NEW FINANCIAL
Rethinking capital markets

BEYOND BREXIT: THE FUTURE OF UK BANKING & FINANCE

RECALIBRATING THE UK FRAMEWORK IN A POST-BREXIT & POST-COVID WORLD

October 2020

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Supported by:

BARCLAYS

> *This report analyses the shifting trends in European and global markets and identifies the big strategic choices the UK will need to make in the coming years on the future of banking and finance, capital markets, and the City of London*

INTRODUCTION

What this report is about

This paper analyses the big strategic decisions that the UK will need to make in the coming years on the future of banking and finance, capital markets, and the wider economy. Brexit provides the UK with an opportunity and an imperative to review and recalibrate its approach to banking and finance at a domestic level and on the global stage. More recently, the Covid crisis has underlined the value that banks and capital markets provide to the wider economy and the vital role they will play in helping drive a recovery.

We think it is important to frame these choices in the context of the shifting trends in global banking and finance. Our starting point is that Brexit means Brexit - whether you like it or not - and that whatever the outcome of the negotiations in the coming months, Brexit will inevitably raise significant barriers in financial services between the UK and EU. This will require a degree of relocation of activity from the UK to the EU and will lead to gradual supervisory and regulatory divergence over time, at a time when the EU and US frameworks are evolving in different directions. This gives the UK the opportunity to recalibrate its own framework and tailor it to the unique nature of the banking and finance industry in the UK. In many areas this framework will look and feel remarkably like the EU's, but in some crucial aspects it will be different.

While the EU is the single most important overseas market for UK financial services and is readily accessible on its doorstep, the global context for the banking and finance industry has been transformed over the past few decades. Markets in Asia have significantly increased their share of global activity in the decade since the global financial crisis, are growing much faster than the EU, and will account for the vast majority of future growth in banking and capital markets activity over the coming decades.

In contrast, in a global context EU markets are small and shrinking in relative terms. Capital markets and the wider banking industry in the EU are fragmented and operate in an overly complex regulatory patchwork, acting as a drag on economic growth and innovation. Given the challenging geopolitical environment, the UK will need to work hard to develop closer partnerships in financial services with like-minded economies around the world.

While Brexit presents many challenges, it also provides an opportunity and a wake-up call for policymakers in the UK - and the EU - to set a clear strategic direction for the financial industry and capital markets in the face of structural global changes. We have included 25 suggested policy recommendations and areas of focus for discussion at the end of this report but we think the key questions for the UK boil down to:

- Given the reality of Brexit and the outlook for EU capital markets and the European banking and finance industry, how closely aligned does the UK want to stay to the EU and in which areas? Or should it accept a degree of dislocation, adjust its own framework and look to bigger and faster growing markets further afield?
- If the UK chooses to diverge, what would it do with that divergence and what would the trade-offs be? What could it do to ensure that its markets and market participants remain competitive in a global context? And what measures should the UK take to ensure the banking and finance sector can best support a post-Covid economic recovery?
- What are the other markets around the world where the UK could develop closer partnerships? What might closer cooperation with those markets in different sectors of activity look like in practical terms? And what role does the UK want to play in the global financial system in future?

Acknowledgements
Thank you to Panagiotis Asimakopoulos and Manuel Haymoz at New Financial for conducting much of the heavy-lifting in this report; to the many individuals who have fed in to this paper through our events programme; to Barclays for supporting this important project, and to our members for their support for our work in making the case for bigger and better capital markets in Europe.

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EXECUTIVE SUMMARY

Here is a short summary of this report:

1. **An opportunity and imperative:** Brexit will be a seismic change for the UK economy, the UK's place on the global stage, and the UK banking and finance industry. At the same time, Brexit - combined with the recent Covid crisis - provides an opportunity and an imperative for the UK to review, rethink, and in some areas recalibrate its approach to banking and finance at both a domestic and international level.

2. **Brexit means Brexit:** whatever the outcome of the negotiations, Brexit will involve significant disruption for the banking and finance industry. In some key areas mutual access may continue, but in many sectors some business will have to relocate to ensure continued access to the EU. Instead of focusing on how to retain as much access to the EU market as possible we think the UK should consider at least some of this relocation as a sunk cost.

3. **Alignment vs divergence:** in some key areas such as clearing the UK will most likely stay aligned with the EU in order to retain some access and reduce market friction. But over time gradual divergence between the UK and the EU is inevitable, particularly in prudential supervision. While the EU is (not unreasonably) defining what business must be done in the EU, the UK will aim to be a financial centre where people want to do business.

4. **Part of the solution:** the Covid crisis has underlined the vital role that banking and capital markets play in supporting the wider economy and how they can be part of the solution. Bank lending and capital markets funding injected more than £120bn into the economy in the first few months of the crisis and the industry will play an important role alongside government in helping fuel an economic recovery. This has highlighted the value of UK banks and the need to ensure that the supervisory framework in the UK supports this important function.

5. **The wider context**: Brexit means that the EU is losing its biggest and most developed capital market. The UK accounts for just under one third of all capital markets activity in the EU. On the global stage, EU capital markets will shrink from just over a fifth (22%) of global activity, making it comfortably the largest bloc in the world after the US, to around 13% of global activity (the same as China). This separation, combined with a revised UK perspective, poses a profound challenge to the EU and highlights the urgency of the capital markets union project.

6. **A strong platform:** financial services is one of the most important sectors of the UK economy; the UK is the dominant financial market in Europe and the second largest international financial market in the world after the US. In some key areas - such as derivatives and FX trading, fintech and sustainable finance - the UK is a world leader and it will need to build on this position to help set global standards and drive international business.

7. **A structural shift:** over the past 15 years in banking and finance the pendulum has swung decisively towards Asia, which has significantly increased its share of global activity in every sector we analysed and overtaken the EU. The EU's share has shrunk by a third over the same period and its market share has dropped in all but two sectors. On our conservative estimates we think Asia will account for more than half of all growth in global capital markets in the coming decade while the EU will represent just 10% of global growth.

8. **Future partnerships:** just under 40% of the UK's trade in financial services today is with the EU27 and inevitably some of that trade will be lost as a result of Brexit. While the geopolitical backdrop is acutely challenging we think there is an opportunity to develop trade in financial services and closer partnerships with markets like the US (currently 27%), Japan (6%), Switzerland (4%) and other smaller markets such as Singapore and Australia.

9. **The future framework for UK financial services:** the UK has played an important role in shaping the EU framework under which it currently operates and it should not diverge for the sake of it. But in time it will need to ensure that the UK financial sector remains competitive on the global stage, and review key areas such as the prudential supervision framework, bank capital and structure, tweaks to Mifid II and Solvency II, the taxation of banking and finance, and regulatory process, to create a framework more tailored to the UK market.

10. **Renewing the UK economy:** the Covid crisis has injected more urgency into the government's plans to reform the UK economy and we think the capital markets can play a big role in areas such as infrastructure investment, supporting innovation and long-term investment to boost productivity, and financing the transition to a more sustainable economy.

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FOREWORD BY JES STALEY, CHIEF EXECUTIVE OF BARCLAYS

The future of UK banking and finance

The Covid-19 pandemic has shone a bright light on the importance of strong, stable banks able to support economies and to act as shock-absorbers for people impacted by the economic impact of the pandemic.

Whereas banks were a catalyst for the 2008 global financial crisis, this time, they are part of the solution. Smart political and regulatory action since 2008 has transformed the sector for the better and meant that banks were well placed to extend forbearance to consumers and businesses and support the delivery of government schemes.

Governments have taken unprecedented action to bolster the capital markets, underlining their economic value and contribution to society. In the UK alone, the capital markets channelled more than £100bn to companies through the corporate bond and equity markets.

We asked William Wright to write this report before the world even knew the term Covid-19 or the havoc it would wreak. The UK and EU were deeply entrenched in untangling decades of shared oversight of the capital markets and it seems inevitable that Covid-19 will have thrown a new light on the legal and regulatory jurisdiction of capital markets, given the critical role they have been shown to play, that will influence the shape of the future relationship between the UK and EU.

As the UK leaves the transition period at the end of this year, it faces into a more unstable and fragmented global world order than we have seen for some decades. While I feel confident that the UK will remain internationally competitive, with strong regulatory standards and a stable legal system, it has choices to make about the UK's framework governing its capital markets that will have ramifications for generations to come and faces new challenges made more acute by Covid-19.

That is why we asked William and his team to explore some of the options that policymakers should consider to ensure that London continues to remain one of the preeminent global, financial centres. We thank New Financial for their work and the series of reports we have worked on together. Collectively, we hope that this has led to an improved understanding of capital markets and the positive role they play in society.

Jes Staley
Group chief executive
Barclays plc

UK and European capital markets in a global context

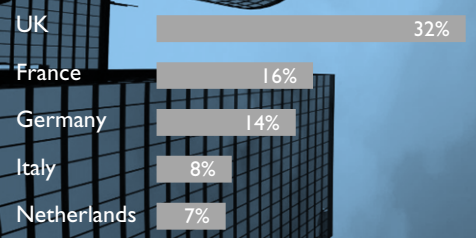
This section provides 10 key takeaways on UK, European and global capital markets:

>>> A DOMINANT FINANCIAL CENTRE

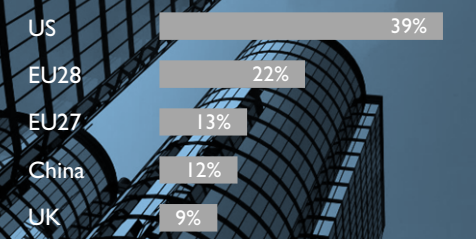
32% UK share of EU financial activity

On average the UK accounts for around a third of the total financial activity in the EU. The UK is the largest market in 80% of the financial sector metrics that we looked at (24 out of 30). In other words, Brexit means that the EU will be losing its largest market in the vast majority of the different sectors of banking and finance. The UK's dominance is most pronounced in sectors where firms can choose the location of a particular activity: for example, more than 80% of OTC derivatives trading and foreign exchange trading in the EU is conducted in the UK, and the UK accounts for over 40% of all assets under management and more than half of all private equity fundraising

Share of EU capital markets activity by country (top 5)



Share of global capital markets activity



>>> Oiling the wheels

8 million The number of people employed in the UK by UK companies that use the capital markets

Capital markets play a vital role supporting the wider UK economy: 95% of large UK companies use the capital markets and overall 15,000 UK companies employing around eight people across the UK use capital markets to raise money and manage their risks, according to our recent research.

>>> A cash injection

£120bn The amount of money injected into the UK economy from bank lending and capital markets in response to Covid

In the first four months of the Covid crisis bank lending and capital markets hit record levels. Banks increased their lending to UK companies by net £45bn, and UK companies raised more than £70bn in the corporate bond and equity markets, underlining the role that banking and finance will need to play to help fuel an economic recovery.

>>> A global financial centre

15% The UK's share of global international financial activity

The UK is the second largest financial centre in the world after the US, according to our analysis of 28 metrics of financial activity. This is particularly pronounced in cross-border activity, where the UK has a 15% share of all global international activity compared with 24% for the US and 8% for Hong Kong.

>>> Fragmentation

5,963 The number of credit institutions in the EU

For all the progress towards a single market in financial services in Europe the banking industry is still fragmented and inefficient. The EU has 20% more banks than the US but they are only half as profitable, and on average the top five local banks in each member state have a 66% market share.

>>> THE RISE OF ASIA PACIFIC

28%

The share of the Asia Pacific region across global banking and financial markets

Since 2006 Asia has increased its share of global activity by around 40% and has overtaken the EU. In key sectors such as banking Asia's share of activity has more than doubled since before the last financial crisis. Over the same period, the EU27's share of global activity has fallen by a third from 20% to 13%.

>>> A GLOBAL SHIFT

54% The share of Asia Pacific in global capital markets activity by 2040

We estimate that the share of Asia Pacific in global financial markets activity will increase to 54% by 2040 from around 30% in 2018. This means that by 2040 Asia Pacific will overtake the US and will have the biggest capital markets in the world. The US will account for a quarter of global capital markets activity from around 40% today.

>>> FALLING BEHIND

10% The share of the EU27 in the future growth of global capital markets activity

Just 10% of the growth in global capital markets activity over the next decade will come from the EU27 compared to 58% from Asia Pacific and 22% from the US. On current trends, the EU27 would shrink in relative terms from 13% of global capital markets in 2018 to just 10% by 2040.

>>> A STRONG PLATFORM

61% of UK financial services trade conducted with countries outside the EU

While the EU represents the largest market for the UK in financial services trade with 39% of activity, the majority of trade in financial services is with the rest of the world. More than 40% of financial services trade outside the EU is with the US. While the EU is a big market on the UK's doorstep, there is significant scope to develop closer ties with other financial centres further afield, particularly Canada, Switzerland, Japan and Australia.

>>> LOSING GROUND

-45% The decline in the global share of bank assets at EU banks since 2006

In 2006, four of the five largest banks in the world were from the EU and EU banks accounted for 53% of global bank assets. Since then, the EU's share of global banks has nearly halved to 29%. The global market share of European asset managers has fallen by nearly a third, while European investment banks have lost more than a quarter of their markets in the US and EU markets over the past decade.

PART 2 - SETTING THE SCENE

The starting point for UK banking and finance

In this section we analyse the impact of Brexit on financial services; the strong position of the banking and finance industry in the UK; the relative size of capital markets in the UK and EU; and the global context for European capital markets.

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Brexit means Brexit

Whatever the outcome of the negotiations between the UK and the EU over the next few months, Brexit will inevitably have a significant impact on the financial services industry in the UK and increase the barriers for financial services activity in both directions. Here is a summary of five key Brexit themes for the banking and finance industry:

1. **Barriers & dislocation:** The vote to leave the EU and the single market will cause significant disruption to large parts of the banking and finance industry in the UK. Without the automatic access to EU markets and clients that firms enjoyed under passporting, many firms have had to relocate at least part of their business from the UK to the EU to guarantee access in future. More than 300 firms in the UK have already set up new legal entities or moved some of their staff, assets and operations to the EU, according to our research. We estimate that around a quarter of UK financial services activity is related to the EU and that as much as half of that may need to relocate in some form to the EU over time.

2. **Access & equivalence:** Many people in the industry hope that an agreement on equivalence would allow some access to EU markets and customers from the UK on the other side of Brexit. While equivalence would mitigate some of the disruption we think this is a false premise for most sectors: equivalence is limited in scope, does not apply for large parts of activity, and given the opaque nature in which it can be withdrawn at short notice, it is not a firm basis for long-term planning. Equivalence is designed to encourage long-term alignment and convergence, and the EU is wary of granting it when the UK has made its intention clear to diverge in some key areas. A more likely outcome is that the EU will grant equivalence in a few key areas such as clearing and trading venues for a 'time-limited' period (for example, equivalence in clearing has been granted for 18 months).

3. **Divergence & alignment:** The debate is ultimately about the trade-off between access and divergence. The more access the UK wants, the more aligned in more sectors it will have to be. The more it wants to diverge, the less access it will have and the more activity will need to relocate. In key areas such as clearing and trading venues, the UK should remain aligned with EU regulation to reduce market friction. Many firms in sectors such as investment banking and asset management are keen to remain broadly aligned with the EU to limit the impact on their business and reduce the risk of reduced access in future - but are also keen to smooth some of the rougher edges of the EU framework. We think in many areas the industry should treat the dislocation from Brexit as a sunk cost and take the hit from relocations on the chin. The relocation of some activity from the UK to the EU will provide most firms with the access they need on the other side of Brexit. With this access in hand, the UK will then be free to rethink and recalibrate its supervisory framework to the unique dynamic of the UK financial services industry. This selective divergence, outlined by the government in June, will be gradual, and in many cases the future UK framework will look remarkably similar to the EU's.

4. **Friendly competition:** Over the past few decades the UK has competed for EU business within the single market with many firms choosing to concentrate their EU activities in London to take advantage of economies of scale. On the other side of Brexit, this competition will take on a different tone as the UK and EU compete directly for business. The EU is (not unreasonably) keen for significant parts of EU-related activity to be conducted inside the EU under the remit of EU supervisors and is uncomfortable with the prospect of the UK acting as a large offshore financial centre for EU companies and institutions. One way of thinking about this future competition is that the EU is seeking to define what business *must* be conducted in the EU, while the UK will focus on making people *want* to conduct their business in the UK. While the political debate has hardened in recent months, it will be important to avoid a tit-for-tat approach to regulation between the UK and the EU in future.

5. **A change in tone & direction:** The departure of the UK means that the EU is losing its biggest and deepest capital market and dominant financial centre. It will also lose the expertise and experience of UK supervisors and regulators who have often played a key role in shaping EU financial regulation. This is already leading to a change in the tone and direction of EU policy: the recent agreement on the Covid recovery fund and a huge programme of EU-wide borrowing is a significant step forward in convergence. In addition, without the UK, the EU is more likely to shift towards a more institutionalised single market in financial services and move towards a single rulebook ultimately enforced by a single supervisor.

A strong platform

Before thinking of the future of banking and finance in the UK on the other side of Brexit, it is worth reflecting on the state of the financial services industry in the UK today. The banking and finance industry in the UK is one of the most successful industries in Britain: it is not only vital to the UK economy, but it plays an important role as a European and global financial centre. While Brexit will inevitably cause disruption, banking and finance in the UK has a strong platform off which - with political support - it can forge a new path. While this high level of activity shows what is at stake when it comes to Brexit, it also underlines the industry's strength in depth.

Fig.1 Top 10 financial centres

	Country	Score
1	US	79
2	UK	40
3	China	29
4	Japan	27
5	Hong Kong	26
6	Luxembourg	26
7	Germany	23
8	France	22
9	Netherlands	21
10	Singapore	20

Note: value of activity across 28 metrics, maximum possible score of 100

Source: New Financial

1. **A big contribution:** The banking and finance industry is a hugely important sector for the UK economy in its own right. It employs more than 1.1 million across the country - with two thirds of staff working outside London - representing around 3% of the total UK workforce. It is a highly productive industry, accounting for more than 7% of overall UK gross valued-added. And it is the biggest single sector in terms of tax contribution, generating around £76bn in tax a year or over 10% of all tax receipts.

2. **Supporting the wider economy:** The industry plays a vital role in oiling the wheels of the wider economy and supporting companies in their day-to-day business. More than 95% of large UK companies use the capital markets to raise money and manage their risks, according to our recent research on *The value of capital markets to the UK economy* and those companies employ more than six million people in the UK. A further 14,000 smaller companies in the UK use the capital markets, employing an additional two million people. This role has been highlighted by the industry's response to the Covid crisis: from March to June, banks lent record amounts to UK companies and helped facilitate tens of billions more in government-backed lending, and UK companies raised more than £70bn in the capital markets.

3. **The dominant EU financial centre:** Over the past few decades the UK has reinforced its position as the dominant financial centre in Europe. The UK accounts for nearly a third (32%) of all financial activity in the EU - slightly more than France and Germany combined - according to our analysis of 30 sectors of activity. While much of this activity represents deeper domestic financial and capital markets, the UK's dominance is particularly acute in international sectors where firms have more discretion over the locations of their activity. For example, the UK accounts for over 80% of all derivatives and FX trading in the EU, and over 40% of all assets under management.

4. **A global financial centre:** The UK is one of just two global financial centres along with the US: our index of the value of financial activity across 28 sectors shows the UK is a long way behind the US but well ahead of China, Japan and the rest of Europe (see Fig.1). The UK is particularly strong in international financial activity (where it scores 46/100 compared with 72 for the US). The UK accounts for 15% of all global business and it is the top financial centre in the world by a clear margin in areas such as trading. The UK asset management industry, with nearly £10 trillion in assets under management, is the second largest in the world after the US. The UK is one of the most open and competitive financial centres in the world: it is the third most competitive banking market in the EU, and it accounts for more than a third of all branches and subsidiaries of non-EU banks operating in the EU and around 70% of their combined assets.

5. **Driving trade & investment:** financial services is one of the most successful sectors in the UK when it comes to international trade. Financial services exports totalled £83bn in 2018 and around 60% of those exports went outside the EU. This accounts for more than a quarter of all services exports and generated a trade surplus of more than £60bn (without which the UK's overall trade deficit would triple). Foreign direct investment in financial services into the UK of £438bn represents nearly a third of all inward FDI.

A European hub

Perhaps the most striking aspect of capital markets when it comes to Brexit is how dominant the UK capital markets are today within the EU, how consistent that dominance is across sectors, and how much smaller EU capital markets will be post-Brexit.

Fig.2 shows the share of total EU financial activity of the UK and the EU27 member states in the three years to 2018 in different sectors. On average the UK accounts for just under a third (32%) of total financial activity in the EU. The UK is the largest market in 80% of the financial sector metrics that we looked at (24 out of 30). In other words, Brexit means that the EU will be losing its largest market in the vast majority of the different sectors of banking and finance.

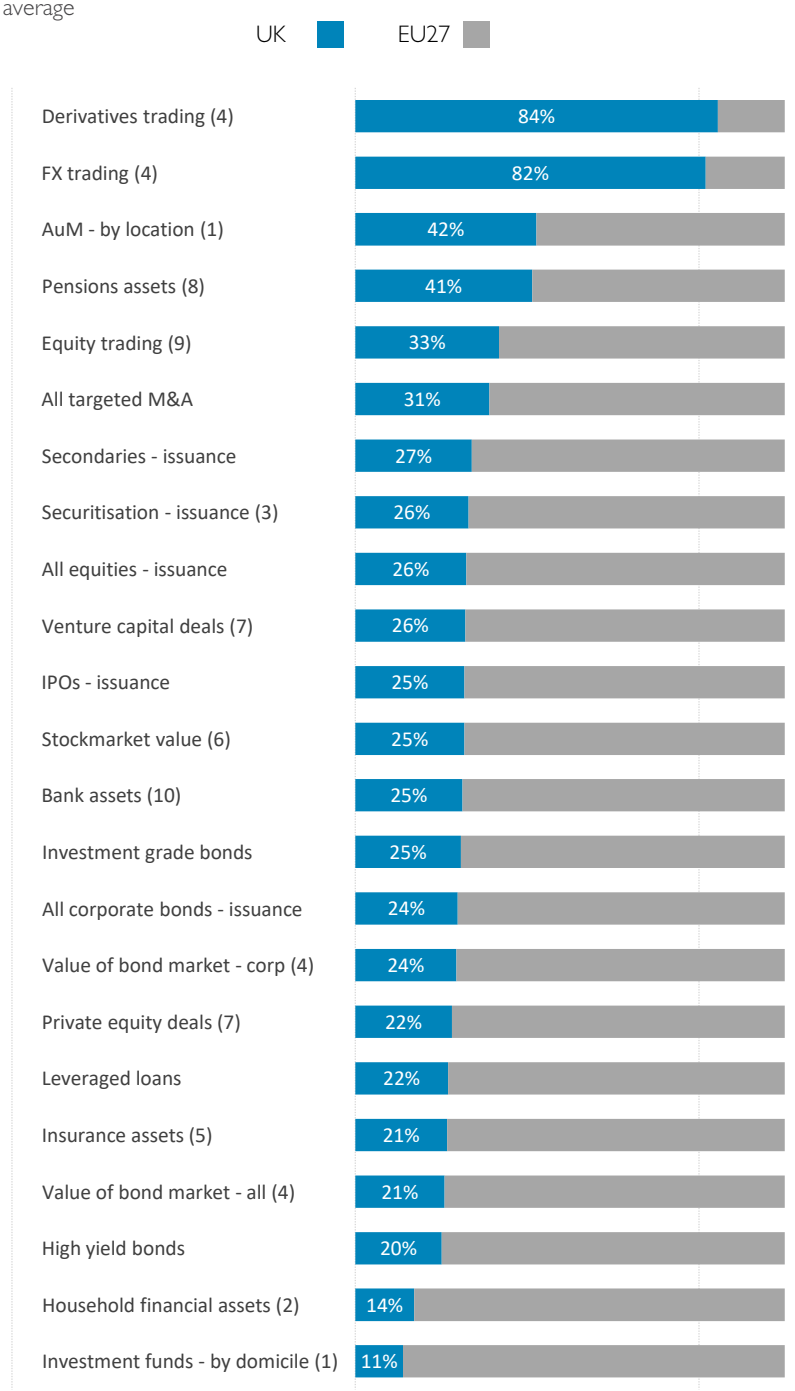
The UK's dominance is most pronounced in sectors where firms can choose the location of a particular activity: for example, more than 80% of OTC derivatives trading and foreign exchange trading in the EU is conducted in the UK, and the UK accounts for over 40% of all assets under management and more than half of all private equity fundraising.

This reflects London's role as the dominant hub in European banking and finance which has accelerated over the past 20 years within the single market. However, this dominance is also evident in sectors based on the nationality of activity, such as pensions assets, M&A and stock market value, which underlines the high level of development of domestic UK capital markets.

France is the biggest market in the EU today in four sectors (value of corporate bond market, insurance assets, bank lending to corporates, and convertible bonds), and it is the second largest market in another 12 sectors. Luxembourg is the largest market in just one sector and Germany in none. The few areas where the UK does not have the biggest market are the value of corporate bonds and insurance assets (where it ranks 2nd), investment funds by domicile (5th), household financial assets (3rd), and bank lending (4th).

Fig.2 The concentration of financial activity in the EU

Share of financial activity of the UK in the EU by sector in 2018, 3 year rolling average



Sources: all data from Dealogic except 1) EFAMA 2) Eurostat 3) AFME 4) ECB / BIS 5) Insurance Europe / EIOPA / US Treasury 6) WFE / local exchanges 7) Invest Europe / NVCA / AIC / Preqin 8) OECD / EIOPA / Willis Towers Watson 9) Fidessa / WFE 10) ECB

Size matters

While the UK is the dominant player in the EU market, it is important to put things in perspective in a global context. The EU and UK have a combined share of global financial activity of around 22% making it the second largest block after the US (with a 39% share) and well ahead of China (on 13%). On the other side of Brexit, the EU's share will shrink from over a fifth to just 13: half the size of activity in Asia and a third of the size of activity in the US.

Fig.3 shows the share of global financial activity of the US, Asia Pacific, EU27, UK and the rest of the world in 2018 across different sectors. The US is the largest market in nearly 60% of the financial sector metrics that we looked at (17 out of 29).

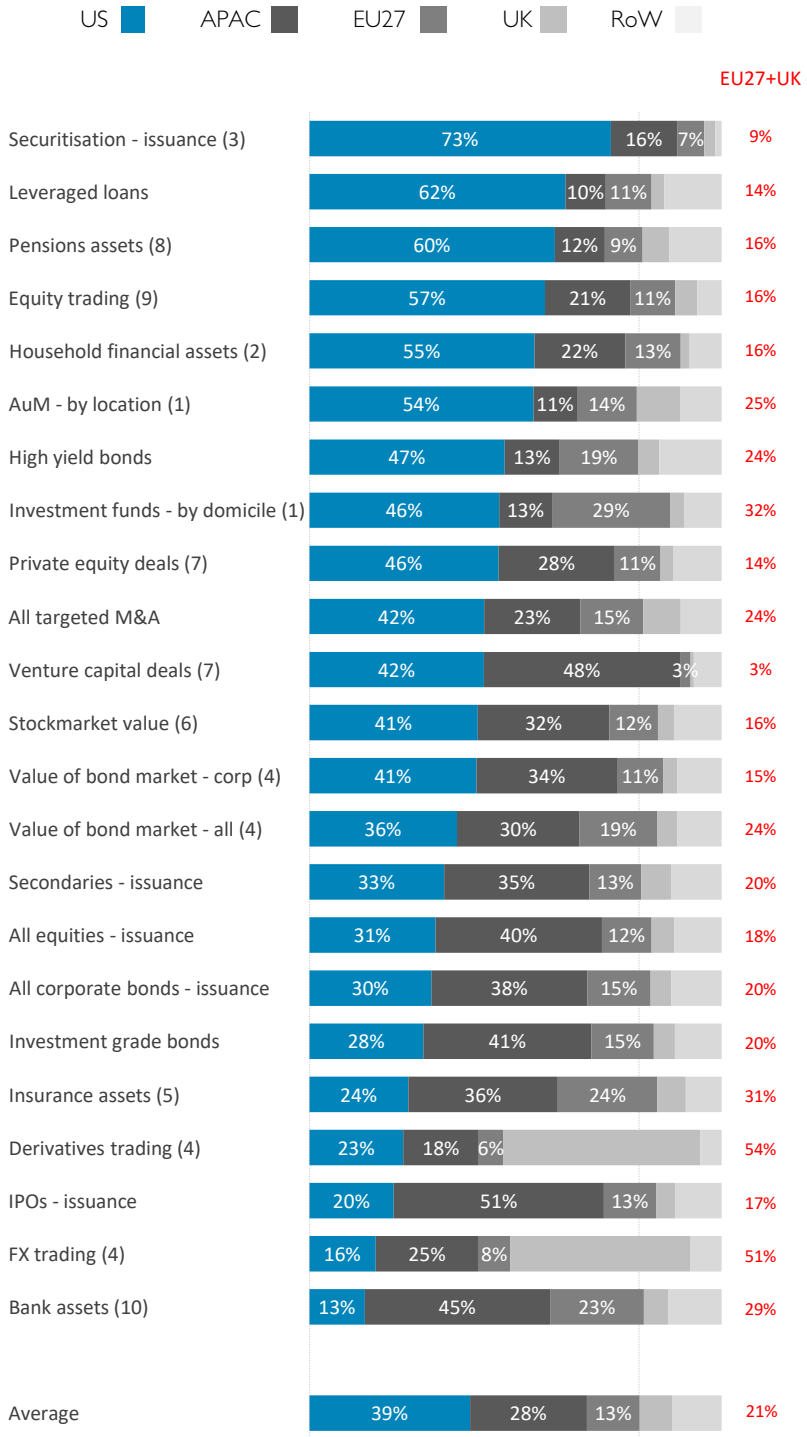
The dominance of the US is most pronounced in securitisation, leveraged loans, pensions, equity trading, household assets and assets under management where its share is more than half of global activity. It has also the largest stock market and bond market as well as the largest pool of long-term capital (combined value of pensions and insurance assets, household assets). The US is the second largest market in eight sectors including equity and corporate bond issuance, IPOs, equities trading and derivatives trading.

Financial markets in Asia Pacific have already overtaken European capital markets with a share of 28% of global activity. Asia Pacific is the biggest market in the world today in nine sectors including insurance, bank assets, equity issuance, corporate bond issuance, IPOs and venture capital investments, and the second largest market in 14.

There is no sector where EU27 is the largest market in the world although it is the second largest market in five sectors: insurance, bank assets, assets under management, investment funds and high yield bonds. If the UK remained in the EU it would be the largest market in the two sectors where the UK maintains its global leadership (that is OTC derivatives and FX trading) and the second largest in 11 sectors.

Fig.3 The concentration of global financial activity

Share of financial activity by region in 2018



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PART 3 - THE CHANGING SHAPE OF GLOBAL MARKETS

A structural shift

In this section we analyse the structural shifts in the size and regional share of global banking and finance activity since 2006; what the future might look like in 10 and 20 years from now based on past growth trends; the extent to which the EU framework for banking and finance supports the industry; and how the health of European capital markets and the European banking and finance industry are closely intertwined.

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A global shift

Over the past few decades there has been a seismic shift in global banking and finance: markets in Asia have grown rapidly and in many cases have overtaken Europe. This structural change provides vital context for the debate on the future of UK banking and finance post-Brexit.

Fig.4 shows how the share of global financial activity of the US, Asia Pacific, EU27, UK and the rest of the world has changed in key sectors since 2006. The US dominates global financial activity and its overall share has remained relatively stable at around 40%. The big change since before the global financial crisis is the rapid growth in activity in the Asia Pacific region and the relative decline of the EU over the same period. Fig.5 on the next page shows that the EU27 lost market share in all but two of the 23 sectors that we analysed, while Asia increased its market share in all of them.

Since 2006, the EU27's share of global activity of 20% was just ahead of Asia on 18%. But since then, the EU27's share has fallen by a third to around 13%, while Asia's share has increased by a half to 28%. Asia Pacific has increased its share significantly in all sectors since 2006 and its overall share of global financial activity is now more than double that of the EU27.

Its share of global corporate bond issuance has more than doubled while its share of global IPOs has increased by 40% compared to 2006. The share of APAC in global stock market value has gone up by 40% and in global corporate bond market value by two thirds. In 2018 the share of APAC in global IPO issuance was bigger than the combined share of the US, EU27 and the UK.

The share of the EU27 and the UK has been declining since 2006. EU27 share is smaller than 2006 in all sectors but high yield bonds and private equity investments. The biggest hit has been in EU27 equity markets: the value of equity issuance has gone down by nearly 45% and its global share declined by more than a third while its share in equity trading dropped by two thirds. The share of the UK has decreased in all sectors but assets under management, high yield bonds, investment funds, FX and derivatives trading.

Fig.4 The change in selected sectors since 2006

Share of global financial activity in 2018 by region compared to 2006

Note: numbers in green denote the change in the EU's share of global activity since 2006

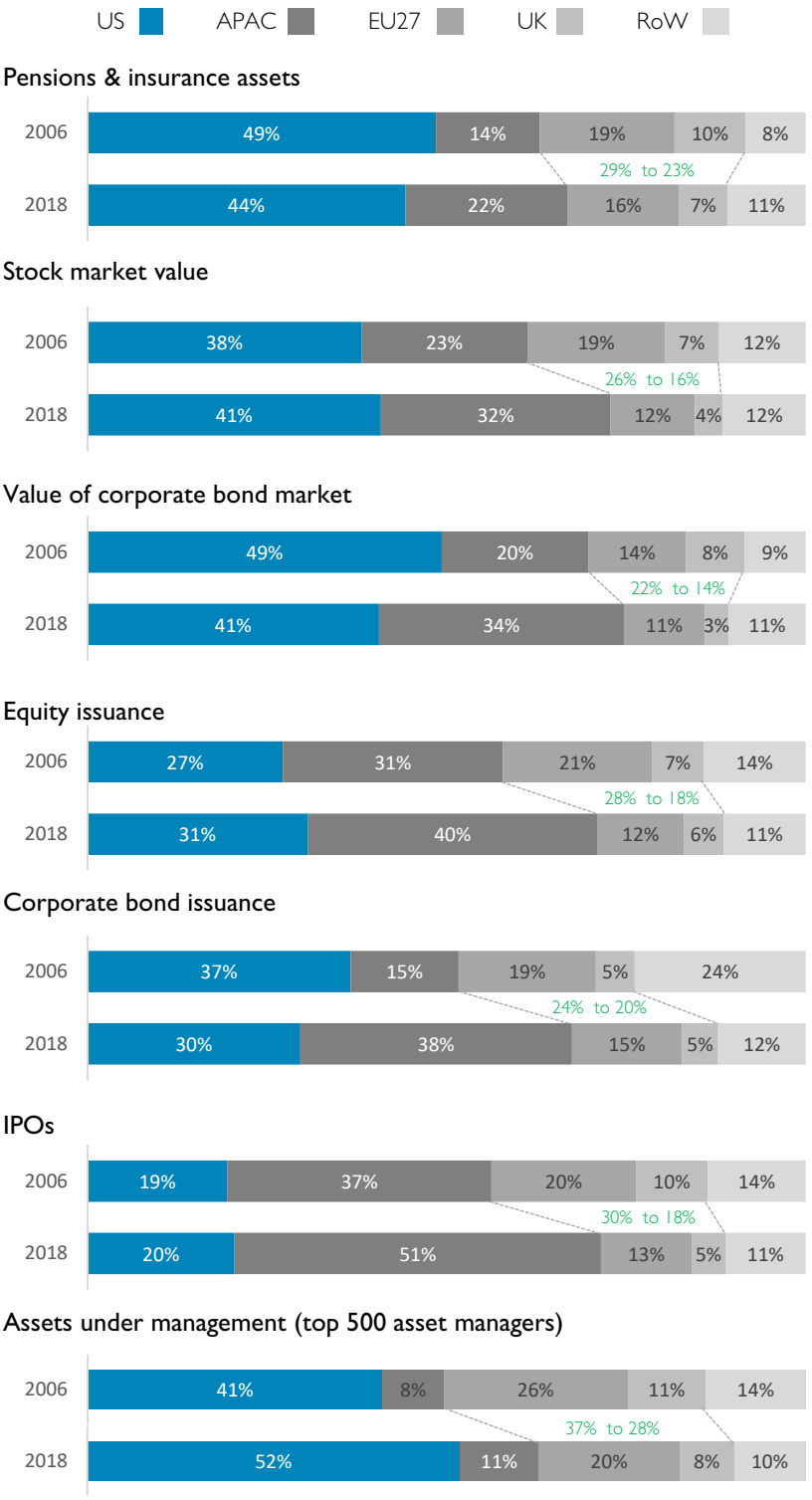


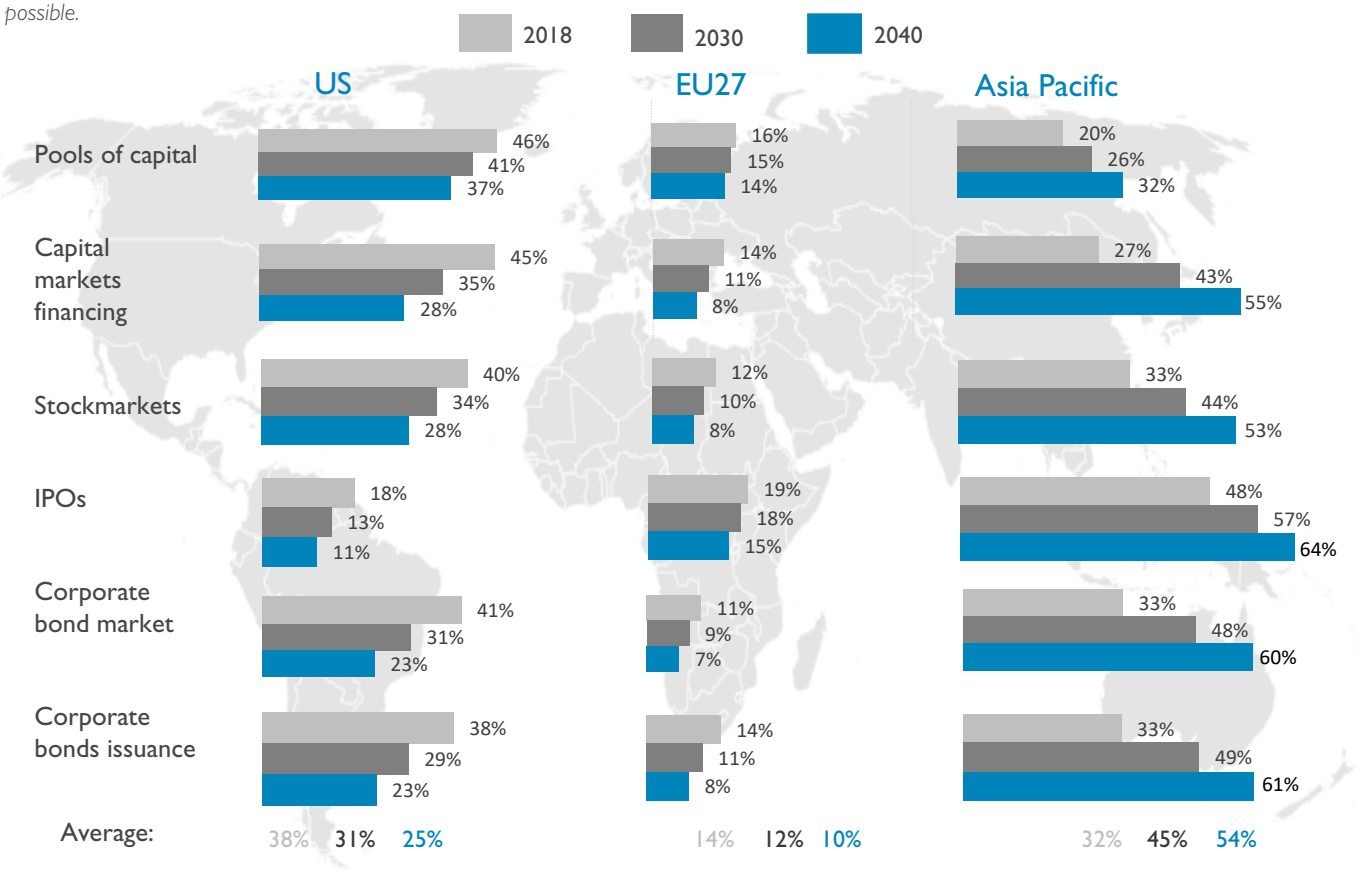
Fig.5 The change in global capital markets since 2006

This table summarises the change in absolute size and in the share of global activity in the US, EU27 and Asia Pacific between 2006 and 2018. It highlights the massive growth in size and share in Asia Pacific in all sectors, the decline in size in nearly half of the sectors and in share in almost all sectors in the EU27, and the growth in size in the US in almost all sectors and in share in nearly two thirds of the sectors.

	US		EU27		APAC	
Sector	Value +/-	Share +/-	Value +/-	Share +/-	Value +/-	Share +/-
Pools of capital						
Pensions assets	49%	●	50%	●	133%	●
Insurance assets	37%	●	26%	●	136%	●
Household financial assets	57%	●	-7%	●	155%	●
SWF assets	279%	●	0%	●	301%	●
HNWI assets	119%	●	78%	●	145%	●
Market / asset values						
Stock market	56%	●	-11%	●	101%	●
Corporate bond market	99%	●	100%	●	304%	●
Bank assets	68%	●	-9%	●	240%	●
Asset management						
Assets under management	67%	●	36%	●	80%	●
Investment funds (by domicile)	95%	●	90%	●	176%	●
Debt markets						
Corporate bond issues	101%	●	99%	●	524%	●
High-yield bond issues	11%	●	51%	●	54%	●
Investment grade bond issues	152%	●	112%	●	832%	●
Leverage loans	82%	●	2%	●	338%	●
Equity markets						
All equity issues	7%	●	-45%	●	25%	●
IPOs	-8%	●	-45%	●	21%	●
Secondary issues	42%	●	-46%	●	27%	●
Trading						
Equity trading	164%	●	-28%	●	162%	●
Derivatives trading	175%	●	-9%	●	141%	●
FX trading	84%	●	7%	●	106%	●
Merger & acquisitions						
All M&A activity	14%	●	-28%	●	68%	●
Domestic M&A	10%	●	-47%	●	83%	●
Private equity & venture capital						
Private equity funds raised	-10%		24%		138%	
Private equity activity	56%	●	78%	●	170%	●
Venture capital activity	348%		44%		-	

Fig.6 The changing face of capital markets

The regional share of capital markets activity in selected sectors today and the forecast share in 10 and 20 years.
Note: this chart does not represent the absolute size of capital markets activity but the changing balance of activity between different regions according to our analysis of potential growth based on the growth trends over the past 10 to 20 years. We used a 3 year average to 2018 where possible.



A global shift

If the past 20 years are anything to go by, Asian markets are set to dominate the global capital markets over the next few decades. Using a selection of sectors where we have the most robust historical data and which we believe are broadly representative of the overall direction of capital markets, we estimate that the balance of power will swing decisively towards Asia over the next 10 to 20 years. The share of Asian markets will increase from an average of 32% in 2018 to 45% in 2030 and as much as 54% through to 2040, with roughly half of this growth from China alone.

The biggest areas of growth for Asian markets will be the annual flow of capital markets financing, which our analysis suggests will nearly double from 27% of global activity in 2018 to 55% in 2040, and corporate bond markets where we estimate that it will nearly double from a third of global activity in 2018 to almost 60% in 2040. If that sounds unrealistic, note that our estimate assumes that growth in GDP and market depth will continue at around half the rate in future than the rate at which it has grown over the past few decades.

On average, on current trends, the EU27 would shrink in relative terms from 14% of global capital markets in 2018 to just 10% by 2040. This underlines the urgency of the capital markets union initiative and wider efforts to develop capital markets in Europe. It also raises the fundamental question for the UK of how closely it wants to remain aligned and attached to a market that is shrinking in a global context. The US would shrink from 38% today to 31% on a 10 to 15 year horizon: some time around 2030, the Asia Pacific region would overtake the US in terms of global market share, and by around 2040 Asia would account for more than half of all global capital markets activity.

Driving growth

As the UK emerges on the other side of Brexit, it will be important for it to capitalise on the future growth of capital markets around the world. While the EU is a large and accessible market on the UK's doorstep, we estimate that it will account for just 10% of the growth in capital markets activity in the coming decade while markets in Asia will account for nearly 60% of future growth (see Fig.7).

We analysed the potential growth in each sector over the next 10 years in different regions based on historic growth trends over the past 15 to 20 years. We assumed (before the Covid crisis) that the growth in GDP and market depth will continue at around half the rate in future than the rate at which it has grown over the past few decades. Fig.7 shows the potential growth in each region in key sectors over the next 10 years in percentage terms and in value added as well as the contribution of each region to the potential growth of global capital markets activity.

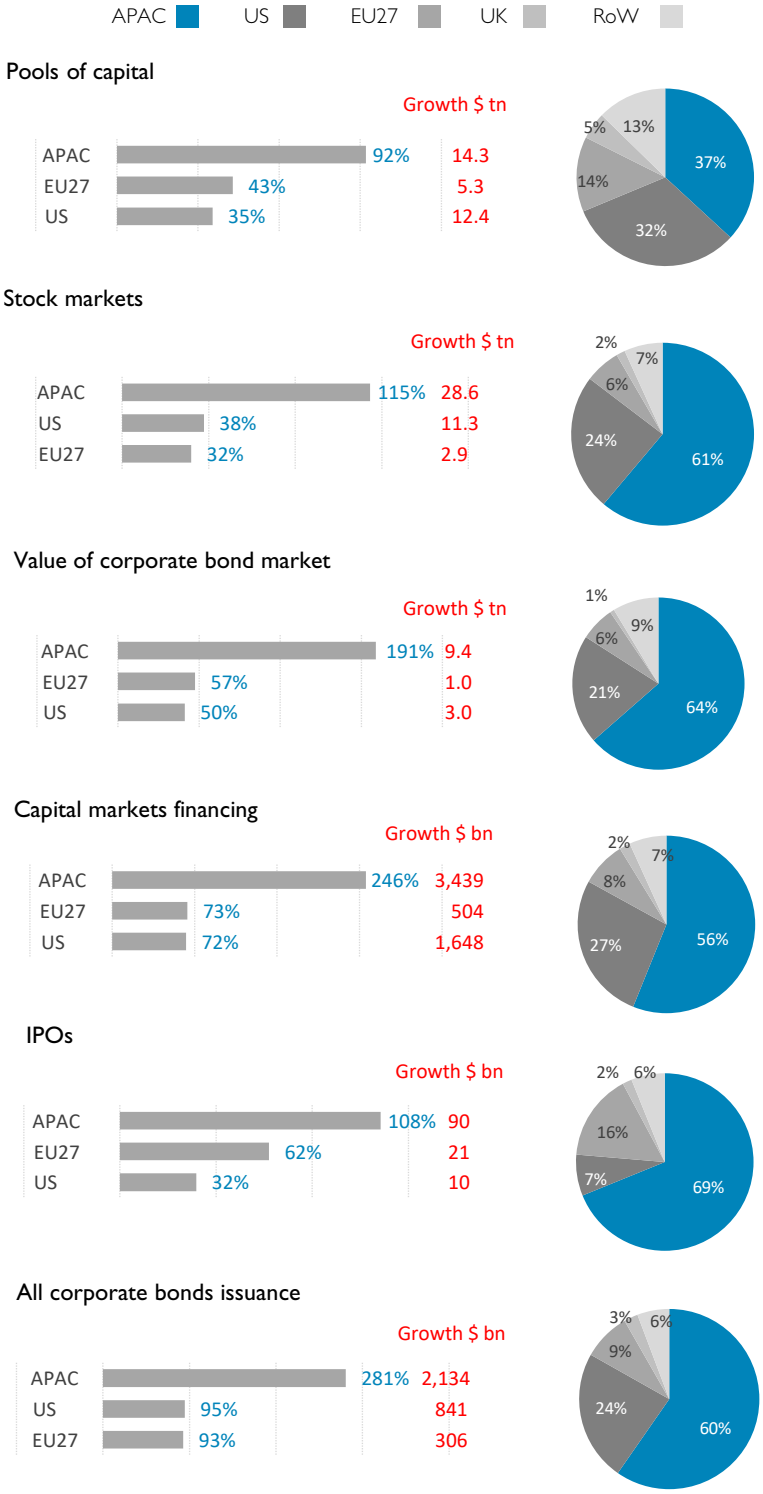
Nearly two thirds of the growth in global capital markets activity over the next ten years will come from Asia Pacific. Corporate bond issuance and the annual flow of capital markets financing in Asia Pacific will increase nearly fourfold. The value of stock markets will double and that of corporate bond markets will triple.

While most of the future growth in global markets will come from Asia Pacific, the UK should not ignore the US and the EU27 as there will be a considerable growth in the value of activity over the next ten years. Pools of capital, that is pensions and insurance assets in the US will grow by more than $12tn and in the EU27 by around $5tn.

The annual flow of capital markets financing in the US and in the EU27 will increase by three quarters over the next ten years. In the EU27 that means an additional $500bn per year in financing through equities, corporate bonds, leveraged loans and venture capital. In the US we estimate that the annual flow of capital markets financing will increase by $1.6tn by 2030.

Fig.7 The potential growth in selected sectors

The potential growth by region over the next 10 years in real terms *(note: the figures in red denote the potential growth in $ trillions and the pie charts show where the potential growth in global activity will come from)*



One size fits all?

There are many reasons why capital markets in Europe are relatively under-developed and why the European banking and finance industry has performed relatively poorly at a global level over the past decade, ranging from fragmentation and market structure, to national, regulatory and cultural barriers. Here is a summary of the main factors that EU policymakers will need to address on the other side of Brexit:

1. **Regulation & supervision:** While there has been huge progress over the past few decades towards a single market in European financial services, the regulatory and supervisory framework remains complex, multi-layered and fragmented. While officially the EU has a single rulebook for banking, insurance and markets, there are more than 80 supervisors and regulators across the EU, each applying a slightly different interpretation of EU rules. Small changes in rules effectively mean that there are still 27 separate markets. By necessity, EU rules are set on a detailed and prescriptive 'one size fits all' basis that apply as much to a bank in Croatia or Estonia as they do to the UK or France. This national patchwork markets adds an additional layer of cost and complexity. Local banks, insurers, exchanges and asset managers often enjoy some degree of regulatory protection from cross-border competition which encourages domestic bias, raises costs for customers, and rewards inefficiency.

2. **Fragmentation:** The EU banking and finance market remains highly fragmented which limits the ability for many firms to develop economies of scale. There are nearly 6,000 credit institutions in the EU (around 20% more than in the US). On average the top five banks in each country in the EU account for two thirds of bank assets in that country, and the vast majority of banks in the top five in each country are local firms. This fragmentation is clearly on display with market infrastructure, where Europe has more than 30 (mainly national) exchanges owned by 16 groups, supported by 18 different central counterparties and 20 securities depositaries (just in the equity market). This raises costs for companies, investors and market participants, and reduces growth in smaller markets. There are five times as many investment funds in the EU as in the US market but US funds are seven times larger (average value of €1.8bn versus €250m). Average fees on passive and active mutual funds in the EU are nearly twice as high as in the US and the same fund may charge different fees in different countries.

3. **Domestic bias:** The relative novelty of the single market in financial services is reflected in the high levels of domestic bias across the EU. More than 90% of companies in the EU that carried out an IPO in the five years to the end of 2018 listed on their home market and just 56 EU companies (less than 5%) chose to go public with their main listing on an exchange in a different EU country. Nearly three quarters of all assets under management in the EU are held in funds only available for sale in that domestic market. This bias is reflected in overall asset allocation: more than half of equity investments in the EU are held in the investor's domestic market, and in smaller markets this is as high as 75% to 90%. Domestic bias reduces returns, raises costs and concentrates risk.

4. **Political wrangling & vested interests:** Banking and finance is a highly political industry and the EU framework represents the trade-offs and compromises made between different member states with strong vested interests. It is hard to overstate the cultural and social significance of banking in different countries: in Germany the three pillar banking system is effectively untouchable, while overcapacity in the banking industry in France, Italy and Spain is largely the result of political pressure to maintain vast networks of local and regional mutual banks. In many countries, the banking and finance industry has powerful political connections and enjoys a degree of protection, particularly in arguments between Brussels and individual member states.

5. **Culture and the lack of trust in the industry:** A widespread political and cultural suspicion of banking and markets in many EU countries compounds this problem. Public attitudes towards the industry are significantly less positive in France, Germany, Italy and Spain than in the US or the UK, which in turn is reflected in the political framework for the industry. Politicians often reserve a special distrust of 'Anglo-Saxon capitalism'. Given the impact of the financial crisis on the EU economy and the behaviour of some market participants in the run-up to it this suspicion is understandable. In the wake of the Covid crisis, the banking and finance industry needs to redouble its efforts to demonstrate how it can be part of the solution instead of being part of the problem.

Losing ground

The geography of the global banking and finance industry has been transformed over the past 15 years. Europe has lost significant ground at a global level through a combination of the fallout from the financial crisis, lower economic growth, a fragmented market, challenged business models and tough regulation. At the same time, US firms have held their ground or increased their market share, and Asian banks - particularly Chinese firms - have grown rapidly.

The global market share of banks in the EU nearly halved from 53% to 29% between 2006 to 2018 as measured by bank assets (see Fig.8i) as European banks were forced to retrench after the financial crisis. Banks in Asia have largely taken their place: in 2006, four of the five largest banks in the world were based in the EU. In 2018, all five of the largest banks were from Asia and the top four were Chinese. The number of European banks in the top 20 has fallen from 14 in 2006 to just eight in 2018. Over the same period, the global share of US banks has remained constant.

In the global asset management industry, US firms have significantly increased their market share while European firms have again lost ground. Between 2006 and 2018 US asset managers increased their share of global assets under management by around a quarter to 52% (see Fig.8ii) while the share of their European counterparts has dropped by nearly a third to 31%. Seven of the 10 largest asset managers in the world are based in the US, up from five in 2006.

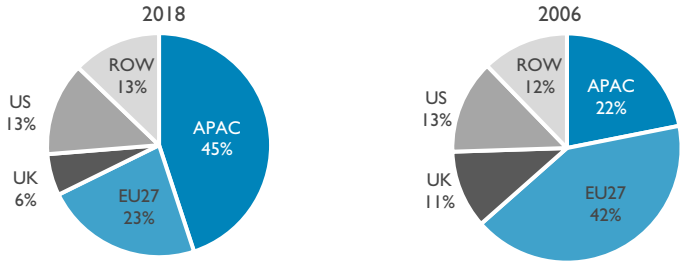
A similar shift is apparent in investment banking where US firms are gaining ground at the expense of their European rivals. Between 2009 and 2019, US firms defended their high market share of 72% in their home market (see Fig.8iii) and significantly increased their share of investment banking fees in the EU (from 33% to 41%). Meanwhile, the share of European investment banks in the US market fell by around a fifth to 18%. European firms fared little better in their own backyard, with their share of total fees falling from 62% to 52%.

Fig.8 The shifting geography of banking & finance

The shift in market share by region in banking and finance from 2006 to 2018

i) The regional shift in banking

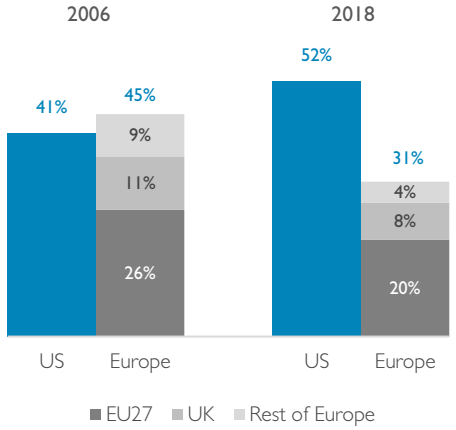
Share of global bank assets by nationality of bank



Source: analysis of the top 1,000 banks from The Banker

ii) The regional shift in asset management

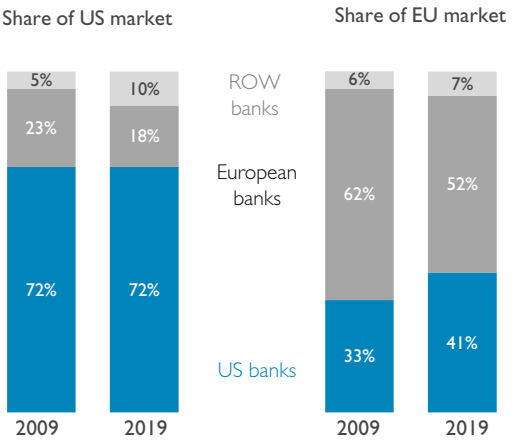
Share of global AuM by nationality of asset manager



Source: analysis of the top 500 asset managers from Willis Towers Watson

iii) The regional shift in investment banking

Share of investment banking fees by nationality of investment bank

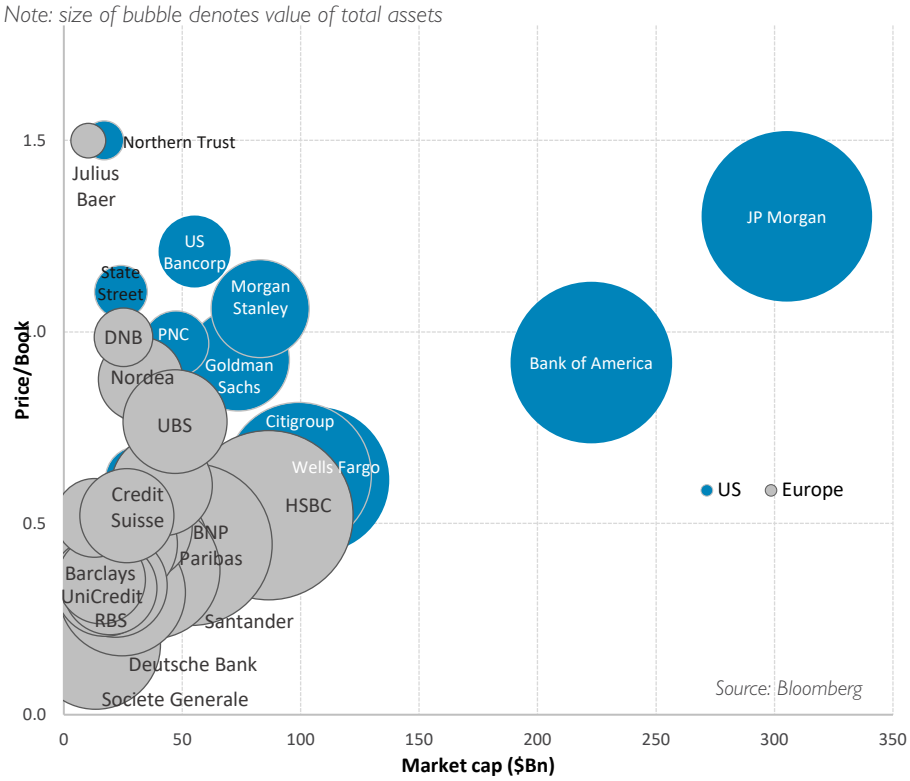


Source: Dealogic (includes fees from DCM, ECM, loans and M&A)

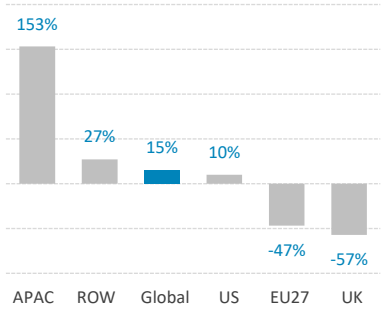
Fig.9 The changing economics of banking

i. The relationship between price to book ratio, market value and total assets at US and European banks *(data from end of August 2020)*

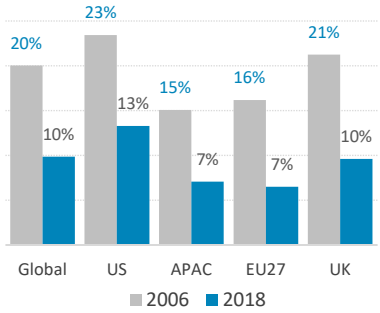
Note: size of bubble denotes value of total assets



ii. The change in banks' pre-tax profits from 2006 to 2018 by region



iii. Return on capital in 2018 compared to 2006 by region



Source: analysis of the top 1,000 banks from The Banker

A widening gap

The economics of banking have shifted significantly as a result of the global financial crisis and the concerted global programme of regulatory reform since 2009. While banks may be bigger overall (total assets of the top 1000 banks in the world have increased by more than two thirds), they have been disproportionately affected across regions and European banks have been hit hardest of all.

Fig.9i shows the relationship between the price to book ratio, market value and total assets in the biggest US and European banks. The cluster of European banks in the bottom left hand corner shows that large European banks are valued by investors significantly less than their US counterparts: they have an average price / book ratio of around half that of their US peers and a significantly lower market capitalisation than their US counterparts. For example, JP Morgan and HSBC have assets close to $2.5 trillion each but the value of JP Morgan is more than double the value of HSBC and its price to book ratio is two thirds higher than HSBC.

A similar trend is seen in the profitability of banks across regions (see Fig.9ii). Pre-tax profits have increased by 15% in real terms across the industry since 2006. However, profits at Asian banks have more than doubled in real terms, in the US profits have increased by 10% but in Europe they have roughly halved since 2006.

The average return on capital for the 1,000 largest banks in the world has halved to 10% in 2018 from 20% in 2006 (see Fig.9iii). Although return on capital has fallen significantly across all regions and countries, the fall is more pronounced in Europe: in the US, return on capital has fallen by around 40% since before the financial crisis, but in the EU27 and UK it has more than halved.

PART 4 - UK CAPITAL MARKETS IN A POST-BREXIT WORLD

UK capital markets in a post-Brexit world

In this section we provide a snapshot of the current relationship of the UK and other countries and regions in financial services, we analyse the trade-offs the UK faces when it comes to its post-Brexit relationship with the EU

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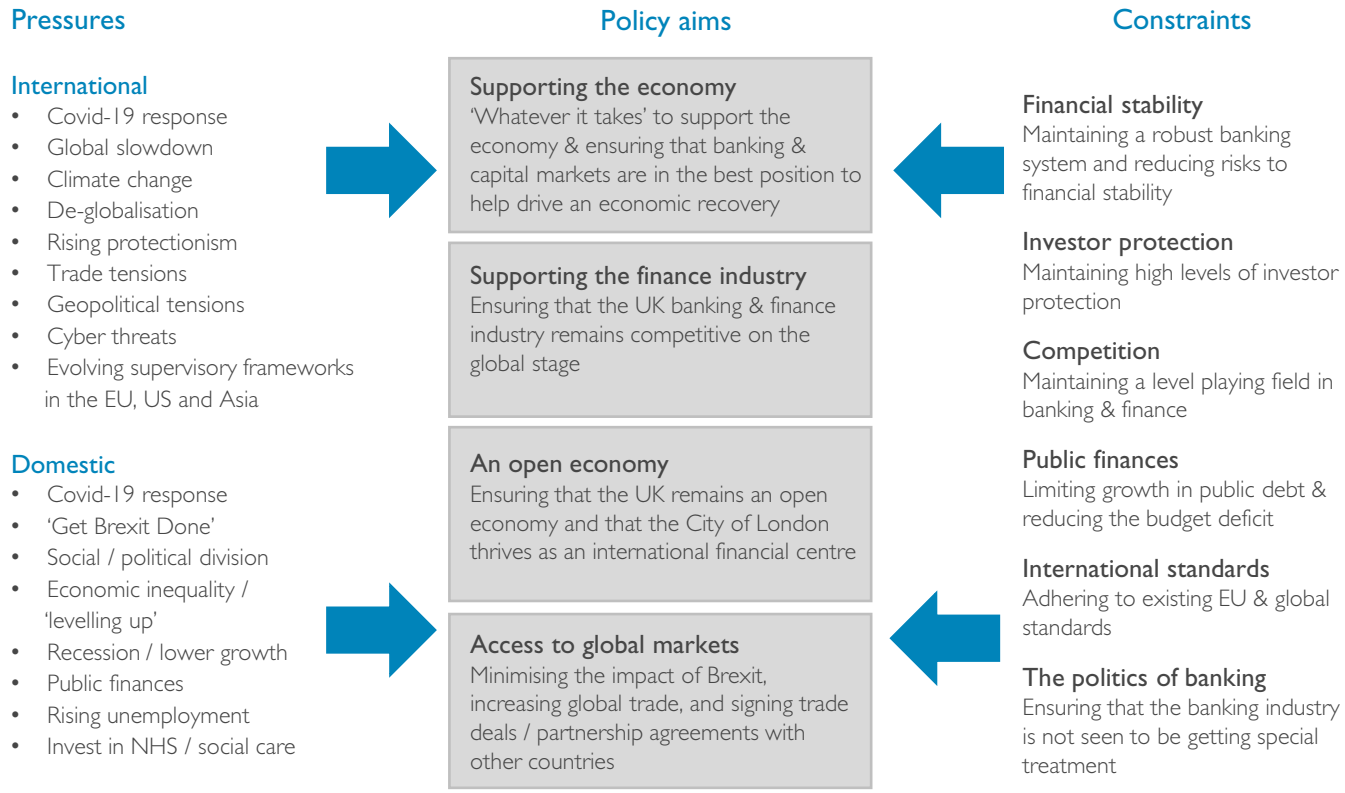
Fig.10 A policy challenge

A schematic summary of the strategic questions, pressures and constraints on UK policymaking on the other side of Brexit



A difficult juggling act

While the UK will have the ability and the opportunity to review the supervisory and regulatory framework around banking and finance on the other side of the Brexit it will face a difficult balancing act. All policy decisions have knock-on effects, trade-offs and unintended consequences in other areas. But in light of Brexit and the Covid crisis the policy decision-making process will be even more sensitive than usual.

Fig.10 summarises the main pressures (both domestic and international), the main policy aims in the financial sector and the main constraints on those decisions. For example, the economic impact of Covid and Brexit, combined with the government's levelling up agenda from the 2019 election will encourage the UK to ensure that the banking and finance sector is able to play as big a role as possible in helping support the economy and drive a recovery. At the same time, the UK is keen for its finance sector to remain competitive on the global stage and for the City of London to continue to thrive as the dominant international finance centre.

This may lead to some changes in supervision to encourage activity, level the playing field between UK and overseas firms, and tailor some elements of the current EU framework to the UK's unique finance sector. However, any reforms will quickly run into political and economic constraints. Any changes to the UK framework may have a knock-on effect on the level of access that UK firms will have to EU markets in future, and will need to be framed in such a way that they don't undermine financial stability, investor protection or competition. At the same time, the politics of banking means that the government will be wary of any suggestion that it is giving the City special treatment, and in rebuilding the public finances, the government will be torn between wanting to raise more tax from a sector that already generates 11% of tax receipts, and not wanting to raise taxes on such a successful and important sector for the UK economy.

Five big areas for review post-Brexit

On the other side of Brexit the UK will have a new found degree of control over its own supervisory and regulatory framework for financial services. We think there are five broad areas within banking and finance where the UK can review the existing framework and redefine or recalibrate its approach. The UK will have to juggle the trade-offs between helping the UK economy recover from the Covid crisis and ensuring the UK finance sector remains competitive, with the backdrop of a constantly shifting supervisory framework in the US, EU and other jurisdictions.

1) Capital requirements and bank structure

One of the biggest questions for banking and finance in the UK on the other side of Brexit is the extent to which the UK will continue to follow the EU prudential framework on capital requirements, and whether UK-specific overlays on the structure of banks will remain in their current form. The Basel III framework agreed in the wake of the financial crisis has strengthened the banking system and was applied at an EU level through CRD VI and CRR III: a UK review of the remaining requirements is working its way through parliament. The UK will also be applying its own version of the upcoming Basel IV international standards, and deciding when to introduce accounting standards such as IFRS9, which deals with how banks should treat expected credit losses.

In many areas the UK 'gold-plates' EU standards: the combination of EU rules, tough Bank of England requirements, and the ringfencing structure for UK banks have created a significantly more robust banking system than before the financial crisis, but have arguably set a higher bar for large UK banks than their peers. For example, the UK sets higher capital requirements for large UK banks than their US and European peers through a combination of applying the solus regime (which applies capital requirements to each bank in a group as well as at a consolidated level), requiring higher levels of pillar 2 capital, and setting higher counter-cyclical capital buffers.

In addition, the UK applies stricter leverage requirements and is the only country to have introduced the ringfencing of retail and small business banking from wholesale banking activities (the EU dropped its own reverse proposal a few years ago). This requires large UK banks to create two separate structures each with their own capital. On top of that, large UK banks operating in the US need to have capital in a bank or an intermediary holding company, and have had to relocate some of their capital into new entities in the EU27 as a result of Brexit. This means that UK banks have a higher effective capital requirement and more complex structure than many of their international rivals.

The same debate applies with insurers and pension funds under Solvency II (which many UK insurers argue is actively preventing them from investing in many parts of the economy) and Mifid II for securities and investment. In the wake of the Covid crisis, the UK has suspended stress tests, postponed the introduction of IFRS9, and encouraged banks to use their capital buffers to boost lending. While the government is reviewing the regime to ensure that supervision and regulation are 'proportionate and effective', it is unlikely that there will be any significant divergence from the EU regime in the near future. This will be complicated by the EU's recently launched review of its own framework.

2) Taxation of banking and finance

As one of the UK's most successful global industries, it is not surprising that banking and finance generates nearly 11% of total tax receipts in the UK - more than any other sector. But there are concerns that the industry is overtaxed relative to other countries, and that it may be a tempting target for a government looking to raise taxes in future. In addition to corporation tax, banks in the UK pay a bank levy that is calculated based on the size of their assets in the UK and a bank surcharge of 8% of their pre-tax profits (arguably putting UK headquartered banks at a disadvantage to international rivals). On top of this, more than half of the total tax contribution from the banking sector comes from employment taxes (income tax and national insurance contributions).

The impact of these taxes is a higher effective total tax rate for banks in the UK than either the US or Germany, according to research by PwC, which could be a significant factor in where banks choose to locate parts of their business on the other side of Brexit. It is unlikely that this situation will change anytime soon: 'tax cuts for bankers' doesn't win many votes. And it may get worse: in the wake of the massive government response to the Covid crisis, the government is likely to launch a fundamental review of taxation which may affect areas such as corporation tax and it may introduce new and higher taxes.

3) Regulatory process

The UK has a different regulatory approach from the EU and Brexit will provide the opportunity to redefine how it develops, implements, applies and coordinates regulation. This difference can be simplified as style versus substance: at an EU level, regulation is detailed and codified to reflect its application in 28 different countries, while in the UK it tends to be based more on broad principles. With the UK taking on more direct supervisory and legislative powers after Brexit, a likely change of style in supervision and regulation in the UK could relieve what many market participants believe is an over-burdensome and prescriptive approach of EU regulations and directives while still achieving similar outcomes. It will also involve a potential review of the structure and remit of UK bodies as they assume more responsibilities that were previously the preserve of EU authorities. For example, the Treasury Committee in parliament (or a specialist sub-committee) may have to assume a large part of the legislative scrutiny role that had previously been conducted by the ECON committee in the European Parliament.

A big challenge for the UK outside of the EU will be managing the flow of regulatory reform and legislation, particularly as it seeks to carve out a UK-specific regime that juggles EU-wider rules and global standards. A system of 'air traffic control' will lead to better coordination between the financial services regulators to ensure that the combined regulatory policy pipeline is more streamlined after the transition period ends. It would also consider the effect of other regulations that are not specifically targeted at the financial sector, such as GDPR. These functions were previously handled by a Joint Regulatory Committee of EU-wider supervisors, but will be replaced with a new initiative launched in March called the Financial Services Regulatory Initiatives Forum that will bring together UK regulators and supervisors to review, plan and prioritise reform. It will publish a regulatory initiatives grid twice a year, which should give firms in the UK more time to plan and implement reforms.

4) Wider UK financial services environment

Brexit is an opportunity to review the wider environment for banking and finance in the UK and ensure that it is proportionate to an economy in which finance plays such an important role and appropriate for one of the two global financial centres in the world (along with the US). For the past 20 years that framework has been set at an EU-wide level with differing degrees of discretion as to how individual countries apply it and differing levels of implementation. This complex body of regulation includes 37 main areas of legislation covering everything from payments and car insurance, to auditing, market abuse and trading. In many areas, the UK has been instrumental in setting this framework (such as research unbundling under Mifid II) and in others it has pushed back hard (such as the bonus cap under CRD4).

On top of EU legislation, the UK has often applied 'gold-plating', such as tougher rules on bonus clawbacks on top of the bonus cap, and its own rules such as bank ringfencing and the senior managers regime (which places a high level of responsibility on senior executives for the behaviour of their employees). There are also important areas such as the transition from Libor that the UK will have to manage. Anyone who still expects a bonfire of regulation in banking and finance on the other side of Brexit is going to be disappointed, but as and when the Covid crisis passes, there will be time for a measured review of many different areas of the UK framework and the opportunity to recalibrate and tailor them to strengthen the important role the industry plays in the UK economy, to help London remain a global financial centre, and ensure the competitiveness of the UK financial services on the global stage.

5) Digitisation & technology

One area where the UK has a clear opportunity to help set new standards is in technology, particularly fintech where it is already a global leader. The Covid crisis has accelerated the digitisation of financial services, and the UK already has a head start on many markets in this field. This shift to digital brings new challenges around the huge volumes of personal and financial data that underpin financial activity - and which are incredibly valuable for cyber-criminals: cyber-risk was cited as the biggest threat to finance after Brexit / 'UK political risk' in the latest Bank of England Systemic Risk Survey. It also raises questions around data privacy and ethics: how firms use customer data and how they ensure its privacy will become more important in the future. The UK will want to be at the forefront of developing international standards and solutions in this area.

Wider economic challenges

While a full analysis of wider economic challenges the UK is facing in future is beyond the scope of this report, here are five broad themes that we think the government and the finance sector should focus on post-Brexit and post-Covid:

1) Infrastructure
The Covid crisis has increased the urgency to the government's proposals to significantly increase investment in infrastructure across the UK to make up for decades of under-investment and help 'level up' regional inequality. The government has proposed £640bn of gross capital investment in infrastructure over the next five years and had planned to publish a National Infrastructure Strategy earlier this year. This sort of investment, combined with additional private sector funding from inherently long-term investors such as insurance companies, pensions funds and sovereign wealth funds, would help boost productivity across the economy. The Covid crisis has also exposed how the introduction of super-fast broadband and the 5G network (the UK ranks 35th globally for internet speed), would make the UK more competitive. A key question will be how to unlock private sector infrastructure investment.

2) Immigration
The UK has made it clear that on the other side of Brexit it wants to remain an open economy (it is already the most open major economy in the EU, according to our rankings), a champion of free trade, and one of the world's dominant international financial centres. This will involve a delicate balance between an immigration regime that gives the UK more control over immigration policy and one that is flexible enough to accommodate the needs of different sectors (highly-skilled staff in finance and technology; highly-skilled but lower paid staff in health and social care; and lower skilled and low paid staff in sectors like agriculture and food). The points system introduced earlier this year was designed to attract the 'brightest and the best' by setting a minimum salary requirement with discounts for more qualified people, but it may have to be recalibrated to reflect the renewed awareness from the Covid crisis of the huge contribution that lower paid staff make to the UK. The government will also need to ensure there is consistency between its messaging and reality on openness and immigration.

3) Education, education, education
Investing in new infrastructure and a new immigration regime will not be enough to renew the economy. The government will need to invest significantly more in education and ensure that the UK workforce is better equipped than ever to compete on a global stage. Reversing the significant cuts in spending in further education, increasing investment in early years education (which is the biggest determinant of future progress and also enables working parents to be more productive), continuing the reform of technical education, improving numeracy for all school leavers and graduates, widening access to apprenticeships and helping universities address the economic challenges caused by the Covid crisis will all need to be on the government's agenda in the next few years.

4) Productivity and innovation
The UK has experienced a fall in productivity growth since the global financial crisis that shows no sign of coming to an end. Achieving higher growth in productivity creates a virtuous circle of rising living standards, higher economic growth, and higher tax receipts. In addition to investing in infrastructure and education, the UK will need to support entire industries that have been hit by the Covid crisis to recover and focus on investments in digitisation, automation, and AI to boost productivity. Capital markets can play a significant role in allocating the funding for this recalibration of the UK economy - particularly in terms of a significant increase in equity funding - and investors and companies will need to be encouraged to take a longer term view on investments.

5) Building back better
Since the beginning of the Covid-19 epidemic there has been much debate around the need to 'build back better': a more responsible, greener and more sustainable economy. After unprecedented levels of peacetime government support for the economy, businesses will need to get on the front foot in terms of thinking about how they can contribute to this process. This may involve redrawing the social contract between business and society with a particular focus on social issues (the S in ESG), a renewed focus on pay and bonuses, and a wholesale review of the balance of taxation between income versus wealth, and individuals versus companies.

Challenges and opportunities

Brexit provides the UK with both an opportunity and an imperative to develop closer ties with markets around the world. The headline opportunity is huge: the rest of the world outside of the EU represents 78% of global GDP and 85% of capital markets activity, and many economies and markets outside the EU are growing much faster than the EU. Here are five themes that will define and shape the UK's future approach to banking and finance on the global scene:

1) Geopolitical tension
The Covid crisis has increased political tensions around the world and accelerated the trend towards deglobalisation over the past few years. This has involved heightened political and trade tensions between the US and China, an increase in protectionism and localism around the world, and challenges to the global framework such as the WTO. The UK will need to develop a clearer foreign policy that navigates a path between China, the EU and the US and that is closely aligned with its commercial and economic interests. While these geopolitical tensions make for a challenging backdrop for the UK to be setting out on its own, this dislocation could provide opportunities for the UK to carve out new relationships.

2) Brexit trade-offs
The key debate on Brexit from a financial services perspective is the trade-off between access to EU markets and customers on the one hand and alignment with or divergence from EU rules on the other. The more closely aligned the UK remains to the EU, the less room for manoeuvre it will have in recalibrating its domestic framework and the less flexibility it will have to develop closer financial ties with non-EU countries. In the short-term it may make sense for the UK to remain closely aligned to the EU in some key areas - particularly around market access and reducing the frictional cost of doing business - to minimise disruption and retain some access through equivalence. But in the longer-term, given that many firms have relocated at least some of their business to the EU, it perhaps makes more sense to treat this as a sunk cost and explore sensible divergence in the UK's domestic regime that focuses on ensuring the competitiveness of UK financial services on the global stage and provides more flexibility to develop closer ties with key markets around the world.

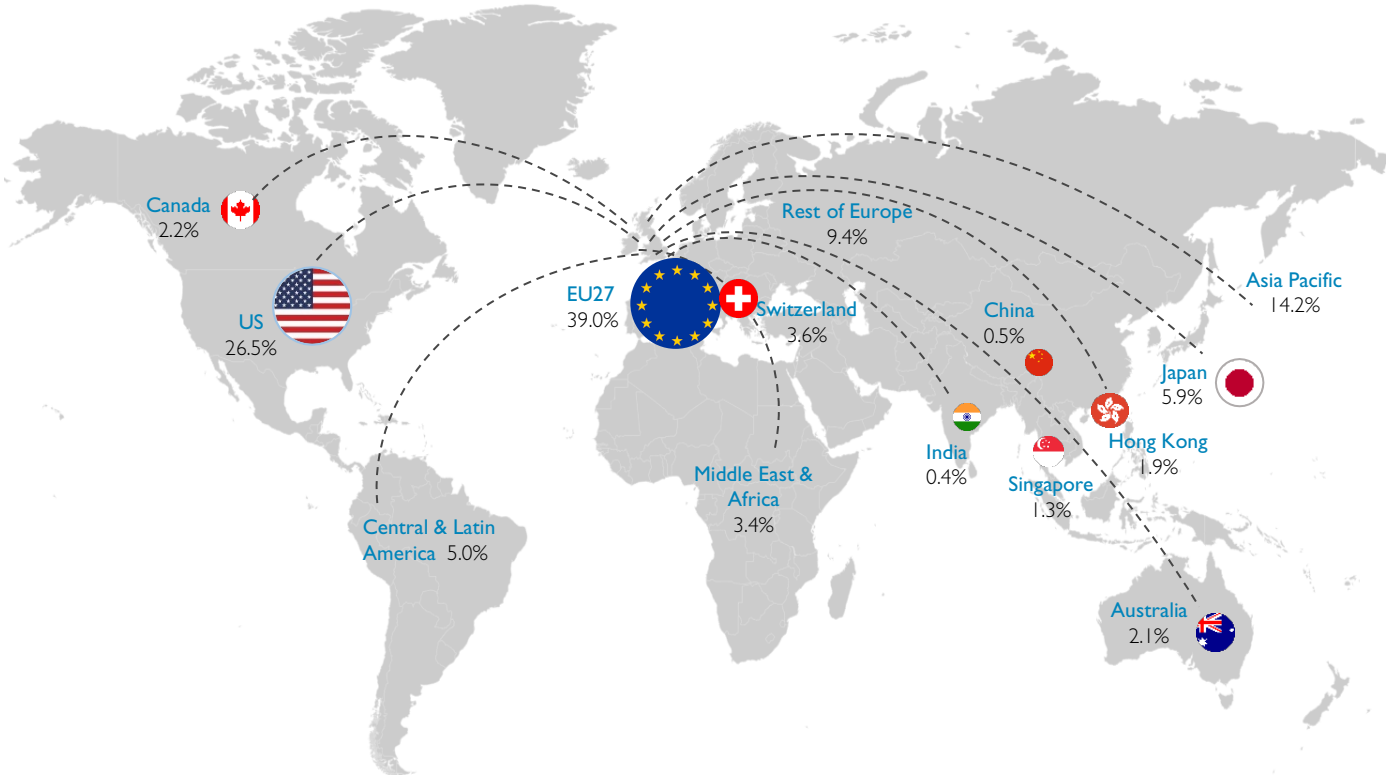
3) Global standards
One of the most immediate challenges for the UK will be defining a clear vision of the UK's future role in global finance. The UK will lose its influential voice in many of the formal channels that help shape European and global financial regulation (such as the European Parliament, Commission and Council, and the EU-wide supervisory agencies) as a result of Brexit. The UK has a strong voice in global bodies such as the Financial Stability Board, the G7 and G20, and IOSCO but will need to redouble its efforts to retain its influence. The UK has an opportunity to help lead the way in setting global standards in areas such as sustainable finance, derivatives and post-trade, and fintech, using the convening authority of London as a financial centre and its existing links to emerging markets as demand for financial services increases in those economies.

4) Financial centres
Outside of the EU, the UK is going to face fierce competition from other financial centres. In addition to existing competition from the likes of the US, Singapore and Hong Kong, financial centres in the EU will aim to attract business at the margin from the UK in different sectors. The outcome of the US elections in November may define whether the US continues on a path of easing the framework for banking and finance, which could further increase competition. Our research shows that the UK is the second largest international financial centre in the world after the US based on the value of activity, and it is well ahead of any of its competitors in Europe. While we expect the City of London to continue to thrive as a global financial centre post-Brexit, it cannot afford to be complacent.

5) A focus on partnerships
Much of the debate on the future of the UK's international trade since Brexit has focused on formal trade deals. When it comes to financial services, this focus is misplaced. Most trade deals focus on goods (particularly agriculture) and have very limited provision for financial services (if any). The only example of an international trade deal with substantial provision for financial services is the EU itself, and recent EU deals with Canada and Japan have very limited impact on financial services. A better approach is to develop closer bilateral partnerships with countries around the world that can have a bigger impact than a formal trade deal and take much less time. These involve formal structures for cooperation between supervisors, specific agreements to support particular sectors, dialogue on reducing regulatory frictions, and trade promotion.

Fig.11 The current relationship between the UK and the rest of the world

Share of UK financial services trade (imports and exports) by country and region in 2019



A good starting point

The benefits of London's position as a global financial centre and of the UK's membership of the single market are reflected in its trade and investment relationship with other countries. Fig.11 shows the share of the UK's total financial services trade by country and region in 2019. It is clear that the UK has developed a much stronger relationship in financial services with the EU27 and with the US than with the rest of the world.

Nearly 40% of the UK's total trade in financial services is with the EU27, and another quarter is with the US. The obvious multi-billion dollar question is how much of this trade with the EU will the UK be able to retain on the other side of Brexit - and where will it turn to make up for any shortfall? It is striking that while countries like China and India offer big growth prospects, their current level of combined trade in financial services is just 2.5% of the value of the UK's trade with the EU and a fraction of current trade with individual EU member states such as France or Germany.

Obviously on the other side of Brexit, the UK cannot afford to ignore its biggest market on its doorstep, but it has an opportunity to boost trade with other regions such as with Asia Pacific. Our analysis show that Asia is set to contribute by far the most to future growth in global financial activity and it currently accounts for just 14% of UK's total trade in financial services. There is also scope to look at European countries that are not EU members such as Switzerland which accounts for 3.6% of total trade and with whom the UK has recently started formal talks on a financial partnership that would improve ties between two of the most important financial centres in Europe. The picture is similar in foreign direct investments in the financial sector. More than half of inward and outward FDI in financial services to and from the UK is done with companies from the US and the EU27. Nearly half of all direct investment in UK financial services firms comes from US firms, reflecting the fact that London is used by US firms as the point of entry into Europe, while a fifth comes from EU27 firms.

The future of UK banking and finance in a post-Brexit world

This report has argued that while Brexit brings many challenges for UK banking, finance and capital markets, it provides an opportunity and an imperative for the UK to address some big strategic questions about the future of one of its most important industries. The Covid crisis has sharpened this debate by highlighting the vital role that banking and finance play in supporting the wider economy and in fuelling a recovery.

Here is a selection of ideas for discussion as to how the UK might think about the challenges and opportunities ahead and what measures it might take in terms of responding to Brexit; its future international trade in financial services; a future recalibration of the UK supervisory and regulatory framework; and the role that capital markets can play in supporting the UK economy to help drive a longer-term and more sustainable post-Covid recovery.

i) Responding to Brexit

1) **A short term measure:** the UK government should continue to push for 'day one equivalence' in as many of the 40 or so areas of legislation where it applies but should focus in particular on securing equivalence for trading venues in both equities and derivatives to minimise disruption to markets (the EU has already granted equivalence in clearing for 18 months). But the UK should avoid thinking of equivalence as a broad or long-term solution to Brexit.

2) **A sunk cost:** the UK's base case should be to accept that a certain amount of activity will relocate from the UK to the EU in any scenario to ensure that firms in the UK can retain access to EU customers and markets. Once it has done so and this market is secured, the UK should focus more on sensible recalibration of the UK framework than on long-term alignment (outside of key areas of equivalence).

3) **A pause for breath:** while there are many areas of the EU framework that the UK government and market participants would like to recalibrate, it may make more sense to put in place a moratorium on any substantive change for a defined period (perhaps a year or two). This will increase trust with the EU and give firms and regulators time to adjust to life after Brexit without also having to deal with radical changes in rules and regulations. The other side of Brexit will last a very long time: there is no need to rush.

4) **Informal cooperation:** while the UK has already lost its seat at the table in the formal channels of EU policy (The European Parliament, Commission, Council and ESAs), close cooperation between the UK and EU will be a fact of life. It will be vital to maintain high levels of cooperation and communication between UK and EU supervisors and create new informal channels for dialogue. The UK could launch a series of bilateral initiatives involving high-level conferences (like the Belvedere Forum between Poland and the UK) and expert working groups between supervisors, particularly on key issues such as digitisation, cyber security, data, and fintech.

5) **Supporting CMU:** the combination of Brexit and the Covid crisis has injected a renewed sense of urgency to the EU's capital markets union project. The EU has lost its largest and deepest capital market and while the UK will not be part of CMU, it should support the initiative and even mirror it in some areas. The UK government and industry should offer their supervisory, technical and market expertise to the EU and to individual member states to help support the CMU project. While bigger, deeper and more integrated capital markets in the EU may be seen as a competitive threat to the UK in the medium term, they will also offer big opportunities for the banking and finance industry in the UK in the longer-term.

6) **Focus on openness:** there is a danger that after Brexit, capital markets in the EU and in some other financial centres become more inward looking and less open to international capital and investment. The UK should maintain a strong focus on openness and avoid any political tit-for-tat responses to EU regulation. The Temporary Permissions Regime is a good example: while in most cases EU supervisors have required firms to set up new subsidiaries in the EU to prepare for Brexit, the UK has extended EU firms' existing access to the UK for three years.

ii) The international stage

The UK can build on its position as a global financial centre to reassert its standing on the global stage, support international flows of capital and investment, and retain its competitive position in a rapidly changing global market:

7) **A focus on competitiveness:** as the UK forges a new path on the other side of Brexit it will be vital to ensure that UK firms can remain competitive on a domestic and international level in the face of pressure from larger markets in the US, Europe and Asia. One approach would be for the UK to launch a commission to analyse the competitive position of UK firms, the UK framework, and of London as an international finance centre. Under forthcoming legislation, competitiveness is likely to become a formal part of the mandate for UK supervisors, and any future legislation or regulation will need to be tested against its potential impact on competitiveness.

8) **Financial diplomacy:** the UK should significantly increase its spending on financial diplomacy around the world - particularly in key markets such as the EU, US, and Asia. This effort would promote UK expertise in banking and expertise overseas and promote the UK as a financial centre. It would provide a focal point for the wide range of activities conducted by HM Treasury, the Foreign & Commonwealth Office, Department for International Trade and industry initiatives. It could be matched by the creation of an agency to create a single point of access for international firms in banking and finance looking to invest in the UK or set up in the UK.

9) **Global standards:** the UK has long been an influential voice in helping to shape global standards in banking and finance, but on the other side of Brexit it will have to step up a gear. The UK can build on its existing strengths in a number of key areas to help shape new global standards through the likes of the G7, G20, Financial Stability Board and Iosco. These might include areas such as trading and clearing in derivatives and FX (where the UK accounts for about half of all global volumes); ESG, where the UK can build on hosting the COP26 talks in Glasgow next year; and fintech. As a potential free agent with a significant market share and deep expertise, the UK could help make or break competing regional initiatives. For example, in derivatives the UK and US have a combined 70% share of global activity and closer cooperation could effectively create de facto global standards.

10) **A closer financial partnership:** while much of the debate on the future of the UK trade post-Brexit has focused on free trade agreements, in financial services it would be better to focus on less formal but more effective financial partnership agreements with like-minded countries around the world with highly-developed capital markets (such as Switzerland, Canada, Japan, Singapore, and Australia). These partnerships would aim to reduce regulatory frictions and increase market access, as with the bilateral talks on financial services with Switzerland and the recent trade deal agreed with Japan. At the same time, the UK should continue parallel discussions on agreements with larger markets that may prove politically more difficult, such as China, India, and the US.

11) **Joined up thinking:** the UK will need to focus across government on joined up thinking in areas such as immigration, education, and infrastructure to ensure that policy is aligned with the stated commitment to be an open economy and a crossroads for international trade. Policies on aspects of immigration, tax and trade that are designed to assuage domestic political concerns will need to be carefully balanced with the need to support and project the UK as an open and international market.

iii) Recalibrating the UK framework

Given the importance of banking and finance to the UK economy both as a sector in its own right and in oiling the wheels of the UK economy, it will be important for the UK to ensure that on the other side of Brexit it develops a supervisory and regulatory framework that is tailored to the unique nature of the UK's financial services industry:

12) **A clear strategy:** *'Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat'*. Before diving into a fundamental review of its framework, the UK should develop a clear vision for UK banking and finance. A commission of government departments, regulators and different sectors of the industry could take their time to develop a clear financial services strategy for the UK for the next 20 years. What role should financial services play in the UK economy as a sector in its own right, on the international stage, and in supporting the domestic economy? And what sort of framework will the industry need in order to achieve that?

iii) Recalibrating the UK framework (continued)

13) **A sensible plan:** the danger with any recalibration of the UK framework is that it could quickly become a laundry list of policy changes that creates as many problems as it solves. A sensible plan would involve a handful of guiding principles, a short set of priorities in each sector, a clear set of targets with defined milestones, deadlines and sunset clauses. It will be important to avoid expending too much time and political capital on the wrong problems (things that would be 'nice to have') and focus instead on a smaller number of 'first principle' issues. A good separation would be to think of alignment with the EU when it comes to issues of market friction and access, and recalibration when it comes to the prudential framework.

14) **A clear process:** the UK will need to develop a transparent and formal process for reviewing the existing framework that it has inherited from the EU. This would provide clarity on how the government is reviewing different areas of legislation and the metrics and criteria it is using to do so. The starting point should be ensuring that the UK banking and finance industry is able to provide the right level of support to the wider economy, and key considerations might include whether a particular measure is reducing the ability of firms to provide services, creating a market failure or distortion, or putting UK firms at an identifiable competitive disadvantage.

15) **The politics of regulation:** for the past few decades most legislation covering financial services in the UK has come from the EU (with the European Commission proposing it, the European Parliament scrutinising it and member states approving or rejecting it in the European Council). Post-Brexit, the UK will have to redesign the policymaking and legislative process for banking and finance. This might include the new Financial Services Regulatory Initiatives Forum working in tandem with a beefed-up Treasury Committee (or specialist sub-committee) to ensure that all financial legislation has appropriate input and scrutiny.

16) **Taking the lead:** Brexit could be an opportunity for the UK to lead by example on some of the big common challenges facing different regulators around the world. These might include addressing the tax differential between debt and equity funding; providing carefully-managed public access to private capital; rethinking the obsession with daily liquidity investment funds; addressing the problems of closet-indexing; driving diversity in banking and finance; and the future of finance in the data economy.

17) **A revolution in regulation:** Brexit is a good occasion for the UK to rethink its approach to supervision and regulation in at least two ways. First, the UK should take the lead and embrace digital regulation that would reduce costs and improve efficiency, accelerate the moves towards digital IDs for companies and individuals, and help identify how to rationalise the UK rulebook. Second, the UK could rethink the mandate for regulators to ensure a renewed focus on a level playing field for competition and perhaps introduce an element of widening market participation into their mandates.

iv) Supporting the UK economy:

In the last financial crisis more than a decade ago, banking, finance and the capital markets were a big part of the problem: this time they are a big part of the solution. The Covid crisis has underlined the value to the UK of a diversified financial system with a combination of bank- and market-led financing, and a combination of local and international firms (UK banks facilitated the vast majority of government-backed lending in response to Covid) and the role the industry can play in fuelling a post-Covid recovery and tackling regional disparities in the UK:

18) **Unlocking investment:** one of the fundamental challenges for the UK is that while it is blessed with deep pools of long-term capital (roughly £5 trillion in pensions, insurance assets and savings) it has a desperate shortage of patient capital. One of the most urgent changes to the UK framework should be reviewing the regulatory barriers from Solvency II and other regulations that are limiting the ability of inherently long-term investors such as pensions funds and insurance companies from investing more in long-term productive assets like infrastructure, environmental projects, social investments, and private or publicly-listed companies with long-term growth potential. At the same time, the supervisory framework for banks should ensure that it does not inhibit bank lending to those companies - particularly SMEs - that cannot realistically access the capital markets.

iv) Supporting the UK economy (continued)

19) **Building back better:** capital markets could play a bigger role in supporting infrastructure investment across the country to help level up regional economies and raise the overall resilience of the economy. Along with unlocking more long-term capital from pensions and insurance assets, the UK could develop new investment vehicles and structures (perhaps along the lines of the municipal bond market in the US or covered bond markets in Europe) to help channel a huge increase in private capital into infrastructure, environmental, and social investments.

20) **Boosting public markets:** equity finance drives growth and innovation but public equity markets in the UK, Europe and US are shrinking. The UK can build on its position as the largest stock market in Europe and a global centre for international listings to encourage the growth of new issues in a number of ways, including:

    i) taking a global lead on reviewing the tax differential between debt and equity finance and potentially experiment with a tax-deductible corporate equity allowance or notional interest deduction, or setting tougher limits on the amount of debt that is tax deductible to encourage more equity financing.

    ii) high standards of corporate governance and disclosure are a hallmark of high-quality markets. However, there is scope to review whether the current framework is appropriate for all sizes of companies, and perhaps reduce the disclosure gap between public and private companies.

    iii) a clearer segmentation of markets that includes periodic trading in smaller stocks - perhaps three auctions a day - could make stock markets more attractive for smaller companies and attract more investors.

21) **A longer-term view:** innovation and investment require a longer term perspective than the next quarter. The UK could take a lead in encouraging companies, intermediaries and asset owners to take a longer-term view. For example, it could build on the new UK stewardship code and encourage companies and their investors to focus more on their longer-term strategy over the next five to 10 years, along with a clear roadmap and milestones marking progress. Public sector pension funds could be encouraged to lead by example.

22) **A focus on scale-ups:** a cross-government focus on high potential growth companies and scale-ups, with a clear definition and a revised tax and regulatory regime would help support this key area of the economy. Local government could work more closely with industry and universities to help foster local centres of innovation.

23) **Closing the exclusivity gap:** the returns from private capital and illiquid assets can exceed the returns from public markets by as much as 5% a year, but these markets are effectively off limits to most individuals and smaller pension schemes. Reviewing regulations to enable wider access to private capital and illiquid assets and identifying the right vehicles to enable it would help close this gap and be a significant boost to wealth creation.

24) **A third way:** the UK could explore the creation of a 'third way' between private and public markets. This could involve a formal market with regular but infrequent trading; a level of disclosure and governance requirements that is not as demanding as a fully-listed company; and tax incentives for issuers and investors. This could be a potential venue for private companies that need to raise forms of equity (such as preferential shares or convertible debt) in response to the Covid crisis but which are not ready or willing to do a full listing.

25) **A post-Covid recovery:** while the full economic impact of the Covid crisis and the eventual shape of a recovery are not yet fully understood, it is clear that addressing it will require creative and radical solutions by government and the capital markets industry. The big danger for the economy is that any recovery will be suffocated by tens of thousands of previously viable companies going under - and millions of jobs being lost - because of the emergency debt they took on to see them through the crisis. Capital markets will need to work with the government to develop the right structures and vehicles to help these companies and channel equity and growth capital into the economy. While the government has downplayed the idea of a state-backed recovery corporation, other options to explore include creating an industry-wide bad bank; the launch of a public / private patient capital fund seeded by government money but funded largely by private investment; or turbo-charging existing vehicles like the Business Growth Fund.

NEW FINANCIAL
Rethinking capital markets

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A reality check on equivalence

The Crisis of Capitalism

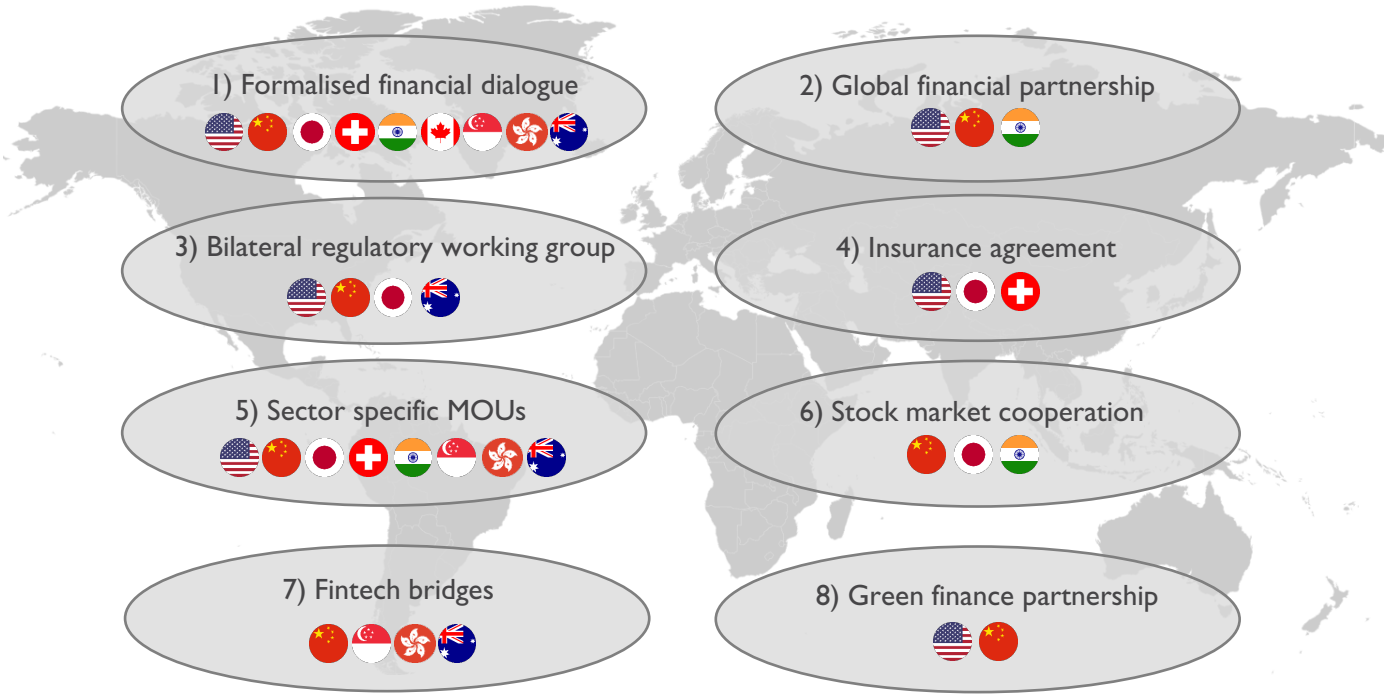
A new sense of urgency: the future of capital markets union

What do EU capital markets look like on the other side of Brexit?

Unlocking the growth potential of European capital markets

Fig.12 Potential future financial partnerships

Summary of main themes and components of discussions between the UK and other countries on future potential partnerships



A closer partnership

While the EU27 will remain the most important partner and market for UK financial services on the other side of Brexit, both the government and the financial services industry have focused in the past few years on developing closer relationships with countries further afield. These partnerships do not require a comprehensive trade agreement but can have a significant impact on the value of activity. Here is a summary of the main types of agreements underway:

1) Formalised financial dialogue: a clear structure for a commitment to developing closer partnership at a government and industry level.

2) Global financial partnerships: a forum that enables high-level talks allowing finance ministers and regulators to have regular exchanges on financial services with a view to developing closer ties.

3) Bilateral regulatory working groups: key regulatory institutions in each country meet formally on a regular basis to discuss the outlook for financial regulatory reform, areas of cooperation, and encouraging efficient trade between the two jurisdictions.

4) Insurance agreement: the UK has signed insurance agreements that replicate the conditions under its former EU membership with Switzerland, the US and Japan, including the elimination of local presence requirements.

5) Sector-specific memorandum of understanding: the UK has signed a variety of MoUs in areas as diverse as fintech, insurance, financial services regulatory cooperation, anti-money laundering and promoting green finance solutions.

6) Stock market cooperation: this cooperation mechanism provides a bridge for investors and issuers between London and fast-growing markets, such as the Shanghai-London Stock Connect.

7) Fintech bridges: the aim of this initiative under the leadership of HM Treasury and the DIT is to improve and accelerate access for fintech companies in the UK and overseas to each other's markets.

8) Green finance partnership: the UK has established partnerships with the aim of fostering green bonds and green IPOs and promoting joint investments into green infrastructure projects, such as the Green Finance Task Force with China.

APPENDIX B - FUTURE PARTNERSHIPS BY COUNTRY

Fig.13 A summary of discussions with other countries

This is a country-by-country summary of the main discussions on financial partnerships that have taken place so far, their progress to date, and potential next steps.

Country	Existing discussions	Progress to date	What is planned for the future
USA	• Regulatory cooperation and coordination, fostering commercial engagement, e.g. through connecting market participants.	• Financial regulatory working group (FRWG) between Fed and BoE, founded in 2018 and meeting twice a year. • Financial innovation partnership since May 2019 for collaboration between US Treasury and HM Treasury, regulatory engagement.	• Financial innovation partnership on commercial engagement; supporting private sector, industry associations & market participants trade promotion missions. • UK-US industry coalition with recognition agreements for accountants to practise in both jurisdictions. • Codification of outputs from regulatory dialogue within a future trade agreement.
CHN	• Boost bilateral trade and investment and increase exchanges and cooperation when it comes to regulatory questions.	• Establishment of a RMB clearing bank in London • Issuance of Chinese sovereign bonds outside China and London - Shanghai Stock Connect with issuance of Panda Bonds by British banks • BoE and the PBC 2 joint symposiums on macro-prudential frameworks, green finance, regulatory cooperation.	• MoU on Anti-Money Laundering Cooperation between PBC and FCA • Opening of Chinese market to UK-based FRPSs • London as hub for offshore Renminbi, green finance, fintech and infrastructure activity, including Belt and Road Initiative (BRI).
JPN	• UK-Japan trade deal signed in September 2020. • UK-Japan Financial Dialogue to deepen financial partnership. • TheCityUK market access group (MAG)	• Exchange of letters with temporary measures from 2021, when EU-Japan mutual recognition agreement on conformity assessment no longer applies. • MoU between City Corporation and Tokyo Government in 2017, renewed partnership between LSE and JEG to support dual listing opportunities	• Building on UK-Japan trade deal and provision of new financial services • Access to payment & clearing systems, ensuring national treatment when requiring use of self-regulatory organisations • Maintaining transfers of information, providing public information on licencing requirements
CHE	• "Mind the gap" strategy since October 2016 • Formal talks on a bilateral financial services agreement started in June 2020.	• Trade agreement in 2019 that replicates majority of existing agreements through EU. • Insurance agreement in 2019 that guarantees freedom of establishment for insurance companies (direct insurance other than life insurance)	• Securing grandfathering provision, current market access to each other's financial markets and infrastructure, including clearing houses, trading venues and repositories, settlements, payments and securities transfer systems. • Global financial partnership agreement.
IND	• Promoting the internationalisation of the Indian Rupee and increasing fintech cooperation	• MoU on stock exchange cooperation signed in 2018 to create a dual listing route for Masala bonds. • Fintech dialogue launched in 2019	• Development of India's corporate bond market and reinsurance industry, Indian Stewardship code, internationalisation of the Rupee, and developing India's green finance market
CAN	• Promoting fintech industries • Joint initiatives in financial services through trade missions and industry associations	• DIT trade mission in 2019 with 12 Canadian fintech companies. • MoU between TheCityUK and Toronto Finance International on digitisation	• Potential financial services chapter in future trade deal
SGP	• UK-Singapore 'partnership for the future' • Cooperation in promoting fintech & sustainable finance	• Fintech bridge • MoU between the Monetary Authority of Singapore and the City of London Corporation enhancing cross-border KYC processes, and green / sustainable finance	• Digital economy • Sustainable business and innovation • Security and defence • Education culture and youth
HKG	• Foster stock market cooperation and mutual recognition of funds • Fintech bridge	• MoU between FCA and SFC on mutual recognition of funds, allow eligible Hong Kong public funds and UK retail funds to be distributed in both markets	• Developing clear regulatory environments to enable businesses to operate easily between both markets.
AUS	• Fintech cooperation and regulatory cooperation between the FCA and the Australian Securities & Investments Commission	• Two MoUs between FCA and ASIC signed in 2019, on trade repositories and on alternative investments funds (AIFs). • Fintech bridge	• UK adoption of EU equivalence decisions that relate to Australia's supervisory & regulatory regime for trading venues, OTC derivatives markets and credit rating agencies. • Comprehensive FPS bridge, with selective mutual recognition