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MAKING THE BEST OF BREXIT FOR THE EU27 FINANCIAL SYSTEM

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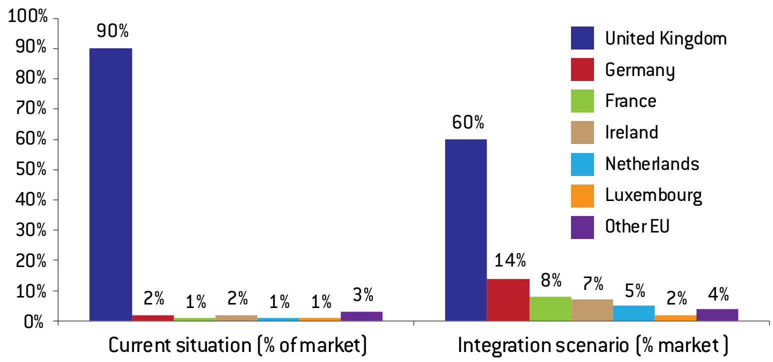
POTENTIAL MIGRATION OF WHOLESALE MARKETS FROM LONDON TO EU27



Source: Bruegel. Note: Market shares as a percentage of the total European wholesale markets. See page 5 for definitions.

THE ISSUE

The United Kingdom's exit from the European Union creates an opportunity for the remaining EU27 to accelerate the development of its financial markets and to increase its resilience against shocks. Equally, Brexit involves risks for market integrity and stability, because the EU including the UK has been crucially dependent on the Bank of England and the UK Financial Conduct Authority for oversight of its wholesale markets. Without the UK, the EU27 must swiftly upgrade its capacity to ensure market integrity and financial stability. Furthermore, losing even partial access to the efficient London financial centre could entail a loss of efficiency for the EU27 economy, especially if financial developments inside the EU27 remain limited and uneven.

POLICY CHALLENGE

The EU27 should upgrade its financial surveillance architecture to minimise the financial market fragmentation resulting from Brexit and the corresponding increase in borrowing costs for firms. While some decline in cross-Channel integration is unavoidable, the EU27 should move quickly towards a fully integrated single market for financial services, with harmonised rules and consistent supervision and enforcement. Policy initiatives need to include governance reform and greater empowerment of the European Securities and Markets Authority, further steps towards banking union and third-country regimes for the supervision of market infrastructure firms (eg clearing houses), similar to those in the United States. With policy integration, there will be less need for financial firms to move to one location, reducing the pressure for all facilities (infrastructure, offices with trading floors, residential housing) to be in one city.

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1 INTRODUCTION

London is the financial hub of Europe, providing corporate and investment banking services to the European Union's 28 member states and well beyond. In a scenario in which the United Kingdom leaves the EU single market by the spring of 2019, UK-based financial firms would lose their passports to do direct business with EU27 clients. Brexit would thus lead to a partial migration of financial services activities from London to the EU27 (EU minus UK[1]) so that financial firms can continue to serve their customers there. Some activities might also be relocated to other jurisdictions, primarily the United States (New York)[2]. The next section discusses the orders of magnitude involved for wholesale banking, a crucial market segment. It should be noted that our estimates throughout this paper are for the purposes of illustration and debate, and not intended as forecasts.

The short-term and longer-term risks and opportunities involved in this shift make it essential for the EU27 to adopt clear policy positions on some key issues. In the short term, an abrupt departure of financial firms from London could cause disruption to financial markets and to the financing of the EU27 economy. Section 3 analyses the structural risk that the ensuing fragmentation of trading activity might result in increased costs and reduced access to capital for companies. There is also the related risk of a regulatory race to the bottom among EU27 countries, leading to misconduct, loss of market integrity and possibly financial instability.

On the upside, Brexit is also an opportunity to build more integrated and vibrant capital markets in the EU27 that would better serve all its member economies, improve risk sharing to withstand local shocks and make the EU27 an attractive place to do global financial business. This would speed up the rebalancing from a primarily bank-based to a relatively more market-based financial system, which is a central objective of the EU's Capital Markets Union (CMU) policy[3].

To address these risks and opportunities, we review three key areas relevant for policy (section 4). The first is directly linked to the finding that intra-EU27 financial market fragmentation is likely to lead to higher borrowing costs. To avert this, a single set of rules (or single rulebook) is necessary but not sufficient. Consistent supervision and enforcement are also needed, and would be best achieved by a reformed European Securities and Markets Authority (ESMA) playing an enhanced role as the single European capital markets supervisor. ESMA should operate in a hub-and-spoke model with national capital market authorities, similarly to EU competition policy enforcement and euro-area banking supervision.

Second, financial stability requires the euro area's unfinished banking union to be further strengthened to generate the desired incentives for banks and national authorities. We recommend that further risk-sharing should go hand-in-hand with additional harmonisation initiatives and the limitation of banks' holdings of individual countries' sovereign bonds.

Third, the future European capital markets framework should adequately take into account cross-jurisdictional interdependencies inside the EU27 – especially while not all member states are part of the banking union, let alone the euro area – and in relation to third countries, including the UK, the United States and other jurisdictions such as Switzerland. The next few years may also call for renewed emphasis on the EU's strategic interests in joint global initiatives in the area of financial regulation, given the likelihood of a less multilateral approach from the United States.

In parallel, EU27 countries should also work on quality of infrastructure, the skills base, English-language proficiency and tax and labour laws within the limits set by the EU framework (eg state aid control and fundamental rights) in order to foster efficient and vibrant markets. The competition between EU27 countries to attract financial activity and jobs can be broadly aligned with European interests if EU-level arrangements prevent a financial regulatory race to the bottom.

1. The single market also includes non-EU countries of the European Economic Area. In this policy brief we use 'EU27' as shorthand for all single market countries.
2. See Véron (2016a) and Schoenmaker (2017) on the likelihood of hard Brexit and loss of passporting rights. See also Martin Wolf, 'Business should assume a hard Brexit', *Financial Times*, 13 January 2017.
3. See Langfield and Pagano (2016) on the case for CMU, and Véron and Wolff (2015) on a desirable policy agenda. The European Commission will publish a mid-term review of CMU in June 2017, to which this policy brief is also intended as a contribution.

2 WHOLESALE BANKING ON THE MOVE

To assess the extent to which wholesale banking could shift to the EU27, we estimate the current size in London of that market segment, which comprises the issuing and trading of debt and equity securities, foreign exchange trading and derivatives. Table 1 provides an overview of total (retail and wholesale) UK banking assets, amounting to €10.3 trillion. Our ballpark estimate is that about 50 percent of total UK banking assets is related to wholesale banking in London[4].

To offer financial market products to EU27 clients, banks need a passport under the Markets in Financial instruments Directive (MiFID)[5]. Based on discussions with market participants throughout Europe, we estimate that about 35 percent of London wholesale banking is related to EU27-based clients, varying from about one fifth for UK-headquartered banks to a third for US-headquartered banks and half for EU27-headquartered banks. Thus, about €1.8 trillion (or 17 percent) of all UK banking assets might be on the move as a direct consequence of Brexit.

As for employees, Goodhart and Schoenmaker (2016) provide detailed data for the London operations of the top five US investment banks, which together account for about a third of London wholesale banking. Panel A of Table 2 suggests that 35 percent of the corresponding sales might move to the EU27. The number of positions that will move with this volume of business depends on business considerations of the investment banks and on the 'substance requirement' of the EU supervisors. This requirement enables supervisors to demand sufficient 'substance' in the form of management, staff and internal control systems as part of the licencing procedure. At a minimum, it is expected that the new EU27-based entities will need to have autonomous boards, full senior management teams, senior account managers and traders, even though much of the back-office might stay in London or elsewhere in the world[6]. We thus estimate that 10 to 15 percent of positions might move, or about 3,300 positions at the five top US investment banks (Table 2, Panel B). As US investment banks count for one third of London wholesale activity that might move, our estimate for the entire wholesale banking segment would amount to 10,000 banking positions moving from London to the EU27. In a separate paper (Batsaikhan *et al*, 2017), we estimate that a further 18,000 to 20,000

4. See Batsaikhan, Kalcik and Schoenmaker (2017) for a more detailed assessment.

5. Directive 2004/39/EC, http://ec.europa.eu/finance/securities/isd/index_en.htm.

6. See Principle 5 of the Basel Core Principles of Effective Supervision (Basel Committee on Banking Supervision, 2012), which states that *"The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis."*

Table 1: Wholesale banking in London (end-2014)

Bank types	Total assets		Wholesale banking in London		Wholesale banking for EU27 clients		
	Assets (€ billions)	% of total UK banks	Assets (€ billions)	% of total assets	Assets (€ billions)	% of wholesale	% of total assets
Major UK international banks	4,583	45%	1,375	30%	275	20%	6%
Major UK domestic banks	1,489	15%	0	0%	0	-	0%
Other UK banks	321	3%	0	0%	0	-	0%
Rest of the world investment banks	2,221	22%	2,221	100%	777	35%	35%
Rest of the world other banks	591	6%	591	100%	207	35%	35%
Branches of EU banks	1,018	10%	1,018	100%	509	50%	50%
Total UK banking system	10,223	100%	5,205	51%	1,768	34%	17%

Source: Bruegel. Note: Total assets based on Burrows, Cumming and Low (2015) and for branches from EU banks on ECB (2015). Bruegel estimates for wholesale banking (issuing and trading securities, foreign exchange, derivatives) in London and for wholesale banking for EU27 clients. The final columns (wholesale banking for EU27 clients) are estimates for the business moving to EU27 after Brexit.

positions related to professional services (eg consultancy, legal and accounting) might be on the move[7].

3 INTEGRATION VERSUS FRAGMENTATION IN THE EU27

Where would the London business move to in the EU27: an integrated wholesale market or one fragmented along national lines? We make a first tentative analysis of the benefits and drawbacks of integration. Fragmentation would lead to an increase in borrowing costs in the EU27, compared to an integrated market for the EU27. By using different trading venues and central counterparties, banks would forego synergies from cross-margining across products, and would need to expand their staff and systems to comply with diverging local requirements. Even assuming that banks can continue to participate in the London market for their own risk management purposes (eg derivatives or off-setting forex deals), they would need to relocate the wholesale trading of securities, foreign exchange and derivatives for EU27 clients to the national markets of the EU27 because of the MiFID passport. This would result in a higher cost of capital for households (mortgages and consumer credit) and corporates (bank loans and corporate bonds). We conservatively estimate the higher cost of capital to be in the range of 5 to 10 basis points. This amounts to an extra annual cost of €6 billion to €12 billion for households and corporates, or 0.05 to 0.1 percent of EU27 GDP[8]. This extra cost of the fragmented EU27 compared to the integrated EU27 would be additional to the (possibly greater) cost resulting from the partial loss of access to the efficient London financial market, which we take as given and do not attempt to estimate here.

As for the drawbacks of integration, concentration of financial activities can have a negative impact on other industries. The financial sector might

Table 2: European operations of top five US investment banks, revenues and employees

Panel A	Revenue by country, end-2014 (in € millions and %)		Potentially relocated revenue (in € millions and %)	
United Kingdom	22,744	92%	7,960	35%
Germany	513	2%		
France	361	1%		
Italy	193	1%		
Ireland	201	1%		
Luxembourg	276	1%		
Other EU	438	2%		
Total	24,726	100%		
Panel B	Number of current employees by country		Potentially relocated positions	
United Kingdom	26,629	89%	3,329	10-15%
Germany	794	3%		
France	293	1%		
Italy	326	1%		
Ireland	1,011	3%		
Luxembourg	491	2%		
Other EU	365	1%		
Total	29,909	100%		

Source: Goodhart and Schoenmaker (2016). Note: The data refer to European operations of the five US investment banks, namely Bank of America Merrill Lynch, Citi, Goldman Sachs, JP Morgan, and Morgan Stanley. Goodhart and Schoenmaker (2016) provide a breakdown for each bank. Bruegel estimates for potential moves.

7. We do not discuss here the extent to which the relocated positions might be filled by the same employees who held them in London.
8. Our calculations are based on €6.1 trillion of household loans and €5.0 trillion of corporate loans from EU27 monetary financial institutions and €1.2 trillion of corporate bonds (*ECB Monetary Statistics*, December 2016).

attract too many graduates from a country's talent pool and overvalue the real exchange rate, and it can also become too big for the country (as London has for the UK). But trading parties do not need to be all in the same physical location to enjoy the benefits of integration[9]. As long as consistent rules and enforcement guarantee equal conditions, traders can operate from different places. Moreover, trading venues can be linked electronically to facilitate best execution. But common rules across member states are not enough. The framework must ensure that administrative decisions (which we refer to here as 'enforcement', but which also include various regimes of authorisation, registration and supervision) are also consistent (Véron, 2015).

To illustrate these points, we present two scenarios for the EU27 financial system, while acknowledging that these are inevitably arbitrary. In both scenarios the UK's share of the total European wholesale market drops from 90 to 60 percent because of Brexit. The starting point is that financial firms with a MiFID passport can serve EU27 clients from anywhere in the EU27, just as they currently do from London. In Batsaikhan, *et al* (2017), we compare London and four major cities that together might ultimately host most of the new EU27 wholesale market: Frankfurt, Paris, Dublin and Amsterdam[10]. Scenario A assumes fragmented markets in the EU27, with financial rules subject to national variations and national supervision. Paradoxically, fragmentation of markets leads to a concentration of the financial industry. Banks have an incentive to move to the same place in order to minimise the cost of fragmentation. Frankfurt already hosts the biggest European operations of the US investment banks outside London (see Table 2) and is home to the European Central Bank (ECB), which is now also the euro area's banking supervisor[11]. For this and other reasons, we assume that Frankfurt is positioned to become the most prominent centre with 45 percent of the EU27 wholesale market. Next, Paris, which is home to the markets supervisor ESMA and several large banks, may cover 20 percent. The runners-up, Dublin and Amsterdam, might cover 15 and 10 percent respectively, and an aggregate 10 percent in all other centres (see Table 3).

By contrast, under scenario B, which

9. See, for example, Degryse, De Jong and Van Kervel (2015).

10. Of course, other financial centres will also play a key part in the new system, including presumably Brussels, Copenhagen, Luxembourg, Madrid, Milan, Stockholm, Vienna, Warsaw and probably others as well. What we present here should be viewed as a simplistic projection for illustrative purposes, not a forecast.

11. Some investment banking operations may be currently outside of the ECB's scope of supervisory authority, but we expect financial firms to anticipate the likely future enlargement of the ECB's mandate to the oversight of such market segments.

Table 3: Scenarios for migration of wholesale markets

	Current situation (% of market)	Scenario A: Fragmentation (% market)		Scenario B: Integration (% market)	
	Total European market	Total European market	EU27 market	Total European market	EU27 market
United Kingdom	90%	60%		60%	
Germany	2%	18%	45%	14%	35%
France	1%	8%	20%	8%	20%
Ireland	2%	6%	15%	7%	18%
Netherlands	1%	4%	10%	5%	12%
Luxembourg	1%	1%	3%	2%	4%
Italy	1%	1%	3%	2%	4%
Spain	1%	1%	3%	1%	4%
Other EU	1%	1%	1%	1%	3%
Total	100%	100%	100%	100%	100%

Source: Bruegel. Note: The current market shares are based on Goodhart and Schoenmaker (2016). In both scenarios 35 percent of the UK market moves to the EU27, so that 60 percent of the current European wholesale market stays in London. Scenario A assumes fragmented markets in the EU27, leading to concentration. Scenario B assumes an integrated market for the EU27, allowing a geographically spread industry.

assumes integration, there is less need for all activities to move to one location, which reduces the pressure to (and price of) having all facilities (infrastructure, offices with trading floors, residential housing) in one city. In this scenario with a more geographically spread industry, 35 percent of EU27 wholesale finance might be in Frankfurt, 12-20 percent each in Amsterdam, Dublin and Paris, and an aggregate 15 percent in all other centres.

Regardless of whether the EU27 financial system post-Brexit is hosted mainly in one location or dispersed between several locations, these locations are likely to be inside rather than outside the euro area, for two reasons. First, currently the largest financial centres within the EU, besides London, are located in the euro area. Second, the ECB, as supplier of liquidity and banking supervisor, is clearly unrivalled in the EU27[12].

The fact that several countries are currently vying to attract business from London suggests that they hope to reap benefits from having larger financial sectors, not least in the form of additional tax revenue. At the same time countries with larger financial sectors face higher potential costs associated with potential public expenditure in case of financial turmoil. These potential costs would be shared by all euro-area countries in a full banking union, but not in an incomplete banking union, as is currently the case. Overall, it will be a challenge to keep a sense of the balance between benefits and potential costs across euro-area countries.

4 RECOMMENDATIONS FOR POLICY

EU27 leaders need to set their objectives clearly for the reshaping of the financial system that is being triggered by Brexit. Different countries and cities will naturally compete to attract business moving out from London, leading to an unavoidable mix of competition and cooperation. We strongly recommend that leaders unambiguously state that this competition should not be on the basis of financial regulation and supervision[13]. Such a statement should be rapidly backed up by concrete decisions – even though their implementation will inevitably take time. A topical example is the substance requirement: EU-level arrangements should prevent national authorities from imposing only superficial requirements in order to attract business.

A GREATER ROLE FOR ESMA

As we have noted, consistent oversight of wholesale markets and enforcement of relevant regulation is critical to achieve cross-border integration. This requires integration of the institutional architecture, for which the tried-and-tested model in the EU is a hub-and-spoke design, long used for competition policy and, more recently, for banking supervision. The straightforward way of implementing this, without the need for changes to the EU treaties, is through the reinforcement of ESMA, the European Securities and Markets Authority that was created in 2011 and that already has a direct EU-wide supervisory role, though only for limited market segments[14]. It is notable that the call for a single EU capital markets supervisor has come not only from EU authorities, most prominently in the Five Presidents' Report of June 2015, but also from some countries (eg German Council of Economic Advisers, 2016).

A broadening of the scope of ESMA's authority requires reform of its governance and funding, which currently limit its independence and capacity. Such reform should not disrupt ESMA's operations in the meantime, but should align it with better designed institutions, such as the ECB's Supervisory Board and the Single Resolution Board. ESMA should be managed by an executive board of five or six full-time members vetted by the European Parliament, in place of the current supervisory board of national representatives (in which the chair cannot even cast a vote). This would help to overcome distortions arising from influential national interests and would prevent regulatory capture. In line with international practice, the reinforced ESMA's funding should rely on a small levy on capital markets activity under scrutiny of the European Parliament, instead of the current political bargaining

12. Countries outside the euro area, however, might level the playing field by joining the banking union under the so-called Close Cooperation procedure.

13. The Governor of the Central Bank of Ireland made a similar point in Lane (2016).

14. These include credit rating agencies and trade repositories. Note: one of the authors of this paper (Nicolas Véron) is an independent board member in a trade repository supervised by ESMA; see Bruegel website for details.

through the general EU budget.

The reformed ESMA should be primarily focused on those market segments for which EU activity is currently most concentrated in London, such as the wholesale banking aspects of MiFID/MiFIR, eg the oversight of trading platforms, benchmarks, and all regulatory provisions applying to international financial infrastructures and derivatives (eg the European Markets Infrastructure Regulation, EMIR)[15]. For other aspects, such as initial public offering authorisations and fund management registrations, ESMA's policy-setting role should be strengthened but national authorities could continue to take their own decisions for the foreseeable future. One other area that requires further convergence within the EU is accounting and auditing. ESMA should be the central authority for enforcement of International Financial Reporting Standards, even though accounting experts in national authorities would continue working on individual cases, and an EU-level supervisory framework should be created for audit networks (see also Véron and Wolff, 2015)[16].

STRENGTHENING BANKING UNION

Thanks to the wide-ranging reforms agreed in 2012-14 and implemented since, the prudential supervision of banks is now significantly more integrated than other areas of financial regulation in the euro area, and this European banking supervision is working broadly as intended[17]. International investment banks that operate in London and want to set up a new entity or build up an existing entity in the euro area are already in talks with the ECB, which will ensure that they meet the substance requirement discussed in section 2. This will surely require the ECB to quickly learn and adapt, but overall there is no reason to doubt its ability to manage the corresponding authorisation and oversight processes.

But banking union remains incomplete and its further development is needed to buttress the reshaping of the EU27's financial markets post-Brexit. Specifically, the goal of strengthening banking union should include more explicit euro-area-wide risk-sharing arrangements, which could encompass the creation of a European Deposit Insurance Scheme (broadly along the lines proposed in November 2015 by the European Commission)[18], a mandate for the European Stability Mechanism (ESM) to act as a backstop to the Single Resolution Fund and the future European Deposit Insurance Fund, and for the use of the ESM's direct recapitalisation instrument for precautionary recapitalisation purposes. Simultaneously, there is a need for a properly calibrated framework for binding exposure limits on sovereign exposures of euro-area banks and for further harmonisation to come closer to the vision of a single rulebook required for banking supervision and for the insolvency regime that applies to euro-area banks.

Completing the banking union would also better enable European banking groups to challenge the currently dominant positions of leading US investment banks. The key factor here is the home base of European banking groups, which is still largely framed at a national rather than European scale[19] and perpetuates significant distortions in euro-area countries (Schoenmaker, 2016).

Strengthening the banking union should also imply that not only the risks but also the benefits from an expanded euro area financial sector post-Brexit are better shared by euro area countries. Unless there is some sharing of benefits there is a danger that countries will be unwilling to share the risks, which would make the expanded financial sector of the euro area more vulnerable to financial instability.

FINANCIAL SYSTEM INFRASTRUCTURE

With Brexit, some components of the EU27's financial system infrastructure will find themselves outside of its territorial scope. This challenge should force a broad rethink of the way the EU27 manages its regulatory relationships with third countries, which for now are largely organised around the principle of

15. MiFIR refers to the Markets in Financial Instruments Regulation (https://ec.europa.eu/info/law/markets-financial-instruments-mifir-regulation-eu-no-600-2014_en). EMIR is the European Markets Infrastructure Regulation (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services_en).

16. We don't discuss here the separate issue of the European Banking Authority (EBA), currently based in London. Our recommendation is that its future location be decided as soon as possible, in order to minimise operational disruption and loss of staff morale, and that its possible broader reform (also in the wake of banking union) be deferred to a later stage.

17. Schoenmaker and Véron (2016) found that European banking supervision of significant banks was generally *"tough and fair"*, based on euro area-wide observations and nine country-specific studies, as of mid-2016. Since then, developments especially in Portugal and Italy have further reinforced the assessment of effectiveness of the new supervisory mechanism.

18. COM/2015/0586 final; https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en.

19. See Goodhart and Schoenmaker (2016) on the rising share of US investment banks in the European investment banking market.

recognition of equivalence. This generates too much reliance on third-country authorities for critical infrastructure, such as clearing houses (also called central counterparties or CCPs in Europe), which are financial firms whose role in the financial system has been enhanced by recent derivatives market reforms and, in particular, by the requirement that many over-the-counter derivatives transactions should be centrally cleared by CCPs. Currently, EU-based CCPs are supervised by authorities in their home countries[20], and third-country (ie non-EU-based) CCPs are supervised by their home authorities on the basis of recognition by the European Commission of the equivalence of their supervisory regimes. By contrast, EU-based (or other) CCPs that operate in the United States are supervised not only by their home authorities, but also by the US authorities, including for their home-country operations (eg in London for UK-based international CCPs), under a robust surveillance framework that includes on-site (ie extraterritorial) inspections and data access.

To ensure proper alignment between supervision and risk exposure, euro-area-based CCPs should be supervised by European authorities under a framework akin to that in place for banking supervision, and a US-style third-country regime should be established by which these European authorities would also acquire extraterritorial supervisory capacity over non-EU-based (eg UK and US) CCPs that have systemic relevance for the EU27. Such arrangements would be in the interest of both the UK and the EU27, since they would avert the alternative option of a costly and economically sub-optimal 'location policy' that would restrict contingent ECB liquidity to only those CCPs that are based in the euro area.

20. Recent legislative proposals from the European Commission (http://europa.eu/rapid/press-release_IP-16-3747_en.htm) extend this country-level framework to CCP resolution.

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