Wholesale capital markets, investment banking and market infrastructure sector report

This report covers market infrastructure (financial services); and wholesale markets and investment banking.

1. This is a report for the House of Commons Committee on Exiting the European Union following the motion passed at the Opposition Day debate on 1 November, which called on the Government to provide the Committee with impact assessments arising from the sectoral analysis it has conducted with regards to the list of 58 sectors referred to in the answer of 26 June 2017 to Question 239.

2. As the Government has already made clear, it is not the case that 58 sectoral impact assessments exist. The Government's sectoral analysis is a wide mix of qualitative and quantitative analysis contained in a range of documents developed at different times since the referendum. This report brings together information about the sector in a way that is accessible and informative. These reports aggregate some sectors in order to either avoid repetition of information or because of the strong interlinkages between some of these sectors.

3. This report covers: a description of the sector, the current EU regulatory regime, existing frameworks for how trade is facilitated between countries in this sector, and sector views. It does not contain commercially, market or negotiation-sensitive information.

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Description of the sector

4. "Wholesale capital markets" covers a wide range of capital market linked activity. The subsector includes, in particular, many of the services traditionally associated with investment banks, such as Goldman Sachs and JP Morgan. It also includes banking activity carried out by more diversified market actors such as Barclays and HSBC. Beyond banking, other firms in the sector include stock and futures exchanges such as the London Stock Exchange Group and ICE and wholesale market brokers such as TP ICAP and BGC Partners, as well as thousands of assorted smaller or specialist firms which operate in the wholesale markets "ecosystem".[1]

[1] This report does not cover other important parts of the financial sector including retail and corporate banking, insurance, and asset management.

5. Wholesale markets have a role in facilitating capital raising and risk management for the real economy: across the UK, Europe and globally. They also contribute to the economy in terms of employment and taxes.

6. The UK's wholesale markets agglomerate global capital, keeping costs low for end-users within an international financial centre hosted in Europe, enabling efficient and diverse financing to the real economy. In turn, there are serious implications if business fragments - as the Bank of England, among other commentators, have observed.[2] There are few truly global financial centres worldwide and the agglomeration of capital provides access to deep and liquid capital markets. This may in part account for the EU's level of exposure to the US financial system, in addition to the UK.[3]

7. The wholesale capital markets subsector benefits from the wider economic 'cluster' of related services, expertise and international capital co-located in the UK. In addition, the UK's stable tax system, its competitive labour laws and robust legal framework are frequently cited as key competitive advantages in studies of world-leading jurisdictions and cities. For example, professional services related to corporate finance is a core revenue stream for non-financial firms including law firms, where London is a global centre for legal advice and where English law governs many securities transactions,[4] business advisory services and for accounting firms.

8. Within government and with respect to the devolved administrations, financial services is a reserved policy area.

Character and composition

9. The wholesale capital markets subsector is highly international in nature. One of the attractions of the UK as a location for providing services has been the ability for overseas-headquartered firms (e.g. major US investment banks) to use their UK authorisations to "passport" their activities throughout the European Union. 15% of the £7.9trn of "assets" held in London are held by UK domestic banks, whilst 45% are held by major UK international banks (HSBC, RBS, Barclays and Standard Chartered) and 22% by "rest of the world" investment banks.[5]

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[2] See, for example, Bank of England's *Financial Stability Report* (June 2017): http://www.bankofengland.co.uk/publications/Documents/fsr/2017/fsrjun17.pdf

[3] According to Eurostat, the largest proportion of the EU27's financial services imports were from the UK in 2015, representing 17 per cent of the total, and greater than those of the US (11 per cent) – both ahead of the rest of the European Union. *See: International trade in services (since 2010) (BPM6), Eurostat (accessed 14 September 2017).in*

[4] See: http://www.allenovery.com/SiteCollectionDocuments/Derivatives_Brexit_Bulletin.pdf

[5] See: http://bruegel.org/2016/06/lost-passports-a-guide-to-the-brexit-fallout-for-the-city-of-london/

10. The financial sector overall, including professional services related to the sector, is estimated by CityUK to account for 11.8% of GDP, 11% of tax receipts and to employ 2.2m staff.[6]

11. Wholesale capital markets, as the most export-heavy subsector, is an important proportion of the UK financial services sector. As an approximation, the wholesale capital markets subsector makes up to £68bn and £43bn in annual revenue and annual GVA respectively, contributing £24bn in UK revenue and employing approximately 220,000 staff, across domestic, EU and global activity.[7]

12. Unlike some other parts of the financial services industry, most activity in this subsector is concentrated in London – the five major US investment banks[8] employ 89% (26,629) of their EU staff in London[9] – although some firms have back-office functions in other parts of the UK.

13. The activities of the wholesale capital markets subsector can be broken down, broadly, into four categories: corporate finance activities; trading and market making; provision of market infrastructure; and other activities.

Corporate finance (primary markets)

14. This is the part of the capital market that helps companies to raise finance by issuing shares and debt securities (e.g. bonds), and facilitating mergers and acquisitions through underwriting, advisory and other services. 46% of EU equity capital is raised via UK markets and the UK is home to 27% of EU listed companies by value.[10] According to one estimate, nearly 80% of EU capital markets activity on behalf of European businesses is conducted in the UK.[11]

Trading, brokerage and market making

15. Another important component of activity in the subsector is the trading of financial instruments such as derivatives and equity and debt securities, foreign exchange and commodities. According to the Bank of International Settlements (BIS), in 2013, the UK accounted for 48.9% of the world's turnover in Over-the-Counter (OTC) interest rate

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[6] See: https://www.thecityuk.com/assets/2016/Reports-PDF/Key-facts-about-UK-financial-and-related-professional-services-2016.pdf

[7] Approximate calculations taken from Oliver Wyman, as a summary of sales and trading, investment banking and financial market infrastructure and other specialist activity. See: http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/Brexit_POV.PDF

[8] Bank of America Merrill Lynch, Citigroup, Goldman Sachs, JP Morgan and Morgan Stanley.

[9] See: http://bruegel.org/2016/06/lost-passports-a-guide-to-the-brexit-fallout-for-the-city-of-london/

[10] See: https://www.afme.eu/globalassets/downloads/publications/how-europes-capital-markets-interconnect.pdf

[11] See: http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2014/jun/EUScenarios_UKMembership_OliverWymanResearch.pdf

derivatives (derivatives traded bilaterally between firms, rather than over exchanges), compared to 16.8% for the rest of the EU.[12]

16. For UK-based investment bank operations, trading in financial instruments is considered at least as sizeable a business as more traditional areas of investment banking. For these firms, "trading" primarily involves dealing for the account of the bank with clients (such as hedge funds or corporates). The bank remains broadly "market neutral" by hedging its risk by trading with clients seeking opposite positions, making its profits on the "spread" – the difference between the prices quoted for the two clients. In undertaking these activities, investment banks provide a valuable service because they will offer a price to their clients on a very wide range of products – this is known as 'market making'. In the absence of this function, firms, both financial and non-financial, would only be able to take positions where they could, by coincidence, find another firm that wanted to take the opposite position.

17. Data from Bruegel[13] suggests that almost half of UK banking assets relate to trading and derivatives activities (£3,750 billion). The statistic shows how important market making has become in the UK relative to traditional banking activity such as extending loans. It should be noted too that market-making activities consume significant capital on a bank's balance sheet. In addition to banks, there are numerous brokerage firms present in the market (loosely speaking, firms which make markets in financial instruments by broking deals between counterparties without dealing on their own account).

Market infrastructure

18. Market infrastructures are categorised as exchanges, central counterparties, trade repositories and central securities depositories.

19. A well-known exchange is the London Stock Exchange, where companies obtain a listing for newly issued equities (e.g. UK company shares) and where those shares are subsequently traded. There are also purely "secondary" markets – where shares listed on a primary market can be exchanged – such as BATS Chi-X Europe, a London based equity venue, which holds over 23% market share in European equity trading.[14]

20. Other exchanges specialise in other asset classes, including derivatives, such as ICE.

21. Central counterparties (CCPs) are firms which interpose themselves between market participants when they trade financial instruments and effectively guarantee the obligations agreed between the two counterparties. If one party fails, the CCP has dedicated resources available to pay any outstanding obligations to the other counterparty. They have become much more important in recent years particularly as a result of regulatory reform following the global financial crisis and are considered by regulators as crucial "firewalls" to prevent

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[12] Based on daily averages in April 2013 on a net-gross basis: https://www.bis.org/publ/rpfx13ir.pdf

[13] See: http://bruegel.org/2016/06/lost-passports-a-guide-to-the-brexit-fallout-for-the-city-of-london/

[14] See: http://cdn.batstrading.com/resources/press_releases/BCE_July2015_Volume_FINAL.pdf

contagion in the event of future crises. The UK hosts three CCPs: LCH Clearnet Ltd (owned by the LSE Group), ICE Clear Europe (owned by ICE Group) and LME Clearing. LCH and ICE are the largest UK CCPs with LCH clearing over 90% of global cleared interest rate swaps.[15]

22. Trade repositories (TRs) are firms that collect and maintain the records of derivative contracts. Under the same legal reforms as CCPs, trade repositories have become important in ensuring that there is greater transparency in derivative markets and enhancing financial stability. Under the EU regime, ESMA is the direct supervisor for all authorised TRs within the Union. UK TRs represent a significant proportion of reporting landscape in the EU as the UK hosts five of the seven authorised TRs: DTCC Derivatives Repository Ltd, UnaVista Limited (owned by the LSE Group), CME Trade Repository Ltd. (owned by CME group), ICE Trade Vault Europe Ltd (owned by ICE Group) and Bloomberg Trade Repository Limited.

23. Central securities depositories (CSDs) are financial market infrastructures that guarantee the initial recording and subsequent transfer of securities. The UK has one CSD, Euroclear United Kingdom and Ireland (EUI) which operates the CREST securities settlement system and provides CSD services to UK and Irish markets. Through the CREST system market participants can access settlement in central bank money against sterling, euros and US dollars.

Other activities

24. Numerous other firms can be considered to form part of the wholesale markets sub sector, including:

- Custody and collateral management services. This includes the holding (by institutions) of customers' securities for safekeeping. Customers include asset managers, hedge funds, pension funds, sovereign wealth funds and other regulated firms.
- Financial data and information services. In the wake of the financial crisis, EU law established a number of data reporting obligations for firms and these must be carried out via a recognised entity such as an Approved Reporting Mechanism (ARM), an Approved Publication Arrangement (APA). Firms operating ARMs include Bloomberg, TRAX, Euroclear and LSE Group.
- Operating Credit Rating Agencies (CRAs). CRAs offer credit rating in respect of issuers' securities. These are paid for by the issuers and may be used by financial firms (e.g. asset managers) to fulfil regulatory obligations (e.g. relating to the quality of their holdings). The big three firms (S&P, Moody's and Fitch) all have offices in London.
- Benchmark administration. Benchmarks help to set prices, measure performance, or work out amounts payable under financial contracts in a wide range of markets. The

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[15] See: http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf

largest of the benchmarks administrated in the UK, LIBOR, is used to reference approximately $300 trillion worth of contacts[16] and is administrated by IBA, a subsidiary of ICE. Other benchmark operators with UK operations include FTSE Russell and MSCI.

25. It must be emphasised that these categories are not tightly defined, and do not map neatly on to individual firms. Some businesses are specialised, but others are highly diversified. For example, a major bank may be present not only in capital markets and corporate finance but also in custody and traditional commercial lending or retail and commercial deposit taking (the last three of which are covered in other sectoral analyses). Businesses like Bloomberg offer regulated trading platforms in addition to their core data and information activities. ICE operates the LIBOR benchmark contract in addition to its core activities of clearing and operating an exchange.

The current EU regulatory regime

26. There is a wide range of EU legislation that affects firms in this sub-sector. Much of this has either been revised or put in place following the 2008 financial crisis. Typically, a large firm like an investment bank may need to comply with several of these laws to offer its services. More specialist firms may rely on a narrower range of legislation.

27. Legislation governing wholesale markets activity is established by the EU in part to implement international standards, e.g. from FSB, G20 and IOSCO. However, EU rules will often go beyond these global standards both in terms of scope and granularity. Others are designed specifically for the EU market, although standards originating at international level have become increasingly prevalent, especially since the financial crisis. This is particularly true for prudential banking standards.[17]

28. In aggregate, the areas of regulation that relate to this sector include rules in relation to e.g. bank capital, remuneration of staff, transparency of trading financial instruments and market abuse. The core list of EU legislation relevant to this sub sector is:

- Prospectus Regulation (PR)
- Markets in Financial Instruments Directive (MiFID II)
- Markets in Financial Instruments Regulation (MIFIR)
- European Market Infrastructure Regulation (EMIR)
- Capital Requirements Directive (CRDIV)
- Capital Requirements Regulation (CRR)
- Market Abuse Regulation (MAR)

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[16] See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf

[17] Prudential regulation relates to the management of risk and includes requirements relating to capital and liquidity ratios.

- Benchmarks Regulation (BMR)
- Central Securities Depositories Regulation (CSDR)
- Financial Collateral Directive (FCD)
- Credit Ratings Agency Regulation (CRA)
- Securities Financing Transactions Regulation (SFTR)
- Transparency Directive (TD)
- Short Selling Regulation (SSR)
- Settlement Finality Directive (SFD)
- Bank Recovery and Resolution Directive (BRRD)
- Central counterparty recovery and resolution *(still under negotiation)*

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29. These regulations rarely correspond neatly to different categories of firm within the wholesale markets subsector. In some cases, a firm may need to comply with numerous pieces of legislation, even where the scope of their activities is reasonably narrow. For example, an investment bank may be authorised under the Capital Requirements Directive (CRD) which determines how much capital banks must hold, and need to comply with at least MiFID and the Market Abuse Regulation to offer just its core market making services.

30. One of the most important pieces of legislation for the sector is MiFID (which is in the process of being replaced by MiFID II and MiFIR). Compliance with MiFID enables firms to conduct many core capital market activities across the EU, for example: reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, advice to professional investors. MiFID is also the key directive for operating exchanges and trading venues.

31. Broadly-speaking, if a firm is authorised in one member state to provide investment services under relevant EU legislation, then it is permitted to serve clients across the EU under that authorisation. This arrangement is known in the industry as “passporting”. In some areas, similar rights of market access are achieved through third country equivalence or national market access regimes within the EU.

32. EU Financial Services legislation is generally applicable to Gibraltar but not Crown Dependencies or other Overseas Territories. Crown Dependencies and Overseas Territories with substantial Financial Services sectors may choose to adopt EU legislation.

Third country equivalence

33. Within the legislation described above, there are a range of rules affecting how firms from non-EEA countries may interact with the EU, known as third country regimes. These tend to involve so-called “equivalence assessments” (and also exist across parts of insurance, asset management and other financial activity).

34. Equivalence involves a set of piecemeal regimes that sometimes support market access to the EU (notably for MiFID and EMIR services), or sometimes operate to support market efficiency and avoid duplicate regulatory burdens, e.g. for CRR. The MiFID II third country regime comes into force at the start of 2018. Once this is in place many, but not all, capital market activities will be subject to third country access gateways under EU law. However, equivalence does not always provide a mechanism by which market access is secured, and the European Commission has itself observed that it is specifically not a system aimed at delivering international trade in financial services.[18] There are, for example, no powers for the EU to extend CRR market access to non-EEA lending banks.

35. Additionally, national regimes may also establish rules under which third country firms can provide services. The requirements for achieving market access in this way differ under each individual national regime (and may be subject to a complete prohibition) and national regimes only confirm rights to access customers in that country. Therefore, a firm accessing EU markets on this basis could theoretically be subject to 28 different sets of regulatory and supervisory requirements.

Existing frameworks for how trade is facilitated between countries in this sector

36. The arrangements described in this section are examples of existing arrangements between countries. They should not be taken to represent the options being considered by the Government for the future economic relationship between the UK and the EU. The Government has been clear that it is seeking pragmatic and innovative solutions to issues related to the future deep and special partnership that we want with the European Union.

37. For financial services, only limited liberalisation has been achieved in the WTO context. Conventional Free Trade Agreements (FTAs) have not provided for either comprehensive market access or deep regulatory cooperation, even though there is no structural impediment that would prevent two contracting parties to agree a more comprehensive set of provisions if they so wished.

38. The EU's FTA with Canada (CETA) is a recent example of one such conventional FTA. CETA provides market access in "WTO terms" for financial services firms, meaning access cannot be subject to quantitative restrictions on size and form of investment or service provision. CETA provides investment protection for investors in financial services and includes some commitments relating to transfer of data, regulatory transparency, nationality requirements for senior managers, membership of self-regulatory organisations and operations of payment and clearing systems. However, CETA does not remove barriers

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[18] See: https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf

related to regulatory requirements and provides only for limited dialogue mechanisms to discuss and manage these.

39. Across all of financial services, CETA does provide some clear commitments for provision of services in specific sub-sectors[19] but this is partial. In practical terms under CETA, a European bank still requires a significant local presence in Canada to carry out extensive capital market operations and *vice versa*.

40. The EU has agreed similar provisions with respect to financial services in its free-trade agreements with Korea and Singapore.

41. Whilst there are limited *models* to point to in terms of international trade, progress to promote open global markets whilst still ensuring high, comparable standards is already a well-developed *principle*[20] in international financial services regulation. This is especially notable within the G20, so as to support major cross-border financial services and avoid duplicate regulation and fragmentation.

42. While none of these principles have, as yet, been used to support material cross-border access in financial services, they have been used to allow complex wholesale market activity to occur within consolidated business entities, including in areas that raise issues of systemic risk such as the clearing and trading of derivatives. The most relevant principles and types of arrangements developed by financial services policymakers and regulators in this area include:

- **Deference**. A central commitment of the G20 is to "defer" to comparable rules wherever possible to protect global cross-border business.[21] It is a principle which underpins the EU's own equivalence regimes, albeit that these have been developed in an *ad hoc* way in individual post-crisis legislation, rather than as a strategic basis on which to support market access. Sometimes deference also takes the form of 'substituted compliance', e.g. in the US, in which comparable rules can be substituted for those of the host.

- **Regulatory coherence and regulatory convergence.** These are norms in international trade to foster comparable regulatory outcomes for cross-border markets,

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[19] For example, advisory on M&A, corporate restructuring, corporate strategy, investments, research, and credit rating; in asset management, investment advice and portfolio management services (excluding custodial, trustee or execution services); in insurance, insurance and insurance intermediation relating to Maritime, Aviation and Transit (MAT) and insurance of goods in international transit, retrocession, reinsurance as well a range of services auxiliary to insurance, including actuarial, consulting and claim settlement services.

[20] For example, Norton Rose offers a comprehensive discussion of the principle of financial services recognition and equivalence: http://www.nortonrosefulbright.com/files/regulatory-equivalence-paper-145872.pdf

[21] The G20 Leaders at the September 2013 St Petersburg Summit agreed: *"jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes"*.

to improve supervisory quality and support market access by increasing substitutability of rules.[22]

- **Mutual regulatory recognition.** Mutual recognition exists in the area of services (including financial services) – stemming from Article 7 GATS[23] – as well as in goods. It relies on the recognition by one party that the authorisation of financial firms in another's territory is sufficient to permit that firm to provide cross-border services, and establishes any supporting mechanisms needed for such an arrangement to work for the two parties concerned. Mutual recognition can take the form of both unilateral or bilateral agreements, and is a key principle that has emerged as a tool to increase openness in cross-border financial services activity, for the benefit of competition and avoiding fragmentation. For example, Australia and New Zealand have several mutual recognition agreements covering e.g. goods, recognition of equivalent occupations, and in relation to securities issuance.[24]

- **Supervisory cooperation.** Post-crisis, there have been new systems for regulatory co-operation and cross-border oversights established both at EU-level (e.g. via the creation of the European Supervisory Authorities and EU colleges for resolution and day-to-day supervision) and via global 'norms' (e.g. global colleges, crisis management groups).[25]

Sector views

[This information was provided by the Government to the Committee, but the Committee has decided not to publish this section]

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[22] Major international bodies have explored this concept, e.g. the OECD: https://www.oecd.org/tad/policynotes/stri-heterogeneity-indices.pdf. This was also a policy the European Union sought to develop in TTIP negotiations with the US. See, for example: http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153002.1%20RegCo.pdf

[23] See: https://www.wto.org/english/docs_e/legal_e/26-gats.pdf

[24] See for example https://fma.govt.nz/assets/Guidance/_versions/5432/Offering-financial-products-in-New-Zealand-and-Australia-under-mutual-recognition.2.pdf

[25] See for example: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf

Annex: Selected third country regimes

Relevant EU law	*Third Country Regime*
MiFID II	MiFID II introduces in January 2018 a third country regime with respect to investment services and activities provided to professional clients. Professional clients include other authorised financial services firms, institutional investors, corporate firms and governments. The Commission must adopt an equivalence decision with respect to a third country determining that the prudential and business conduct requirements in the third country have equivalent effect to those in the EU. Firms from the equivalent third country may then register with the European Securities and Markets Authority (ESMA) to provide investment services and activities across the EU without any authorisation requirements in member states.
EMIR	Under EMIR, the Commission may recognise third country regulatory regimes for CCPs as equivalent. Individual third country CCPs are then recognized by ESMA. The Commission has recognized 19 third countries' regulatory regimes. It took three years for the US regime to be recognized as equivalent. Due in part to the size of the US market, the Commission set strong and detailed conditions on equivalency, which were the subject of complex and strenuous negotiations.
CRAs	Third country CRA ratings can be used if either the rating is endorsed (after ESMA assessment) by an EU CRA to which a third country CRA is affiliated and which is in the same group as the EU CRA, or by having ESMA certify equivalence.
CSDR	The CSDR is the process of being implemented, and includes a third country regime process, which involves an equivalence decision by the Commission. This allows a third country CSD to provide core services within the EU on a cross-border basis or provide its services through a branch. A transitional regime applies to existing third country CSDs that provide services in the EU whereby they remain subject to existing national regimes until they have been recognised by ESMA.
Benchmarks	Following the full application of the Benchmarks Regulation in January 2018, a benchmark produced by an administrator based in a third country must follow one of three pathways to access to the EU market – equivalence by ESMA, recognition by external auditor/third country authority or endorsement by an EU registered administrator. Individual benchmarks/administrators can be found equivalent, rather than whole regulatory frameworks.
Prospectus	Under the Prospectus Directive (and Prospectus Regulation, which

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Directive	replaces it from 20 July 2019), the Commission can adopt implementing acts to deem prospectus rules of third countries equivalent to the EU regime. In this case, prospectuses drawn up in accordance with those rules and approved by the competent authority of the third country can be passported into the EU/EEA. Third-country issuers choose a home member state in the Union to get their EU prospectus approved.

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