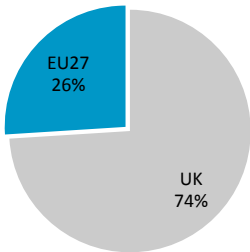
- **Market impact:** while the details of the market impact of Brexit are beyond the brief of this report, a vote to leave the EU could be a 'market event' that could trigger uncertainty, market volatility and lower liquidity, with a big impact on levels of cross-border investment activity. The nuclear scenario was that a vote for Brexit could trigger more pressure on the future of the eurozone and of the EU itself.
- **Timing:** on June 24th the only thing market participants would know for sure is that one option had been taken off the table. There would not be a stampede of firms or individuals relocating from the UK to the EU27, but lots of firms would want to be first in the queue at the Bundesbank, or the Central Bank of Ireland to ask for their advice and consider their options. Different sectors of the UK economy - IT, pharmaceuticals, or telecoms - would all want priority treatment from the Treasury, which officially at least has made no contingency plans for Brexit. Firms could be unwilling to invest in their business in the UK during this period until they had more clarity on the nature of the UK's future relationship with the EU. Many firms would probably start to react once the two year clock started ticking under Article 50.
- **Relocation:** the base case in the event of Brexit is that UK-based firms would need to have a physical presence inside the EU in order to continue to enjoy passporting rights. Many respondents said they had started exploring relocating some staff and assets from London to the EU27. Some said they may consider whether it made sense to retain their European HQ in London. Initially, the numbers involved would be small, but several respondents said they feared a chain reaction as banks followed their clients and vice versa. EU regulators could put more pressure over time on UK-based firms to increase the substance of their local operations inside the EU.
- **Legal nightmare:** all of the respondents agreed that lawyers would have a field day. The UK government, regulators and market participants would have to unpick every element of UK and EU regulation; firms would have to review their existing contracts and business arrangements with clients, and review the legal and regulatory status of their staff, operations, and IT systems across the EU.
- **Staffing:** many respondents expressed concern over the potential impact of Brexit on their staff. Around a quarter of staff at investment banks in the UK (and a higher proportion for hedge funds and private equity) are non-UK EU nationals. While there is no talk of mass deportation, EU 27 nationals could lose the automatic right to live in the UK (and vice-versa) in future.

We estimate that the potential short-term costs could run to billions of dollars: if you assume that two thirds of investment banks and asset managers in Europe would be affected by Brexit and assume they could face a conservative 5% increase in their costs, it would add up to nearly \$4bn in addition to potential lost activity and investment. These costs would probably be passed on to customers.

WHAT COULD BE THE REGULATORY RESPONSE TO BREXIT?

11 Offshore euros

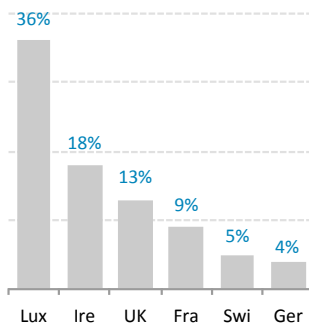
Share of OTC derivatives trading in the EU %



Source: BIS

12) Welcome to Ireland?

Domicile of UCITS funds by country - end 2015 as a % of total



Source: EFAMA

Making life difficult

Many respondents expressed concern that in the event of Brexit the EU could pull up the drawbridge to EU27 capital markets. This could involve the potential relocation of euro-denominated business, a decline in UK influence over EU regulation, EU countries actively encouraging firms in the UK to relocate, and could mean that over time it could become more difficult for UK-based firms to access the capital markets in the EU – with significant cost implications for market participants and their customers.

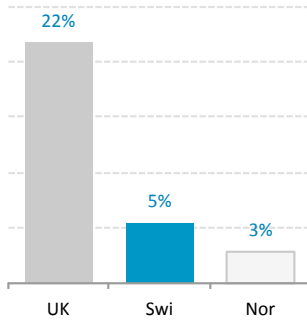
- **Defending the euro:** many respondents said the European Central Bank would reopen its legal proceedings with the UK to require clearing (and possibly even trading) of euro-denominated assets to take place inside the eurozone. This could force LCH Clearnet, with 36% of derivatives business denominated in euros, to relocate or lose business, and for many staff at other firms to move as well.
- **A loss of influence:** the UK has been one of the most liberal and outward looking advocates in EU financial regulation, and has played a significant role in shaping at the European Commission and EU supervisory agencies such as the European Securities and Markets Authority. Without a seat at the table, the UK could have less influence over future regulatory reform. As one respondent said: 'God knows what Mifid III and CRD V would look like without the UK'.
- **Regulatory divergence:** respondents said that while the UK could have to retain some form of equivalence in its regulatory regime in order to have continued access to the single market as a third country, but warned that decisions about equivalence can be very political. Over time, many respondents expected to see a gradual divergence in the regulatory framework between the UK and EU, and several of them said it was already difficult enough to juggle different regimes in the US, EU and Asia without adding a separate regime for the UK.
- **Making life difficult:** respondents said EU regulators and individual countries could make it difficult for the UK to renegotiate the access to the rest of the EU that it had previously enjoyed. Countries could put small but significant bureaucratic obstacles in the way of allowing equal access to UK-based firms and in processing applications. They could also put pressure on UK-based firms to increase the substance of their local presence (many UK-based firms have little more than a letterbox presence or a handful of staff in their continental European offices). As an example, one respondent said that on day one a UK-based firm may only need to have five staff inside the EU, but that in five years' time that could increase to have 50 or 100.
- **Self-interest:** at the same time, many respondents said other countries would focus on their national interests. Ireland and Luxembourg, which have a combined share of 54% of UCITS funds, could encourage more asset managers from the UK to move the domicile of their funds to inside the EU. France, Germany and Ireland could actively encourage UK-based banks, investment banks, and asset managers to relocate some of all of their business, and may even require some of their own firms to move large numbers of staff out of the UK.

However, several respondents said concern about a regulatory backlash were overplayed for two reasons. First, that issuers and investors inside the EU 27 could put significant pressure on the authorities not to disrupt their existing business arrangements with UK-based firms. Second, that any attempt to lock-out the UK would also have a big impact on US access to EU markets.

WHAT WOULD BE THE BEST POST-BREXIT MODEL?

13) A different scale (i)

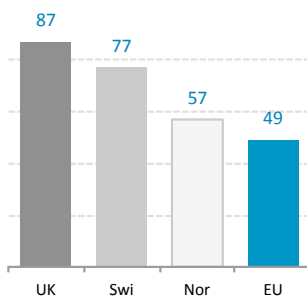
Share of European capital markets activity (M&A, ECM, DCM) 2010-2014 %



Source: New Financial

14) A different scale (ii)

Depth of capital markets relative to GDP 2010-2014 (rebased to US = 100)



Source: New Financial

An uncertain future

In the event of Brexit, one of the most pressing issues for the UK government would be what sort of relationship with the EU it would seek to negotiate. The outcome of those negotiations would have a big impact on capital markets across Europe.

While the discussion is hypothetical, the overall view from our respondents was that they would like to see the UK negotiate a relationship with the EU similar to that of Norway today. However, there was a broad consensus that a more realistic outcome could be a negotiated arrangement closer to the Swiss relationship with the EU or the WTO framework for international trade.

Several respondents said the sheer size of UK capital markets - figures 13 and 14 show that the UK accounts for three times as much activity in European markets as Norway and Switzerland combined, and its markets are much deeper relative to GDP than either country - meant that neither the Norwegian nor the Swiss option might be suitable.

- **The Norwegian option:** the main reasons given to support the Norwegian option were that it would represent the closest level of integration and access to the single market that the UK enjoys today – what several respondents called the ‘next best option’ – and may involve the least uncertainty, lowest transitional costs, and be the quickest option to negotiate. Some respondents even talked optimistically of ‘Norway Plus’.

However, it may be unrealistic to assume that if the UK voted to leave the EU, the government would invest a lot of political capital in seeking to negotiate a deal that from a political perspective could look a lot like what had just been rejected by British voters. In exchange for access to the single market in financial services and other sectors, Norway allows free movement of labour from the EU, contributes to the EU budget, and has to implement much of EU financial regulation without having much input into it.

- **The Swiss option:** The other main option put forward was closer to the Swiss model, whereby access to the single market is negotiated separately for individual sectors on a bilateral basis. While some respondents were attracted by the extra control that the ‘Brizterland model’ might give to the UK, they said it may take the longest time to negotiate and could be more disruptive in the short-term.

- **Other options:** several respondents warned that the two year process of negotiation that would be triggered by invoking Article 50 was more about the EU closing down its existing relationship with the UK in an orderly way. Negotiating the detailed terms of its future relationship could take much longer. Respondents said a Canadian-style free trade agreement could work for the UK’s trade in goods with the EU, but was widely seen as inadequate to accommodate trade in financial services, as was the WTO framework.

- **Caveat relinquor:** Under whichever option the UK chose to pursue, it may have to broadly follow the EU regulatory framework in order to retain access to the single market – unless (as suggested by one respondent) it decided to reinvent itself as a ‘turbo-charged offshore financial centre’. None of the respondents thought that was a likely option.