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THE CITY AND FINANCIAL SERVICES AFTER BREXIT: HISTORICAL PERSPECTIVES

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Foreword

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Abstract

Among the many uncertainties about the nature of the UK's international economic relations after Brexit, the role of the City of London as a financial centre is one of the most difficult to predict. Membership of the EU and therefore the common regulatory frameworks have allowed London firms to provide services to European customers even though the UK is not part of the Eurozone. But if we examine the long run historical record, and the evolution of London as an international financial centre, we can clearly see the City's resilience and potential for innovation that could enable it to meet these Brexit threats.

Key Words:

Brexit, Financial Services, Financial Regulation, International Financial Centres, City of London, European integration

Note: a later version of this paper will appear in *Political Quarterly* in 2019.

Introduction

Among the many uncertainties about the nature of the UK's international economic relations after Brexit, the role of the City of London as a financial centre is one of the most difficult to predict. The financial services sector in London is globally competitive, with a long history of innovation and adaptation to change. The geographical distribution of global banking and finance has been remarkably stable at least at the top, where London and New York have jointly hosted the major global markets for the past 100 years. However, there are legitimate fears that the locus of European finance will shift away from London with the repeal of EU passporting rights that facilitate the EU-wide services trade. Brexit threatens to disrupt the London-New York duopoly if the bulk of European business migrates to within the Eurozone after 2019. The City will need to draw upon all of its competitive strengths – in labour cost, skills, and the agglomeration of services – to retain its global pre-eminence.

Since the 1990s financial services in the UK as a whole has contributed 5.5-6.5% of GDP a year (rising to almost 9% in 2010) of which about half is generated in London.[i] In 2016 financial services generated 1.1m jobs, 3.2% of total jobs. Financial services exports amounted to £61 billion and imports of £11 billion in 2016, generating a surplus of £51 billion that helps to pay for imports of manufactured goods. This trade is focused strongly on Europe; in 2016 44% of financial services exports went to the EU and 39% of financial services imports came from the EU. It is clear that cross border business with the EU is an essential part of the business generated in the City of London so the implications of Brexit could be profound for the British economy.

While Britain's financial activity is dispersed around the country, it has always been dominated by London, which has also been the country's major commercial centre. The financial services sector benefits from economies of scale and scope so that financial firms tend to be located in close proximity. This arises from the interdependency of services ranging from insurance, banking, legal, accounting, media and other ancillary business services. The demand for specialised skilled labour also tends to create economics of scale and scope in financial services, for finance at its heart relies on networks, reputation and constant innovation based on human and social capital. The dynamic, inter-active and often personal relationships that underpin modern finance thus benefit from centralisation even in an age of digital communication. As a result, entrenched international financial centres have proved difficult to dislodge in the absence of war or sudden economic collapse.

Brexit poses particular challenges for the City of London. Membership of the EU and therefore the common regulatory frameworks have allowed London firms to provide services to European customers even though the UK is not part of the Eurozone. But if we examine the long run historical record, and the evolution of London as an international financial centre, we can clearly see the City's resilience and potential for innovation that could enable it to meet these Brexit threats.

The City of London: emergence and resilience

The British model of economic development has had finance and financial agglomeration at its core at least since the industrial revolution of the 18th century. In the 20th century, the City of London proved resilient to a range of political and economic shocks and to the transformation of the structure of the global financial system. During the interwar global economic depression, sterling lost its dominance to the US dollar (albeit temporarily), free trade was abandoned and capital controls marked the Great Reversal of globalisation. After the international economic system was restored in 1947, a new model prevailed: the emphasis was the promotion of freer trade combined with pegged exchange rates that were supported by national controls on cross-border financial flows. The floating exchange rates and volatile capital markets that characterised the 1930s had ended the enthusiasm for open capital markets. But even in this hostile environment for international finance, the City of London was not restricted merely to the domestic market.

First, the Sterling Area and the international role of sterling provided continuing opportunities for the City through the Bretton Woods era of capital controls in the 1950s and 1960s. Capital flows to sterling area countries (e.g. Australia, New Zealand, South Africa, Malaya, Singapore, Hong Kong) were allowed on a preferential basis. Britain also joined the European Payments Union that allowed more multilateral trade among Western European states and sustained demand for commercial services in London.

London also benefited from tighter exchange controls imposed by other European states. Thus, the development of financial markets in Paris and Frankfurt were hindered by regulations that discouraged inflows and outflows of short term capital in order to protect their respective exchange rates. Similar controls on flows of sterling were imposed by the British Treasury, but financial institutions in London soon found ways to circumvent them. The most important innovation of this period – and one that may have important lessons for the Brexit era - was the Eurodollar market, which revived the City of London merchant banks and attracted an invasion of banks from around the world.[ii] The Eurodollar market comprised bank deposits, loans and bonds issued in London for customers from around the world, denominated in US dollars but outside the US jurisdiction. The use of the dollar as the main currency of the City of London demonstrates the ability of British finance to innovate around regulatory obstacles. The toleration of the Eurodollar market by the Bank of England and Treasury in turn demonstrates the official commitment to the advantages of the City for the British economy, particularly in this instance its capacity to earn scarce foreign exchange by exporting services. Other European governments pushed such offshore markets out of their own jurisdictions and this helped to launch London into an unrivalled position in the international financial system in the 1960s and 1970s while exchange controls persisted in New York and European centres.

During the 1970s (in common with other centres) London was rocked by a series of fraud scandals as bankers struggled to cope with newly floating exchange rates and huge opportunities for speculative trading (and losses).[iii] Supervision of international banking in London was tightened up somewhat and the leading industrialised economies turned their attention to prudential supervision of an increasingly international market with the launch of what became the Basel Committee on Banking Supervision in 1975. By this time, New York was the largest global banking market in terms of size of assets, but London remained a premier centre, particularly for Europe. Unhindered by the restrictions of the US

Glass-Steagall Act, and benefiting from close access to a large European customer base and a time zone 5 hours ahead of New York, London remained an important host for global financial institutions.

By the 1980s, the City was again lagging behind New York and faced its next existential crisis. In 1974 'May Day' in New York eliminated minimum commission charges, making trading more competitive particularly for larger traders. From 1979, the final exchange controls in London were abandoned, which opened up New York for British investors in US, UK and international equities. This time the pressure to increase competition was prompted by the state. Margaret Thatcher's Conservative government led the attack on the restrictive self-regulation of the London Stock Exchange (LSE) by challenging the traditional Rule Book under the Fair Trading Act.[iv] By 1983, a compromise was reached whereby the LSE agreed to increase competition among brokers, take foreign members into the LSE and combine brokering and jobbing. The Big Bang of 1986 also included a computer-based trading system to rival the NYSE. Although the LSE never again challenged New York in terms of scale, it retained its position as the main equity market for Europe.

But the really lasting and profound transformation of the City arising from Big Bang was the rush of international banks into mergers and acquisitions to seek the scale and scope to enter proprietary trading and take on the booming securities business. The mid-1980s regulatory changes heralded the arrival of global financial conglomerates spread across London and New York with offices in other centres across the world's time zones. Banks' business models shifted from interest income to fees and trading income and raising liquidity through money markets rather than attracting deposit liabilities. Money markets grew rapidly as innovations in securitisation and asset management came to dominate global investment banking.

An important advantage during the 1980s and 1990s was the culture in the City. London combined close geographic links to Europe with a business model for finance that more closely approximated the US culture. Innovation, competition, low personal and corporate tax rates, performance-related compensation, quick and short lines of management and decision-making were all part of the 'Anglo-American' model that underpinned the growth of major global investment banks in the 1980s and 1990s. Many European financial institutions sought to emulate or acquire these attributes in a rapidly changing market through acquisition both of institutions and teams of professionals and traders. In this context Deutsche Bank provides a cautionary tale. Unable to find the expertise and skills to embark on investment banking in Germany, Deutsche Bank looked to London to acquire these attributes through a take-over of Morgan Grenfell in 1989.

But the cultural gulf between Frankfurt and London proved extremely difficult to bridge. The German model of matrix management structure ensured cross-cutting regional and functional interests for board members and reinforced the governance by consensus that marked the German universal bank. But investment banking, with its need for quick decisions, short lines of management and performance-related rewards was ill suited to this format. The result was prolonged battles between Frankfurt and London over the management and structure of the investment banking business of Deutsche Bank in London. In 1995 the difficult decision was finally taken to move control of Deutsche Bank's investment banking business to London from Frankfurt. This was a clear recognition that the talent, networks and business practices in London were superior. At this point, New York was a difficult market for European institutions to breach, but Deutsche Bank acquired Bankers Trust in New York in order to get a foothold there in 1999. Deutsche Bank's global investment banking business, however, continued to be led from London.

During the 1990s another existential threat to London emerged: the introduction of the single currency in Europe and the European Central Bank. How would London fare outside the Euro and beyond the reach of the ECB? At this time there were widespread predictions that Frankfurt would overtake London as the main European financial centre. But London persisted, moving into Euro- as well as Dollar-business, becoming the leading centre for Euro-clearing. This time the benefits to European customers of the agglomeration of services and expertise in London, the regulatory framework and governance structures that promoted revenue-seeking and short term returns outweighed efforts in Frankfurt or Paris to rival London as the leading European financial centre. In June 1999, six months after the introduction of the Euro, the Bank of England reported that 'There is quiet confidence among international market firms that London has been maintaining its market share'.[v]

Frankfurt was considered the main potential rival at the time and indeed it had many benefits. It was the centre for post-war German finance and banking, the strongest European industrial nation and the host for the new European Central Bank. In 1991 Helmut Kohl's German government launched their plans for Finanzplatz Deutschland to enhance the financial services offered there, including reforming regulation, modernizing the stock exchange, promoting new sectors of the industry and championing German financial firms.[vi] Key characteristics of the traditional German system, as opposed to the Anglo-American model, was the cross-holding of bank-industry-insurance companies and the operation of 'hausbank' system that secured the bank-based financial system rooted in long term relationships. This internalised the financial flows for large companies and secured loan finance for the successful *mittlestadt* firms that were at the core of the German industrial success. It also reduced the demand for money market facilities that were resisted by the Bundesbank and also side-lined the stock exchange as a source of capital.

The German system contrasted with the more competitive, fluid and fickle markets of New York and London but left gaps in the financial markets in Germany, particularly in lucrative corporate bonds and equities, pension fund management and money market financing. Lower taxes on securities trading in 1991 were followed by the relaxation of regulations over money market funding instruments in 1994.[vii] But while this changed the business model for German banks and firms, Frankfurt did not eclipse London. The agglomeration effects of breadth and depth of expertise, flexible labour markets and lower tax structure were sustained. These advantages in London were especially important as the global financial markets entered a period of instability during the emerging market crises in the late 1990s and early 2000s.[viii]

Now, Frankfurt is again a clear rival to London, with German officials calling for Euro-clearing to be moved from London to Frankfurt and some banks shifting parts of their clearing operations there.[ix] This poses a direct threat to the London Clearing House that deals with about Euro1 trillion per day. Other European financial centres are also jockeying for position; particularly Paris and Amsterdam, and some activities will inevitably increase their presence there after the UK leaves the EU. Paris, for example, will be the new host for the European Banking Authority. While many European banks are poised to open offices in other centres, jobs and activity in London will not necessarily decline in the short term. In most cases, the announcements have been accompanied by reassurance that activities in London will not necessarily be scaled down, or jobs moved away, although some extimates put the net job losses as up to 30,000.[1] But in the longer term, it is likely that London will share more of its business with centres elsewhere in Europe. This in turn many undermine the gravitational pull of London that has supported the range of finance-related business.

What will keep finance in London?

While regulation is clearly key to the location of international financial services, the historical record of governments deliberately 'creating' financial centres is not strong. The City of London grew organically and has adapted to a variety of international environments over the past 100 years. This is not just historical determinism, but also the strong centripetal effects in the range of financial services which are interdependent and rely on a flexible workforce with particular specialised skills. Efforts to promote Paris in the 1960s or Frankfurt in the 1990s have faced obstacles either from competitive advantages of incumbents or recognition of the costs to hosting a global financial centre, including the need for low taxes, low barriers on movement of key workers, accepting flexible labour markets. Moreover, the concentration of financial activity contributes to income inequality and vulnerability to external shocks and this does not suit all political economy climates.

Hosting an international financial centre carries with it risks and burdens as well as advantages. From the 19th century when London was in its most dominant global position, there were frequent complaints that the financial services sector concentrated in the Southeast inhibited industrial and manufacturing growth in the country as a whole. The geographic distance between finance in the South and manufacturing in the North, it was argued, made it more difficult for factory owners to raise capital. With its outward, global focus, scarce capital resources were instead directed to foreign investment that built up British industry's competitors in Europe, the Empire and the USA. This critique of the City of London's role in British relative industrial decline became an important focus of academic research in the 1980s.[x] As is often the case, the trends in historical research mirrored the time in which it was written.

The historic model of the cultural and geographic gulf between The City and the domestic economy seemed particularly apt in the decade after the de-industrialisation of Britain accelerated and when Margaret Thatcher's Conservative government waged war against trade unionists in the North. At the same time, the image of the City trader finishing business in the early afternoon before retiring to the champagne bar seemed to re-emphasise the dislocation in the British economy and society. Whether these tropes are legitimate, they reinforced a sense that hosting a global financial centre increases income inequality and contributes to social and housing problems in London. This distortion is less important for New York because of the huge scale of the US economy both in terms of output and geographic size compared to London's position in the UK.[xi]

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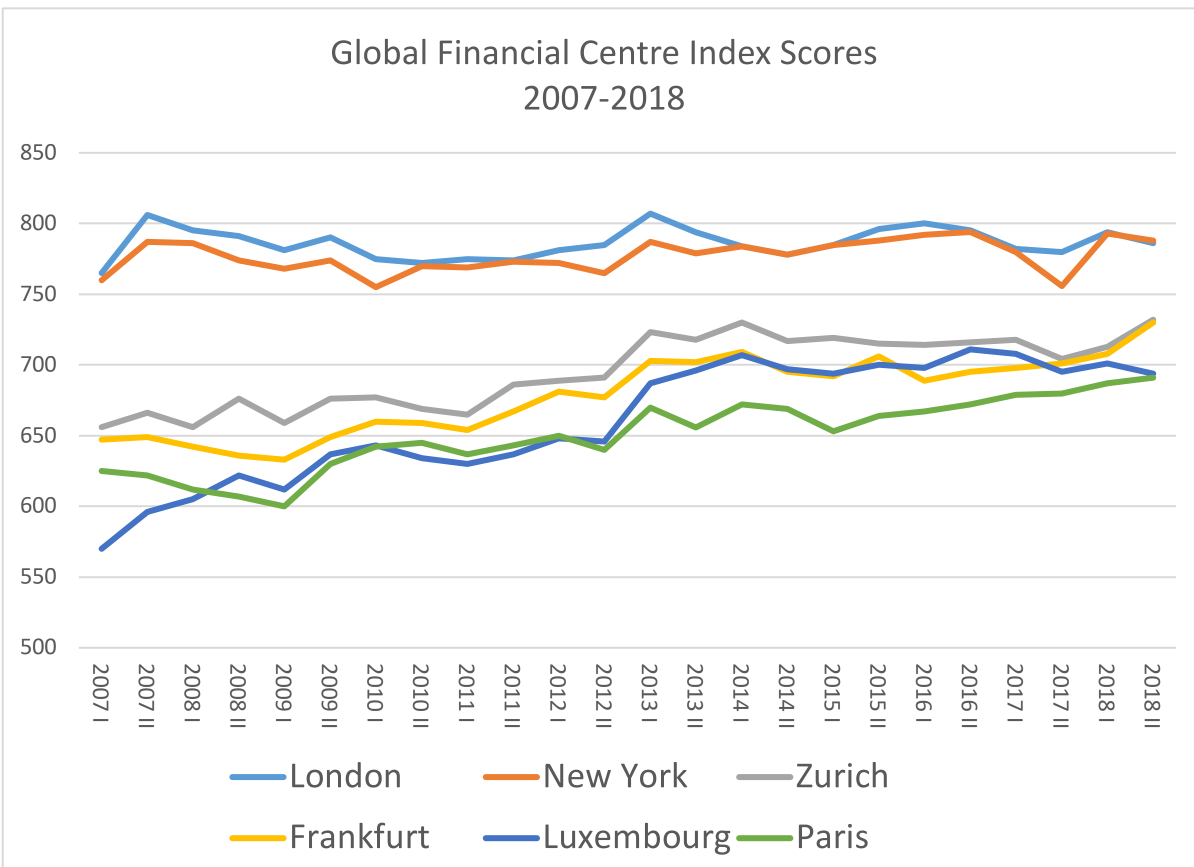
[1] http://bruegel.org/2017/02/brexit-and-the-european-financial-system-mapping-markets-players-and-jobs/

What were the sources of London's competitive advantage in a globalised world of the 1990s and 2000s? Agglomeration effects induce a kind of inertia, but there is more to it than this. The advantages of London are perhaps felt most strongly now in the large pool of skilled labour available to employers in London. This has long loomed as a major advantage for London over other European centres. Linked to this advantage are language and legal transparency. It is the ability not only to hire talent, but also to fire in the wake of downturns in the market that help London's competitiveness. No continental European centre made the Top 10 IFCs in the category of Human Capital in 2018, but London ranked second in the world (after Hong Kong).[xii] Figure 1 shows the persistently high ranking of London and New York since the GFCI index began to be compiled in March 2007. The methodology includes a wide range of secondary data as well as a questionnaire of c.2200 individuals, of which 40% are located in Asia-Pacific region. It scores the centres across a range of features including Business Environment, Human Capital, Reputation, Infrastructure and Financial Sector Development. It is striking that London's position has not fallen significantly since the Brexit vote although other European centres have gained ground. But the figure also indicates that the catch-up is a longer-term process than just a reaction to opportunities arising from Brexit.



Note: The GFCI are published mostly on a half-yearly basis in Spring and Autumn Source:. Z/Yen Partners. For methodology see http://globalfinancialcentres.net/explore/

Certainly, London's position relative to New York is about equal and this has been the case evidence since 2007.[xiii] The September 2018 edition marked some changes with New York narrowly overtaking London and increases for Frankfurt and Zurich. Zurich is persistently the second ranked European financial centre, although well below London, but other European centres have been catching up since 2007 With different methodologies, *The Banker* ranking has somewhat different outcomes for European centres other than London (e.g. Amsterdam and Paris come above Zurich), but it also puts London well ahead of any European centre, particularly with regard to inward foreign direct investment and new firms opening in 2016/17.[xiv] Furthermore, the city's financial services cluster is expanding, with 1208 new firms launching operations in London between June 2016 and early May 2017, according to data provider Dun and Bradstreet, bringing the total to 49,185. But this status should not necessarily create complacency about the changes to come after 2019.

'Passports' allow financial institutions based in London to offer a range of services to customers in the EU either directly from London or on preferential terms through a branch. In 2017 5,476 UK firms used Passports into the UK and 8,008 EEA firms used passports into the UK.[xv] Without this, UK firms would not have the right to market their services, although they could supply services if a customer approached them (unsolicited).[xvi] Losing the Passports will require financial institutions under the UK regulatory bodies to establish regulated businesses within the EU and to apply for a license to trade in each EEA country. In August 2018 the UK Treasury announced that the government was committed to continuing inward flows of services from EEA resident firms to UK customers for 3 years after March 2019 even if there is no transitional 'deal' for Brexit by this time. But the reciprocal rights are not being offered by the EU.[xvii]

The Government's 2018 White Paper on the exit from the EU and future relationship with Europe dropped the automatic regulatory equivalence for services. While stressing that 'In our new strategic partnership agreement we will be aiming for the freest possible trade in financial services between the UK and EU Member States' the White Paper stressed mutual cooperation arrangements and pledged that 'As the UK leaves the EU, we will seek to establish strong cooperative oversight arrangements with the EU and will continue to support and implement international standards to continue to safely serve the UK, European and global economy'.[xviii] This provoked considerable disappointed angst in the City of London because of the lack of specifics on the transition for existing contracts or certainty about the pursuit of mutual recognition of regulations that would facilitate the continuation of relationships.[xix] The relationship between the City and the state has always been complex, and James and Quaglia demonstrate that the relations between the financial services sector and the UK government has waxed and waned during the negotiations with the EU.[xx]

The main route to mitigate the effects of the loss of Passporting (and the most likely) is through regulatory equivalence in London for some businesses: but this process is bilateral and not fully secure so it is not a substitute for existing arrangements. Most importantly, equivalence can be unilaterally revoked by the EU at short notice. There are 11 areas listed in the Equivalence Decisions by the European Commission and over 200 decisions on 30 partner country jurisdictions (including the USA) have been taken under this instrument.[xxi] In April 2018 Michel Barnier, the main EU negotiator, asked "Why would the equivalence system, which works well for the US industry, not work for the City?"[xxii] The draft Brexit agreement in November 2018 accepted that the EU's system for determining regulatory equivalence would be the likely solution for the City of London's access to EU markets.

As financial regulation conforms to a global standard through the G20, FSB and BIS initiatives then equivalence might be easier to achieve, or at least has less opportunity cost. The UK is a 'rule-taker' from the BIS and FSA as well as from the EU. The review of the European Commission experience published at the end of 2017 noted that a lighter touch was possible where the exposure of the EU to the country was small and that preponderance was deployed in these contexts. This suggests, conversely, that achieving equivalence in London could require a high threshold of compliance than many of the existing agreements. Moreover, the Commission from late 2014 introduced periodic reviews and monitoring into the equivalence decision, which might be onerous for London.[xxiii] The decision can also be reversed 'at any moment', which creates costly uncertainty. But markets cope with a range of uncertainties and risks and London should be resilient if it is able to offer competitive services to its customers.

In April 2018 Barnier concluded a speech to Eurofi High Level Seminar with optimistic remarks about the future of the City and its relationship to Europe, but he also dashed hopes that the UK might get a special and more permanent equivalence deal as proposed by Philip Hammond, the Chancellor of the Exchequer.[xxiv] One possible adjustment strategy would be to develop strategic partnerships between UK and EU financial firms. This was how British, American and European banks responded to the prospects of European integration in the 1960s: through the creation of consortium banks and banking clubs. But here the lesson of history is less optimistic. In the 1970s it proved impossible to sustain these cooperative structures; their interests diverged, the new entities competed with their 'parents' and there was costly duplication. Within a decade most had been abandoned and banks returned to traditional cross-border branches and subsidiaries.[xxv]

In the past, London has responded to challenges through innovation and it is possible that new advances in Fintech will undermine the importance of regulatory boundaries in some markets. There may also be opportunities to deregulate in London to make it more attractive for global business in some areas, although there will need to be compliance with global BIS and FSB standards.

Certainly, new barriers between London and other European financial capitals will induce changes in the geographic distribution of activity. But this may not necessarily lead to a withering away of the influence and centrality of the City of London, but may (in a more optimistic outlook) disperse activity among European centres in order to conform to regulatory barriers. To some extent this process has already begun due to high property costs in London and the outsourcing of some back-office IT and accounting tasks that ICT innovation made possible in the 1990s and 2000s. The challenge for London is to retain its traditional advantages in quality of labour supply, communications, ease of business, and legal infrastructure for the high value-added parts of financial services.

Conclusions

London as a financial centre has been resilient to a series of seemingly existential crises over the past century and London's markets have a long history of innovation and adaptation. Core strengths continue to include the agglomeration of services, the pool of skilled labour and flexible labour market.

The reliance on breadth and agglomeration means that losing part of the high value-added sectors of the financial industry may undermine the attractiveness of London. Meanwhile, London's exceptional talent pool relies on continued open access for migrant labour from the EU and the rest of the world, a key feature challenged both by the Brexit referendum and the government's long-standing immigration policy.

All told, the challenge of Brexit is important and dangerous. The clearest route to mitigation is through equivalence: this has advantages (institutions are likely to continue to be able to access EU customers) but also disadvantages (London will be a rule-taker from EU and may lose competitiveness vis-à-vis New York). While some lower grade functions are liable to be dispersed, this may also leave City institutions providing some high-level services through subsidiaries in the EU. It is not clear, however, that other European financial centres yet have the infrastructure to replace London in the short term. The optimistic outcome, therefore, is greater complementarity rather than complete eclipse.

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[xii] Human Capital included availability of skilled personnel, flexible labour market, education and development, quality of life. London came second after Hong Kong and before New York on this measure.

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