Brexit and the City of London

No Equivalent to the Financial Services Passport

DECISIONPOINT™ by WNS

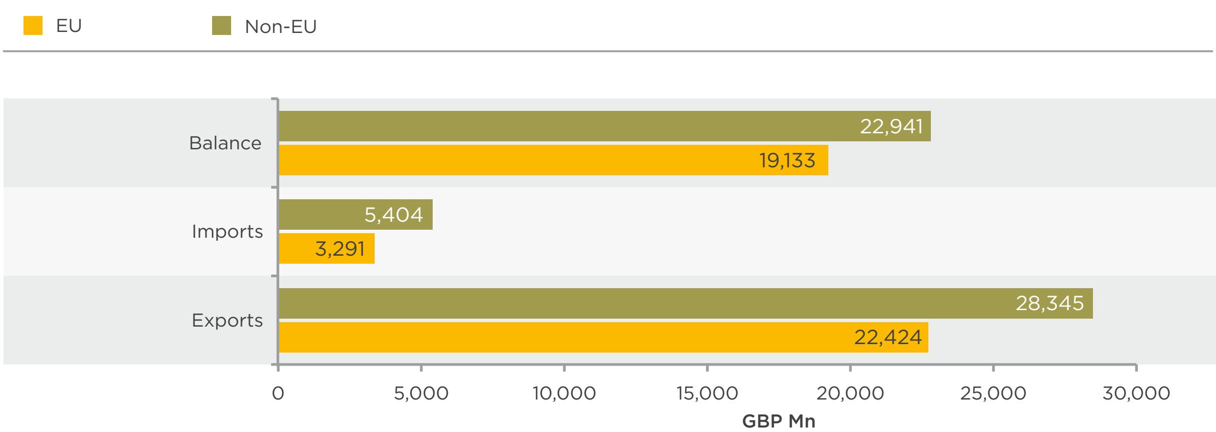
Table of Contents

FINANCIAL SERVICES: BREXIT – A THREAT TO THE CITY OF LONDON'S POSITION AS A GLOBAL FINANCIAL CENTER

For decades, the United Kingdom (U.K.) has served as the financial center not just for Europe, but for the rest of the world as well. Britain's trade surplus of GBP 63 Billion in financial services in 2015 was more than the combined surplus of the next 3 countries – the United States (U.S.), Switzerland and Luxembourg. The European Union's (EU) share of the trade surplus was 67 percent of the U.K.'s total trade surplus with the world, at GBP 42 Billion.[1] The U.K. benefits economically from having a strong financial and related professional services sector, underpinned by a strong regulatory environment that is fair and consistent, a conducive business climate essential to the growth of new products and ideas, easy access to a single market, and openness to foreign firms.

Exhibit 1

U.K. Trade in Financial Services 2015



Source: ONS Trade Data

The benefits of the U.K.'s financial services industry to Europe extend beyond economic growth and job creation. The industry functions as a key determinant of how European businesses fund their investments, how pensions are paid for, how investors hedge risks and how public funding takes place. Europe's easy access to a truly global capital market helps reduce cost of finance to EU companies, and in attracting foreign investment. The U.K. benefits from its position as a leading destination for companies elsewhere in Europe operating in retail financial services.

However, the Brexit referendum has now cast a shadow over the future of the U.K., and particularly London's position as the global center for financial services.

Following the Brexit vote, London slipped 13 points in the Zyen Group's annual Global Financial Centres Index, though it continued to retain the number one position as the world's best financial center.

The following pages will analyze the current structure of the U.K.-EU interrelationships with regard to financial services and the impact of Brexit on key industry subsectors.

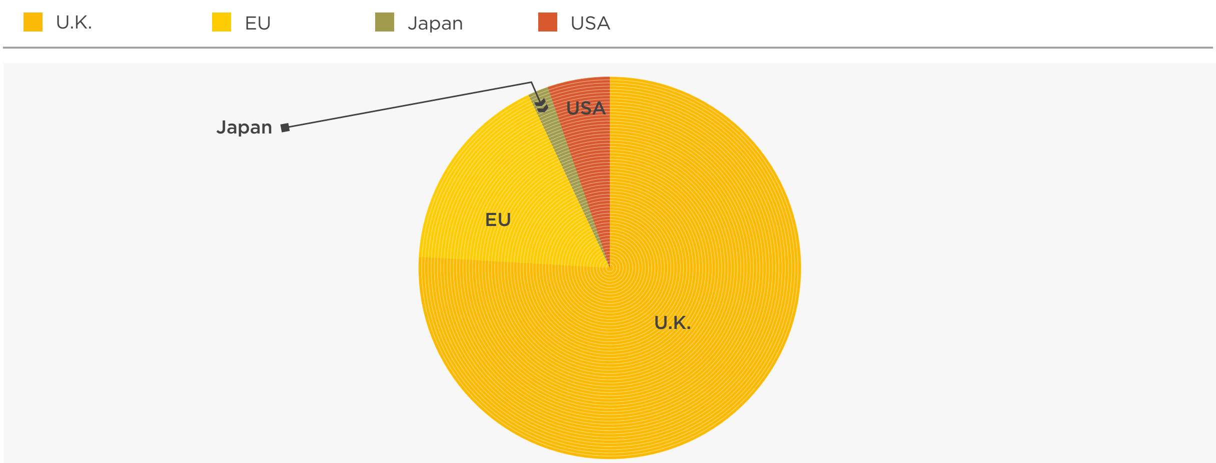
1. Office for National Statistics (ONS), U.K.

BANKING

The U.K. has the third largest banking center globally. London hosts over 250 foreign banks[2] – more than any other center. The U.K. accounts for 17 percent of international bank lending[3] – more than any other center. The EU has the largest share in the U.K.'s banking sector by way of assets and claims.

Exhibit 2

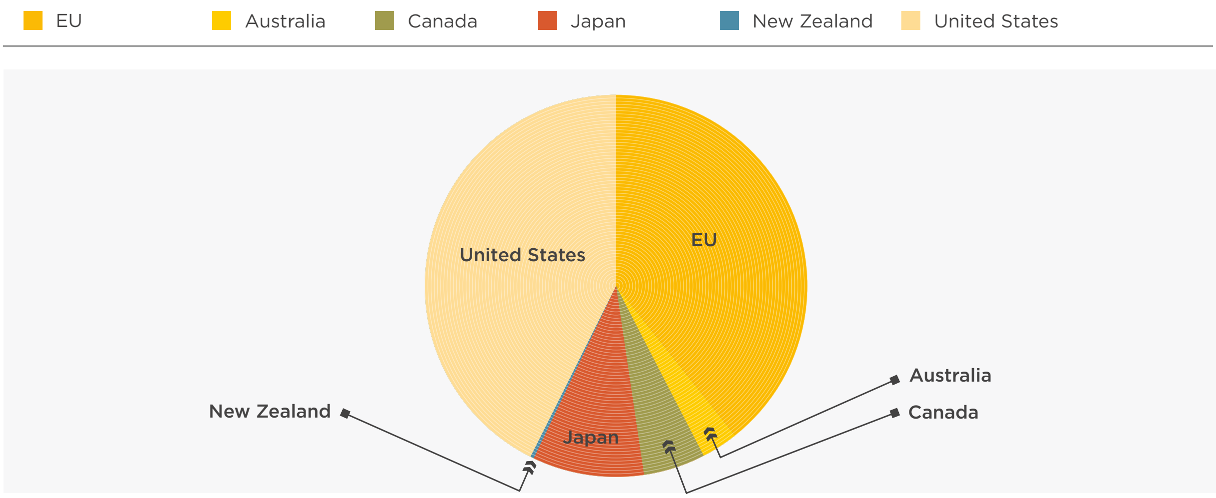
Regional Share of Bank Assets



Source: Bank of England

Exhibit 3

Bank Claims by Region



Source: Bank of England

2. TheCityUK, 'Key Facts about the U.K. as an international financial center', Nov 2016.
3. Ibid.

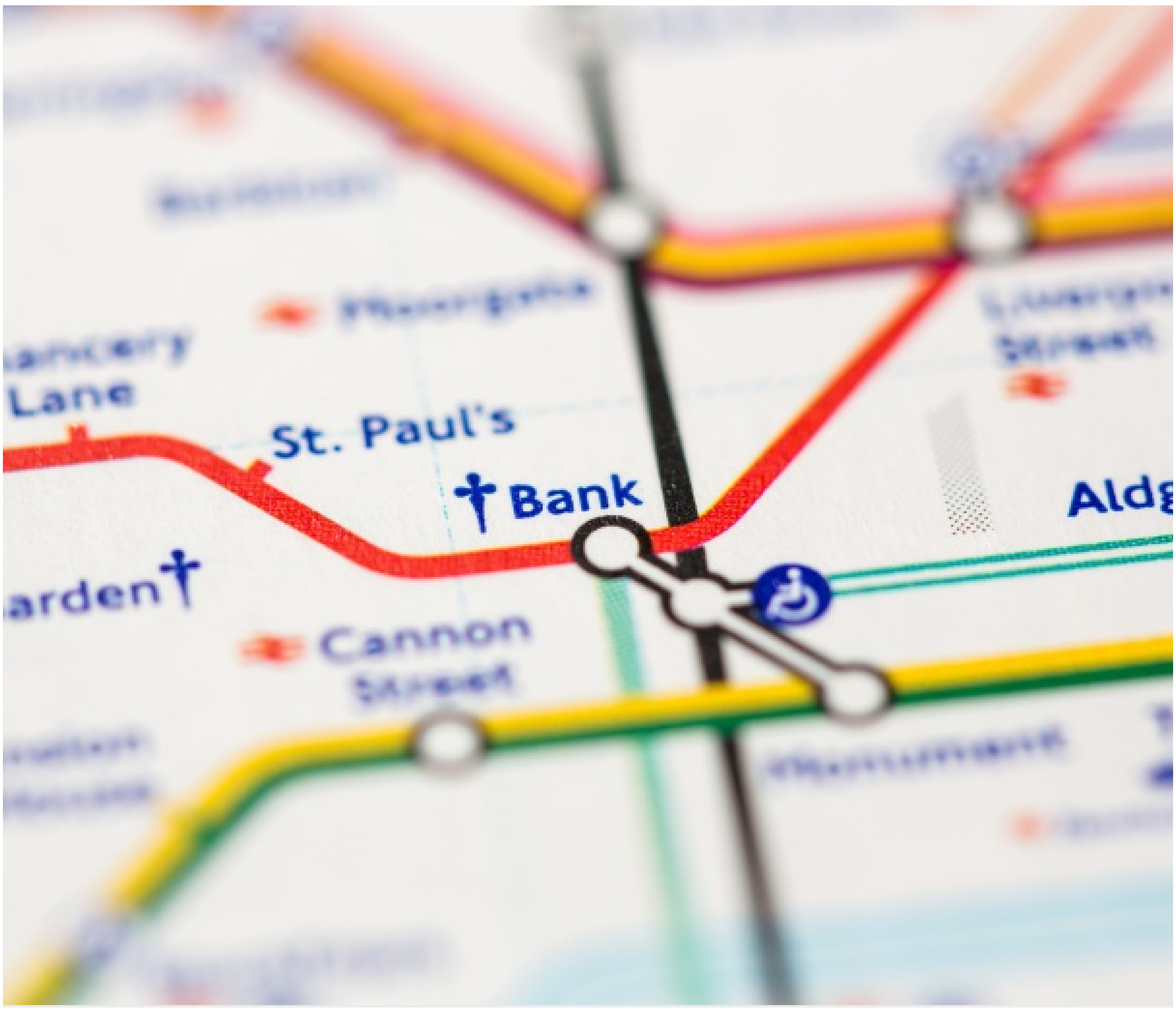
The EU banks collectively held 17 percent of total bank assets in December 2016, second only to the U.K. banks, and surpassing both Japan and U.S.-based banks. The EU held 38 percent of the consolidated claims of U.K.-owned banks and their branches and subsidiaries worldwide, second only to the U.S., which held 41 percent of the claims.

The above statistics demonstrate the importance of the EU to the U.K.'s financial services sector and vice-versa. This interdependence between the two regions has been made possible because of certain regulations and systems, which now need to be restructured in the wake of the referendum.

'PASSPORTING' AND BANKS

For over two decades, the scope of the EU single market has expanded to trade in financial services, with a particular focus on banking, made possible by the harmonization of regulatory framework and the establishment of a single rulebook of financial services across the EU. In order to facilitate this trade in financial services, EU states have opened their national markets to the provision of financial services directly from other EU states, or by making it easier to establish branches and subsidiaries of banks and financial services firms of other EU states. Once a bank or financial services firm is established or authorized in one EU country, it can apply for the right to provide defined services throughout the EU, or to open branches in other countries across the EU, with relatively few additional authorization requirements. This pan-EU authorization is regarded as its financial services 'passport'.

These passports are not available to third-country firms, i.e. firms incorporated outside the EU. Even if a non-EU firm obtains a license to conduct business in an EU Member State, it will be able to provide services only to customers of that Member State, thereby restricting its ability to conduct pan-European business operations.



PASSPORTS USED BY BANKS AND FINANCIAL SERVICES FIRMS

There are various types of passports that banks use, including core banking services such as lending and deposit taking, market services such as sales and trading, asset management, payments services and electronic money services.

Fourth Capital Requirements Directive (CRD)

An EU legislative package encompassing prudential rules for banks, building societies and investment firms. U.K.-based banks use it to provide advisory services, lending or custody or deposit services to a business in another EU state. A U.K.-based bank may also serve clients in the rest of the EU through a branch established in another EU state under the preferential terms created by the passporting framework.

Markets in Financial Instruments Directive (MiFID)

This EU legislation regulates firms who provide services to clients linked to financial instruments, and the venues where those instruments are traded. It is used by U.K.-based banks to help a business in another EU state take a derivatives position to hedge a loan, debt issuance, or exchange rate exposure through London-based markets. The U.K.-based banks also use their MiFID passports to help clients buy and sell shares, bonds or other financial instruments and trade on exchanges and trading venues around the EU.

A U.K.-based bank might use its CRD and MiFID passports to assist a customer in an EU state in arranging a line of credit, managing an investment portfolio or to advise on financial planning.[4]

Payment Services Directive (PSD)

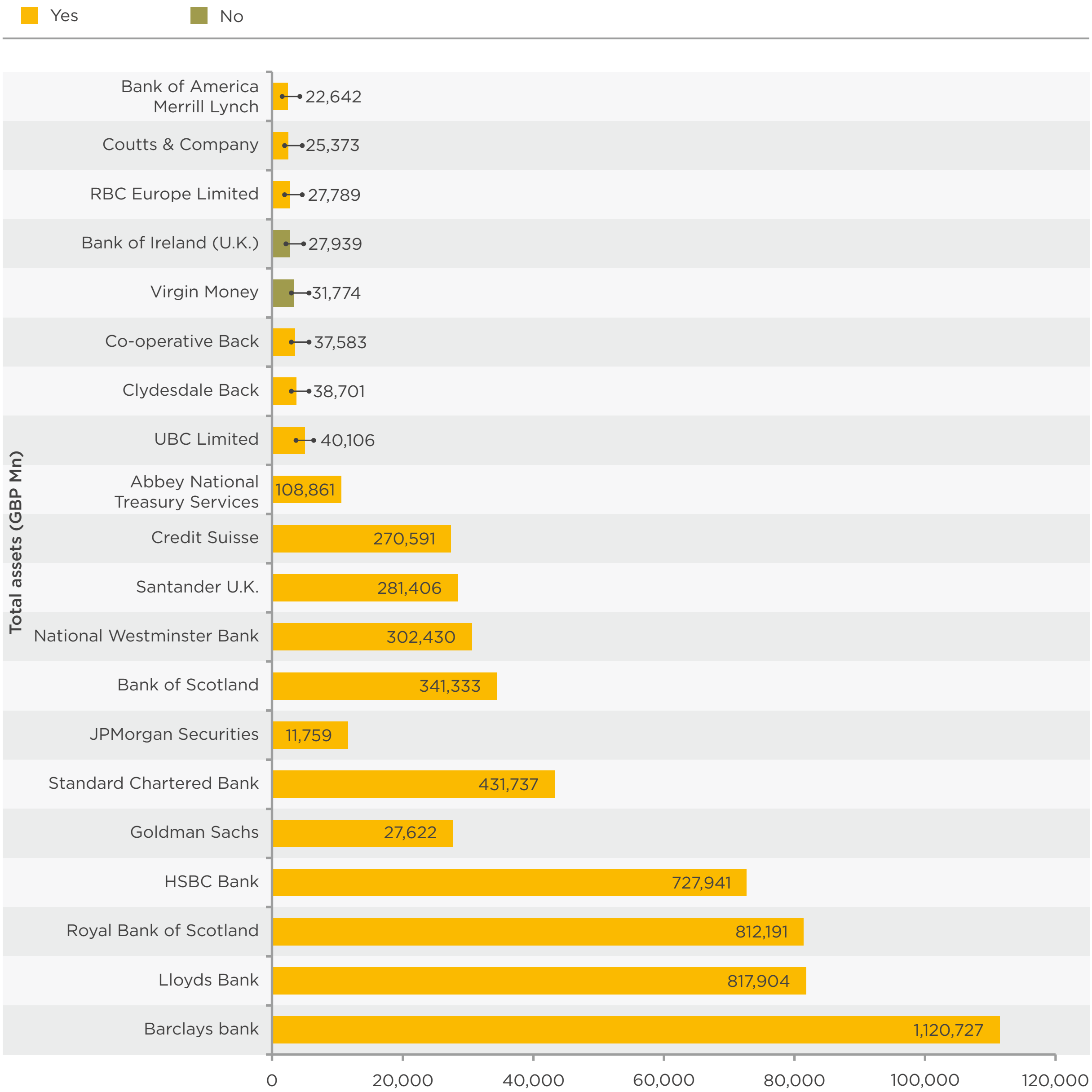
It is a key piece of payments-related legislation in Europe, designed to develop the Single Euro Payments Area (SEPA) and regulate payment institutions.

Eighteen top U.K.-based banks use passporting to operate across the EU. These banks are on the brink of losing their passporting rights, a major fallout of the Brexit referendum.

4. British Bankers' Association, 'What is "passporting" and why does it matter?'

Exhibit 4

U.K.-incorporated Banks Depend on Passporting



Source: Financial Times, Sept. 2016, Bank of England

According to the U.K. Financial Conduct Authority (FCA), 8,008 firms based in the European Economic Area (EEA) make use of 23,532 passports to provide financial services in the U.K. Furthermore, out of 2,229 companies and a total market cap of GBP 4 Trillion, 112 companies from other EU Member States are listed on the London Stock Exchange with a market cap of GBP 378 Billion.[5]

Exhibit 5

Passports used in the U.K. Financial Services industry

	Total	Inbound (into the U.K. from the EEA)	Outbound (U.K. firms into the EEA)
Number of Passports in Total	359,953	23,532	336,421
Number of Firms using Passporting	13,484	8,008	5,476

Source: FCA 2016

Exhibit 6

Importance of Passports in the U.K. Financial Services Industry

How Does Passporting Work?

A passported U.K. bank can do the following:

- Provide its customers with the widest range of banking services across the U.K. and all of 27 EU countries
- Establish a branch in any other EU country from which it can offer cross-border banking services to other EU Member States
- Do so efficiently, without duplication and at low cost

What Does the Loss of Passporting Mean?

Once outside the EU, a U.K. bank has no 'passports'. Instead, it has to apply for a license for each EU country:

- A license is not available in many EU countries
- The range of licensed banking services is much more limited
- The license is usually available to one country at a time, i.e. no cross-border rights
- Duplication and substantial additional costs

Source: British Bankers' Association

5. Financial Conduct Authority, U.K.

BANKS OUTSIDE THE EU

The passporting system has been extended to cover the EEA, which comprises the EU states and Norway, Iceland and Lichtenstein. Passporting services are extended to these countries based on their commitment to honor the basic freedoms of movement, capital, goods and services in the EU Treaties and to incorporate the EU financial services rulebook into their own domestic law.

The referendum has forced a large number of banks to rethink their future strategy in the U.K. in terms of jobs, trade operations and EU staff. In January 2017, HSBC and UBS outlined plans to shift about 1,000 jobs each from the U.K. to the EU. The same was already announced by Citigroup, Deutsche Bank and JP Morgan Chase. In July, Deutsche Bank announced its plans to establish a new Frankfurt booking center to transfer most of the investment banking assets that it currently books in the U.K. Deutsche Bank books hundreds of billions of euros of non-U.K. business through its London broker dealer, which is the single biggest EU bank branch operating in the U.K. It will keep its London-based booking center but this will only serve clients in the U.K. and those who have a preference for keeping their contracts under British Law.

Citigroup has decided to base its EU broker dealer, its main trading operation, in Frankfurt and plans to distribute other businesses across Amsterdam, Paris, Dublin, Luxembourg and Madrid.[6] Lloyds of London has confirmed that it will set up a subsidiary in Brussels as its new European base. The subsidiary is expected to be up and running by January 2019. Goldman Sachs announced its plans to relocate 'hundreds of jobs' from Britain to the EU. Several Japanese banking giants such as Nomura, Daiwa and Sumitomo Mitsui Banking Corporation have confirmed their plans to shift their European headquarters to Frankfurt. In July 2017, Bank of America moved its investment and market operations to Dublin. It confirmed its plans to move staff from the bank's London office, which employs about 4,500 people.[7]

Banks shifting large-scale business operations along with their European headquarters from the U.K. to other places in the EU will result in a loss of strategic bank assets of the U.K., thereby causing a serious blow to London's status as the world's most favored destination for business in financial services. This also means high costs associated with staff relocation and setting up new office premises.

6. Article by Financial Times, 'Citigroup and Deutsche Bank give Frankfurt a Brexit boost', July 2017.
7. Article by Financial Times, 'Bank of America chooses Dublin as EU base after Brexit', July 2017.

SUBSTITUTE FOR PASSPORTING – 'EQUIVALENCE'

Equivalence is a system pioneered and developed by the EU, in which one State asserts that the standards of the other in a specific area match its own and hence can be pronounced 'equivalent'.[8] Equivalence has an important role in financial services trade between the U.K. and the EU. It is used by the EU for two main things. Firstly, it grants rights to non-EU Member States to carry out certain defined services within the EU. Secondly, it defines the EU legislative and regulatory framework for banks in non-EU Member States to carry out operations.

HOW DOES THE EU USE EQUIVALENCE?

Some important examples of the way the EU uses equivalence in banking and related areas are:

- In assessing the regulatory standards in their home market of non-EU banks that operate branches in the EU. These judgments are reflected in the way in which EU supervisors treat foreign branches and determine the imposition of additional requirements. For instance, these judgments are used in determining how to assess the risk posed by EU banks taking exposures to banks in these markets.[9]
- In assessing the standards that apply to market infrastructure in countries outside the EU, especially central counterparties for clearing securities trades. These judgments are used to determine how freely EU firms can use these market services to clear trades.[10]
- In assessing the data protection standards of non-EU countries. These judgments are used to determine how freely the personal data of EU citizens can be moved by banks to these countries for processing or storage.[11]

8.British Bankers' Association, 'What is "equivalence" and how does it work?'
9. Ibid.
10. Ibid.
11. Ibid.

U.K. BANKS AND EQUIVALENCE

For the U.K. as a country outside the EU, seeking access to the EU single market based on judgments of equivalence will mean weighing various political and policy priorities. There is currently no equivalence regime applicable for the EU's core banking rulebook – the Capital Requirements Directive (CRD IV). CRD IV applies to core bank services such as lending and deposit taking.[12] This is the most distinctive feature between the breadth of the EU passporting system for EU and U.K. banks and the restrictive treatment of non-EU banks under the limited equivalence frameworks.

The EU has recommended a limited number of equivalence regimes that would allow non-EU banks to export specific services to EU Member States. One of them is the Markets in Financial Instruments Directive II (MiFID II). This covers a range of investment services, including the design, sale and trading of securities and the provision of investment advice, all the central functions of an investment bank. However, the services covered by MiFID II are narrower in scope and coverage in comparison to those under the MiFID Passport.[13]

Exhibit 7

What Does Equivalence Mean After Brexit?

	For U.K. based Banks	For the U.K.
Advantages	▪ Some limited market access or operational rights in the EU ▪ Some limited rights for EU banks to trade in the U.K. or with U.K. based banks	▪ May facilitate the use of U.K. as a base for exporting financial services to EU states under an equivalence regime
Disadvantages	▪ Granting equivalence uncertain ▪ Activation of key equivalence regimes such as the proposed MiFID third-country framework uncertain ▪ Equivalence-based market access frameworks currently not available in most EU Member States ▪ Loss of equivalence can materially affect operational or market access rights	▪ Against the basic tenets of judicial and regulatory independence that led to the U.K. referendum

Source: British Bankers' Association

12. Ibid.
13. Ibid.

Exhibit 8

Passporting and Equivalence under Brexit Scenarios

PASSPORT/ DIRECTIVE	Service or Activity Covered	Hard Brexit – No Access to Single Market	Soft Brexit – Access to Single Market (EEA/Norway Model)	Decision-Making Authority on Equivalence
The Fourth Capital Requirements Directive (CRD IV)	Core bank services such as lending and deposit taking and corporate advisory services	**Passport not possible**; No market access rights for non-EU banks. Banks and other deposit taking institutions will have to relocate to be able to continue with Euro-denominated lending and deposit taking activities	**Passport possible**; cross-border rights across the single market and local treatment for branch operations	No Equivalence regime
The Second Markets in Financial Instruments Directive (MiFID II)	Range of investment and market services, including the design, sale and trading of securities and the provision of investment advice	**Passport not possible**; No specific arrangements for an equivalence regime. Firms will have to obtain authorization under the regulatory regimes of each Member State in which they want to operate	**Passport possible; Equivalence will give limited rights** with regard to MiFID services; not been activated	**A combination of**: European Securities and Markets Authority, the European Commission and EU Council
The Second Payments Services Directive (PSD II)	Payments Services	**Passport not possible**; No specific arrangements for an equivalence regime. Firms will have to obtain authorization under the regulatory regimes of each Member State in which they want to operate	**Passport possible**; No market access for non-EU service providers under Equivalence	No Equivalence regime

Source: British Bankers' Association; WNS DecisionPoint™ Analysis

OUTLOOK FOR BANK ASSETS – HARD BREXIT VS. SOFT BREXIT

The five-year outlook for the U.K.'s consolidated bank assets can be assessed in two scenarios – Hard vs. Soft Brexit. A hard Brexit means the U.K.'s complete departure from the EU single market and a subsequent loss of passporting rights for majority of the banks that rely on these to conduct cross-border business with the EU. The biggest loss will be for the non-U.K. banks, which control majority of the bank assets in the U.K. The U.K.'s status will be reduced to that of a third country which will have to determine a new set of financial services trading framework with the EU.

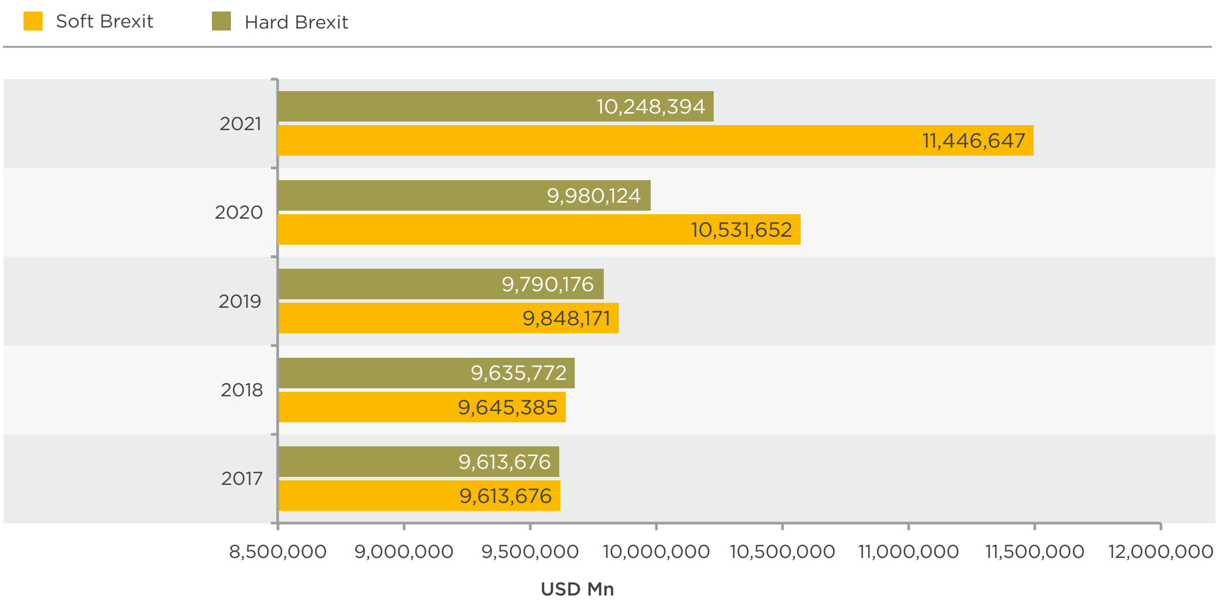
The current uncertainty regarding Brexit negotiations has had an impact on the banking sector in two ways. Firstly, with a large number of banks already in the process of shifting their European headquarters and consequently majority of their business and trade operations from London to other parts of the EU, the U.K. will see a loss in its consolidated assets over the medium term. The decline in assets will continue until mid-2019, when the Brexit framework has been finalized and the U.K. has officially departed from the EU. Bank assets will see some stabilization from 2019 onwards, and will pick up from 2019 to 2021, when the U.K. political framework post Brexit is in its final form.

Secondly, the initial impact of the referendum has been the depreciation of the sterling, resulting in higher costs for companies exposed to imports and a more favorable environment for exporters. Rising domestic costs resulting from higher import prices may impact household incomes and affordability of consumer loans and home loans, important subsets of bank assets. This, in turn, may affect businesses dependent on consumers for revenue. Real estate markets, both commercial and residential, have also been impacted negatively leading to a lowering of value.

Bank assets will continue to decline in the near term, as a direct fallout from banks moving their operations from the U.K. to the EU and a declining sterling, but how fast they pick up and the magnitude of the increase from 2019–2021 will be determined by the final framework of Brexit and the deal the U.K. ultimately strikes with the EU. The U.K. stands to lose a large number of assets by the end of the Brexit negotiations in the event of an exit from the single market and loss of their passporting rights. A soft Brexit, with continued access to the single market and retention of passporting privileges for banks, will imply a healthy growth in assets in the forecast period from 2019–2021.

Exhibit 9

Forecast for Bank Assets



Source: WNS DecisionPoint™ forecast based on data from European Central Bank. Includes Domestic Banking groups and standalone banks, foreign (EU and non-EU) controlled subsidiaries and foreign controlled branches

INSURANCE

According to data published by the Association of British Insurers (ABI), the U.K. insurance market happens to be the largest in Europe and the third largest in the world, and contributed GBP 29 Billion to the U.K.'s Gross Domestic Product (GDP).[14]

The U.K. insurance market differs from the London Market. The wider U.K. insurance market refers to the underwriting by insurers of standard insurance policies, such as home, motor etc., while the London Market has become, over time, a leading market for specialty commercial insurance and reinsurance business, providing coverage for complex or wholesale specialty risks such as natural catastrophes, marine and aviation, and where virtually all business is placed by brokers on behalf of their clients. Insurers and reinsurers, Llyod's syndicates and managing agents form part of the ecosystem of the London Market that is worth an estimated GBP 60 Billion in gross written insurance premiums.[15]

Currently, over GBP 8 Billion of premium is brought annually to the London Insurance Market by brokers on behalf of EU customers. Over GBP 6 Billion of international business is written in London by firms with a parent company or principal base located elsewhere in the EU, demonstrating the importance of continuing mutual market access between the U.K. and the EU post Brexit.[16]

PASSPORT IN THE INSURANCE INDUSTRY

The Solvency II Directive, which became applicable on January 1 2016, is the EU directive for insurance companies. It is based on requirement rules pertaining to the valuation of assets and capital, risk management and disclosure. It is the 'passport' through which insurers operate in other EU Member States through branches and sell products and services across borders.

14. Association of British Insurers.
15. European Parliament Briefing Papers, 'Brexit: The United Kingdom and EU financial services'.
16. London Market Group, 'A Brexit Roadmap for the U.K. Specialty Commercial Insurance Sector'.

EQUIVALENCE UNDER SOLVENCY II

In the event of a hard Brexit and the subsequent loss of their passporting privileges, insurers have the option of relying on Equivalence to be able to continue their cross-border operation with the EU.

If the solvency regime applied to reinsurance activities of a third country is found equivalent, reinsurance contracts concluded with reinsurers established in that third country shall be treated in the same way as reinsurance contracts concluded with EU reinsurers (Article 172 of the Solvency II Directive). As a result, Member States may not consider contracts concluded with third countries less favorable than those concluded with EU insurers (Article 172-173). Thus, these provisions provide reinsurers with passporting rights. In case third-country insurers pursue activities in the EU as a parent undertaking of an EU insurer, an equivalence decision under Article 260 of the Solvency II Directive exempts these insurers from some aspects of group supervision and requires Member States to rely on the group supervision exercised by that third country. Supervisors of Member States will then form a college led by the third-country group supervisor. Also, Solvency II does not include a third-country regime for solo entities of third-country insurers.[17]

Furthermore, if an EU-based insurer pursues activities in third countries, the presence of an equivalence decision under Article 227 allows them to carry out the solvency calculations for prudential reporting for the subsidiary in the third country in compliance with the rules of that country instead of rules under Solvency II.[18]

The future of the U.K.-EU insurance industry is reliant upon how clearly the equivalence framework is spelt out during Brexit negotiations in the face of a hard Brexit, while a soft Brexit will imply continuance of cross-border rights for insurers.

17. European Parliament Directorate-General for Internal Policies, 'Implication of Brexit on EU Financial Services, 2017'.
18. Ibid.

ASSET MANAGEMENT

Assets under management (AuM) in Europe reached EUR 22.8 Trillion by the end of 2016, bringing the size of the industry to 138 percent of the GDP. Investment fund assets accounted for 51.8 percent of all AuM, totaling EUR 11,800 Billion, whereas discretionary mandates represented 48.2 percent of total AuM, or EUR 11,000 Billion.[19]

Exhibit 10

European AuM at end 2015 (EUR Billion) and AuM/GDP (Percent)

Countries	AuM	% Change in 2015	Market Share	AuM/GDP
U.K.	7791	6%	36.3%	320%
France	3787	5%	17.6%	174%
Germany	2026	9%	9.4%	67%
Switzerland	1466	2%	6.8%	242%
Netherlands	1244	1%	5.8%	184%
Italy	1156	10%	5.4%	70%
Denmark	367	3%	1.7%	135%
Belgium	279	8%	1.3%	68%
Austria	104	3%	0.5%	31%
Portugal	81	7%	0.4%	45%
Turkey	48	4%	0.2%	7%
Czech Republic	35	n.a.	0.2%	21%
Hungary	28	5%	0.1%	25%
Greece	11	20%	0.05%	6%
Rest of Europe	3047	6%	14.2%	102%
Total	21469	6%	100%	132%

Source: European Fund and Asset Management Association, May 2017

19. European Fund and Asset Management Association (EFAMA), 'Asset Management in Europe', 9th edition, Facts and Figures, May 2017.
20. Ibid.

The majority of the investment fund assets managed in Europe remain concentrated in a small set of European countries. The U.K., followed by France and Germany, is the biggest asset management market in Europe. Altogether these three countries own 63 percent of the total AuM in Europe, reflecting the size of their economies.[20]

The large AuM/GDP ratios in the U.K. (320 percent), Switzerland (242 percent), the Netherlands (184 percent), France (174 percent) and Denmark (135 percent) give an indication of the relative importance of asset managers in these countries, and the responsibility they have taken in managing investors' assets.[21]

PASSPORTS IN ASSET MANAGEMENT INDUSTRY

In the area of collective investment schemes, European law currently comprises two main pieces of legislation covering two types of harmonized investment funds – Undertakings for Collective Investment in Transferable Securities Directive (UCITS) and Alternative Investment Fund Managers Directive (AIFMD). Designed to enhance the single market while maintaining high levels of investor protection, the AIFMD is the main passport used by non-EU investment fund companies to conduct business across the EU. The aim of the AIFMD is to set up a regulatory framework for monitoring the risks posed by unregulated investment funds. The directive targets fund managers. The AIFMD includes requirements for authorization, registration of the fund manager, conduct of business, regulatory capital, safekeeping of investments, marketing and leverage.[22]

Access to EU markets for U.K. fund managers will be negatively impacted in case of a hard Brexit since the UCITS directive does not have a third-country regime with European Commission equivalence in place for third-country alternative investment fund managers (AIFMs) and third-country alternative investment funds (AIFs). Under AIFMD, third-country AIFs either need an authorized EU AIFM to market their units or shares in the EU or the third-country AIFM needs to be authorized by the competent authority of the 'Member State of reference'. These requirements effectively mean that the third-country AIF and the third-country AIFM need to comply with the AIFMD rules in order to benefit from the EU passport.[23]

21. Ibid.
22. Financial Times Lexicon.
23. European Parliament Directorate-General for Internal Policies, 'Implication of Brexit on EU Financial Services, 2017'.

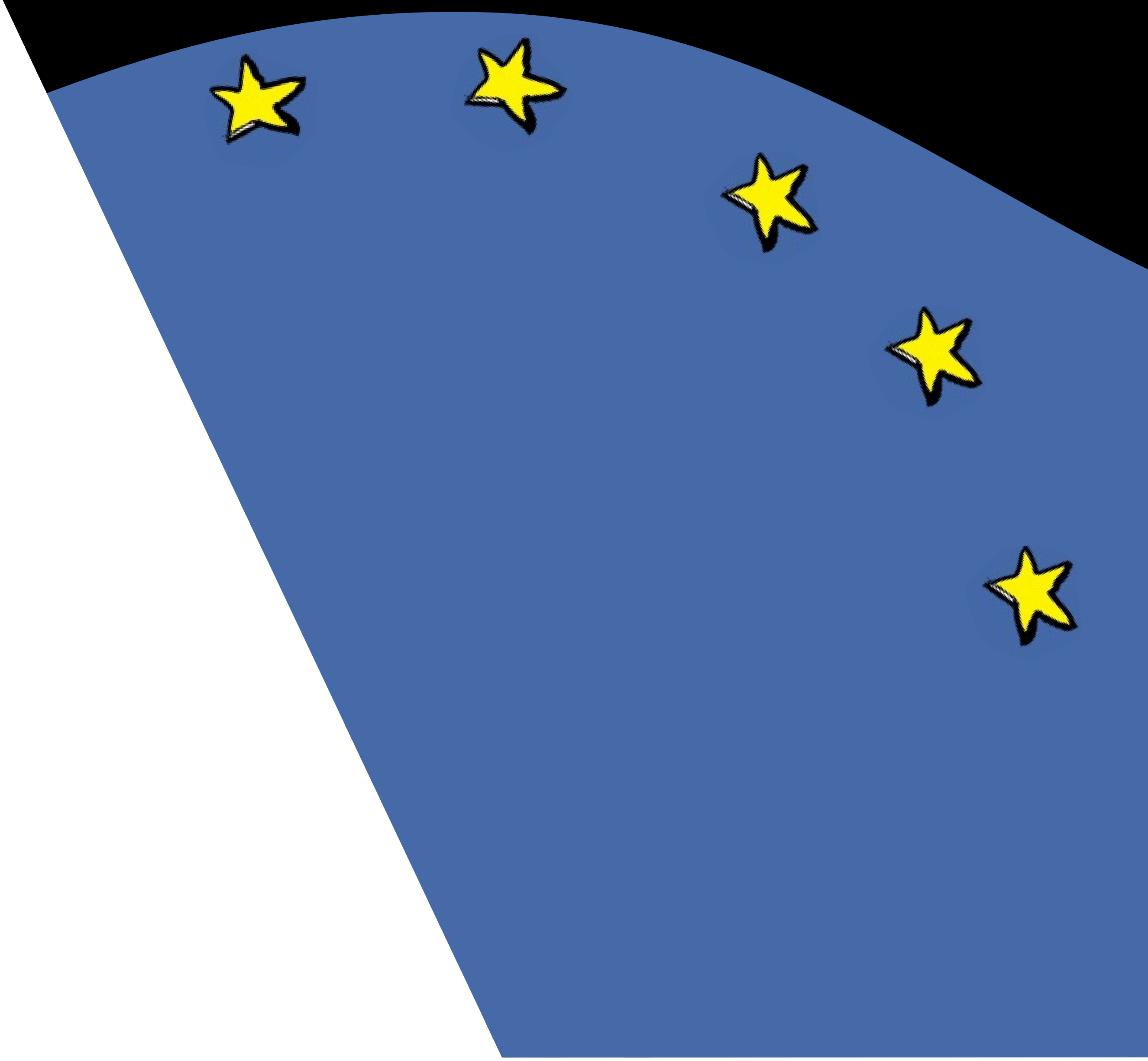
CONCLUSION

The financial services industry is the backbone of the EU-U.K. trade in services. Its success is essential for the sustenance of both the EU's and U.K.'s positions as unrivalled centers of financial business excellence. The industry in both the regions draws its strength from the mutually beneficial economic and political partnership between them, built and sustained over centuries. However, the events of the last one year pose a threat to this successful partnership. The Brexit referendum of 2016 has shaken the foundations of the banking, insurance and asset management industries in these regions. With the Brexit negotiations seeming to hit a roadblock and consequently jeopardizing the City of London's future as a favorite of the world's leading financial groups, we can expect more financial firms shifting the majority of their operations from London to other cities in the EU. If London has to safeguard its position as the world's most favored destination for business in financial services, it is for the politicians in the U.K. and Brussels to reach an amicable agreement that ensures regulatory fairness for all parties concerned.

About DecisionPoint

Making key decisions that improve business performance requires more than simple insights. It takes deep data discovery and a keen problem solving approach to think beyond the obvious. As a business leader, you ought to have access to information most relevant to you that helps you anticipate potential business headwinds and craft strategies which can turn challenges into opportunities finally leading to favorable business outcomes.

WNS DecisionPoint™, a one-of-its kind thought leadership platform tracks industry segments served by WNS and presents thought-provoking original perspectives based on rigorous data analysis and custom research studies. Coupling empirical data analysis with practical ideas around the application of analytics, disruptive technologies, next-gen customer experience, process transformation and business model innovation, WNS aims to arm you with decision support frameworks based on 'points of fact.' Drawing on our experience from working with 200+ clients around the world in key industry verticals, and knowledge collaboration with carefully selected partners including Knowledge@Wharton, each research asset comes up with actionable insights with the goal of bringing the future forward.



DECISION POINT™ by WNS

A credible insights hub for companies looking to transform their strategies and operations by aligning with today's realities and tomorrow's disruptions.

Email: **perspectives**@wnsdecisionpoint.com
Website: wnsdecisionpoint.com