A negative-sum game: Brexit has caused European finance to relocate to the US rather than across the continent

__Martin Heneghan__ and __Sarah Hall__ find that Brexit has triggered a negative-sum game for European finance as activity shifts to the more established centres across the globe, particularly in the United States which has both regulatory access to the EU through equivalence and deep capital markets.

The United Kingdom's decision to leave the European Union initiated a scramble in Europe as rival financial centres across the EU competed to lure financial services away from the City of London. The EU Single Market had facilitated access for the City to provide financial services across the EU through 'passporting rights'. These enabled financial services to be provided on a cross-border basis to EU clients. It also allowed the setting up of branches across the bloc rather than more costly subsidiaries. Once it became clear the UK intended to leave the Single Market, political actors in Europe's financial centres sensed an opportunity to entice international banks and other providers to their locales. However, to date, whilst some activity and resources have shifted to the EU as a result of Brexit, there has not yet been the mass exodus that many in the industry feared at the onset of the referendum result.

Early scholarship on the new geography of European financial centres chartered the activities of political actors in the EU seeking to take advantage of the disorder caused by Brexit. Some noted that whilst economic actors were wedded to the status quo, political actors saw advantages in disruption to maximise gains for their districts. Paris in particular aggressively campaigned for financial service providers to relocate to the French capital. Similarly, Frankfurt sought to make use of its hosting of the European Central Bank to claim it was the natural heir to London as the new European financial centre.

In a recent paper we drew on this analysis to suggest that an emerging geography of fragmentation in the EU and concentration in the UK may be underway. In the EU, the relocation activities suggested a clustering of specific sub-sectors within European centres. Frankfurt was the main beneficiary of banking relocations, whilst asset management firms preferred Dublin and Luxembourg. Market infrastructures have chosen Amsterdam, whist Paris has been the beneficiary of a broader range of activities. Despite the loss of some personnel and assets, there has yet to be a large reconfiguration of financial services within the UK. Indeed, focusing on the movement of people may be a misnomer as the industry is likely to be changed by jobs that are never created rather than jobs that relocate.

Past crises in the UK offer a framework for how Brexit may play out in the medium to long term for financial services in the UK. After the global financial crisis, an initial contraction in London was followed by growth in financial sector employment and output in the capital as it reinvented itself and created new markets such as the internationalisation of the Renminbi. Employment and output in many of the UK's regional financial centres, on the other hand, contracted, particularly in core cities such as Birmingham, Manchester and Leeds. This led to a process of concentration of financial services in the UK. As pressures to downsize and consolidate were brought on by the crisis, back office functions were either relocated abroad or economised. The prestige of having a London office protected the capital from these pressures, despite the higher costs associated with employment in London.

A new dynamic has taken shaken shape since January 2021, as the transition period ended, and the UK lost its access to the Single Market. This has impeded access for the City of London on some trades such as euro-denominated derivatives, which EU rules state must be executed on an EU trading venue. However, whilst European financial centres have been the beneficiaries of some of this, such as Amsterdam in shares trading, the US has thus far been the main beneficiary of the new trading landscape. In the absence of passporting rights, third countries must rely on an equivalence decision by the EU Commission. This is where the Commission deems regulation to be equivalent to EU regulation. It is the poorer cousin of passporting as it is not as comprehensive and can be withdrawn with 30 days' notice. The City of London currently only has an equivalence arrangement in two areas of financial services. The US, on the other hand, has 22 equivalence arrangements. In trades like derivatives, this has given it an advantage over other financial centres. In the absence of passporting rights or equivalence, the City of London is unable to execute some trades. European financial centres have passporting rights, but they do not have the deep, liquid capital markets that New York has, which also has regulatory access to some services through the equivalence arrangement.

Brexit can therefore be thought of as creating a negative-sum game for European finance. Rather than financial services relocating across the continent in a zero-sum game between the UK and EU, some activity is leaving the continent completely to other centres, particularly New York and Chicago. This is illustrated by the case of derivatives trading, whereby UK counterparties trading in-scope derivatives with EEA counterparties (and vice versa) may find that contradictory sets of rules apply, and they cannot comply with both. The only workaround to this solution is to re-route them through a third country with an equivalence decision – such as the US.

The negative-sum game for European finance should not necessarily be interpreted as a strategic miscalculation by the EU. It simply demonstrates there are wider factors in play than economic efficiency. Losses for the City of London have political gains for the unity of the EU project, even if they are not materialising as economic advantages to the bloc. This makes the prospects bleak for the UK on an equivalence decision. These decisions have always been political as well as technocratic. In the case of Brexit, it seems likely that politics will supersede technocratic and economic efficiency concerns.

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