BRIEFING

Brexit: the United-Kingdom and EU financial services

This briefing describes the prominent role of the UK in the single market for financial services, and highlights which activities rely today on passporting for their daily business with the other 27 Member States. The briefing relies on publicly available information, including secondary sources, such as analytical papers done by research institutes and private sector companies. The briefing may be regularly updated pending new information.

In 2016 the Global Financial Centres Index placed London once again as the leading global financial centre, ahead of New-York, Singapore, Hong-Kong and Tokyo. This index factors in a number of dimensions: business environment, financial sector development, infrastructure, human capital as well as reputation. This highlights the prominent role played by London in the single market for financial services, since it operates as a hub for the whole Union.

The place of London as a major financial centre largely predates the single market and relies on a dynamic business environment, the predictability of the British legal system, the worldwide use of English as language for business, and the attractiveness of a cosmopolitan city. London managed to attract a critical mass of expertise in financial and other related professional services, and benefitted from the development of the single market or financial services in the nineties and more recently from the introduction of the single currency in continental Europe (Center for European Reform).

Today, half of the world's financial firms have based their European headquarters in London, and more than 1 million people work in the financial sector in the UK: banking activities, insurance and reinsurance, asset management and market infrastructures. With related professional services (accounting, legal, advisory...), the total amount reaches 2.2 million people. The financial sector earned about GBP 200 billion (11% of GDP) in total revenues (turnover) in 2015, half of which relates to domestic activities, while the other half includes international and wholesale business related with the EU and other foreign markets. This represents about 24% of all EU financial services, and generates about GBP 60 - 67 billion (3.5% of GDP) in UK taxes each year (see details in annex).

Table 1: Interconnections between UK and EU financial services

	Total	Banking	Asset management	Insurance and reinsurance	Infrastructures and others
UK financial services revenues (GBP bn)	**190-205**	**108-117**	**20-23**	**39-42**	**22-26**
UK financial services revenues (% of GDP)	11%	6%	1%	2%	1%
UK financial services revenues related to the EU	23%	22%	26%	10%	44%
UK market shares in the EU	24%	26%	41%	22%	-

Note: market shares relate to revenues (whole sector), bank lending (banking), value of assets under management (asset management) and insurance premiums (insurance and reinsurance). Source: EGOV based on figures provided by TheCityUK, LSE, New Financial, Oliver Wyman

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Banking activities

Banking activities include mainly (i) traditional retail and business activities (ii) international and wholesale finance, and (iii) private banking and wealth management. Among financial services they together constitute the largest contributor to the UK economy: they represent about half of the revenues, workforce, gross added-value and annual taxes of the financial sector (see annex). About 22% of overall banking revenues comes from international and wholesale activities related to the EU.

Regarding those interconnections between the UK and the EU-27, banks operate either through subsidiaries, branches or directly through cross-border transactions. While operating through cross-border transactions or through branches is less expensive than establishing a fully-fledged subsidiary, it requires the use of the so-called regulatory passports which rely on the participation of the UK in the single market (see box 1). According to the Boston Consulting Group, setting up subsidiaries in the EU-27 would increase global costs by 3% to 8% for investment banks, depending on their current operational model. Conversely, European banks operating in the UK through branches (10% of the total assets in the UK, see table 2), would also face higher costs.

Table 2: The UK banking system (2014)

in GBP bn	Total assets	Wholesale banking in London
Major UK international banks	3570	1180
Major UK domestic banks	1160	-
Other UK banks	250	-
Rest of the world - investment banks	1730	1730
Rest of the world - other banks	460	310
Branches of EEA banks	790	530
Total UK banking system	**7960**	**3750**

Source: *Bruegel*

The UK banking system is dominated by major UK banks (60% of total assets), with a particularly strong focus on wholesale activities, both from the UK and foreign international banks (see table 2).

Box 1: Passporting banking services in the single market

The financial passport first appeared as a framework for single banking licence and mutual recognition. In 1989 the second banking directive allowed banks to operate branches throughout the EU while remaining mostly under home State supervision. The single banking licence is now enshrined in the Capital Requirement directive IV (CRD IV). Article 17 CRD provides that "*Host Member States shall not require authorisation or endowment capital for branches of credit institutions authorised in other Member states*". Banks can therefore establish branches or provide services in other Members States, subject to the prior notification of competent authorities.

As to the supervisory regime, article 49.1 CRDIV provides that "*the prudential supervision of an institution (...) shall be the responsibility of the home Member State*", albeit the host supervisor retains a number of competences, in particular as regards liquidity supervision and the protection of depositors or investors. Conversely, the CRD IV does not include any provisions for third-country access to EU markets, which means third-country banks must first get supervisory authorisation before conducting business in the EU. See also EGOV briefing on *Third-country equivalence in EU banking legislation*, PE 587.369.

Wholesale banking

Wholesale banking consists in large transactions between financial institutions, or the provision of banking services to large customers (pension funds, large corporates, asset managers and other institutional customers) with specific needs in terms of cash management, access to capital markets, large trade transactions and foreign exchange exposures. They play an essential role in helping big issuers (large corporates, governments, financial institutions) reach out to investors (asset managers, hedge funds, insurers, pension funds) and therefore benefit from the network effects of London as a global financial centre.

Figure 1: The role of wholesale banking in the financial market ecosystem

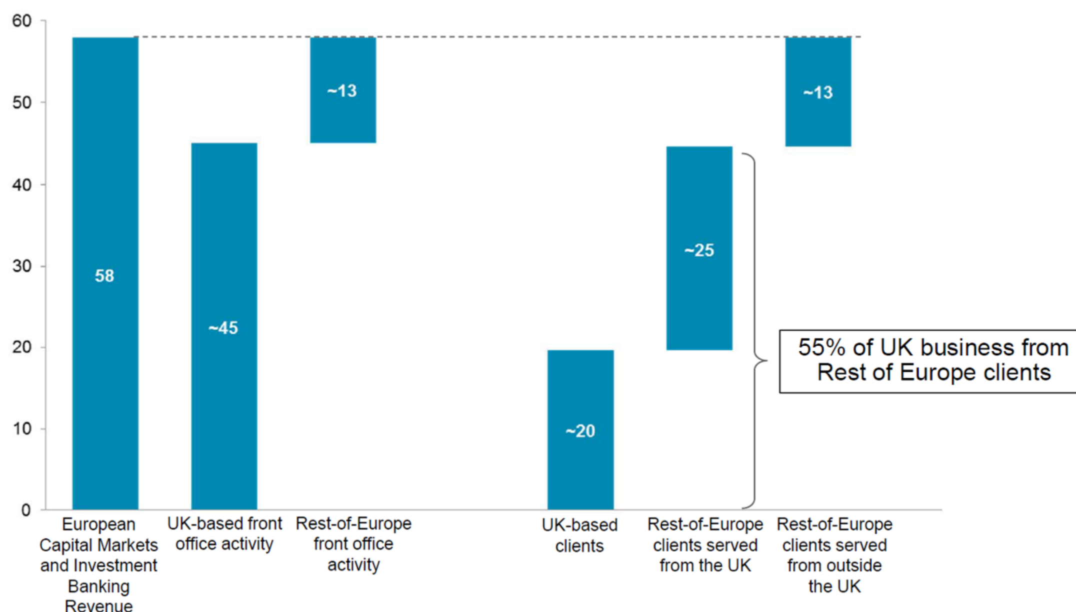
Source: Oliver Wyman

Table 2 shows the importance of wholesale banking in the UK banking system: it accounts for nearly half of its total assets, due to the prominent role of London as a global financial centre. Indeed, 588 overseas companies are quoted on markets in London (of which 112 EU-27 companies are listed on the London Stock Exchange): European companies take advantage of the deepness of the UK capital markets to reach out to investors. As a result, 46% of the EU equity is raised in London. Large corporates and investors also turn to wholesale banks to manage their cash and hedge foreign exchange and interest rate risks: about 75% of the EU foreign exchange and interest rates derivatives trading takes place in the UK. As a consequence, 35% of the wholesale financial activities of the EU takes place in London (source: TheCityUK).

Wholesale banks include UK banks, other EEA banks and non-EEA banks (in particular big US investment banks). The financial passport is therefore used by other EEA banks which provide services in London through a branch, and by UK and non-EEA banks to provide services in other EU markets where they do not have established subsidiaries. Some non-EEA banks use their London subsidiary to passport financial services throughout Europe. For example, it is estimated that the top five US investment banks' locate about 90% of their European operations in the UK.

Looking at the EU wholesale market, about 78% of European capital markets and investment banking revenues (EUR 45 billion out of total revenues of EUR 58 billion) are based in the UK, 55% of which (EUR 25 billion) originate from EU-27 clients (see figure 2).

Figure 2: Breakdown of wholesale revenues by front-office location and client location



Source: Oliver Wyman

Retail and business banking

Traditional retail and business banking accounts for about 55% of banking revenues in the UK (GBP 58 - 67 billion, see annex). Those activities are mainly domestic, with only a marginal share of the business operated cross-border. The European Commission estimates that for credit cards, mortgages and current accounts, less than 3% of consumers have already purchased such banking services from another Member State, and that cross border loans account for less than 1% of household loans in the euro area. Therefore the main interactions between the UK and the EU-27 in retail services occur through branches or subsidiaries from EU banks in the UK or, conversely, through branches or subsidiaries from UK banks in the EU-27. According to Bruegel (see table 1), the retail and business activities of EU branches in the UK is rather limited (total assets amounting to EUR 260 billion, i.e. 3% of total banking assets in the UK). UK banks operate in other Member States through branches (between 10 to 15 typically for RBS, Barclays and HSBC) or subsidiaries. Open Europe estimates that less than 10% of their global revenues originate from the EU-27. Since this figure doesn't refer to retail business activities only, but also encompass wholesale activities, the share of revenues generated only by retail and business activities in the EU-27 remains rather limited in UK banks' global revenues.

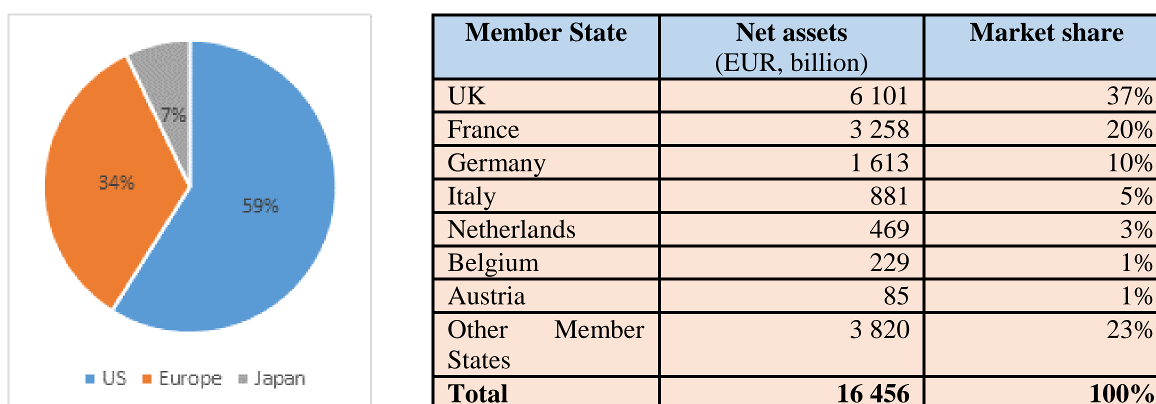
Private banking and wealth management.

Private banking and wealth management is directed at wealthy individuals who are by nature very mobile, and the offshore business has historically played a prominent role in order for those individuals to manage their wealth and protect their belongings from political events (confiscations, wars...). While the development of offshore jurisdictions largely predates the single market for financial services, within the EU private banks benefit from financial passports to deal with their international clients. The size of the business remains small compared to retail and wholesale banking activities: revenues from private banking and wealth management amount to GBP 5-6 billion in the UK, about 5% of total banking revenues (see annex).

Asset management

The asset management industry plays a key role in the financing of the European economy by channelling savings and investments from retail and institutional investors to non-financial corporates, financial institutions and governments. The importance of asset management in the financing of the economy has grown steadily since the 1990s and this phenomenon has even accelerated since the 2008 financial crisis where direct market-based financing had to substitute impaired bank lending channels. The Capital Markets Union is meant to increase such trend even further.

Figure 3: Assets under management, worldwide and EU market shares



Member State	Net assets (EUR, billion)	Market share
UK	6 101	37%
France	3 258	20%
Germany	1 613	10%
Italy	881	5%
Netherlands	469	3%
Belgium	229	1%
Austria	85	1%
Other Member States	3 820	23%
Total	**16 456**	**100%**

Source: EFAMA (European Fund and Asset Management Association), Asset Management in Europe, 8th annual review, April 2015

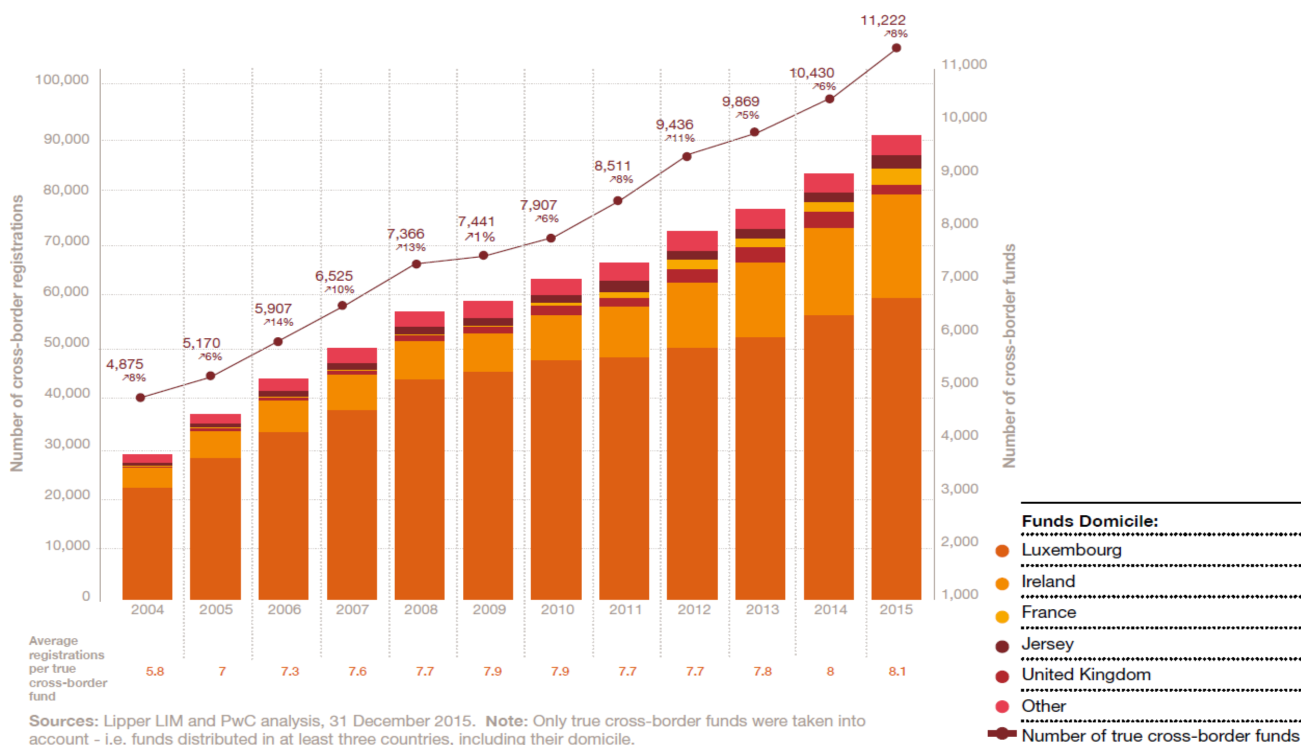
The UK has a very strong position in asset management worldwide and within the EU. The City of London is the second largest global centre for hedge funds after New-York City. While the EU ranks second -behind the US- for asset management globally, the UK is the largest centre of asset management in the Union with a market share of 37% of assets under management. In terms of direct employment, the EFAMA estimates that 90 000 people work for the asset management industry across the EU, among which 31 800 are based in the UK.

Funds managed in the UK have a cross-border reach. According to the European Fund and Asset Management Association (EFAMA), 40 % of the assets under management in the UK are invested by clients located abroad. These clients are predominantly institutional clients who provide 80 % of the total assets under management (among which more than 40 % are invested by pension funds).

If the UK is Europe's leading centre for fund management, it ranks behind Luxembourg and Ireland for fund domiciliation. Actually, many fund managers in the UK are in fact 'delegated' managers: they manage the assets of funds domiciled elsewhere in the EU. Such delegation is provided for in EU law. Figure 4 provides with the number of cross-border funds and the breakdown by country of domicile: 65% and 22% of cross-border funds are actually domiciled respectively in Luxembourg and in Ireland.

Access to EU markets for UK fund managers is likely to be negatively impacted by the loss of the EU passport. The possibility to delegate the management of funds to a third-country is currently quite restricted under EU law. If the AIFM Directive grants cross-border rights to non EU firms, providing that equivalence is recognised by the Commission and the firm is authorised by ESMA (Article 35 and articles 37 to 41 of AIFMD), such equivalence rights do not exist under the UCITS Directive: a UCITS fund must be domiciled in the EU and managed by an EU company.

Figure 4: Number of cross-border funds and registrations



Source: PriceWaterhouseCoopers

Box 2: Relevant EU legislation

An ***asset management company*** (AMC) is a company that invests its clients' pooled funds into securities (stocks, bonds, money market instruments, etc.). AMCs allow for more diversification and more investment options than investors would obtain by investing individually. AMCs earn income by charging fees or commissions to their clients. There are various types of funds, from 'plain vanilla' ***mutual funds*** that invest in highly liquid assets to more aggressively managed ***hedge funds***. Hedge funds are alternative investment funds that use a number of alternative strategies in order to get high yields for their clients (e.g. use of derivatives, leverage, etc.).

In the area of collective investment schemes, European law currently comprises two main pieces of legislation covering two types of harmonized investment funds:

- ***The Undertakings for Collective Investment in Transferable Securities Directive*** (UCITS) is the main European framework covering collective investment schemes that are suitable for retail investors;

- ***The Alternative Investment Fund Managers Directive*** (AIFMD) covers managers of alternative investment schemes that target professional investors.

Both directives establish passport rights across the Single Market. As regards third-country equivalence, it is provided for under AIFMD but not envisaged under the UCITS directive (i.e. firms established in third-countries are excluded from the EU retail asset management business). For more details on passporting and equivalence in EU legislation, see EGOV briefing PE587.369.

Source: European Commission, DG FISMA

Insurance and reinsurance

According to the statistics (key facts 2015) provided by the Association of British Insurers (ABI):
- The UK insurance market is the largest in Europe and the third largest in the world;
- The UK insurers held GBP 1.9 trillion of invested assets;
- The UK insurers contributed GBP 29 billion to UK GDP, which equates to more than a fifth of the total gross value added for the financial services industry.

The "UK insurance market" differs from the "London Market". The wider "UK insurance market" refers to the underwriting by composite insurers of standard - plain vanilla - insurance policies (e.g. home, motor insurance), while the "London Market" has become over time a leading market for specialty commercial insurance and reinsurance business, providing coverage for large, complex or wholesale specialty risks (e.g. natural catastrophes, Marine, Aviation), and where virtually all business is placed by brokers on behalf of their clients. Insurers and reinsurers, Lloyd's syndicates and managing agents as well as a wide range of affiliate professional services all form part of the ecosystem of the London Market that is worth an estimated GBP 60 billion in gross written insurance premiums (including business managed by, but not written in London).

According to the report published by the London Market Group, just under 60% of the business that is directly written in London (GBP 45 billion in gross written premiums), is written by managing agents and syndicates of Lloyd's and just above 40% by the other company market participants, i.e. global, European, and UK insurers and reinsurers.

As regards the geographic breakdown of the London Market business, based on the location of the insured, approximately one third of the London Market premiums originate from the UK and Ireland, another third from the US and Canada, and one third from Continental Europe and other parts of the world. The share of business from Continental Europe, Asia, South America, and emerging markets is hence relatively small, as the majority of the commercial business in those regions is written domestically or in international insurance hubs, partially due to local regulations.

The Solvency II Directive (as amended by the Omnibus II Directive) is the EU directive for insurance companies, which became fully applicable on 1 January 2016. The Directive is based on the three pillars of harmonised rules: rules on the valuation of assets and capital requirements, risk management requirements, and disclosure requirements. It recognises the fact that the insurance industry is a global industry. To avoid unnecessary duplication of regulation, the European Commission may therefore decide about the equivalence of a third country's solvency and prudential regime. The European Insurance and Occupational Pensions Authority (EIOPA) assists the Commission in preparing equivalence decisions pertaining to supervisory regimes in third countries.

Equivalence decisions cover three distinct areas under Solvency II (an overview of those decisions is available on the EIOPA website):
- Reinsurance (Article 172 of the Solvency II Directive): relevant for reinsurers from third countries. If the third country's rules are deemed equivalent, such reinsurers must be treated by EEA supervisors in the same way as the EEA reinsurers.
- Solvency calculation (Article 227 of the Solvency II Directive): relevant for EEA insurers operating in a third country.
- Group supervision (Article 260 of the Solvency II Directive): relevant for insurers from third countries with activities in the EEA. If the third country's rules are deemed equivalent in this area, EEA supervisors will under certain conditions rely on the group supervision exercised by a third country.

Solvency II is also the main piece of legislation through which the passport is operated in the insurance industry. As for banks and asset managers, passporting allows insurers to operate in other EU Member States through branches and to sell products and services cross-borders. Open Europe argues that passporting is not widely used for providing insurance services in Europe, albeit 13% of

the business is provided across the EU through branches. They also quote an IMF report which indicates that most insurers, except Lloyd's, already operate through subsidiaries. The IMF then concludes that "*U.K. insurance companies would be relatively insulated from the effects of Brexit*".

Box 3: Lloyd's

Lloyd's has become the world's leading market for specialist insurance. Lloyd's is not an insurance company but a marketplace on which underwriters, traditionally known as the "Names", come together to pool and spread risk. While Lloyd's tradition spreads back over 300 years, its current structure is much more recent: The initial concept that the coverage of losses stemming from insured risk is mainly backed up by the unlimited liability of its founding members, wealthy individuals (the "Names"), turned out to be hugely inadequate for the size and type of risks that is nowadays insured. Already in the late 1980s, unexpectedly large legal awards in US courts for punitive damages and claims related to asbestosis showed that the structure was not fit to cover "long-tail" insurance risk, with some of the Names facing bankruptcy. Between 1987 and 1989, a series of very large oil, wind and fire claims, including the loss of the North Sea oil rig Piper Alpha, came into Lloyd's which brought it to the brink of collapse and subsequently initiated sweeping reforms (in particular the introduction of corporate members and limited liability). In 2001, Lloyd's self-regulating status was replaced with oversight by the UK's new Financial Services Authority. Two years later, Lloyd's laid down some minimum underwriting standards and introduced a kind of stress test, asking its members to model their expected losses in the event of a range of major disasters, such as an earthquake or an act of terrorism, to ensure they hadn't taken on too much exposure to a single event.

Lloyd's has prepared contingency plans to continue providing services to its continental clients. On 21 October 2016, John Nelson, Chairman of Lloyd's, gave an interview to the German media, in which he was asked about Lloyd's contingency plans regarding the future servicing of the continental European markets. He sees three alternatives: "*Strategy 1 is to seek the retention of the system of* ***passporting rights*** *that Lloyd's currently enjoys, allowing us to continue to trade in the same way with the European market. Strategies two and three, which are running in parallel, are to pursue alternative solutions. We have already done much of the groundwork for these alternatives. Earlier in the year we carried out detailed analysis of the access to the 27 European markets and how we would approach securing branch licences for the Lloyd's market model as a "****third country" insurer****. This is strategy 2. Strategy 3 is about looking at the option of having some sort of "****subsidiary" based in an EU jurisdiction****, allowing underwriting on a cross-border basis within the EU*."

Market infrastructure and other services

Figure 1 (see page 3) highlights the central role of the City in European financial services. This central role relies on strong market infrastructures and benefits from networking effects. Market infrastructures include settlement systems for wholesale payments, settlement systems for the exchange of securities and listed derivatives, as well as central securities depositories. It is to be noted that central securities depositories and central counterparty clearing houses often belong to the same group. In addition, a number of other businesses (rating agencies, legal, advisory, audit, etc) are closely connected to the market for financial services.

Market infrastructures

Four main payments systems are used in the UK, including one (CHAPS, a real-time gross settlement system) whose infrastructure is provided by the Bank of England. In addition, the payment system for the euro area, TARGET2, is open to institutions from the whole EEA. Therefore UK banks and other UK financial institutions are allowed to participate in TARGET2, and to settle wholesale payments directly with other members of the system in the euro area.

As to clearing and settlement of securities and derivatives, four recognised clearing houses operate in the UK: LCH Clearnet, ICE Clear Europe, EuroCCP, and CME Clearing Europe. Such businesses feature strong network externalities and economies of scale: the cost of each transaction settled through the system diminishes as the number of transactions increases. This creates powerful incentives for consolidation among the different operators. This also explains why the introduction of the single currency, by eliminating exchange rate risks and facilitating cross-border transactions, has facilitated the consolidation process in continental Europe (in particular with Euronext and Eurex). But finally London has also greatly benefited from the introduction of the euro, since it has become the main financial centre for euro-denominated foreign exchange trading. Indeed, the market share of London rose from 34% in 2001 to 44% in 2013 in those activities. Overall, 49% of global over-the-counter single currency derivatives are traded in the UK, far beyond the United States (22%).

Box 4: ECJ annulment of the ECB location policy

On 5 July 2011 the ECB published its Eurosystem Oversight Policy Framework. Arguing that problems affecting CCPs which settle euro-denominated transactions outside the euro area may have detrimental consequences on the payment systems located in the euro area, the ECB had concluded that such infrastructures should be incorporated in the euro area.

The UK complained that the ECB lacked competence to impose such location requirements. In its judgement of 4 March 2015, the General Court concluded that "*the ECB lacks the competence necessary to regulate the activity of securities clearing systems as its competence is limited to payment systems alone*".

The ECB has favoured for years the development of a coherent domestic infrastructure in the euro area, but his attempt to move the clearing of euro-denominated transactions inside the euro area was countered by the ECJ following a complaint from the UK (see box 4). As a consequence, within the European Union CCPs can provide services to their members regardless of their location. In addition, under the EMIR regulation, third country CCPs can also operate in Europe provided their regulatory regime is deemed equivalent by the European Commission. Ten CCP regulatory regimes have obtained such equivalence as of October 2016: Australia, Canada, Hong-Kong, Mexico, Japan, South-Korea, Singapore, South-Africa, Switzerland and the United States. Finally, a number of CCPs operate in several locations. For example, Bruegel stresses that LCH Clearnet, which enjoys the biggest market share in euro-denominated transactions in the UK, also operates in Paris and in New-York. Regarding trading in government bonds, the split between the two European entities is geographical: the Paris entity deals with French, Italian and Spanish bonds, while the London entity clears trades for bonds from 9 other euro area countries.

Other professional services

A number of services have become instrumental to the development of financial services, such as credit rating agencies, the provision of market data or of information and technology solutions, as well as payment services. Oliver Wyman estimates that those services account for up to GBP 20 billion in annual revenues in the UK, and about 80-90 thousands employees (see table 3 in annex).

Other professional services related to the financial services include legal services, accounting services, as well as management consultancy. It is estimated that those related professional services account for about 1.1 million employees in the UK. However only a portion of those activities are directly related to the financial sector.

Annex 1: Contribution of the financial sector to the UK economy

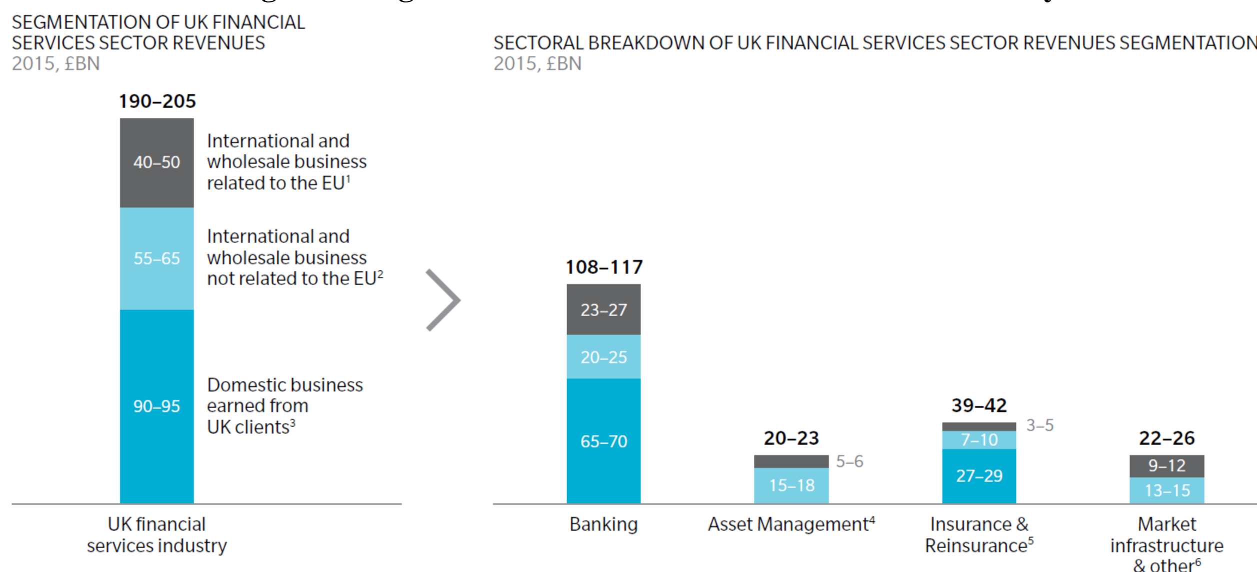
Some figures referred to in the briefing come from Oliver Wyman's report on *The impact of the UK's exit from the EU on the UK based financial services sector* (see table 3 and figure 4 below), which estimates the contributions of different sub-sectors (banks, asset management, insurance and infrastructures) to the UK economy, in terms of revenues, gross added-value, taxes and employment.

Table 3: Quantification of UK-based financial services industry (2015)

SECTORS	ANNUAL REVENUES (£BN)/ VOLUME (WHERE RELEVANT)	ANNUAL GVA[5] (£BN)	ANNUAL TAX[6] (£BN)	EMPLOYMENT[7] ('000)
Sales and Trading	~30	13-16	7-9	55-65
Investment Banking	10-12	5-7	3-4	~15
Retail and Business Banking	58-67	35-39	17-19	450-470
Private Banking and Wealth Management	5-6	3-4	1-2	21-26
BANKING	**108-117**	**55-61**	**29-33**	**540-565**
ASSET MANAGEMENT (REV/AUM[1])	**20-23 /~7TN**	**14-18**	**5-7**	**40-50**
Domestic Retail and Commercial (GDP[3]/GWP)	27-29/150-155	21-23	9-10	260-290
Corporate and Specialty[2] (GDP[3]/GWP)	8-10/50-53	7-9	3-4	43-46
Reinsurance[2] (GDP[3]/GWP)	2-4/16-18	2-3	1-2	~5
INSURANCE & REINSURANCE[2] (GDP[3]/GWP)	**39-42/215-225**	**30-33**	**13-15**	**310-335**
Exchanges, Clearing & Inter-Dealer Broking	3-4	2-3	1-3	10-12
Securities Services	3-4	2-3	~1	30-40
Technology, Data and Other[4]	16-20	13-15	6-8	80-90
MARKET INFRASTRUCTURE & OTHER[4]	**22-26**	**16-20**	**9-11**	**120-140**
TOTAL FINANCIAL SERVICES	**190-205**	**120-125**	**60-67**	**~1,050**

Source: Oliver Wyman

Figure 5: Segmentation of the UK financial services industry



Source: Oliver Wyman

Oliver Wyman estimates that the annual gross added-value of the financial sector amounts to GBP 120-125 billion, which represents about 7% of the UK GDP. This is consistent with the IMF estimation (8%).

As to the contribution of the financial services to tax revenues, various estimates are available (see table 4). The Oliver Wyman's estimation of the banks' contributions (EUR 29-33 billion) is in line with the calculation of the HM Treasury, since the figure published by the HM Treasury (GBP 24.4 billion) does not include unrecoverable VAT and other taxes (about GBP 4.5 billion). The

overall contribution of the financial sector (GBP 60-67 billion) seems in line with an estimation made by PriceWaterhouseCoopers, albeit the breakdown between banks and non-banks differ. It is to be noted that the GBP 67 billion figure was quoted in a speech by the Economic Secretary to the Treasury on 11 October 2016.

Table 4: Estimates about tax revenues from the UK financial /banking sector (in GBP bn)

Source	Reference year	Financial sector[a]	*Of which banking sector*
HM Treasury	2015-2016		*24.4*[b]
Oliver Wyman	2015	60-67[c]	*29-33*[c]
PwC	Financial year to 31/3/2014	65.6[d]	*42*[e]

[a] The Financial sector includes the Banking sector, Asset Managers, Insurance and Reinsurance companies, as well as other providers of Market infrastructure

[b] Tax revenues including income tax, national insurance contributions, corporation tax, bank levy, bank surcharge, and bank payroll tax;); the figure would reach GBP 29bn if unrecoverable VAT and insurance premium tax were included.

[c] Total tax contribution: tax collected and tax borne (including employment tax, national insurance, income tax, irrecoverable VAT, bank levy, other taxes borne and collected)

[d] Total Tax Contribution

[e] PwC estimates the share of the banking sector to be 64.7% of the Total Tax Contribution

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