

## The Impact of Brexit on Financial Services

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*On June 23, 2016, the United Kingdom voted in a referendum to leave the European Union (“Brexit”).<sup>1</sup> The impact on the UK’s financial services industry, while not yet clear, is likely to be disruptive.*

### London is the financial center of Europe

Financial services in London make up an industry “cluster.” Clusters are groups of interlinked firms that share knowledge, are close to clients, can access specialized labor and services inputs, and benefit from economies of scale. The UK’s cluster of financial and related services firms generates \$300 billion in output yearly, with 2.2 million employees, and by some estimates makes London the world’s top financial center.<sup>2</sup> This industry generates large amounts of international trade: in 2014, the UK’s \$102 billion in insurance and financial services exports came to 3.4% of its GDP. By contrast, such exports made up only 0.8% of GDP in the rest of the EU and 0.6% in the United States. Many foreign firms (including U.S. firms) have financial operations in London and use it as a gateway to the EU market.

The EU is the UK’s top market for financial services: it receives about one-third of the UK’s financial and insurance services exports and one-half of its cross-border bank lending. In 2015, London had only 2.6% of the EU’s total jobs, but had 6.2% of the EU’s finance and insurance jobs, reflecting the high geographic concentration and tradability of these services. And while the UK accounts for 18% of the EU’s GDP, it hosts 85% of the EU’s hedge fund assets and 64% of its private equity funds.

This concentration is possible because EU membership offers a “passport,” signifying mutual recognition of prudential standards, to UK-based financial firms (including foreign firms that have offices in the UK). This allows financial firms to offer cross-border services and open branches across the EU.<sup>3</sup> Without such a passport, firms must get regulatory permissions for each location where they operate.

### Many financial firms in London will probably move some of their operations to the EU

Before the referendum, several financial firms indicated that Brexit would likely cause them to shift resources from the UK to subsidiaries in the EU (e.g., in Dublin, Paris, or Frankfurt) in order to retain access to their clients. HSBC said it may move up to 1,000 trading jobs to Paris, Morgan Stanley said it may move 1,000 jobs out of London, and JP Morgan said it may move up to 4,000 jobs out of the UK.

There have been previous efforts to reduce London’s role in the EU’s financial system. In 2011, the European Central Bank required clearing houses that handled large volumes of euros to be located in eurozone countries so it could better monitor trades and provide liquidity in a crisis. The UK challenged this policy, and in 2015, the EU General Court ruled that the UK could host such clearing houses, which process about \$1 trillion of euro-based trades per day. However, after the referendum, French president Hollande reopened the issue by arguing that euro-denominated clearing must take place within the EU.

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<sup>1</sup> The campaign to leave the EU won by 52% to 48%, on a turnout of 72% (or more than 30 million voters).

<sup>2</sup> For example, the Global Financial Centers Index (which tracks business environment, human capital, financial sector development, infrastructure, and reputation) ranks London first, followed by New York and Singapore.

<sup>3</sup> “Passporting” applies to retail and wholesale banking, as well as specialized financial services like operating trading platforms, regulating prospectuses for public offerings, and acting as central counterparties.

## Brexit raises urgent questions for the UK's financial services industry

- Will the UK have a voice in designing future EU financial regulations, and will it have to abide by those regulations in order to access the EU market?
- Will the UK fall outside of the EU's data protection and transfer regime?
- Will the UK lose preferential trade benefits (including provisions on financial services) that have been established by EU trade agreements with 53 other countries?
- As skilled labor is a key input to the financial sector, will new restrictions on the movement of people or the loss of workers through emigration erode London's competitive position?
- How will ancillary industries like legal, accounting, and consulting services be affected?

## The consequences for financial services will depend on new UK-EU arrangements to be negotiated

The future of the UK's relationship with the EU is unclear. The EU may offer terms which discourage other countries from leaving the union, and any new agreements that are negotiated will face many veto points in European parliaments. In the UK, some "leave" voters wanted less immigration and more protection for UK industries, while others wanted a more deregulated economy with lower trade barriers, so there is no clear mandate for the type of deals to be struck. Furthermore, Scotland and Northern Ireland both voted to remain in the EU, so divisions within the UK are another source of uncertainty that could cloud negotiations. Examples of possible trade arrangements between the EU and the UK appear below.

Arrangement	Description
Norway model	Membership in the European Economic Area and the European Free Trade Association. Requires contributions to the EU budget and acceptance of the free movement of people. Provides access to most of the EU's single market, including the market for financial services, contingent on adopting EU regulations (without any formal influence on such regulations).
Switzerland model	Membership in the European Free Trade Association with bilateral sector-by-sector agreements. Requires contributions to the EU budget and acceptance of the free movement of people. Provides access to the EU's single market in some sectors, but not financial services, contingent on adopting EU regulations (without any formal influence on such regulations).
Turkey model	Membership in the EU Customs Union. Requires adoption of common external tariff for non-EU trade. Provides tariff-free access to the EU's single market for goods. No preferential access for services (including financial services).
World Trade Organization	Default trade relationship if no UK-EU agreement is made. "Most favored nation" tariffs apply. No preferential access to the EU's single market for goods or services (including financial ones).
New trade agreement	Impact on financial services is unknown, but passporting rights have not been included in previous EU trade agreements.

In any scenario, London will likely retain competitive advantages in financial services by virtue of its legal system, business environment, and skilled labor, and the city will incentivize financial firms to stay. However, many firms will wait and see what happens before making new investments or hiring new employees in the UK, and in the meantime will prepare to move some of their operations to the EU.

Sources: Arnold and Noonan, "Banks Begin Moving Some Operations Out of Britain," June 26, 2016; Barker, "City of London Has Lost Its Voice," June 26, 2016; Eurostat, "Employment;" IMF, "United Kingdom," June 17, 2016; IOSCO, "Task Force on Cross-Border Regulation," 2014; Kierzenkowski et al., "Economic Consequences of Brexit," April 2016; Porter, "Clusters and the New Economics of Competition," 1998; Tetlow, "Brexiters' Very Different Visions," June 25, 2016; TheCityUK, "A Guide to the EU Referendum," May 2016 and "Key Facts," March 2016; UK ONS, "Workforce Jobs;" World Bank, "World Development Indicators;" Yeandle, "GFCI 19," March 2016. All data accessed July 2016.

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