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The consequences of Brexit for the City of London

By John Springford and Philip Whyte

CENTRE FOR EUROPEAN REFORM

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★ The UK is home to the largest financial centre in Europe. As the City of London was intimately involved in the financial crisis, the US and the rest of the EU have an interest in ensuring the City's financial stability, and vice versa. International regulation is being more closely co-ordinated to reflect the globalised nature of the financial system.

★ The eurozone's banking union does not pose a threat to the City's European pre-eminence. British and continental regulation has moved in the same direction since the crisis – indeed, the UK has tightened regulation to a greater degree than other EU member-states. And if it remains a member of the EU, the UK can use the European Court of Justice to defend its single market rights.

★ If Britain leaves the EU, banks would shift some of their activities into the EU. The remaining member-states would insist that Britain sign up to many rules in exchange for more limited access to European markets than it currently enjoys. A British exit would damage the City, rather than setting it free.

Introduction

The City of London's pre-eminent position as a European financial centre pre-dated Britain's accession to the EU, and has only increased since the country joined.[1] Until recently at least, EU membership was mostly perceived as a boon to the City. Not only did it allow London to market itself as a bridgehead to non-EU financial institutions wanting to serve the wider European market; it also allowed continental European banks to concentrate most of their wholesale activities in London. (Wholesale finance consists of lending, borrowing and trading between financial institutions, rather than between banks and their customers.) Fears that the City of London's position as a financial centre would be gradually eroded if Britain did not join the eurozone have not materialised: to date, the City has thrived outside the currency union.

Relations between Britain, the City of London and the EU have, however, become more complicated since the financial crisis. Before 2008, British governments could assume that what was good for the City was good for Britain and the rest of the EU. The EU's efforts to remove barriers to trade in financial services were supported by British governments and the City. And while some member-states resented the fact that Europe's largest financial centre was outside the eurozone, British governments could plausibly claim that the City was a European asset whose success was vital to continental European prosperity.[2]

Since 2008, however, any sense of harmony has broken down. In the UK, public attitudes to the City have hardened. Traditional claims made on the City's behalf about its contribution to British jobs, tax revenues and export earnings now have to be set against the costs imposed by the financial crisis, as well as the impact on the City's reputation for probity of repeated scandals

1: In this paper, we use the City of London as shorthand for UK-based financial services firms, which are not only located in London (although the great majority of wholesale activity takes place in the capital).

2: Philip Whyte, 'Britain, Europe and the City of London: Can the triangle be managed?', CER Essay, July 20th 2012.

(Libor rate-fixing and the mis-selling of financial products being the most infamous). Few people still believe that the interests of the British state and the City of London naturally coincide. Indeed, Britain has led the way in tightening the regulatory screws on finance.

In continental Europe, several factors have conspired to upset the previous balance. First, the financial crisis has generated pressure to regulate finance – particularly firms, products and practices considered to be typical of financial capitalism in its most unrestrained, 'Anglo-Saxon' form. Second, the design flaws exposed by the eurozone crisis are forcing deeper levels of integration in the currency union (potentially reducing British influence in shaping financial regulatory policy at the EU level). Third, the European Central Bank (ECB) has sought to force some euro-denominated business to be cleared in the eurozone, rather than London.

Complicating matters further, relations between the UK and the EU have become more difficult than at any time since Britain joined in 1973. Against a backdrop of rising hostility to immigration and to 'rule from Brussels', the British Conservative party has committed itself to renegotiating the terms of the country's membership of the EU and to putting the new settlement to a referendum before the end of 2017 – a move that could result in Britain's withdrawal from the EU. In the interim, the perception among other member-states that the UK is set on a course that will lead to its departure from the EU has weakened its influence, notably over the framing of EU legislation.

"The perception that the UK is on the way out of the EU has weakened its influence."

Against this backdrop, this policy brief assesses the extent to which EU membership has been of benefit to the City, and how the eurozone's banking union or a British exit from the EU might imperil the City's position as a leading financial centre. First, it examines the drivers of the City of London's growth and its integration with the EU's financial system; it then provides an analysis of the implications of the eurozone's nascent banking union for London's status as Europe's dominant financial centre; and, finally, it specifies what forms of financial activity might be put at risk if Britain were to leave the EU.

How the City of London developed

Declining transport and communication costs have driven globalisation. But their impact across economic sectors has not been uniform. In the manufacturing sector, for example, supply chains have displayed a tendency towards increased geographical dispersal across the globe. In the financial sector, by contrast, the reverse has often been the case: lower communications costs have coincided with financial services – and wholesale financial services in particular – becoming increasingly concentrated in a small number of 'global cities'.[3] The City of London has been one of the principal beneficiaries of this trend.

In the 1960s, the City of London was still predominantly an international clearing centre for sterling-based transactions. It has since evolved into a genuinely global financial centre, making markets in multiple currencies and providing the full gamut of financial services across borders – from securities and currency trading to bank lending, asset management, insurance, derivatives, trade and maritime finance, and so on. In so doing, the City has carved out for itself a special role in the European time-zone – not just as a hub between Europe, Asia and the US, but also as a provider of services not found elsewhere in Europe.

Although Britain's share of global GDP has declined to about 4 per cent, the City of London itself has become the location for a disproportionate share of financial activity. Globally, the UK accounted for 46 per cent of the market in over-the-counter (OTC) interest rate derivatives and 37 per cent of turnover in foreign exchange in 2013. In Europe, the City's size is even more marked: it boasts a higher share of euro-denominated foreign exchange trading than the eurozone, and accounts for 85 per cent of hedge fund assets under management, over 70 per cent of OTC derivatives traded, and 51 per cent of marine insurance premiums.[4] These markets are huge: in some cases annual turnover amounts to hundreds of trillions of US dollars.

Historically, a number of factors have encouraged the City of London to attract all this activity. A non-exhaustive list would include, in no particular order, the following 'pull' factors:

★ The predictability of the legal system.

★ The international status of the English language.

★ A generally accommodating regulatory environment.

★ A critical mass of expertise, both in finance and in ancillary services such as accountancy and law.

★ A tradition of openness to foreign firms and migrants.

3: Saskia Sassen, 'The Global City: New York, London, Tokyo', Princeton University Press, 1991.

4: TheCityUK, 'UK and the EU: A mutually beneficial relationship', June 2013.

★ The perceived integrity of London's markets and participants.

★ A market infrastructure able to support high levels of financial activity.

These 'pull' factors can combine to form a virtuous circle. For example, an international bank's principal reason for moving to London might be the legal system and the market infrastructure already in existence. But by setting up in the City, it brings more skilled workers, which provides more talent for the pool of labour. This renders the City more attractive to other banks.

The City also benefitted from the decision by governments to dismantle controls on the flows of cross-border capital in Europe, in which the development of the single market for financial services played a role. After the breakdown of the Bretton Woods system in the 1970s, the United States, Germany, Canada and the UK unilaterally removed controls on foreign capital. But capital controls were only removed at an EU level in 1988, after the introduction of the single market programme.

As part of that programme, the EU's introduction of the single banking licence allowed a bank based in one member-state to set up a branch in another, yet continue to be regulated by authorities at home. Member-states agreed to common prudential and regulatory minimum standards, to prevent a race to the bottom. Nevertheless, the impact was largely deregulatory: countries with higher levels of regulation feared that they would lose financial activity to less regulated financial centres, and so they reduced restrictions on the trading of shares and securities, foreign direct investment in the financial sector, and bank mergers and acquisitions. By 1998, all EU member-states had opened their financial sectors to the degree that the US, Germany, the UK and Japan had in the 1970s and 1980s.[5]

"The City has become the largest financial centre for euro-denominated trading, despite the UK choosing not to join the single currency."

In 1999, the introduction of the euro provided a further spur to financial integration. The City of London became the largest financial centre for euro-denominated trading, despite the UK choosing not to join the single currency. The British government won access to the eurozone's payments system, TARGET, for banks based in the UK, and in so doing established the principle that institutions based in the single market, but not in the eurozone, should have equal rights to conduct transactions in the common currency.

The principal effect of EU membership for the City has been to provide new European markets for banks and other financial firms based in the UK. But most of the increase in cross-border finance has been conducted in wholesale markets – between financial institutions themselves, rather than between banks and consumers. London is the EU's largest wholesale financial centre and the rest of the EU has an interest in its financial stability. Furthermore, the euro crisis has prompted the single currency's members to set up a banking union, to shore up a shaky eurozone financial system. As it is not a member of the euro, the tension over financial regulation between the single market and the eurozone has important implications for the UK's decision about EU membership.

The City's role in the European financial system

The rationale for the fourth freedom of the single market – the free movement of capital – is twofold. First, by allowing financial institutions to move into new markets, it is intended to raise the level of competition, and so drive down prices for consumers. Second, international capital flows allow savings to flow to where they may be most profitably invested, giving savings-constrained but potentially fast-growing countries more capital to invest.[6] How much integration has occurred in retail and inter-bank markets, and with what economic consequences?

Retail markets

The single market programme has not transformed Britain's retail banking market, which has become more concentrated in recent years, not less. Four large banks became dominant mortgage and business lenders in the decade before the financial crisis: HSBC, Barclays, Lloyds group and Royal Bank of Scotland group. A series of mergers and acquisitions led to a less diverse banking sector, and the market share of the largest banks rose between 1997 and 2007. Since the crisis, the Spanish bank Santander has increased its share of the British retail market by taking over three smaller banks, and Lloyds was broken into two by the government, after its bail-out in 2009. But retail finance now exhibits similar levels of concentration to those seen immediately before the crisis (see Chart 1).

5: According to an index collated by Menzie Chinn and Hiro Ito, based upon IMF measures of financial openness. See their 'What matters for financial development? Capital controls, institutions, and interactions', Journal of Development Economics, 2006.

6: See, for example, Dirk Schoenmaker and Wolf Wagner, 'The impact of cross-border banking on financial stability', Tinbergen Institute Discussion Paper, 2011; Claudia Buch et al, 'Cross-border diversification in bank asset portfolios', International Finance, 2009; and Barba Navaretti et al, 'Multinational banking in Europe: Financial stability and regulatory implications', Economic Policy, 2010.

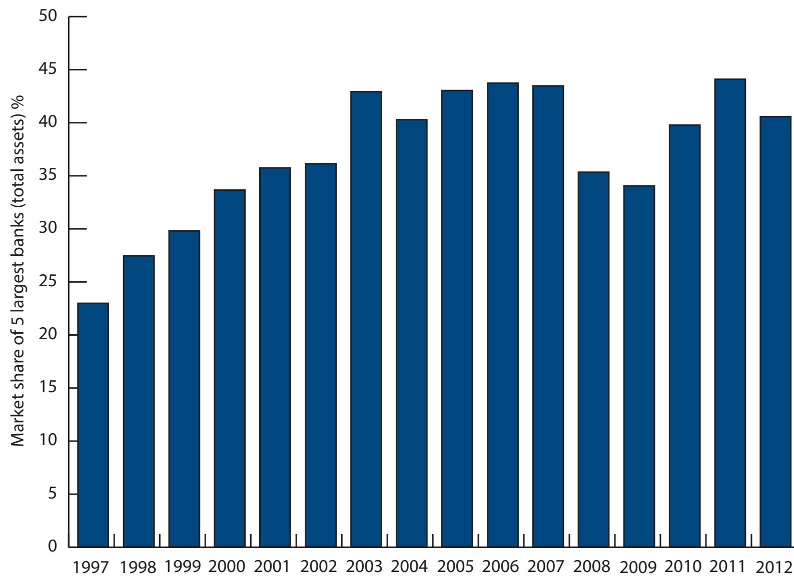

Chart 1:
Five largest banks' UK market share, 1997-2012

Source: European Central Bank.

Inter-bank markets

For Britain, the biggest impact of the single market has been on the City of London as an international financial centre. The development of the single market, as well as the reduction in barriers to capital flows across the developed world, led to larger cross-border flows of savings looking for investments, and the growth of European bond and equity markets. (The British government and its officials were leading advocates for the single market programme, and its architects: the advantages of a liberalised European financial system for the City of London were obvious.) UK-based banks now preside over a quarter of all EU banking assets.[7]

As well as being the largest global financial centre in the EU, the City of London is also at the centre of the eurozone's financial system. Over the last economic cycle, the City integrated faster with the eurozone than with markets elsewhere. Chart 2 shows British banks' lending to the eurozone, the rest of the EU and European Economic Area, the US, Japan and developing countries, as a proportion of their respective GDPs.[8] UK-based banks built up heavy exposures to both the eurozone and other EU member-states, with the scale of flows growing much faster than GDP between 1999 and 2008. The financial integration between the UK and the eurozone was five times greater than with the US, adjusted for economic size, in the depths of the euro crisis in 2012.

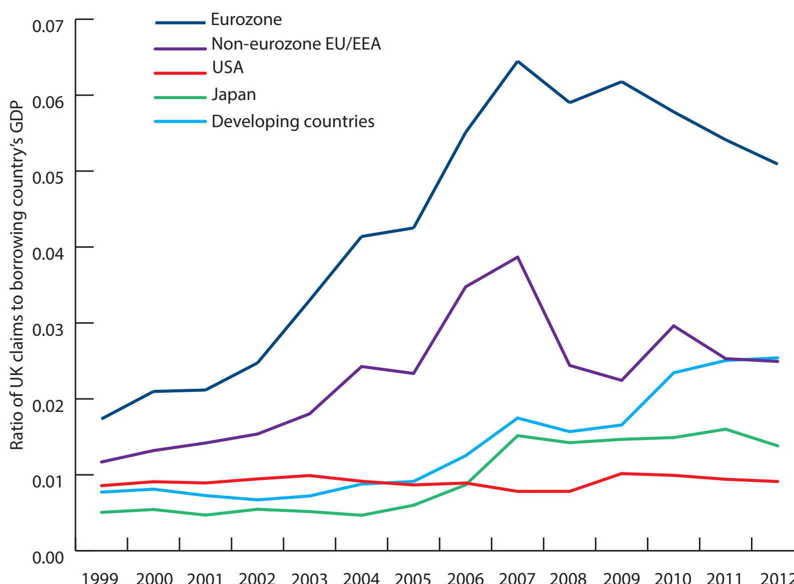

Chart 2:
UK banks' international assets as a proportion of GDP

Source: CER, using Bank of International Settlements and World Bank data.

7: International Monetary Fund, 'Technical note on financial integration and fragmentation in the European Union', March 2013.

8: By controlling for GDP growth, this provides a more accurate assessment of financial integration than gross figures.

Since the eurozone got into difficulty, however, UK bank lending, particularly to countries in the eurozone's so-called periphery, has fallen sharply (see Chart 3.)[9] A significant part of the financial integration between the introduction of the euro and the crisis seems to have been cyclical, rather than structural. Before the crisis, EU banks under-priced macroeconomic risks in the eurozone's periphery, by failing to consider what might happen if their current-account deficits proved unsustainable, and paid the price. (Current-account deficits mean that countries are borrowing from abroad – they are investing more than they are saving – and when lending dries up, current accounts are forced back towards balance.)

Despite the decline in cross-border lending since the start of the euro crisis, the City remains at the heart of the eurozone's financial system. And it is still highly integrated with the US (see Chart 4): in the coming decades the City's largest markets will continue to be the US and the rest of the EU. The implication: the US and the rest of the EU have an interest in ensuring the City's financial stability, and vice versa. International regulation is being strengthened, and the UK, EU and the US are becoming less tolerant of financial centres outside their jurisdiction that may impose risks on the financial system as a whole.

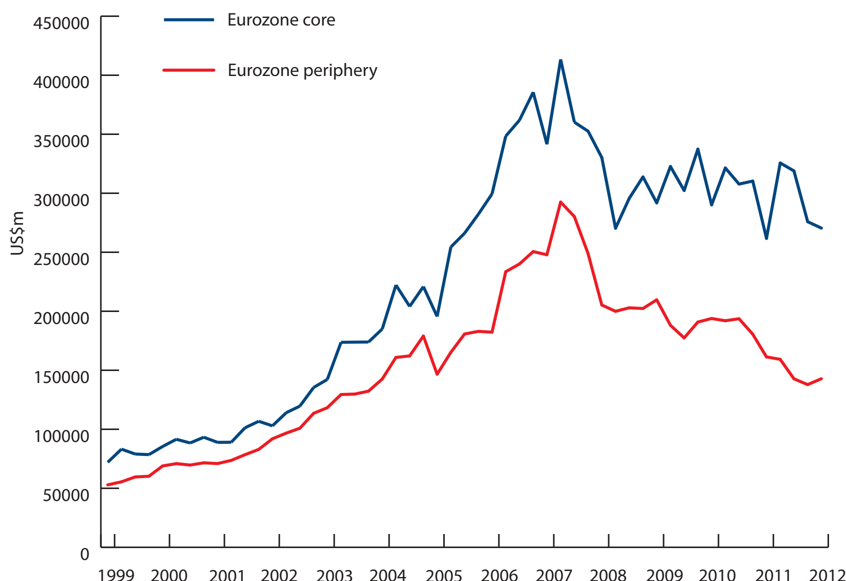

Chart 3:
UK lending to the eurozone core and periphery, 1999 to 2013

Source: CER analysis of Bank of International Settlements data.

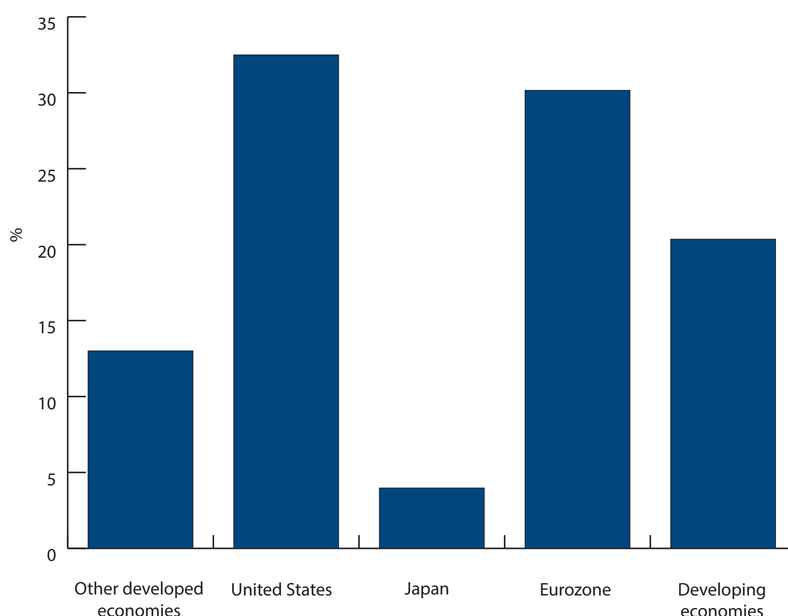

Chart 4:
Proportion of UK international lending, Q3 2013

Source: CER analysis of Bank of International Settlements data.

9: The 'peripheral' eurozone countries in this paper are Greece, Italy, Ireland, Portugal, Spain, as well as Slovenia, Cyprus and Estonia after they joined the euro in 2007, 2008 and 2011 respectively.

As the City of London is at the core of Europe's financial system, but sits outside the eurozone, some compromise between the UK's single market interests and eurozone financial stability must be found. The free movement of capital within the EU's financial system requires member-states to share sovereignty over financial regulation.

But negotiations between the UK and the eurozone will continue to be fraught – perhaps even more so, once the ECB takes over the supervision of the largest eurozone banks, which constitutes one 'pillar' of the eurozone's banking union. Will the banking union render the UK's position in the EU untenable?

The City and the eurozone: an unhappy marriage?

To tackle cross-border financial instability, nation-states face a choice. There is a trilemma in international financial economics – between financial stability, internationalised finance and national sovereignty.[10] It is possible to have two of these options, but not three. Financial stability and cross-border finance require rules that are agreed internationally. Equally, poorly co-ordinated national rules and the globalisation of financial markets can result in financial instability. After the crisis, the member-states of the EU, and those of the G20, recognised that international rules were too lax before the crisis, and that national regulatory competition to give financial centres a competitive advantage increased threats to the stability of the global financial system.

Britain faces the same trilemma as other countries, but more acutely, since it is home to one of the world's largest financial centres – and is outside the eurozone, but in the EU. It could seek to leave the EU, and then engage in regulatory competition to encourage more financial firms to set up in the City – but at the risk of reducing financial stability. And other countries would inevitably argue that the City threatened the world's financial system, and seek to reduce the threat by preventing British-based banks from having access to their markets.

As the City is distrusted by many eurozone politicians, and 'Anglo-Saxon' finance is considered by some to be one of the causes of the eurozone's problems, the eurozone is even more unwilling to allow British authorities wide latitude to regulate and supervise its largest financial centre. Furthermore, eurozone member-states have agreed to pool sovereignty over banking supervision – and, to a lesser extent, the closure or rescue of failed banks. The UK's position on the banking union is that it is necessary to put the eurozone on a more stable footing. But it also wants to maintain regulatory sovereignty, and protect its interests in the single market, despite the City's role as a eurozone financial centre.[11]

Thus, if the City is to remain open to international capital flows – with its banks having access to international interbank markets, its investors buying financial assets in other countries, and its hedge funds providing investment services for international clients – then it must be willing to cede sovereignty over financial regulation.

As it happens, British regulators have shown little desire in recent years to design regulation to give the City a competitive advantage. Before the crisis, the Financial Services Authority was legally required to consider the City's competitiveness when drafting rules. This is no longer the case: Britain has, in many ways, been leading the charge towards stricter prudential regulation. The authorities have forced banks to raise capital and to hold more liquidity; banks are now required to draw up recovery and resolution plans (so-called 'living wills'); and the government has agreed to implement most of the recommendations of the Vickers Commission, which will force banks to ring-fence their retail operations from their trading and investment arms.[12]

"Some compromise between the UK's single market interests and eurozone financial stability must be found."

By contrast, many EU countries have been slower to force their banks to raise capital. The EU directive that aligns the way in which banks across the EU should be resolved was agreed at the end of 2013, well after British rules had been changed. (The British considered it a success for their resolution system, which already included many of the same provisions that the EU directive requires.)[13] And the EU is only now implementing the 2012 Liikanen report's suggestions for ring-fencing operations – although the timeline for implementation is very similar to Britain's.

This is not to say that all recent EU proposals have been welcomed by the City – or the UK government. The draft Alternative Investment Fund Managers Directive (AIFMD), when it was originally proposed by the Commission in 2010, imposed limits on the ability of non-European funds to provide services in the EU. These funds had little to do with the financial crisis, many Britons argued, and the UK government successfully pushed for some (but not all) of the restrictions in the directive to be eased. In addition, the ECB has tried to force clearing houses that settle large volumes of euro-denominated trades to relocate to the eurozone. The British government has taken the ECB to the European Court of Justice (ECJ) over its location

10: Dirk Schoenmaker, 'The financial trilemma', Economics Letters, 2011.
11: Philip Whyte, 'What a banking union means for Europe', CER Essay, December 2012.
12: Independent Commission on Banking, 'Final report', September 2011.
13: Deloitte, 'European requirements on recovery and resolution', June 2012.

policy, arguing that the move violates the free movement provisions governing the single market in the EU treaties. It has also gone to the ECJ over eleven eurozone member-states's plans for a financial transactions tax – a small tax on financial trading – that would raise a disproportionate amount of money from business carried out in London; and also the EU's limits on bank staff's bonuses, which the British government voted against in the Council.

In March 2014, the EU reached agreement on banking union. The UK, while it opted out, had hoped for a more centralised structure for the eurozone than was ultimately agreed. While the ECB has taken over the supervision of the 130 largest banks in the eurozone (although it has ultimate supervisory responsibility for all banks), the provision for closing a failed bank is complex, requiring assent from the ECB, the Commission and the member-states. The common fund to finance the closure of banks is small and will take eight years to reach full capacity.

This leaves the UK in a potentially uncomfortable position: the eurozone financial system may not be much more stable than it is now, which poses further risks to the European economy, the UK included. But supervisory authority will be concentrated in the hands of the ECB, which will thereby wield considerable influence on supervisory and regulatory policy throughout the EU. And the British government fears that financial regulation will be made to satisfy the interests of the eurozone, rather than the EU as a whole.

As a result, many in the City fear a new regulatory assertiveness on the part of the eurozone. There are certainly areas in which it is easy to envisage conflict. The resolution of a eurozone headquartered bank with large operations in the City of London is one. The eurozone and the UK government may have opposing interests when it comes to resolution: eurozone authorities will seek control of the bank's assets, even if a part of its balance sheet is under the Bank of England's jurisdiction. There are unresolved questions about how banks that get into trouble in London will access ECB liquidity. The eurozone member-states may seek to impose caps on the exposure of a eurozone bank to its sovereign, in an attempt to break the link between governments and banks. They might demand that UK banks do the same.

However, these moves would hardly amount to an unbearable threat to the City's competitiveness – and hence a reason for Britain to leave the EU. The regulatory focus on both sides of the Channel has been on bank safety; and the difference in regulatory philosophy between the UK and the eurozone is not as wide as is often implied. There have been few attempts to roll back the freedoms of the single market, the ECB's location policy aside. The financial transactions tax may never come into being, since the participants are divided on how comprehensive it should be, and the Council's legal service has concluded that the tax infringes EU treaties. (On April 30th 2014, the ECJ ruled that the British government's case against the tax was premature, as the member-states involved had not yet decided on how the tax would work. Yet the judges said that this did not stop another challenge once the details had been finalised.)

"It is difficult to argue that eurozone financial integration poses an unbearable threat to the City."

The British government has won a 'double majority' voting system in the European Banking Authority, which sets the rules for the EU, so that any measure requires a majority of both eurozone members and those outside. If more EU member-states join the euro, this rule will have to be revisited, as it would end up granting the UK disproportionate power over financial regulation. (Should the euro 'outs' eventually consist of just Denmark and the UK, which have opt-outs, the UK would have a veto on all financial rules.) But most of the 10 non-eurozone member-states will not join the single currency for many years, and in the medium term, the double majority system will prevent eurozone interests from assuming precedence over those of the single market. Finally, while the UK is a member of the EU, it has recourse to the European Court of Justice, which may determine whether eurozone-inspired regulations violate the single market's principles.

The days when the UK set the agenda on EU financial regulation are over. Eurozone policy-makers will focus on the single currency's financial stability, and extending the single market will be less of a priority. This may make life uncomfortable for Britain in some ways, but it is difficult to argue that eurozone financial integration poses an unbearable threat to the City. Insofar as it makes the European financial system safer, it is to be welcomed.

The consequences of divorce

But what might be the consequences for the City if the UK chose to leave the EU? British eurosceptics argue that even outside the EU, the City's deep and liquid capital markets, legal regime, time zone, language and historic trading ties would give it a formidable competitive advantage. Pro-Europeans argue that it would be a disaster for the City's competitiveness.

Both positions take it as axiomatic that the fate of the City of London should be an important factor in any decision about EU membership. The UK has a strong comparative advantage in financial and related business services, and it has a large trade surplus in this sector. It is in ordinary times an important source of tax revenue for the British treasury, although the cost of recapitalising the banks

in the aftermath of the financial crisis has revealed the size of taxpayers' exposure to banks that are too big to fail. It is perhaps unrealistic to expect Britain not to seek regulatory advantage for a major exporting industry based within its borders. But it is likely that, upon leaving the EU, the City of London would be less open to the rest of the world, not more, unless it signed up to EU rules.

Eurosceptics believe that an EU exit would not be a disaster for the City. This is probably true – at least in the short term. Much of the City's business is global, rather than merely regional. It is the world's largest centre for foreign exchange trading. And, like New York and Tokyo, it is a hub for trade in securities for firms all over the world.

Upon exit, there might be some competitiveness gains for the City if the UK rescinded some rules that it considers damaging. The recent rule limiting bankers' bonuses to double their annual salary would be one. Britain might choose lower capital requirements for insurers than the EU has imposed under the Solvency II directive.

However, marginally lower regulatory costs would have to be set against reduced access for City-based firms to EU markets. In any exit negotiation with the EU, the UK would have to make a bargain, because the EU insists that so-called 'third countries' – those outside the club – must have regulation and supervision of their financial sectors that is equivalent to that of the EU, in exchange for access to EU markets.

The EU is in the process of tightening rules on third country access. To comply with the new markets in financial instruments directive (MIFID II), third-country firms that want to sell services to ordinary consumers will have to open a branch within EU borders. This branch must be regulated and supervised by that country's authorities, in co-operation with the supervisors of the host country. Firms will only be allowed to set up branches if the European Securities and Markets Authority (ESMA) recognises the regulations of the country of origin as equivalent to the EU's. ESMA must also accept that the country of origin's supervisors have the ability to supervise the firm abroad (which is expensive and administratively difficult). The branch will also have to meet EU capital requirements, and if the bank's home country changes its regulations or fails to supervise the branch effectively, the bank will no longer be free to operate in the EU.[14]

After strong pressure from the British government, the Commission's first proposal for testing the equivalence of regulation has been watered down. In its original form, the directive insisted upon 'line-by-line' equivalence tests for third country rules. In its final, agreed form, ESMA will test whether the regulatory outcomes of third countries are likely to be equivalent.

If Britain leaves the Union, banks from other EU countries will face a difficult choice. Currently, many use a branch in the City of London as a base. The UK is by far the largest centre for foreign branches in the EU (see Chart 5): as a centre of wholesale markets, many banks from elsewhere in the EU make London their centre of European operations. Many choose to establish branches, rather than fully capitalised subsidiaries supervised and regulated by the UK authorities, because it reduces funding costs. (Each subsidiary must comply with the capital and liquidity rules of the country it operates in, which makes intra-bank transfers of funds difficult. Branches need only comply with their home country rules, and are supervised jointly by their home authorities and those of their host.)

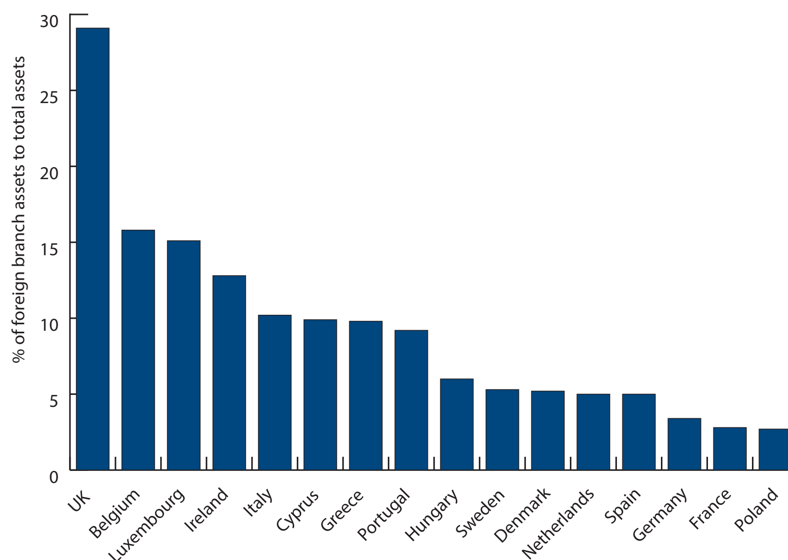

Chart 5: Foreign branch assets as a proportion of total banking assets, various EU member states

Source: Bank of England, 'Supervising international banks: the Prudential Regulation Authority's approach to branch supervision', February 2014.

14: KPMG, 'Provision of services by financial intermediaries from third countries in EU financial markets regulation', 2011.

If Britain leaves, the EU will treat it as a 'third country'. For British banks to continue to be able to sell investment services or retail products to clients in the EU, British rules and supervisory requirements would have to be deemed equivalent. And as a non-member, the UK would not have the power to stop the EU tightening the rules on third country access by insisting upon line-by-line equivalence tests. There would be a risk that it could lose access to the single market, or sign up to EU rules without any say in how they were drafted.

The UK could, of course, still allow EU banks to set up branches in London and recognise EU member-states' rules as equivalent to its own. But banks from outside the EU would no longer be free to set up a subsidiary in London, and then branch out to other EU member-states. To continue to maintain a range of operations across the EU, they would have to set up another subsidiary, probably in Paris or Frankfurt. And they would have to satisfy three regimes under MIFID II: that of their home country; any further supervisory requirements that the British authorities required as a condition for setting up a subsidiary in London; as well as the supervisory requirements of the EU member-state in which they established their EU subsidiary.

It is impossible to know with any sort of precision how large the impact a British exit would have on the location decisions of non-EU banks, as much depends upon future decisions on third country access. As the City of London would continue to be an international centre for wholesale financial markets, some non-British banks might continue to bear the increased supervisory costs of three different supervisory regimes. But this might not be the case. Many banks might instead choose to restructure their operations to reduce the regulatory burden, and this might entail moving some of their business from London to the EU.

There are two areas of financial activity where more precision is possible about the consequences of exit: euro-denominated trading, and hedge and private equity funds serving clients in the EU.

The ECB would be highly likely to force clearing houses that settle euro-denominated trades to relocate to the eurozone, should the British leave. As noted above, the British government is taking the ECB to the ECJ over its location policy, arguing that it violates the rules of the single market. Outside the EU, it would have no such recourse. And the text of the ECB's location policy gives it wide latitude to deal with 'offshore' centres, as the City would be in the event of British exit. It says that 'key technical facilities' and information systems of any clearing house with a large proportion of euro-denominated business must be located in the eurozone. The ECB argues that it must be able to ensure that clearing houses are managing risk effectively, in order to safeguard eurozone payments systems and derivatives markets. The policy says that the ECB may 'grant an exception', but as it has been unwilling to do so for Britain when it is in the EU, it is unlikely to offer one to the City as an offshore centre.

Nor would the UK gain much regulatory sovereignty over hedge and private equity funds by leaving the EU. The AIFMD requires hedge and private equity funds to comply with capital requirements, pay guidelines, and other rules if they are based outside the EU's borders – and those funds that wanted to continue to market their funds in the EU would have to comply with these rules should Britain leave (under the AIFMD, non-EU regulations must be equivalent for cross-border provision of services to be legal).[15]

"The regulatory sovereignty that would supposedly flow from leaving the EU would be largely illusory."

The UK would be likely to find itself in a similar situation to that of Switzerland. Swiss financial institutions only have limited access to the EU, and must set up branches and subsidiaries inside the union – usually in London – in order to be able to sell services to EU customers. To maintain their limited right to sell services across the Swiss border, they must constantly update their regulations to ensure that they are seen as equivalent by the EU. In order to maintain the City's market access, the UK would come under heavy pressure to do the same upon exit.[16]

The regulatory sovereignty that would supposedly flow from leaving would, in short, be largely illusory: in order to maintain access to EU financial markets, the UK would have to align its regulations with the EU. It would have no influence on the design of those rules, so it might even lose regulatory sovereignty upon leaving, if the EU made third countries sign up to EU rules in exchange for market access. As Britain would not be represented in the Council or the European Parliament, such restrictions would be more likely to happen. And as it would no longer be a member of the EU, the UK would not be able to use the ECJ to defend its single market rights.

Finally, it cannot be taken as a given that the UK would be more outward-facing and laissez-faire upon leaving. The British authorities' regulatory stance towards the financial sector has changed dramatically since the financial crisis: a British exit would probably not lead to a bonfire of red tape. And since hostility to immigration from the EU is one reason for Britain's equivocation about its EU membership, and the City's pre-eminence is partly founded upon its skilled foreign labour, banks may find it more difficult to bring in skilled workers if Britain decides to leave the Union.

15: PwC, 'The AIFMD outside the European Union', May 2013.

16: University of Kent Centre for Swiss Politics, 'Switzerland's approach to EU engagement: A financial services perspective', April 2013.

Conclusion

The City of London is at the core of the EU's financial system, and indeed that of the eurozone. Its interests lie in a comprehensive banking union to strengthen the eurozone's financial system, and strong EU institutions – the Commission and the ECJ – to ensure that eurozone integration does not lead to regulatory protectionism. Leaving the EU would deprive Britain of guaranteed access to these institutions.

There are two priorities for the UK government in its negotiations over the City's European status. First, it must ensure that the domestic, European and global financial systems are stable. As finance is internationalised, financial stability requires co-ordination with the EU and the G20. Second, for good or bad reasons, British politicians will inevitably want to maintain the competitiveness of the City of London. Both require it to trade regulatory sovereignty for financial stability and market access.

Britain's eurosceptics are right that the City would not collapse in the event of an EU exit. Its central role in foreign exchange and securities trading, in insurance and asset management, and in financial law and accountancy services would continue, as would its position as the location of choice for many leading private equity and hedge funds. But some activity would be lost if Britain left the EU; and the costs of an EU exit would outweigh the (largely illusionary) benefits of sovereignty. The EU's new regimes for third countries are making the choice for third countries a stark one: they must either maintain standards at EU levels, or lose access to the EU market. It is difficult to believe that this principle would not apply should the EU and the UK negotiate a British exit.

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