NEW FINANCIAL
Rethinking capital markets

BEYOND BREXIT: WHAT NEXT FOR EUROPEAN CAPITAL MARKETS?

This is a summary of some of the main challenges ahead for the European capital markets in the wake of Brexit. It is based on peer intelligence from events that we have hosted over the past few months and discussions with European Commission officials, senior market participants and policymakers. The main trade-offs are between access to the single market, free movement of people, and the regulatory framework.

A brief 10 point summary:

1) Pulling the trigger: The decision by David Cameron not to pull the trigger on Article 50 means that capital markets will be in limbo for at least the next few months (and probably beyond) until a new government or Parliament start the clock on the formal two year process of leaving the EU.

2) First mover advantage: In the meantime, many banks and asset management firms cannot afford to wait. They have to assume the worst case scenario of complete separation with no access to the single market and start the process of relocating legal entities, operations and staff immediately.

3) Relocation, relocation, relocation: In order to future proof their business, banks, asset managers and other market participants will need to have a separately authorised subsidiary with a sufficient management presence inside the EU. Dublin, Frankfurt, Paris and other cities will all be vying for that business.

4) An acrimonious divorce (and a protracted custody battle): Most firms seem to be planning for an acrimonious divorce. While the divorce process itself may be reasonably swift, the separate negotiations to establish the terms of the future relationship between the UK and the EU will be slowed down by the competing domestic political imperatives in all 28 member states and could take many years.

5) A model for the future: While the Norwegian / EEA model is widely seen as the least damaging option, it is hard to see how UK voters will accept something that looks similar to what they have just rejected. EEA-minus (some access to the single market with some freedom of movement) could be the next best option.

6) A regulatory backlash?: Brexit could trigger a concerted regulatory backlash in the rest of the EU against elements of the single market and capital markets union that are seen to play to the UK's advantage, such as the location of euro-denominated clearing or open access market infrastructure.

7) A loss of influence: Whatever the outcome, the UK will most likely lose influence over the future direction and nature of EU regulation that it may have to implement in whole or in part. The departure of Lord Hill will significantly change the tone of the future regulatory dialogue at an EU level.

8) Equivalence vs divergence: In order to retain access to the single market from outside the single market, the UK would have to retain an 'equivalent' regulatory framework. While it would be equivalent on day one, over time changes to EU legislation may lead to costly regulatory divergence or 'regulation by fax'.

9) The future of EU citizens in the UK: In some sectors of the capital markets EU27 citizens account for as much as a quarter of all staff in the UK. Assurances over their future legal status have so far been too vague to instil confidence.

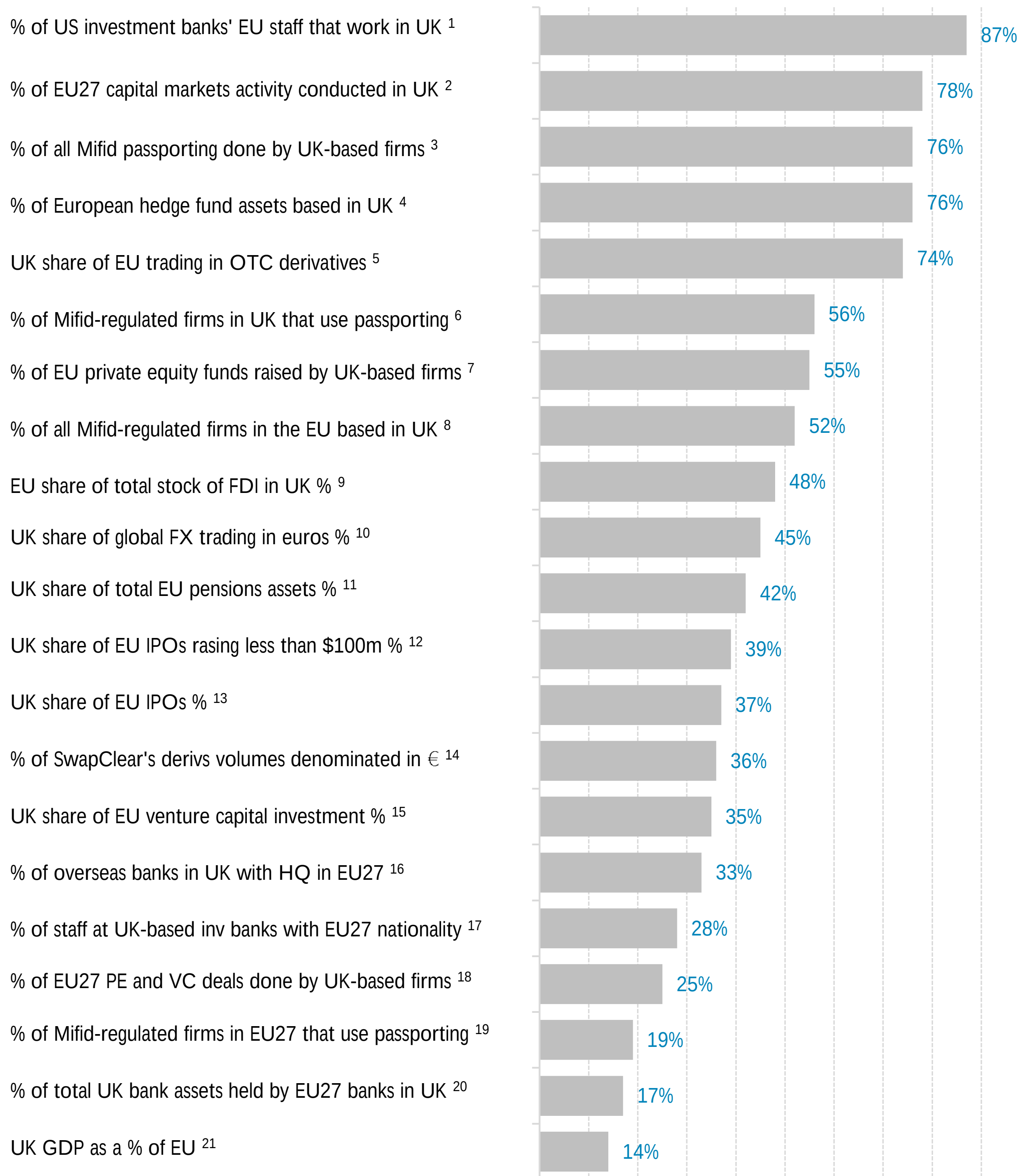
10) The impact on the EU: Brexit poses a huge political challenge for the remaining 27 member states, many of which are also dealing with 'anti-establishment' movements. The question of more or less Europe will define the future of the EU and the eurozone.

How interdependent are EU and UK capital markets?

This chart shows how interconnected UK and EU capital markets are, the extent to which EU capital markets activity is concentrated in the UK – and what's at stake.

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*

A more detailed discussion:

1) Pulling the trigger:

The decision by David Cameron not to pull the trigger on Article 50 the day after the referendum means that capital markets will be in limbo for at least the next few months until a new government or Parliament start the clock on the formal two year process of leaving the EU.

In the UK, there is a debate over whether Parliament or the next Prime Minister has the required authority to initiate Article 50 and when that should happen. The earliest that a new Prime Minister will be in place is September 2, and it would be politically untenable for Parliament to pull the trigger before then. Meanwhile, EU leaders have put pressure on the UK to trigger Article 50 quickly and start formal exit negotiations. While it seems that they cannot force the UK to accelerate the process, they have turned up the heat by saying they will not enter any informal negotiations before Article 50 has been triggered.

One option is that the UK Parliament requires the next Prime Minister to put together the headline terms of a Brexit plan before he or she triggers Article 50. Another option is that Cameron's replacement will call a general election in an attempt to win a clear mandate for an exit plan. In either case, it is unlikely that Article 50 would be triggered before October or November, meaning that the earliest date that the UK would formally leave the EU would be late 2018.

This leaves a vacuum in terms of the nature of the future relationship between the UK and the EU, which is likely to act as a brake on capital markets activity in the UK and Europe and to encourage continued market volatility. The longer the UK waits before triggering Article 50 the more it may test the patience of its EU partners, which could lead to a hardening of positions before negotiations have even started.

2) First mover advantage:

In the meantime, many banks, asset management firms and other market participants cannot afford to wait to find out the final details of any future settlement. They have to assume the worst case Brexit scenario of complete separation with no access to the single market and start the process of relocating legal entities, operations and staff immediately.

In practice, contingency plans have already swung into action. Many firms are concerned that they will not be able to secure the necessary licences and regulatory approvals in time if they wait until the two year clock starts ticking. Even then, the full details of the future relationship between the UK and the EU may not be known for several more years after the formal exit of the UK. Firms are keen to provide continuity and certainty to their EU27 clients and will want to be up and running by the time negotiations are concluded.

There is also huge first mover advantage: everyone wants to be first in the queue talking to EU27 regulators, supervisors and central banks, who may be overwhelmed by the increase in workload and lack the political motivation to act quickly. Although financial services is an important sector for the UK economy, all sectors will want priority treatment from HM Treasury and other government departments, which may struggle with capacity.

While there will not be a stampede of firms or individuals relocating from the UK to the EU27, many firms have said they would prefer to rejig their legal entities and operations sooner rather than later. This process is likely to accelerate once Article 50 has been triggered. Meanwhile, lawyers have been overwhelmed with requests for advice.

During the negotiations market participants will be unwilling to invest in their operations in the UK until they have clarity on the nature of the UK's future relationship with the EU, and we could see a gradual migration of staff and operations out of the UK. This corrosive effect could accelerate if the negotiations drag on.

3) Relocation, relocation, relocation:

In order to retain passporting across the EU and future proof their business, banks, asset managers and other market participants will need to have a separately authorised subsidiary with a sufficient management presence inside the EU.

At the very least, firms would need a legal presence in the EU in order to continue to enjoy passporting rights. Many firms already have existing legal entities or a 'brass plate' presence in the EU (such as asset managers with funds domiciled in Luxembourg or Ireland), but they could face pressure from local regulators to establish a more significant presence and to increase that presence over time. This could involve ensuring that they have more robust local governance structures with senior management on the ground.

There is a big difference in the scale of the potential post-Brexit headache for asset managers and agency businesses on the one hand, and banks or investment banks with big balance sheets on the other. While for some asset management firms this could be little more than an administrative headache, it could impose significant costs on banks and investment banks, which would need separately capitalised subsidiaries with higher staffing levels inside the EU costing billions of dollars. Insurance companies are more insulated because they already operate separately capitalised subsidiaries across the EU.

Initially, the numbers involved would be small, but several firms said they feared a chain reaction as market participants followed regulation and their clients. As banks and asset managers move staff the ecosystem that supports them, such as lawyers, accountants, IT and other services, would have to consider moving staff as well. The big US investment banks and asset managers have roughly 90% of their EU staff in the UK, but generate roughly half of their EU business from the EU27. This balance would inevitably shift. EU27 banks and asset managers could face political pressure to relocate staff and operations in the UK back to their home country. Only a handful of firms have suggested they would consider moving their headquarters out of London at this stage, although this could change as the details of the future relationship between the EU and UK become clearer.

Talk of an exodus from the UK may be overplayed, but banks and asset managers will move as many staff as they feel is necessary to ensure business continuity. This could quickly run into the tens of thousands. The upper estimates suggest as many as 100,000 jobs could be lost in the UK, but we believe somewhere 30,000 and 50,000 is more realistic. This would be a big blow to the UK economy. Our research on pay in the industry suggests that that for every 10,000 staff who leave the UK, the government would lose around £1bn in tax revenues and the economy would lose another £3bn+ in capacity. In addition, any decisions on marginal or discretionary hiring in the UK will be put on hold until a clearer picture emerges.

Here is a summary of what some organisations have already said about relocation:

- JP Morgan may have to move a quarter of its 16,000 British workers to the EU
- HSBC will keep its headquarters in the UK but may move 1,000 of the 5,000 employees in its in investment bank to Paris
- Citigroup may have to rebalance its operations across the EU to retain passporting rights
- Morgan Stanley is understood to be considering moving about 1,000 employees from the UK
- Goldman Sachs expects to move some of its offices and staff to continental Europe
- The European Banking Authority will move its headquarters out of London where it employs roughly 150 staff

Meanwhile, firms will have to choose the country to which they would relocate parts of their business based on the regulatory, business and tax environment. Ireland, Germany and the Netherlands are among the most popular contenders. While moving to France is seen as good lifestyle choice, banks and asset managers are less keen on its labour laws and tax environment. Luxembourg will be popular with asset management firms, and countries such as Poland are pushing hard to win more back office business.

If Scotland breaks away from the UK and rejoins the EU it could be an EU beachhead for the asset management and banking industry, but any such move would not happen for several years if at all.

4) An acrimonious divorce (and a protracted custody battle):

Brexit is the start of a long process, not an event in itself. Most firms seem to be planning for an acrimonious divorce. While the divorce process itself may be reasonably swift, the separate negotiations to establish the terms of the future relationship between the UK and the EU will be slowed down by the competing domestic political imperatives in all 28 member states.

The negotiations over Brexit will fall into two separate parts. First, the two year process under Article 50 to close down the existing relationship between the UK and the EU. And second, in parallel, the more difficult negotiations on a future trade and services deal. It is quite possible that the second part will not be concluded within two years, meaning that the UK could face an interim period in which it has no formal trade relationship with the EU.

In both sets of negotiations, different countries will seek to protect and promote their own interests. For example, Ireland and Luxembourg, which have a combined share of 54% of domiciled UCITS funds, could encourage more asset managers from the UK to move their funds and even their management activities to inside the EU. Meanwhile, France and Germany have already said they are likely to reopen issues that the UK has successfully fought in the past, such as the physical location of euro-denominated clearing inside the eurozone. The four years of line-by-line negotiations between the EU and US to recognise equivalence for central counterparties is a good indication of how long and complex the process could be.

Meanwhile, the process of separating the UK from the EU would be hugely complicated and controversial. All existing UK legislation that derives from the EU would have to be updated, and it is hard to imagine that all references to the EU would simply be replaced with the word 'UK', or that EU legislation in the pipeline would be copied and pasted into UK law. The sheer volume of work would stretch the capacity of the civil service, regulators and policymakers. And the pressure on parliamentary time could mean a significant increase in broad enabling powers for the government to push through changes to accelerate the process.

It is worth noting that the UK hasn't negotiated a trade agreement since 1972 and lacks the relevant individuals and expertise. Negotiating trade deals takes several years, and it is unlikely that the UK would be able to grandfather all of its existing free trade agreements.

5) A model for the future:

The future relationship between the UK and the EU will be critical for the financial services industry. While the UK will be keen to negotiate its own deal, there are effectively four options.

The majority of firms we have spoken to would like the UK to negotiate a relationship with the EU similar to that of Norway today (as a member of the European Economic Area) in order to retain access to the single market. However, many firms believe 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.

- The Norwegian option: the main reasons to support the Norwegian option are that it would represent the closest level of integration and access to the single market that the UK enjoys today and may involve the least uncertainty, lowest transitional costs, and be the quickest option to negotiate.

However, it could be politically unacceptable to adopt something that looks very similar to 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.

An EEA-minus (some level of access to the single market with some freedom of movement of labour) could be the next best option. There has been some suggestion that the UK Parliament (which has a majority of MPs who supported Remain) might push for something closer to the Norway model, and whoever is Prime Minister would accept it as the least damaging option and be able to 'blame' Parliament for imposing it.

- The Swiss option: the other main option on the table could be the Swiss model, whereby access to the single market is negotiated separately for individual sectors on a bilateral basis. While this could provide additional 'control' that the 'Brizterland model' might give to the UK, it may take the longest time to negotiate and could be more disruptive in the short-term. The current deadlock between Switzerland and the EU over limiting free movement shows how problematic this option could be.

- The Canada option: a Canadian-style free trade agreement could work for the UK's trade in goods with the EU, but is widely seen as inadequate to accommodate trade in financial services where non-tariffs barriers are more important than tariff barriers.

- The WTO option: the default option is complete separation and trading with EU under the World Trade Organisation framework. While this could provide a quick solution for trade in goods, it makes very limited provision for services.

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 and passporting. As such, any suggestion that the UK might pursue a Singapore-style offshore financial centre that could throw off the shackles of EU regulation seem far-fetched.

6) A regulatory backlash?

Brexit could trigger a concerted regulatory backlash in the rest of the EU and would provide an opportunity for Eurozone members such as France and Germany to reopen issues that the UK has successfully fought in the past, such as vertical silos in market infrastructure and the physical location of euro-denominated clearing inside the eurozone, while removing the legal mechanisms for the UK to push back against them.

The European Central Bank could reopen its legal proceedings with the UK to require clearing (and possibly even trading) of euro-denominated assets to take place inside the eurozone. One member of the ECB governing council has already said it will do so and President Hollande has said euro-denominated clearing would not be able to take place outside the EU. The UK would lack access to the legal mechanisms within the EU that it successfully used in 2015 to push back against this. This could force LCH Clearnet, with 36% of its derivatives business denominated in euros, to relocate some of its business or risk losing market share, which in turn could force other firms in trading, clearing, and securities services to move some of their staff or operations as well.

Countries across the EU would naturally want to act in their own interests, and would be able to impose bureaucratic obstacles in the way of allowing equal access to UK-based firms and in processing applications even if the UK does retain passporting. Such obstacles are one of the main complaints from the asset management industry over the functioning of the single market today and were a focus of the European Commission's capital markets union project. Outside of the EU, UK-based firms will have less leverage to ensure they receive the same regulatory treatment as local firms.

However, concerns about a regulatory backlash could be overplayed. First, 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 could also have a big impact on US access to EU markets.

7) A loss of influence

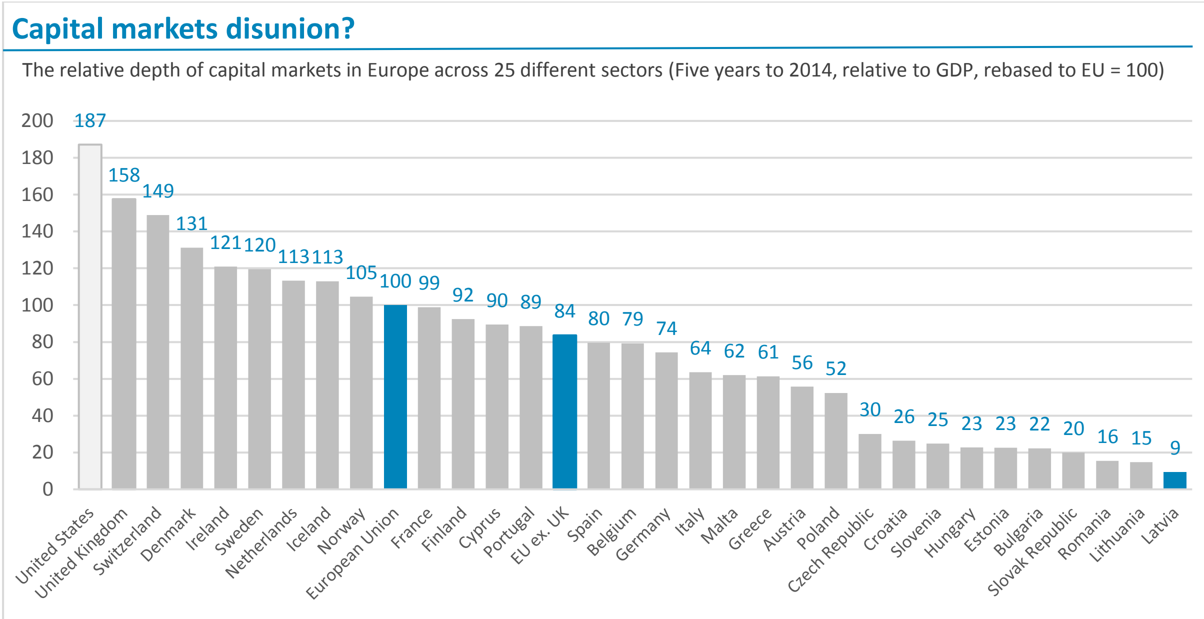
Whatever the outcome of the negotiations, the UK will lose influence over the future direction and nature of EU regulation. At the very least, UK-based firms would have to apply that regulation to their businesses in the rest of the EU. At worst, the UK may also have to adopt future EU regulation in which it has had very little say in order to retain access to EU markets.

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 the regulatory framework at the European Commission and EU supervisory agencies such as ESMA and the EBA. It has also pushed backed successfully against putative policies such as the Financial Transaction Tax. More market-orientated member states such as Ireland, the Netherlands and Scandivanian countries would struggle to make their case without the UK's support. One senior market practitioner said: 'God knows what Mifid 3 and CRD V would look like without the UK at the table'.

Without the UK, the EU could become more eurocentric and regulation would be increasingly dominated by the ECB, France and Germany. Lord Hill, the British commissioner who announced his resignation shortly after the vote, has played a valuable role in resetting the direction of financial regulation and in promoting the capital markets union project. He has since warned that the UK would lose its voice at the table and would be unable to prevent regulation being dominated by French and German interests. There are already suggestions in Brussels that some member states have already pushed back against many elements of EU financial legislation that were seen as too favourable to the UK.

It is worth noting that Hill's successor in the financial services brief, the former Latvian Prime Minister Valdis Dombrovkis, was previously responsible for economic and monetary affairs and the euro, which could suggest a more eurozone-centric approach to regulation. He also comes from a country which has the least developed capital markets in the EU, according to our research: relative to GDP, Latvian capital markets are just 9% as developed as the EU average across 25 different sectors of the capital markets. *(Note: New Financial will soon publish a separate paper on the outlook for capital markets union.)*

This charts shows the range in the average depth of capital markets across Europe relative to GDP across 25 different sectors, rebased to the EU average = 100:



This loss of influence could be particularly important for the future of CMU. The main value of CMU is less as an operational programme of more than 30 different reforms and more in that it marks a philosophical shift in terms of how EU policymakers think about capital markets. They are now seen as part of the solution to the EU's economic challenges rather than one of the main causes of its problems.

Without Hill and the UK, the project will at the very least change direction. The remaining members of the EU could 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 and less focus on market-based finance. Or the project will lose political momentum and hit a brick wall. Both options would represent a huge lost opportunity for Europe and for UK-based financial services firms.

8) Equivalence vs divergence:

If the UK did not negotiate an EEA-style deal, in order to retain access to the single market it would have to retain an 'equivalent' regulatory framework as a 'third country'. While it would be equivalent on day one, over time changes to EU legislation may lead to costly regulatory divergence.

The risk is that in order to retain this access the UK would have to continue to implement new EU legislation in future without having a say in it. It is also unclear how and whether the extended third country regime under Mifid II that is due to come into force in 2018 would apply to different sectors. The example of four years of line-by-line negotiations to grant equivalence for US clearing shows how long and political the process can be.

In our recent report on Brexit, the broadly consistent regulatory framework across the EU was cited by most respondents as one of the most important benefits of EU membership in reducing the complexity and cost of doing business, even if they also expressed frustration with specific regulations and the EU regulatory process. After Brexit many market participants fear that there could be less effort across the EU to ensure that there was a level playing field in regulation in individual countries.

There is little appetite for the UK to adopt a different regulatory framework to the rest of the EU, so even unwelcome regulation such as the bonus cap may have to stay in place. UK regulators have made it clear that they do not envisage a bonfire of regulation after Brexit (and besides, many EU regulations start life as ideas in the UK, and the UK often imposes tougher regulations that are required by EU directives).

That said, the UK may pursue some form of trade-off between financial stability, access to EU markets and international competitiveness. This could lead to a gradual and unwelcome divergence in the regulatory framework between the UK and EU, adding to regulatory cost and complexity.

9) The future of EU citizens:

In some sectors of the capital markets, EU27 citizens account for as much as a quarter of all staff in the UK. Assurances over their future legal status have so far been too vague to instil confidence.

One of the big uncertainties around Brexit is what would happen to EU citizens working in the UK financial industry. Overall, 11% of the 330,000 people working in the City of London are non-UK EU nationals, and in some sectors such as investment banking, more than a quarter of staff are EU nationals. Hedge funds in the UK employ a high number of French and Italian citizens, and an unusually high proportion of staff in the private equity industry across Europe are German or Austrian. Many EU-based firms have significant investment banking or asset management operations in the UK and are able to move staff freely backwards and forwards from their home country to the UK.

The concerns over nationality focus on current staff and future hiring. For current staff, the key question is their future immigration status once the UK has left the EU. There is no talk of mass deportations and both sides of the debate have said that EU nationals already working in the UK would retain their rights and freedom to live here in future.

However, the details are unclear, and David Cameron said this week that their future status would be 'subject to negotiation'. For example, would they automatically retain the right to stay in the UK if they were to change jobs or lose their job in future? Would they be able to bring family members to the UK? If, say, a French banker at a French bank based in London were posted to Paris for three years, would they have to reapply for a visa in order to return to work in the UK? The best advice is for individuals is to check their current EU status (if they have been here for more than five years they can apply for EU Permanent Residence, otherwise they should apply for a Registration Certificate – click here for more information).

The question for future recruitment is whether EU nationals would have to apply for work visas, or whether some form of free movement of people or of labour would continue to apply. There is concern that the introduction of visas could make life more complicated for firms and individuals. Many firms said that access to an EU-wide pool of talent without the need for visas or work permits improved their performance and minimised their costs. What we do know for sure is there will be plenty more paperwork involved.

10) The impact on the rest of the EU:

Brexit poses a huge political challenge for the remaining 27 member states, many of which are also dealing with 'anti-establishment' movements. The question of more or less Europe will define the future of the EU and the eurozone.

The potential impact on Europe falls into three main categories. First, at a political level, whether the EU would react to Brexit with a push towards closer integration or whether Brexit would be a big enough shock to spur a different approach. (In a recent interview in Der Spiegel German finance minister Wolfgang Schäuble hinted strongly that 'more Europe' would not be the best response). The reaction of different member states will be defined by the degree of anti-EU sentiment ahead of their own upcoming elections. This sentiment could be encouraged if the UK is seen to benefit from Brexit, so there is a significant incentive for the EU to make life difficult for the UK.

Second, there is a risk that Brexit could lead to a breakdown in the normal functioning of the EU and potentially the eurozone. If financial markets start to ask existential questions of the euro then we could see a repeat of the eurozone crisis of 2011 onwards, with a return of volatility and concerns over financial stability. The performance of eurozone financial stocks since the referendum does not bode well.

And third, how will the EU address the issue of long-term growth once its most liberal and market-led member has left? The long-term growth prospects of many member states are not rosy as long as they remain so heavily dependent on bank lending. There is a wide range in awareness and acceptance of the issue of long-term growth in different member states. With banking union, there was a real sense of impending crisis which drove the political will necessary for change. With CMU, there is not quite enough sense of crisis across Europe to inject the same sense of urgency. If the CMU project stalls or is shelved altogether, it could have a serious impact on growth across the EU.