The biggest threat to the City of London is now uncertainty

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Uncertainty is now the biggest threat to the City of London, writes ***Simeon Djankov****. It is not simply a question of whether changes to financial regulation will deter business, but whether the government can deliver on its promises to cut corporate taxes, reform immigration while letting in talent and make corporations more transparent without putting off foreign investors. In this extract from a new paper, he looks at the effect Brexit will have on banking, (re)insurance, asset management and clearing.*

Brexit will have negative effects for the City of London, and the preliminary results of our analysis suggest that such effects will be substantial. The City of London may lose up to £18 billion in revenue and up to 30,000 jobs by leaving the single market (Oliver Wyman 2016). Our analysis suggests that these estimates account for about 15 percent of financial sector revenue and 3 percent of employment in the City. Other estimates show similar magnitudes: £14–20 billion in revenue and 70,000 jobs lost (PWC 2016) or 83,000 jobs lost (EY 2017).

According to these estimates, for the City of London the direct negative effect of Brexit on the financial sector will be a 12–18 percent loss of revenue and a 7–8 percent drop in employment, clearly significant effects. In macroeconomic terms the initial effects of Brexit on the country's financial sector are modest: UK GDP may shrink by 0.5 percent and employment by 0.2 percent. These estimates are smaller than those predicted by the government prior to the referendum. In April 2016 the UK Treasury predicted declines of £38 billion in revenue and up to 230,000 jobs in the financial sector as a consequence of Brexit. These effects may materialise in the longer term.

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The UK government's reaction to leaving the single market may be to revisit some of its financial regulation in an effort to bring more investment. But such a policy move may trigger a regulatory race with other major financial markets, to the detriment of the global financial system.

In the meantime, uncertainty surrounding the transition from the European Union and the possible changes in the regulatory stance of the UK government will be deterrents to new business.

The biggest uncertainty, however, is not specific to financial regulation. Instead, it stems from the ability of the UK government to deliver on the various promises made with Brexit:

- **Can corporate taxes by reduced without negatively affecting the fiscal outlook?**

- **Can a reform of immigration maintain the flow of talent to the City of London and more generally to UK universities and companies?**
- **Can reforms on executive pay and transparency in corporate decision making be implemented without diminishing the attractiveness of the United Kingdom for foreign investors?**

So far there is little sense of how any of these changes may take place.

The effects of Brexit on different City sectors

- **Banking** Around £25 billion in revenues come from EU-related banking business, or 23 per cent of total retail and business banking. Banks reliant on EU markets will experience an increase in their operation costs dictated by reorganisation and possible need to open subsidiaries in the EU. As a result smaller banking institutions may consider leaving the City. So far, only one international bank, the Russian bank VTB has publicly announced the possible move of its European operations entirely away from London. Several have announced deep staff cuts in their City operations, such as HSBC which is moving 1,000 jobs to France.

- **Insurance and reinsurance** Around £4 billion of insurance and reinsurance sector revenues, or ten per cent of the total, are from EU-related business. But because 75 per cent of insurance and reinsurance services are provided through subsidiaries, about a quarter of these revenues, or £1 billion, may be lost to competitors due to Brexit.

- **Asset management** Around £6 billion, or 25 per cent of UK asset management revenues, comes from EU-related business that will be directly affected by Brexit. UK-based asset managers may need to set up subsidiaries across Europe to continue to manage investment funds domiciled there in an efficient manner. As a result, investment activities may become more expensive and complex for clients. About a third to half of this EU-related business, £2–3 billion, may look for a new home.US private equity funds Blackstone and Carlyle have announced plans to establish passporting rights in Luxembourg to retain the ability to do business in the EU after Brexit. Morgan Stanley and Aberdeen Asset Management are exploring options for new headquarters in the EU. So far these decisions do not spell out the number of jobs transferred away from London.

- **Clearing transactions** Fragmentation of clearing functions across countries may increase costs for both UK and non-UK clients because of rising inefficiencies. About half of the business in this sector—£6 billion—may be lost to competitors.

- **Spillover effects** The secondary effects of Brexit could be broader than those described in these four subsectors, but they will emerge over time. This is because the strong interconnectedness between the financial services sector and subsectors such as accounting, auditing, legal services, management consultancy, real estate, and other professional business services can serve as a centripetal force in keeping business in the City of London, even at increased costs. Auxiliary legal, accounting, business advisory, advertising, and office management services account for 46 percent of intermediate inputs for banking and asset management services, and 32 percent of intermediate inputs in insurance and reinsurance. Thus the rough effect on auxiliary service revenues is about £8 billion (46 percent of £17 billion in banking, asset management, and clearing services plus 32 percent of £1 billion in insurance and reinsurance revenues.

This post represents the views of the author and not those of the Brexit blog, nor the LSE. It is an edited extract from Simeon Djankov's new paper, The City of London after Brexit.

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Also by this author: Why a soft Brexit is in the interest of both London and Brussels