CERTUS
Policy Think Tank

Brexit and its Impact on Latvia. Threat or Opportunity?

Policy Brief 1/2017

Marina Le Clere

© Certus Think Tank
ISBN 978-9934-8679-2-7

April 2017, Riga

EXECUTIVE SUMMARY

- This report analyses the Brexit process and investigates whether Latvia can benefit from Brexit-induced change in Europe. Latvia does have a higher proportion of bank assets as a percentage of GDP than any other Central European country. Therefore, it is natural to investigate whether the relocation of European financial services firms caused by Brexit might benefit Latvia.

- At present, the global financial services industry faces a number of challenges: a trend towards increasing regulatory compliance in the aftermath of the 2008 financial crisis; the threat of digital disruption; increasing pressure of geopolitical uncertainty; exponential growth of emerging market economies; and changing customer preferences. The combination of all those challenges has had a destabilizing effect on the industry and has provided downward pressure on its profitability and investor attractiveness. Brexit adds to those challenges as it creates uncertainty and instability in the previously presumed stable European region, however, it is not the most important challenge facing the financial services industry today.

- Over the years the United Kingdom has evolved as a key provider of financial services in Europe, with its capital, London, topping the worldwide financial center ranking. Brexit will diminish access for UK-based firms to the Single Market and the UK might lose important volumes of euro-denominated trading activity. As a result, many financial institutions might need to relocate resources from the UK to EU27 countries to comply with new rules and regulations. Key beneficiaries of such a move will be established financial centers of the EU-27, such as Frankfurt, Luxembourg, Paris, Amsterdam and Dublin.

- Brexit pushes questions regarding strategic resource allocation in Europe higher on the agenda of the boards and general management of financial institutions. Such reallocation had already begun before Brexit, driven by the necessity for cost optimization in the age of reduced profitability of financial institutions. It has resulted in significant business process reengineering and is leading to a significant redistribution of the assets of financial institutions within Europe. As a result, back office operations have started relocating to lower cost European destinations, often to Central and Eastern Europe.

- Over the years, Poland has succeeded in building itself a name in the European shared services industry, in particular in the area of European financial services. In light of Brexit, it has redoubled its efforts, promoting itself as a desired location for the shared services centers of global financial institutions. Poland is widely seen as a potential key beneficiary of the Brexit back-office relocation trend.

- Baltic countries have many similar advantages and shortcomings as related to becoming potential beneficiaries of current resource reallocation of financial institutions. Each country, however, approaches the situation with a different strategy. Both Lithuania and Estonia have been streamlining their offering to increase their attractiveness. While Estonia is working to increase its appeal to any potential investor as a country on a global scale, Lithuania has been following a more focused path, trying to capitalize on its existing financial services' client base and broadly following the Polish example.

- Latvia has attracted a number of shared services organizations, and can benefit from optimization-driven resource reallocation of financial institutions in Europe. Given the small size of Latvia's workforce and fierce competition for shared services business among countries in the region, it should focus on specific niches in the shared services' industry, such as second-tier regional banks already present in Latvia. Creating such a niche offering will allow Latvia to build its reputation in the shared services industry (which is set to grow in double digits over the next five years), improve its reputation in the European financial services industry and provide steady and quality employment opportunities.

INTRODUCTION

The June 2017 referendum on British membership in the European Union (EU) provoked shock waves throughout the Union and world financial markets. Coupled with the election of Donald Trump in the USA, it transformed the geopolitical landscape of the world. Brexit negotiations will be complicated and the outcome uncertain.

Attempts to qualify and quantify the impact of Brexit in Latvia have been limited to the evaluation of threats to trade, the impact of expatriate remittances on GDP and cuts in EU funding (further summarized later in this report). This paper attempts to broaden the subject, familiarize the reader with major aspects of upcoming Brexit negotiations and evaluate the short and medium term threats and opportunities for the Baltics and Latvia in particular, that stem from possible negotiation outcomes. Given the importance of the financial services industry to the United Kingdom, the European Union and Latvia, this report will focus on the evaluation of the impact of Brexit on the European financial services industry.

1. THE UK AND THE EU. LIKELY BREXIT SCENARIOS AND THE CURRENT STATUS OF NEGOTATIONS

1.1. THE UNITED KINGDOM AND EUROPEAN UNION

It is impossible to overestimate the importance of the UK to the European Union. While not a founding member, the United Kingdom has been a part of the European Economic Community since 1973, a strong and independent voice often supporting liberal policies in trade, promotion of capital markets and other EU negotiations. It is one of the largest EU economies, constituting 17.5% of the combined EU GDP.[1] It is the second largest net contributor to the operating budget of the European Union behind Germany.[2] London is the financial center of the European Union with 60% of EU capital markets business being conducted under British jurisdiction. The UK is a nuclear power and a founding member of NATO. The list goes on, but one thing is clear, the European Union will not be the same without the United Kingdom irrespective of the results of Brexit negotiations.

The United Kingdom is deeply integrated into the European Union. Trade turnover between the EU and the UK exceeds 700 billion euro and while the UK has a large trade deficit in goods (largely attributable to imports from Germany), it is a big net exporter of services with financial services dominating the picture.[3]

In 2015 alone, the UK exported 36 billion euro in financial services to European Union countries.[4] 2.2 million workers from EU countries are employed throughout different sectors of the UK economy. While the sheer number of low-skilled workers, many from Poland provoked public anger and contributed significantly to the pro-Brexit vote, this does fill the gaps in many UK labor market segments. The effect of labor migration towards the UK has had a significant impact on other countries as well. While their earnings sent home positively affect domestic consumption in such countries as Poland, Latvia, and Lithuania, the shortage in qualified labor is an important drag on the economic activity of those countries.[5]

[1] 2015 GDP in current prices by Eurostat.
[2] Note: Net contribution (difference between total national contribution and total funds received through different EU-funded programs) to European budget in 2015: Germany – 13.3 billion Euros, UK – 10.7 billion and France – 4.5 billion Euros. Based on information by European commission.
[3] Trade turnover is the sum of exports and imports. Based on average exchange rate in 2015. Constitutes 45% of total trade turnover of the UK. European Commission. 2016. EU budget 2015. Financial report. Luxembourg: Publications Office of the European Union. *http://ec.europa.eu/budget/financialreport/2015/lib/financial_report_2015_en.pdf*
[4] UK Office for National Statistics (ONS). 2016. UK Balance of Payments, The Pink Book: 2016. *https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/unitedkingdombalanceofpaymentsthepinkbook/2016/pdf*
[5] Atoyan et al. 2016. Emigration and its economic impact on Eastern Europe. IMF Staff Discussion Note. *https://www.imf.org/external/pubs/ft/sdn/2016/sdn1607.pdf*

1.2. BREXIT SCENARIOS

In preparation for the referendum, the UK Government, led by David Cameron, introduced possible scenarios for the UK's exit from the European Union. Those scenarios and terminology have been refined and amended since Brexit became a reality.

Soft Brexit

This is based on the model relationship between the EU and Norway which is part of the European Economic Area (EEA) and The European Free Trade Association (EFTA). It is estimated that Norway's contribution through EEA and EFTA mechanisms to the EU budget will average 165 euro per capita during the period of 2014 to 2020, which constitutes over half of the current per-capita contribution by the UK, currently an EU member.[6] In exchange it enjoys the EU's 'four freedoms': access to the European Single Market for the sale of its goods and services, free movement of capital and free travel within the European Union. Critics of the Norwegian model point out the fact that Norway is effectively an EU member, but without a voice in the EU decision-making process. Businesses around Europe prefer the soft Brexit scenario, as it would preserve the status quo in most economic relationships. However, the likelihood of this scenario is low due to political pressures for both EU-27 members and the UK. Theresa May, Prime Minister of the UK, and Michel Barnier, chief EU Brexit negotiator, have both made strong statements indicating that the UK will not remain in the Single Market following Brexit's completion.

Hard Brexit

This is sometimes also referred to as a "clean Brexit" and means that the UK will exit the EU without reaching a special agreement with the EU-27. In trade relations, a hard Brexit would mean that the UK will exit the Customs Union, which provides duty free trade between member countries, and revert to the rules of the World Trade Organization (WTO) in its trade relations with all countries including EU members. It also applies to financial services trade relations, which are governed by the WTO's main guiding document, the General Agreement on the Trade of Services. This agreement has been widely criticized for giving individual countries ample possibilities to discriminate against third countries' financial firms in their domestic markets. In its purest form a hard Brexit is unlikely to happen given the interdependence of the UK and the European economy. However, a return to WTO agreements in a number of areas is possible if the UK and the EU-27 run out of time or find themselves unable to reach mutually acceptable agreements on specific issues.

Middle-ground scenarios

Two middle ground scenarios are frequently discussed. One is based on a Swiss model – an EFTA agreement supplemented with bilateral agreements; and the other on so-called bespoke agreements, essentially creating a new status for the UK as an EU partner through a number of specifically-negotiated agreements. The latter, would most closely resemble the recently negotiated EU Comprehensive Economic and Trade Agreement with Canada (CETA). The Swiss model presumes that the UK joins EFTA with its access to the European Single Market governed through sectorial bilateral agreements. Switzerland, for example, does not have access to the Single Market in financial services, and its companies have to operate through subsidiaries in European Union countries. Ironically, many Swiss financial services companies today choose to operate in the EU market through their subsidiaries established in the UK.

Whatever direction Brexit negotiations take, most politicians and business leaders stress the importance of a multi-year transition period once negotiations are concluded. The UK Government acknowledged the importance of this by including it as a separate item in its negotiation outcome priorities.

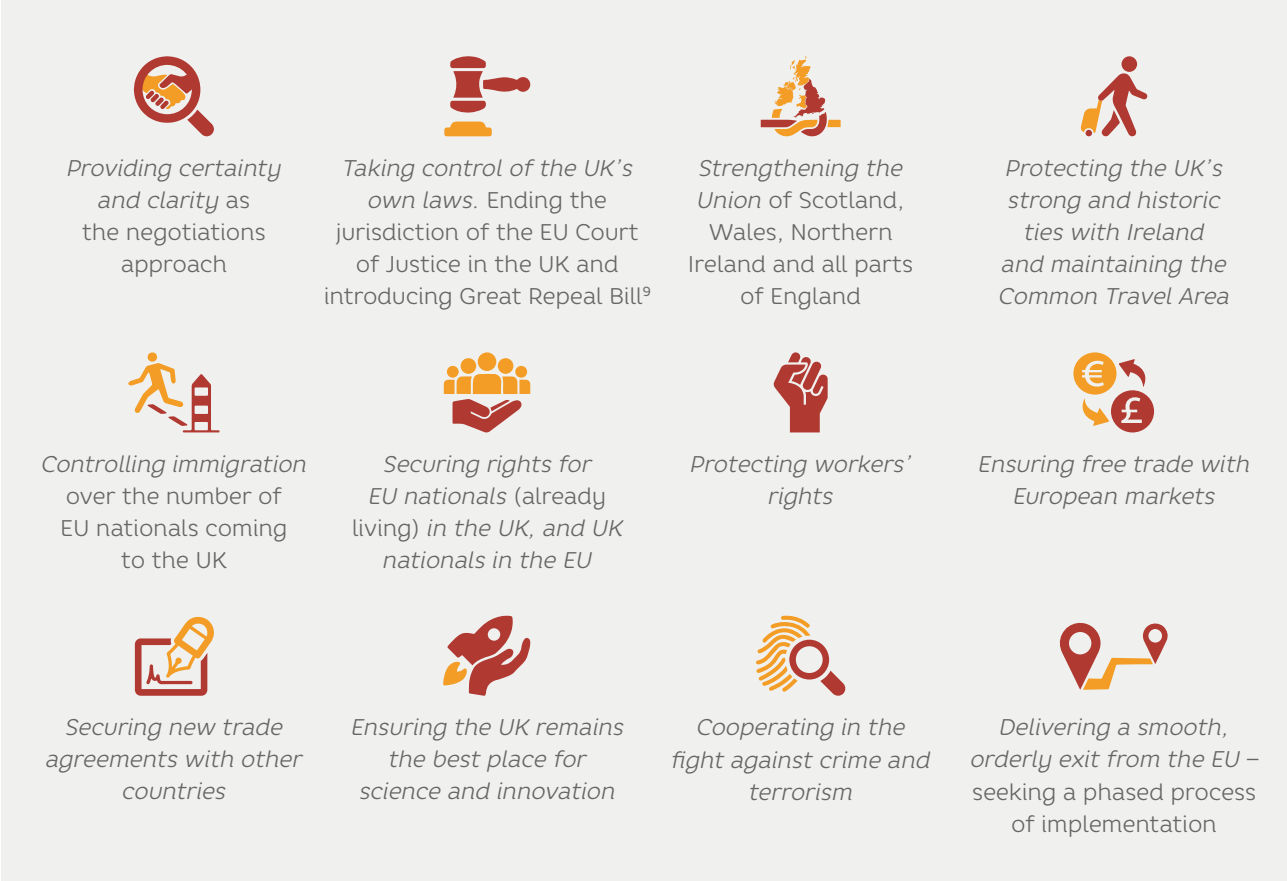
[6] The Norwegian Mission to the EU. Norway's financial contribution. *http://www.eu-norway.org/eu/Financial-contribution/#.WMEY2_l96Uk*

1.3. BREXIT SCENARIOS

Following the initial shock of the referendum results, British political and business leaders pushed their government to outline its position and plan for Brexit negotiations. The resulting plan was presented by Theresa May, the new UK Prime Minister, on 17 January 2017. It comprises 12 points (see figure 1) and clearly states the UK government priorities in Brexit negotiations. Economic policies and trade-related issues do not appear at the top of the government agenda and are stated in only 3 of the 12 priority items (priorities 8 to 10 in figure 1).

Prime Minister May stated that the UK Government was prepared for a hard Brexit and had a plan if negotiations were to fail: "…no deal for Britain is better than a bad deal for Britain… Because we would still be able to trade with Europe…. We would have the freedom to set competitive tax rates and embrace the policies that would attract the world's best companies and biggest investors to Britain. And – if we were excluded from accessing the Single Market – we would be free to change the basis of Britain's economic model".[7]

UK Government Priorities for Brexit Negotiations[8] Figure 1



[7] May, T. 2017, 17. January. Theresa May's Brexit speech in full. London: The Daily Telegraph. *http://www.telegraph.co.uk/news/2017/01/17/theresa-mays-brexit-speech-full*

[8] Her Majesty's Government. 2017. The United Kingdom's exit from and new partnership with the European Union. London: The Stationery Office Ltd. *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/589189/The_United_Kingdoms_exit_from_and_partnership_with_the_EU_Print.pdf*

[9] On October 2, 2016 Mrs. May announced plans to introduce the Great Repeal Bill, which will repeal the European Community Act 1972 (the ECA) and incorporate (transpose) EU law into domestic law, wherever practical. At the time of writing of the report, the Bill has not been published yet.

So, in the case of a hard Brexit, dramatic changes could be expected in governmental policies aimed at protection of UK interests. Not restricted by EU agreements, the UK, if angered by harsh Brexit conditions, might decide to move closer to an offshore regulatory environment by lowering regulatory requirements and taxes to improve its attractiveness and protect its business interests.

As evident from the statements above, Brexit negotiations de facto started already before the UK government triggered Article 50 on 29 March 2017, triggering two years to negotiate exit conditions. What is the likely effect of Brexit on Latvia and Europe's financial services industry?

2. BREXIT'S KEY POTENTIAL RISK AREAS FOR LATVIA

In the wake of the Brexit referendum, a number of institutions evaluated the key risks for the Baltic states associated with the referendum's outcome. The main short-term risks relate to the increase in political uncertainty and the impact of a cheaper British pound on financial flows between Latvia and the United Kingdom.[10] The major longer-term impacts are related to a possible reduction of European funding—as the UK is an important net contributor to the European budget — as well as changes in the political agendas of other EU countries.

The Current State of UK - Latvian Economic Ties

Figure 2

Trade ties - Currently, the United Kingdom is the 4th largest destination for Latvian exports, which constitute 3.9% of Latvian GDP. Latvia is a net exporter. 68% of all exports are wood and wood-related products.[11]

Impact of Latvian expat community living in the UK on Latvian GDP - Eurostat data shows that remittances, made up 5.3% of Latvia's GDP in 2015 giving Latvia along with Lithuania the two highest dependency rates on international remissions in the EU. Remittances from the United Kingdom, however, constitute only a fifth of total amount.

UK FDI investment in Latvia - The United Kingdom does not rank high in terms of foreign direct investment in Latvia (10th place) with cumulative investment of over 500 million euro, predominantly into the real estate and services sector.

UK – Latvia Bank ties - Direct links between the UK and Latvian banking sectors are weak as measured by the sum of UK bank liabilities and bank claims as a percentage of Latvian GDP – 2% of 2013 GDP.[12]

[10] Danske Bank. 2016. Brexit update: 1 July, 2016. Markets implication of Brexit. *https://www.danskebank.ee/public/Macro_outlook/BREXIT_Update_1_July_2016.pdf*
[11] Latvijas Investīciju un attīstības aģentūra. 2016. Latvijas ekonomiskā sadarbība ar Lielbritāniju. Rīga: LIAA. *http://eksports.liaa.gov.lv/files/liaa_export/attachments/2016.12_lv_lielbritanija_ekon.sad_.pdf*
[12] Irwin, G. Brexit: the impact on the UK and the EU. 2015. London: Global Counsel. *https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global_Counsel_Impact_of_Brexit.pdf*

The Impact of a Cheaper British Pound

The British pound has fallen 12% since 23 June 2016 touching the lowest point of 1.11 euro (18% fall) to 1 pound on October 17, 2016.[13] According to Oxford Economics, British pound volatility is likely to continue throughout the Brexit negotiation process but unlikely to recover to its pre-Brexit referendum strength in the foreseeable future.[14] In the short-to-medium term the cheaper pound could have a double effect on the Latvian economy. On the one hand, it might negatively affect Latvian exporters to the UK. The latest export statistics, however, do not confirm such a negative trend.[15] On the other hand, the diminished value of expat remittances to Latvia might have a negative medium-term effect on domestic consumption. Given the modest value of both, the likely short-term effect from both of those trends is likely to be moderate.

Change in European Political Agendas, Budgets and Pace of Integration

Brexit pushed governments and politicians of EU member states to refocus on the interests of their national electorates. Looming French and German elections might further exacerbate those trends. Further integration in a number of areas might be stalled, as countries will be more vocal to voice their disagreements and to show their electorate that they defend national interests within the EU. There is a concern regarding Brexit's impact on EU funding, given Latvia's high dependence on EU funds and the UK as a net contributor to the EU budget. Nevertheless, the long-term Impact of Brexit on the EU budget is unclear and will highly depend on the results of Brexit negotiations. It is expected that softer Brexit scenarios will result in some contribution by the UK to the European budget.

Improvement in Relative Attractiveness of the Baltic States

Brexit and the election of Donald Trump in the USA have moved the focus away from the geopolitical risks of the Baltic states (due to their proximity to Russia). Business does not like instability, so the relative attractiveness of the Baltic countries is likely to increase, if the countries themselves move away from emphasizing those risks and focus on promoting the positive aspects of their locations for investors.

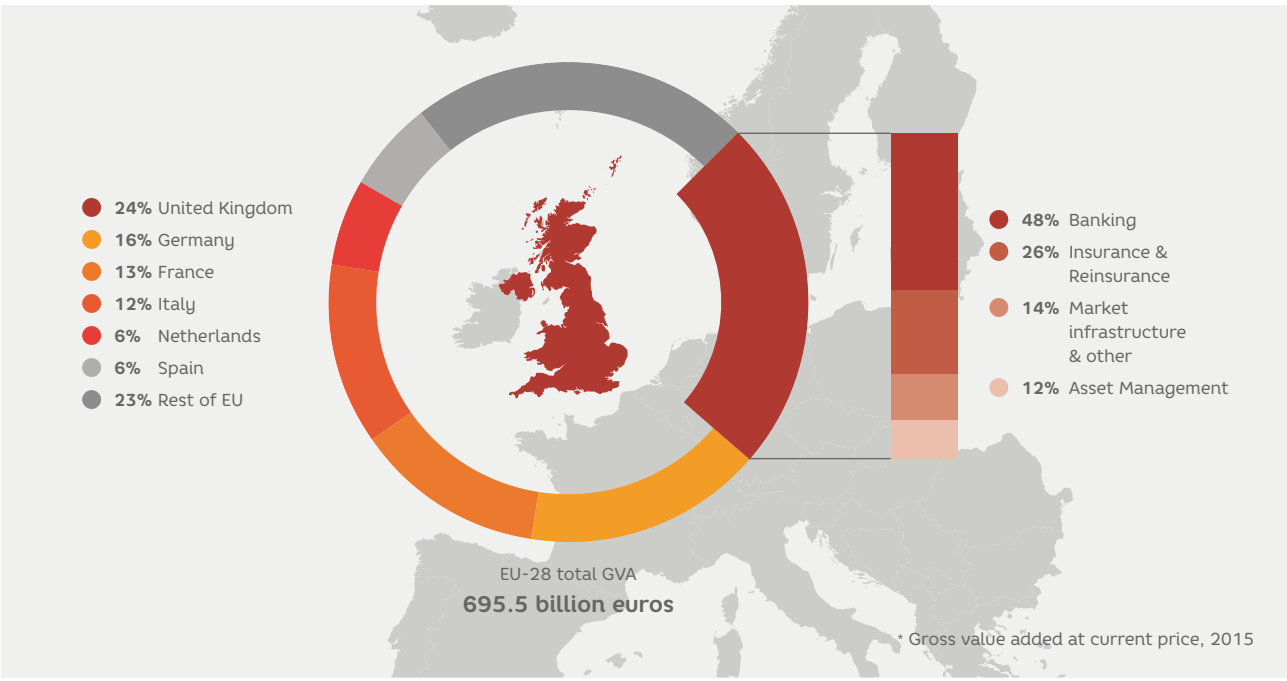
[13] Based on Euro/Pound exchange rate of 1.1461 on March 10, 2017.
[14] Oxford Economics. 2017. Assessing the economic implications of Brexit. *http://www.oxfordeconomics.com/brexit*
[15] Centrālā Statistika Pārvalde. Ārējā tirdzniecība - Datubāze. *http://www.csb.gov.lv/statistikas-temas/areja-tirdznieciba-datubaze-30104.html*

3. BREXIT AND ITS IMPACT ON THE EU FINANCIAL SERVICES SECTOR

3.1. THE ROLE OF THE UNITED KINGDOM IN THE EUROPEAN FINANCIAL SERVICES INDUSTRY

Share of EU financial service activity

Figure 3



Financial services in the EU-28 countries contribute over 5% to the EU's combined Gross Value Added (GVA) and employ 6.4 million people.[16] Financial services are here defined as retail and wholesale banking; asset management; insurance (including the reinsurance business); as well as financial infrastructure supporting services such as clearing, exchanges and data supporting services.

The EU financial services market is deeply integrated. The development of market access arrangements (including passporting rights – see figure 5) across the EU has facilitated growth in cross-border trade in financial services. EU financial services exports constitute 39% of the total EU financial services GVA, more than half of it resulting from the trade between EU-28 countries.

The United Kingdom as the center of EU wholesale financial services and the entry point for non-EU financial institutions to the EEA Single Market

Over the years, the United Kingdom and specifically London, has established itself as the key provider of financial services to European financial institutions and customers. It has successfully capitalized on EU free market access for services and capital and expanded its traditional competitive advantages such as the rule of law, language and a convenient time zone perfectly located between the US and Asian markets.

[16] Gross value added(GVA) is the value of output less the value of intermediate consumption (i.e. the value of the goods and services consumed as inputs by a process of production); it is a measure of the contribution to GDP made by an individual producer, industry or sector.

While European banks use London as a center for their wholesale banking activity attracted by its financial infrastructure and deep liquidity pools, many non-EU financial institutions use London as a point of entry to the EU Single Market benefiting from the advantages of EU passporting rights. Today the UK is a major hub for wholesale banking activities for European banks. Deutsche Bank, for instance, derives 19% of its total revenues from its UK operations.[17] BNP Paribas has been present in the UK for 150 years and over half of its wholesale banking revenues is generated from its London base. 60% of all EU-28 capital market activity is concentrated in London and to the dismay of the European Central Bank, more than half of Euro-related forex and European interest rate derivatives activity take place in London.[18] 42% of all EU pension assets are UK-based.[19] The list can go on, but the point is clear: the level of integration and interdependence is extremely high.

London as the premier world financial center

London today is much more than the center of European financial activity. The Global Financial Centers Index, which ranks 82 centers according to their attractiveness, ranks London as the premier world financial center, closely followed by New York, dynamically developing Singapore, and Hong Kong. Today London handles almost half (48%) of worldwide over-the-counter (OTC) derivatives activity and 39% of all worldwide forex trading activity, being an important market not only for established currencies such as pound, euro and dollar, but also for the emerging currencies of rand, rupee and renminbi.[20]

The city has developed a very strong financial ecosystem, which attracts deep pools of liquidity and provides a complete range of financial and finance-related services protected by a predictable regulatory environment (at least this was the case before Brexit). London's position as the leading financial center is constantly challenged by New York, Singapore and Hong Kong and by a number of smaller financial hubs, which are emerging all over the world. Higher taxes, a more difficult regulatory environment and high operational costs have led to diminishing advantages for London compared to its main competitors. A survey conducted by the British Banking Association (BBA) in 2015 prior to Brexit indicated that many financial institutions have been considering (and some had already started) relocating their staff and assets away from the United Kingdom. BBA estimates that since 2011 London lost 12% of its banking assets, while during the same period banking assets increased in the USA (by 12%), Singapore (24%) and Hong Kong (34%).[21]

[17] Deutsche Bank. Annual Report 2015. *https://annualreport.deutschebank.com/2015/ar/servicepages/downloads/files/dbfy2015_entire.pdf*

[18] Based on Bank of International Settlement triennial survey and data from Bruegel. Based on daily averages. Market share calculations vary for sub-sector categories from 45% Global OTC foreign exchange derivatives to 75% of OTC single currency interest derivatives. Bank for international settlements. 2016. Triennial Central Bank Survey of foreign exchange and OTC derivatives markets in 2016. *http://www.bis.org/publ/rpfx16.htm*. Batsaikhan, U., Kalcik R. & Schoenmaker, D. 2017. Brexit and the European financial system: mapping markets, players and jobs. Brussels: Bruegel. *http://bruegel.org/wp-content/uploads/2017/02/PC-04-2017-finance-090217-final.pdf*

[19] Wright, W. 2016. Beyond Brexit: what next for European capital markets? London: New Financial. *http://newfinancial.eu/wp-content/uploads/2016/06/Beyond-Brexit-what-next-for-European-capital-markets1.pdf*

[20] Oliver Wyman & bba. 2015. Winning the Global Race. The competitiveness of the UK as a center for international banking. London: Oliver Wyman & bba. *https://www.bba.org.uk/news/reports/winning-the-global-race/#.WLQTGTt97Dc*

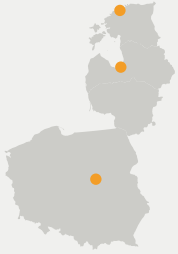
[21] Oliver Wyman & bba. 2015. Winning the Global Race. The competitiveness of the UK as a center for international banking. London: Oliver Wyman & bba. *https://www.bba.org.uk/news/reports/winning-the-global-race/#.WLQTGTt97Dc*

Global Financial Centers Index: How it works[22]

Figure 4

Leading world financial centers (based on total score):
London (795)
New York (794)
Singapore (755)
Hong Kong (744)

Top 5 EU-27 financial centers:
Luxembourg (12th)
Frankfurt (19th)
Paris (29th)
Dublin (31st)
Amsterdam (33rd)



Baltic financial centers:
Warsaw (45th)
Tallinn (50th)
Riga (52nd)
Vilnius (not in the ranking)

Gains in ratings:
- Tallinn (up from 78th place one year ago);
- Riga (up from 71st place).

Factors Of Competitiveness Taken Into Account When Evaluating International Financial Centers

- **Business environment:** Political stability, rule of law, regulatory and macroeconomic environment, tax and cost competitiveness
- **Financial sector development:** Volume and velocity of trading, availability of capital, depth and breadth of industry clusters, employments and economic output
- **Infrastructure factors:** Buildings & offices, transport & ICT infrastructure, environmental sustainability
- **Human capital:** Availability of skilled personnel, education & development, flexible labor market & practices, quality of life
- **Reputational factors:** City brand & appeal, level of innovation, attractiveness & cultural diversity

The United Kingdom as a key location for the European fintech industry

Largely due to its evolved financial ecosystem, the UK has been successful in attracting a significant number of fintech companies and entrepreneurs. One study shows that UK-based fintech companies generated revenues of 6.6 billion GBP and employed over 61,000 people in 2015.[23] The report listed the USA (with two distinct hubs in California and New York), Germany, Australia, Singapore and Hong Kong as other leading fintech hubs. Those locations have been successful in creating the elements essential to fintech ecosystems – access to capital, availability of fintech talent and demand from local financial sector supported by a developed regulatory environment, specific to the fintech industry.

[22] Z/Yen & China Development Institute. 2016. The Global Financial Centres Index 20. London: Z/Yen Group *http://www.longfinance.net/images/gfci/20/GFCI20_26Sep2016.pdf*
[23] Ernst & Young. 2016. UK FinTech: On The cutting edge. London: Ernst & Young. *https://www.gov.uk/government/publications/uk-fintech-on-the-cutting-edge*

3.2. THE IMPACT OF BREXIT ON THE EUROPEAN FINANCIAL SERVICES INDUSTRY

Given the importance of the UK financial services sector to the EU-27 member countries, the abundance of speculation and research to assess the impact of Brexit on the European financial services industry is hardly surprising. Before tackling the details of the potential impact, however, it is important to emphasize that this impact and its severity will highly depend on the outcome of the negotiations and ability of the 28 EU member countries to negotiate an acceptable transition period.

For the financial services industry, a hard Brexit scenario would be associated with a loss of access to the EEA Single Market and a large exodus of financial services and services-related firms from the UK to other European financial centers. This scenario assumes that the loss of passporting rights will not be compensated by an acceptable equivalence regime and most euro-denominated trading activity will have to move to EU-27 financial centers.

EU passporting rights and their equivalence

Figure 5

Passporting rights

With the European financial passport, a financial institution licensed in the UK or other EEA member country is legally entitled to provide services across EEA member states without additional authorization. Those passporting rights are sub-sector specific and are built upon a number of EU financial regulations and principles. The most important EU legislation governing financial passporting rights are CRD, MiFID and UCITS.[24] The importance of passporting rights for Single Market access is considered to be more crucial for the banking industry, while less so for asset management and insurance companies. The passporting regime has enabled banks to conduct their EU operations via branches from a single hub location, and avoid the substantial operational and balance sheet costs associated with operating local subsidiaries.[25] Currently 8,008 firms from EU-27 countries use passporting rights for their access to the UK market and 5,476 UK-based companies (many of them non-European) use their UK financial passports for access to other EEA markets.

Equivalence regime

Some recent EU legislation includes provisions under which non-EEA financial institutions can provide services into the EEA market if their home country regime is "equivalent" to EU standards. Those regimes can be subject to additional conditions and might need to be updated with changes in EU regulations. Currently, the possibility of 3rd country equivalence does not cover the full range of financial services. The best example of how an equivalence regime might work can be found in the Swiss model for financial institutions.

Oliver Wyman, a consultancy, evaluated the impact of a low access scenario (term used by the consultancy for a hard Brexit in the financial services industry) on each sub-segment of the financial industry (sales & trading, asset management, insurance) and concluded that it might result in the relocation of over 30,000 jobs and up to 20 billion pounds in lost revenue for the UK financial services industry. That impact would also spread to other parts of the financial ecosystem (legal, accounting, IT service providers) and would roughly double the number of jobs and revenues at relocation risk.[26]

[24] CRD – Capital Requirements Directive; MiFID – The Markets in Financial Instruments Directive; UCITS – Undertakings for Collective Investment in Transferable Securities

[25] Jenkings, I., Gray, A. & Gemes, A. 2017. Planning for Brexit. Operational impacts on wholesale banking and capital markets in Europe. London: PricewaterhouseCoopers *http://www.pwc.co.uk/assets/pdf/Operational_impacts_on_wholesale_banking_and_capital_markets_in_Europe_Jan_17.pdf*

[26] Sants, H., Austen, M., Naylor, L., Hunt, P. & Kelly, D. 2016. The impact of the UK's exit from the EU on the UK-based financial services sector. London: Oliver Wyman. *http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/OW%20report_Brexit%20impact%20on%20Uk-based%20FS.pdf*

It is hard to say whether such a catastrophic scenario would occur. Given the importance of the financial services industry to the UK, such an outcome would mean the failure of Brexit negotiations for the UK Government and would lead to protectionist actions by the UK. The UK Government cautioned that it would retaliate to preserve jobs and the overall financial ecosystem of the United Kingdom. Lower taxation and an easy regulatory environment in the UK coupled with aggressive bilateral agreements with fast growing emerging economies like China and Hong Kong (today accounting for a mere 2% of UK financial services exports) might compensate for the loss of EU-27 business and increase London's attractiveness for financial institutions.[27] However, the real outcome is likely to be situated somewhere in-between.

3.3. KEY AREAS OF BREXIT'S IMPACT ON THE EU FINANCIAL SERVICES INDUSTRY

- **Brexit will limit access of UK-based financial institutions to the Single Market and EU-27 financial institutions to the UK market.** After Brexit, UK-based firms will not be able to use passporting rights (described in the figure on page 11) to access markets of other EU-27 member states. The extent of this impact will depend on the details of negotiations and availability of equivalence regimes for each subsector. Currently, EU legislation does not have equivalence regime provisions for banks. Therefore, in all likelihood UK-based banks will need to increase their presence by setting up subsidiaries and moving personnel to EU-27 locations. Asset management firms and insurance companies are likely to be less affected as most of them already operate through subsidiaries located in EU-27 countries.

- **Brexit is likely to result in euro-denominated trading activity being moved to EU-27 financial centers.** Trading of certain euro-denominated products is likely to move to EU-27 financial centers. The location of clearing houses for euro-denominated derivatives already created conflict between the European Central Bank and the United Kingdom in the past. In 2011 the ECB published a Eurosystem Oversight Policy Framework, which required institutions that settle euro-denominated transactions to be legally incorporated in the euro area. The UK Government filed and won the lawsuit before the European General Court arguing that such location requirement violates free movement of capital in the Single Market. Most of the market players expect this issue to be reopened during Brexit negotiations. As a result, a significant part of euro-denominated derivatives trading activity might need to move to one of the EU-27 financial centers. Some other bank wholesale banking products and services might also be affected.

Clearing house Figure 6

When a trade takes place in financial instruments, such as equities, derivatives or bonds, a clearing house sits between the buyer and seller. It acts as the buyer to every seller and the seller to every buyer: if either party defaults, the clearing house owns the risk and becomes accountable for the defaulter's liabilities. As part of the process it collects collateral, or 'margin', from buyers and sellers. This process aids financial stability and introduces efficiencies to the market, as buyers and sellers can make transfers to the clearing house rather than to each entity with which they trade.

London is home to four clearing houses: CME Clearing House, ICE Clear Europe, LCH Clearnet and LME Clear. The most important clearing houses in the EU-27 are located in Frankfurt, Paris, Amsterdam and Italy, however, they are not full equivalent to London's, as they are limited either in product coverage or currency coverage.

[27] Woodford. 2016. The economic impact of 'Brexit'. Oxford: Woodford Investment Management. *http://assets.woodford.in/the-economic-impact-of-Brexit.pdf*

- **Weight distribution between European and global financial centers.** New regulation will lead to the unbundling of products and services offered by London's financial center. Many EU companies and banks come to London for efficient wholesale banking activity as they can receive a complete range of complex financial products and services in one location. There is no other financial center in the EU-27 that is capable of replicating London's depth and breadth of offering and expertise. So, it is possible that some of this activity will move outside of the EU-27 financial centers, to other premier financial centers with New York being the most likely beneficiary. Experts have warned that Brexit relocation of banking activity might not be a zero-sum game for Europe.

- **Potential weight redistribution between different offshore and onshore financial centers closely linked to the United Kingdom.** The relationship between the UK, its three Crown dependencies (Jersey, Guernsey, Isle of Man) and its 14 offshore territories and other long-standing financial partners such as Malta and Cyprus might change depending on the type of actual Brexit scenario. Cyprus has especially strong financial links to the UK. UK-based banks have borrowed in total the equivalent of over 40% of Cypriot GDP and lent to entities in Cyprus an amount equal to more than 30% of GDP.[28] It has always had a special relationship with the UK due to historical reasons and has enjoyed political protection by the UK within the EU. Departure of the UK from the EU might have a politically destabilizing effect on the country, while the impact on its financial links might go either way, depending on the outcome of Brexit negotiations.

- **Changing landscape for the European fintech industry.** Brexit might change the fintech landscape in Europe, negatively impacting the attractiveness of the UK, while helping Germany and other aspiring European fintech destinations. Fintech companies rely heavily on a young and mobile talent pool and might not have the resources, time or willingness to deal with the immigration procedures that Brexit might entail. Germany is well-positioned and willing to receive those companies and fintech entrepreneurs.

- **Impact on the Capital Market Union (CMU) project within the EU.** The UK has been a strong advocate of and contributor to the CMU initiative, the main goal of which is to increase the depth and liquidity of EU capital markets. The United Kingdom has the most developed capital market in the Single Market area, while the EU-27 financial system is more reliant on bank lending. Brexit is likely to slow down the CMU process. Some pessimists have already called for the death of the CMU.[29]

- **The overall negative impact on the costs of operations for financial services companies in Europe will lead to efforts to optimize their operational model.** The movement of assets and personnel, duplication of services in European financial centers, time consuming licenses and equivalence status approvals will add to the overall operational costs in Europe. Financial institutions and especially banks have been operating in a diminishing returns environment. RoE in the wholesale banking industry averaged 10% from 2011 to 2014, down from 18% in the period from 2000 to 2006 and there are estimates that a further 2% deterioration is likely in 2017 and beyond.[30]

[28] Irwin, G. Brexit: the impact on the UK and the EU. 2015. London: Global Counsel. *https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global_Counsel_Impact_of_Brexit.pdf*
[29] Bowman, L. 2016. Has Brexit killed CMU? London: Euromoney Institutional Investor. *http://www.euromoney.com/Article/3597213/Capital-markets-Has-Brexit-killed-CMU.html*
[30] Morgan Stanley & Oliver Wyman. 2015. Wholesale & Investment Banking Outlook. Liquidity Conundrum: Shifting risks, what it means. London: Oliver Wyman. *http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/2015_Wholesale_Investment_Banking_Outlook.pdf*

4. BREXIT-DRIVEN RELOCATION: MAJOR FORCES AND KEY BENEFICIARIES

The altered regulatory landscape in post-Brexit Europe will in turn lead to changes in the operational landscape of its financial services industry. Regulations regarding euro-denominated clearing is likely to force parts of wholesale banking operations to move to EU-27 financial centers with euro clearing capacity. The loss of passporting rights, even if partially replaced with equivalence regimes, will force many foreign banks to increase their physical and legal presence in EU-27 markets to access the Single Market for their activities. Asset managers and insurance companies might need to increase their personnel in EU-27 locations or establish new legal structures and subsidiaries. Estimates regarding the impact and costs associated with those relocations vary and will depend on the outcome of Brexit negotiations. Most estimates are expressed as the number of people subject to relocation and vary depending on the assumptions and scenario definitions from several thousand to over 100,000, with the figure of 30,000 appearing most often. Banks say that about 10-20% of their UK-based revenue might be affected by Brexit re-arrangements. The relocation process is notoriously long and cumbersome, especially when dealing with company registrations and licensing, so many institutions have started with their contingency planning and a few have already announced plans for relocation destinations.

Before citing potential beneficiaries, however, it is important to distinguish between two trends that influence the relocation decisions of financial institutions. Brexit is the key driver of one of those trends, and only an accelerator for the second. The first force has appeared as a direct result of Brexit and is regulatory and compliance motivated. The extent of its impact will depend on the outcomes of Brexit negotiations. The second force is a deeper trend driven by the overall squeeze on companies' profitability coupled with increasing levels of digitalization and process automation. While Brexit has accentuated the need for European footprint optimization, this force had been set in motion well before Brexit, and the outcomes of negotiations are unlikely to seriously impact it. Given the fundamental differences behind those two forces, it is important to look at them separately, as they impact the decision-making process of financial institutions in two fundamentally different ways and will lead to different beneficiary destinations, which is of consequence for our analysis.

4.1. REGULATORY-DRIVEN RELOCATION: LOOKING FOR LONDON-BIS

Brexit negotiations will result in financial institutions moving parts of their activities in order to serve EU-27 markets and their clients within those markets. Relocation decisions will depend on the agreements that the UK and EU-27 reach regarding equivalence regimes, trading of euro-denominated products and other issues. A hard Brexit will lead to higher relocation costs while softer scenarios will result in lower numbers of people transitioning to other destinations. As a result of this regulation-driven process, companies will be forced to move from a more desired location (London with its world class financial infrastructure and lifestyle offering) to less desired locations (financial centers within the EU-27, none of which appear in the top 10 Global Financial Center Index). Therefore, it is logical to assume that in their relocation search companies will look for a destination, which can most closely replicate London for the attributes of greatest importance to companies and their employees. In the process, they are likely to further rationalize their operations and might move some of those closer to their customers or to other global financial centers, such as New York.

For this relocation trend, the most important factors in the decision-making will relate to the availability of world-class financial center infrastructure and overall location attractiveness for relocating employees. The relative importance of those requirements will vary for different types of financial institutions depending on their sector activity (wholesale banking, insurance, fund management) and seniority of employees subject to relocation.

Financial center infrastructure requirements include the following:

- Attractive and stable regulatory framework, competence of regulatory authorities, perceived location stability and high level of regulatory compliance. For some operations, similarity to English rule of law will be important.
- ICT infrastructure and data protection environment.
- Financial infrastructure such as overall development of capital markets, existing clearing capacity, reputation as a global financial center and interconnectedness with global financial centers.
- Availability of sophisticated professional services such as legal, accounting and IT consulting services.

Requirements related to location's attractiveness for employees:

The quality of life and overall fiscal regime for employees is of high importance for financial institutions. It will be hard to replace London for its quality of life, but many will not miss the cost of living. Key employee-related criteria:

- Overall reputation and attractive expat lifestyle. Security, healthcare and availability of international schools, a good cultural scene and convenient central location within Europe.
- Integration-related factors, such as wide use of English and a diverse cultural environment.
- Personal tax system for high earning individuals and overall cost of living.

Other important considerations, which may affect a company's relocation decisions:

- Its global strategy and current European and global footprint.
- Proximity to existing and potential customers.
- Short-term and long-term costs of relocation and operations, focus on reducing services duplication across Europe, which Brexit implicitly brings to the table.

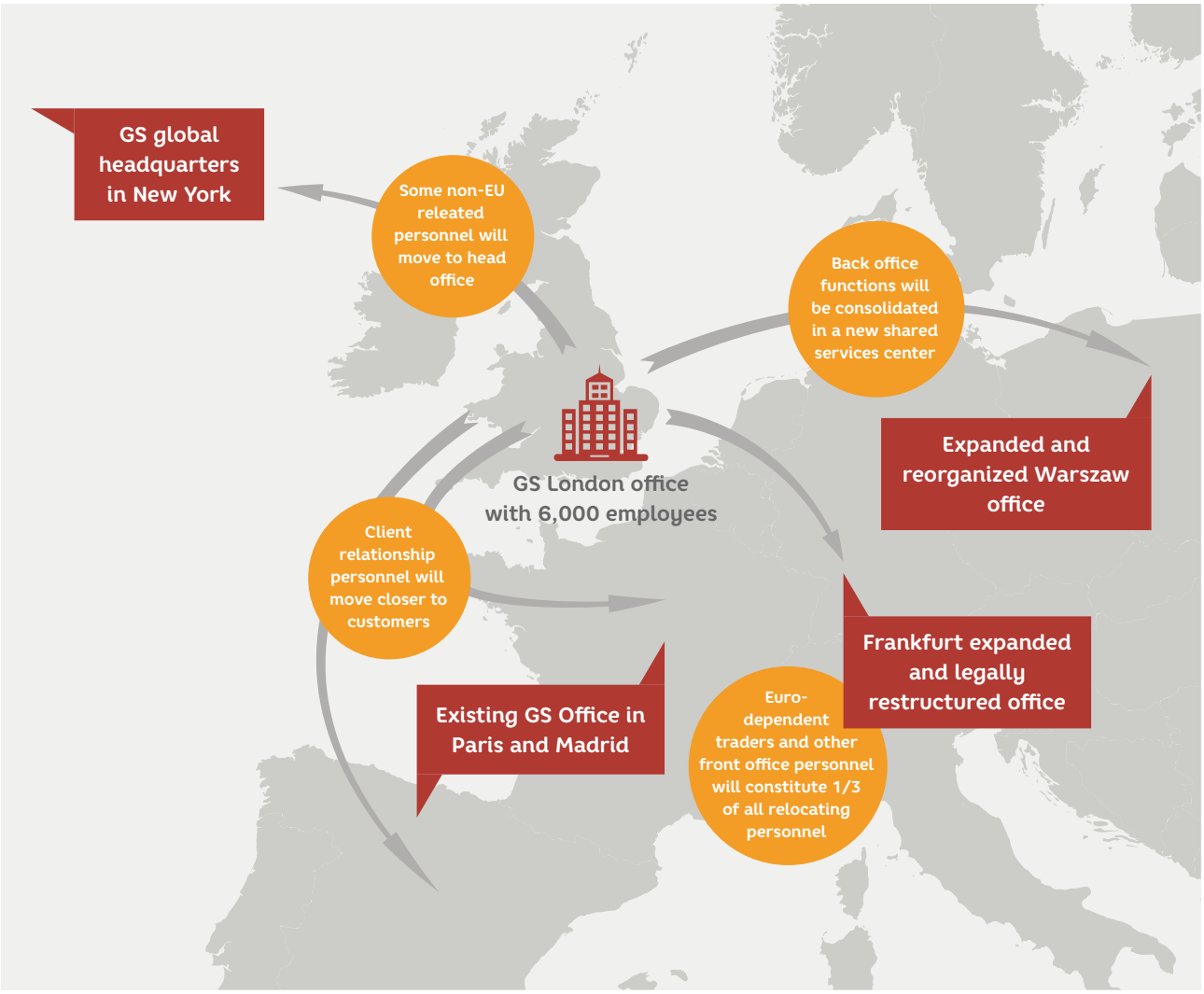
When looking at the above factors, the attractive characteristics of several cities stand out: Frankfurt, Dublin, Luxembourg, Amsterdam and Paris. They have a lot in common: All five are top European financial centers with significant financial services infrastructure. None are in the top 10 GFCI index with Luxembourg and Frankfurt, highest on the list, taking respectively 12th and 19th place. None of the cities have the depth of financial services expertise and lifestyle attractiveness enjoyed by London, and all will face capacity constraints if large chunks of financial service activity are to relocate to one destination. Most have historical ties, preferences and specializations such as Luxembourg for asset management firms, and Ireland for regulatory back-office and the insurance business. Some countries are picky about the types of financial institutions they want to see on their soil. France would like to see big banks' business, while Ireland is reluctant to accommodate the needs of those banks remembering the recent financial crisis. Whatever the results of Brexit negotiations, the competition to attract financial institutions has already begun.

Current consensus and early indications are that financial institutions are likely to relocate to different centers, depending on each company's historical preferences, current European footprint and individual requirements. Big banks and financial institutions might split their staff between several locations. A good example of this is Goldman Sachs, the premier US investment bank who was building its new European headquarters in London before the Brexit referendum. It has announced its intention to move 50% of its 6,000 staff from London. One third will be relocating to Frankfurt, with the rest spread between New York, the regional offices of Paris and Madrid, and to Poland as its back office.

City and central governments, acutely aware of the benefits of accommodating financial institutions on their soil, are working hard to promote the advantages of their locations to attract financial institutions. Those benefits include not only increased tax revenues and jobs in financial and financial-related services industries, but the secondary effects such as investments in real estate, financial and IT services infrastructure, and spillover effects on retail, educational and many other businesses. A combination of those factors would improve cities' overall ratings and attract other global companies as well as smaller institutions and fintech startups. The stakes are high.

Brexit relocation trends: Example of Goldman, Sachs & Co.: Brexit-induced relocation plans will affect 50% of GS London personnel

Figure 7



In the aftermath of the referendum, a series of high-ranking officials from Frankfurt, Paris (and Poland) rushed to London to promote their respective jurisdictions. The FrankfurtRheinMain GmbH, the region's inward investment agency promoted Frankfurt to Asian banks with European headquarters in London. There has been a flurry of public messages from city governors and high-ranking government officials highlighting the benefits of their home countries. Some countries are amending their legislation to eliminate obstacles and perceived competitive disadvantages. The Prime Minister of France, Manuel Valls publicly announced an extension of tax benefits for expats moving to France and in October inaugurated the "Choose Paris Region – Welcome to Greater Paris" one stop administrative point for foreign firms with services in multiple languages. This newly-created structure is designed to help companies and their employees in all legal and practical issues from company formation to helping relocate employees with visas, school selection and even spouse activities. Even Madrid, not high on the list of contenders, launched a campaign geared to Brexit-affected financial institutions promoting its cheap cost of operations, high office availability and good weather. Nevertheless, Madrid is not one of the five main contender discussed below.

Frankfurt
Weighing all the criteria above, Germany's premier financial center has much to offer to wholesale activity and trading for big financial institutions. Frankfurt is an established financial center at the heart of the biggest EU economy and the second largest developed stock exchange. It is home to the European Central Bank. Frankfurt used to have an important European forex market. With the introduction of the Euro, it progressively lost its forex trading activity to London and currently handles only 2% of the world's forex turnover. It is home to Eurex Clearing, which clears all products, albeit in smaller volumes than its UK equivalent.[31] Germany boasts a vibrant fintech ecosystem with three fintech hubs located in Berlin, Frankfurt and Munich. In February 2016 the London Stock Exchange and Deutsche Bourse announced their merger. They have been waiting for approval from the European Commission ever since, with the decision expected in March 2017. If the European Commission agrees to the merger, it will provide additional incentive for the wholesale banking sector to move to Frankfurt. However, the latest information leads to believe that the merger is unlikely to be approved. So far, Citibank, UBS and Goldman Sachs have announced their intentions to move part of their activities to Frankfurt. Frankfurt, however, has some disadvantages related to personal and corporate taxation, stringent labor laws and the German lifestyle, which might not suit all relocating employees.

Paris
Paris is seen by many as a direct competitor to Frankfurt for the wholesale banking business. Both cities have large internal markets with big home-grown international banks and stock exchanges. Paris is already an important center for many markets in the Eurozone, including corporate bond issuance and investment management. It handles around 5% of global derivatives turnover and 3% of global forex trade.[32] From a lifestyle perspective, Paris is hard to beat, however, there are some important drawbacks related to personal and corporate taxation and stringent labor laws. French government officials have been trying to counter those drawbacks by introducing additional tax breaks to expatriate workers. It is likely that banks with significant presence in Paris, such BNP Paribas, Societe Generale and HSBC, all with heavy presence in the UK wholesale banking sector, will consolidate their activities back to their European base. HSBC has already announced the potential move of 1,000 staff to its Paris office. It is less clear if it will manage to attract other, as many say, Paris is not what it used to be 20 years ago.

Amsterdam
Amsterdam can compete with Paris in terms of lifestyle attractiveness and tax regime and has intensive financial links to the UK with almost 250 billion euro worth of the UK loans in the Dutch financial sector. It has a good level of euro clearing capacity, which is important to big financial institutions, and is part of the Euronext stock exchange, which comprises the stock exchanges of Paris, Brussels, Lisbon and Amsterdam. However, it has one extremely important practical disadvantage: in the aftermath of the 2008 financial crisis it introduced an important cap on bonuses (20% of the annual salary, while the EU-wide cap is 100%), which is a severe impediment to attracting the wholesale business of big banks where a significant part of employees' compensation is bonus-based.

Luxembourg
Luxembourg ranks highest among EU-27 financial centers on the global financial services index and is the second largest investment fund center in the world (after the US) with over 3.5 billion euro of assets under management.[33] More than 150 banks, most of them subsidiaries of European banks, have a presence in Luxembourg. It is a place of choice for the management and distribution of investment funds and private wealth management, with a growing presence of insurance and reinsurance businesses. If asset management companies will relocate from London or "beef up" their existing subsidiaries with higher-level personnel, Luxembourg is likely to be a key beneficiary. The Government of Luxembourg is trying to go further and persuade other types of financial institutions to relocate, promoting Luxembourg as "the only (EU) country left that still loves bankers".

[31] Batsaikhan, U., Kalcik R. & Schoenmaker, D. 2017. Brexit and the European financial system: mapping markets, players and jobs. Brussels: Bruegel. *http://bruegel.org/wp-content/uploads/2017/02/PC-04-2017-finance-090217-final.pdf*
[32] Bank of England and Irwin, G. Brexit: the impact on the UK and the EU. 2015. London: Global Counsel. *https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global_Counsel_Impact_of_Brexit.pdf*
[33] Luxembourg's Commission for the Supervision of the Financial Sector.

Dublin
Ireland is the most deeply integrated with the UK in trade and culture, has the same language, and a common border. It is based on the same common law tradition as the UK. More than 500 banks, hedge funds and private equity funds operate from Dublin, many engaged in support functions.[34] Given its closeness to the UK and attractive tax and other incentives, Dublin is a likely choice for many smaller, second tier financial institutions and back office operations of global financial institutions. The Irish Department of Finance has voiced its reluctance to accommodate big banks' high-volume trading activities. It publicly stated that it fears an insurmountable regulatory burden associated with big banks' balance sheets, and the financial crisis of 2008 (when the Irish Government had to rescue banks with billions of public money) is still fresh in everybody's minds.[35] At the same time, the Irish Government has been busy creating a distinct FDI niche, capitalizing on its reputation as a shared services hub and welcoming high value-add back office operations of financial institutions. In the past, the country has been very successful in exploiting opportunities created by globalization and it is likely that its current approach will not be an exception. The position and long-term strategy of Ireland, and Dublin in particular, makes it the only candidate country that might be able to benefit from both relocation trends stemming from Brexit.

4.2. OPTIMIZATION-DRIVEN RELOCATION: IN SEARCH OF AN OPTIMAL LABOR MARKET

European financial institutions, and banks in particular, have been struggling with reduced profitability levels since the 2008 financial crisis. This trend is likely to persist as financial institutions face multiple long-term challenges, which continue to exert downward pressure on margins. In 2015 the report prepared by the consultancy in cooperation with Morgan Stanley, suggests that in order for the wholesale and investment banking industry to reach acceptable 10%+ returns on capital levels, it will need to find 2-3% RoE though restructuring and business process reengineering.[36] One of the ways to achieve this is consolidation of back office operations in shared services business units, which has been high on the agenda of many corporations for quite some time. In recent years many country and city governments have come to understand the advantages of working with big corporations and have undertaken serious efforts to improve the attractiveness of their countries and individual cities. They have invested in education, improved ICT infrastructure and become more "business friendly". It is now easier for international companies to consider those countries as hosts for their shared services operations and facilitated overall analysis of companies' worldwide footprint from a global perspective. In Europe, Ireland is often considered to be a pioneer in this process and an example to follow for many other European countries, willing to improve their attractiveness for global corporations. Figure 9 expands on the Irish example.

What is a Shared Service Center? Figure 8

A Shared Services Center (SSC) is a business unit within an organization, which handles back-office operations for different operational units of the organization. SSCs are generally structured as cost centers and aim to achieve cost savings through increased operational efficiencies due to economies of scale and process standardization. Originally designed to cut costs in transactional activities and IT–related support functions, SSCs are expanding towards higher-value added activities such as human resources, data analytics, sophisticated customer support and regulatory support (for financial institutions). Digitalization and artificial intelligence are expected to increase the benefits of standardization and further expand the shared services centralization trend. According to recent research conducted by Accenture, Cap Gemini and Atos the growth is expected to be at 14%+ over the period from 2016 to 2020.[37]

[34] IDA Ireland. 2017. International financial services. *http://www.idaireland.com/business-in-ireland/industry-sectors/financial-services*
[35] Davies, A. & Halpin, P. 2016, 22. November. Ireland reluctant to host high-risk bank trading after Brexit – sources. London. Reuters. *http://uk.reuters.com/article/uk-britain-eu-dublin-idUKKBN13H1U3*
[36] Morgan Stanley & Oliver Wyman. 2015. Wholesale & Investment Banking Outlook. Liquidity Conundrum: Shifting risks, what it means. London: Oliver Wyman. *http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/2015_Wholesale_Investment_Banking_Outlook.pdf*
[37] Capgemini Consulting. 2015. Shared Services: what global companies do. Key trends and perspectives. Paris: Capgemini consulting. *https://www.fr.capgemini-consulting.com/resource-file-access/resource/pdf/shared_services_what_global_campanies_do.pdf*

In their cost optimization efforts, financial institutions follow a widespread trend initiated by US corporations towards the consolidation of back office functions. Cost savings associated with the centralization of back-office functions in one location, known as shared services, are impressive. Reported savings range from 15% to 60% of initial operational costs depending on the industrialization of processes, level of automation and center location. In most global organizations (not restricted to financial institutions) shared services have become industry standard and common practice (see Figure 8). Today, in search of further cost advantages, organizations are offshoring (moving global SSCs to remote locations such as India) or nearshoring (establishing SSCs as regional centers, closer to regional operations and customers). The advantages of global over regional SSCs are widely discussed by operational managers of global firms. Financial institutions seem to favor regional shared services centers (with the exception of IT-related activities), as the multitude of languages, regulations and customer preferences make regional shared service implementation daring enough.

London-based financial institutions were not exempt from the delocalization and global optimization trends, but were often criticized for being slow compared to the likes from other financial centers, most notably New York. Credit Suisse, for example, with significant presence in London, was subject to such criticism until 2015, when it finally embarked on its so-called "London Initiative". In late 2015 it announced plans to delocalize over 40% of its London-based back-office staff (one third of its London-based 6,000+ employees) to lower cost locations. According to Credit Suisse's estimates this delocalization would bring annual savings of 241 million pounds, which constitutes over 1% of their total operating expenses.[38] Since the announcement, Credit Suisse has reduced the number of London-based employees to 5,000 (from over 6,000 a year earlier), opened a small trading floor in Dublin and inaugurated its second shared services center in Poland.

When evaluating potential regional locations for shared services destinations, financial institutions consider many factors. While the potential for overall cost savings is of paramount importance, factors related to the quality and availability of labor have long dominated their priority list. International corporations, including financial institutions look at the following criteria when choosing a host country for their SSC location.

- Availability of a talent/labor pool with appropriate skill level (including basic knowledge of finance, accounting, technology and foreign languages) or skill acquisition potential. The average age of SSC employees is under 30, so companies pay extra attention to the availability of a young, educated or educable talent pool.

- Overall cost of operations, including overall labor costs, the tax and social security burden on both the employer and employees, and office and infrastructure related costs.

- Proximity to European headquarters and to the company's major operations.

- Infrastructure-related criteria such as the quality and cost of the country's ICT infrastructure, and availability and affordability of office space.

- Medium-term country risk profile (both political and social), as companies evaluate the locations' potential from medium-term perspective.

- Regulatory, legal and corporate tax environment. While corporate taxation is of secondary concern to shared service organizations due to their predominantly cost center status, the overall labor tax burden and progressive, welcoming and predictable business environment are important factors.

While traditionally Ireland was known for its many European SSCs, countries in Central and Eastern Europe have been attracting a growing number of global corporations. Proximity to Europe, cheap and available labor, improving skills and better tax and governmental regulation, have increased the attractiveness of Central and Eastern European locations in recent years. In EY's European Attractiveness survey, 12% of managers of global corporations acknowledged that they would consider Central and Eastern European countries for post-Brexit relocation.[39] Poland, Czech Republic and Hungary, which featured in the survey, "combine affordable labor with steadily improving skills, investor-friendly policies and increasingly sophisticated business ecosystems".

[38] Davies, A. 2015, 21. October. UPDATE 2-Credit Suisse boss delivers blow to costly London. London. Reuters. *http://www.reuters.com/article/credit-suisse-gp-strategy-london-idUSL8N12L1O020151021*. Credit Suisse Group AG. Annual Report 2015. *https://www.credit-suisse.com/media/assets/corporate/docs/about- us/investor-relations/financial-disclosures/financial-reports/csg-ar-2015-en.pdf*

[39] Ernst & Young. 2017. EY's European attractiveness survey. Plan B... for Brexit. A boardroom view on investment and location strategies in Europe. London: Ernst & Young. *http://www.ey.com/Publication/vwLUAssets/EYs-european-attractiveness-survey-plan-b-for-brexit/$FILE/EYs-european-attractiveness-survey-plan-b-for-brexit.pdf*

The Rise of the Shared Services Industry in Ireland

Figure 9

In the two decades prior to the 2008 financial crisis, Ireland was often referred to as the Celtic Tiger, similar to the four Asian Tigers of Hong Kong, Taiwan, Singapore and South Korea. The name disappeared from circulation during the financial crisis, when the country battled with its failing banks, but many good lessons can be taken from the Irish economic success story of the late 20th century. The rise of the Celtic Tiger was significantly attributed to the activities of the Irish Industrial Development Agency (IDA), which served as a lobbyist and coordinator of foreign direct investment in the country. It was endowed with wide powers and a forerunner of most developmental agencies that have been created in Europe and Asia ever since. Few of them, however, managed to replicate the IDA's success.

Ireland's economic success started to take shape in the late 1980s. Before that time, Ireland was characterized by low economic growth, high levels of unemployment (almost 20%) and persistent net emigration. When Ireland joined the EU, it was one of its poorest members and a large recipient of EU structural funds. EU transfers represented over 6% of Irish GDP in 1991.

In the 1980s Ireland implemented a number of structural reforms and heavily invested in telecommunications and education infrastructure. The Irish Government committed to investing 20% of the public budget in education, which led to the establishment of new universities and significant modernization of regional technical colleges. Ireland became an attractive proposition for foreign investors at the time when US global companies were expanding into Europe: abundant, cheap and educated English speaking work force, modern infrastructure, and attractive corporate tax rate. The IDA had wide powers and aggressively marketed Ireland to global companies, providing substantial incentives such as capital grants, ready-made facilities, training and R&D grants. At the time, the government publicly criticized the IDA for being "overly generous towards multinationals". Many US companies established European administrative operations and shared services centers in Ireland, with Apple, Microsoft and Dell arriving at that time and expanding their operations since.

Over the course of the subsequent 20 years, Ireland was successful in understanding changing priorities for global corporations and capitalizing on them. Started as a low-cost destination for transaction processing centers, it has become a European administration center for many global companies. It capitalized on its closeness to the United Kingdom and was equally successful in attracting European-based financial institutions, looking for a low cost, high labor quality location in the euro area. With time, Ireland faced competition from other, cheaper Eastern European destinations for basic shared services functions. So, it focused its efforts on rebranding itself as a destination for higher value added shared services centers. In the aftermath of the Brexit referendum the Irish Department of Finance and IDA reaffirmed their strategy by advertising Ireland to London-based financial institutions as a destination for higher value-added services.

Among Central and Eastern European countries, Poland has been by far the most successful in building expertise and reputation in the area. Today almost 50% of Central and Eastern Europe' SSCs are located in Poland, with Hungary and Czech Republic being the distant followers.[40] According to the Polish Investment and Trade Agency, SSCs in Poland employ over 150,000 people, one third of them working in SSCs established by financial institutions. Some of the big names in the global banking industry have their shared services operations in Poland: 3,000 employees work for UBS, 4,000 for Credit Suisse, 5,000 for Citigroup, and 2,000 for Royal Bank of Scotland. In 2016 Mr. Morawiecki, the Polish Deputy Prime Minister and former Santander banker, set an ambitious goal to increase employment in shared services businesses in Poland to 300,000 by 2020.

[40] Shared Services & Outsourcing Network. 2016. Evolution of Central & Eastern Europe Shared Service Centres (Captive/Hybrid excl. BPO). London: SSON.

SSCs provide attractive employment opportunities for the younger generation across Poland, often offering entry-level jobs to university students all across the country, with SSCs have been located in cities like Krakow, Lodz, Poznan, Wroclaw, and Warsaw. As such, SSCs improve the first-time employment market in Poland and increase the overall skill level through exposure of the younger generation to the best practices of premier global institutions. In many locations, global companies are used to working directly with higher education institutions to prepare students to join their companies. The Polish government offers incentives for training of new employees and supports the tailoring of university degree programs to the needs of shared services organizations. The availability of local, good quality job opportunities additionally benefits Poland as it staves off the emigration of young people, a major drag on the country's long-term economic development.

Thus it is no surprise that the Polish Government saw Brexit as an opportunity to further cement its name as a leader in back-office operations in Europe. Immediately following the Brexit referendum, at the end of August 2016, Mr. Morawiecki, Deputy Prime Minister, went to London to promote Poland as a post-Brexit destination of choice for shared services and back-office operations of financial institutions. He set up meetings with Royal Bank of Scotland, UBS, Barclays, BNP Paribas, Citibank, Credit Suisse and investment fund managers such as Schroeder, Pimco and Black Rock.[41] We may never know what discussions he had with those banks, but the Polish government's efforts appear to be bearing fruit. The international press has singled it out as a likely Brexit beneficiary for back-office job relocation. Goldman Sachs announced that some of its back-office staff would relocate to Warsaw, effectively creating a back-office center there, while UBS announced further expansion of their current presence in Krakow by moving more back-office functions from London. In the meantime, Credit Suisse has inaugurated its second office in Warsaw. Others are likely to follow suit.

All of those moves are good news for Poland where the needs of global financial institutions for cost optimization meet the needs of Poland in search of ways to increase overall employment and educate its workforce. But will this model work for the Baltic countries?

4.3. OPPORTUNITIES FOR THE BALTICS

At first glance, the current presence of SSCs in the Baltic states seems small compared to Poland and Ireland. However, this information is provided by the respective countries' investment agencies, whose goal is to promote their respective countries and successes. According to those agencies, the combined SSCs of the three Baltic countries employ a total of 24,200 people compared to 150,000 in Poland, but the percentage of active population employed by SSCs is approximately the same in all four countries. Ireland, with its 40,000 strong SSC employees has a higher percentage of active population working in shared services centers than Poland, though the gap is closing. None of the Baltic states have exclusive focus on the financial industry and all are home to SSCs from other industries such as manufacturing, chemicals and technology.

For the three Baltic states, the percentage of the active population employed in shared services is quite similar, with Lithuania having a heavier presence in the financial services industry than either Latvia or Estonia. Similarities between the three Baltic states do not stop here, though. They have many similar inherent and historical advantages and drawbacks as seen from the point of view of any global organization considering those countries as a potential location for its SSC. Their proximity to the European main markets, time zone and relatively low labor costs are important advantages. Each country faces similar geopolitical risk (proximity to Russia) as well as affordable, qualified but scarce labor. All three face looming labor shortages and current wage growth exceeds productivity growth. All have a good quality ICT infrastructure and similar fiscal regimes where significant costs to employers come from social security employee-related costs.

[41] Foy, H. 2016, 29. August. Warsaw joins charm offensive to woo London bankers. London: Financial Times. *https://www.ft.com/content/207ffab6-6ddb-11e6-9ac1-1055824ca907*

Key Economic Indicators for Ireland, Poland and the Baltic States[42]

Table 1

	Ireland	Poland	Lithuania	Latvia	Estonia
Population (in thousands)	4,725	37,967	2,889	1,969	1,316
Unemployment rate	7,9%	6,2%	7,9%	9,6%	6,8%
Average hourly labour cost	€ 30,0	€ 8,6	€ 6,8	€ 7,1	€ 10,3
Year-on-Year increase in labour costs (2016 Q4)	1,2%	5,4%	10,7%	8,1%	5,7%
Labour Tax Wedge from average salary	27,5%	34,7%	41,1%	42,6%	39,0%
Employees in Shared Services Centers (in thousands)	40,0	150,0	11,1	7,8	5,2
SSCs'employees as % active population	1,9%	0,9%	0,8%	0,8%	0,8%
Sample presence of major banks in the country	Unicredit, JP Morgan, Wells Fargo, Merrill Lynch	BNP, UBS, Credit Suisse, Citibank	Barclays, SEB, Danske, West. Union	SEB, DNB	Swedbank (IT)

But there are also important differences in their approach.

Lithuania has chosen to follow the Polish path, actively promoting itself as an SSC destination for financial institutions. It already has more finance-related SSCs than Latvia or Estonia combined - 36% of the total, according to InvestinLithuania, the Lithuanian Developmental Agency. Lithuania does not, however, have the same reputation or experience in hosting SSCs as Poland and has a much tighter labor market. Lithuania is keen to capitalize on its biggest success story - Barclays, which has been operating in Vilnius since 2009 and today employs 1,300 people. Working with Barclays over the years, the city and country governments acquired important experience and understanding of key issues and requirements for hosting the shared services organizations of global financial institutions. Such knowledge should help Lithuanian government and municipalities to better adjust their offering to the next wave of SSC relocation if it is to come. Both country government and city municipalities (specifically Vilnius) understand that attracting big financial institutions demands both efforts and concessions from the countries entering the new competitive field.[42]

[42] Eurostat, European Commission, InvestInLithuania, Investment and Development Agency of Latvia, Irish Development Agency, Polish Investment and Trade Agency, FinanceEstonia.
[43] Invest Lithuania. 2016. Shared Service Centres Industry overview. Vilnius: Invest Lithuania. *http://www.investlithuania.com/wp-content/uploads/2016/08/Business-Services-Sector-Handbook.pdf*

Lithuania does offer incentives for training of the personnel (up to 50% of the costs) and up to 15% of the salary costs to the newly established SSCs.[44] Over the last year, the Lithuanian Government, Vilnius municipality and Lithuanian Investment Agency have been vocal in promoting their accessibility and openness to European financial institutions. In August last year a Lithuanian MEP made European headlines when he sent a letter to a number of big London-based banks inviting them to Lithuania. Such action does seem a little extreme and audacious, but many other city mayors and high-ranking officials of key European financial centers have been visiting London promoting the advantages of their cities. Lithuania just followed their example. It is too early to judge the success or failure of that strategy, but Lithuania and Vilnius have succeeded in putting their names on the map as potential locations for shared services centers for financial institutions. In a recent Central and Eastern European Shared Services conference in Warsaw, Vilnius was called one of the most dynamically developing cities for shared services.[45] Time will tell whether it is sufficient for real success.

Estonia has chosen a different path and has attempted to improve its overall attractiveness as a destination for foreign direct investment. It does not have a focus on financial institutions and Brexit does not seem to figure much in its communications. It does take its global competitive positioning seriously though. Estonia is ahead of all three Baltic countries (Poland included) in all rankings and indexes that measure global competitiveness and business environment.[46] The study claims that Estonia is the only country in the Baltic neighborhood that has attained the highest, innovation driven economy status alongside the most developed world economies.

In the shared services market, however, it will be difficult for Estonia to be a serious contender in the Brexit-induced relocation of financial institutions, given its small and tight labor market as well as the highest labor cost in the Baltics.

Latvia does have a number of SSCs in Riga, from which DNB and SEB represent the financial services industry. Both banks have a local commercial presence, while their SSCs, with around 300 employees each, serve markets outside the Baltic region. Both had looked at other Baltic locations before deciding on. SEB has a number of SSCs (including one in Lithuania), while for DNB its SSC in Riga is unique and geared towards servicing exclusively Norwegian market. In recent conversations with representatives of the shared services industry in Latvia, concerns were voiced over labor market conditions and rapid wage increases. Some interviewees observed that if the decision on their SSC location were to be made today, it is not clear whether Latvia would be chosen as a host again.

This report did not intend to cover the development of shared services industry. However, the analysis of relocation trends of financial institutions has led to the conclusion that Brexit is likely to accelerate resource relocation of financial institutions towards SSCs, and Latvia might benefit from this trend if it positions itself correctly. It can follow the examples of countries that have been successful in attracting shared services business in Europe such as Ireland and Poland. Both countries followed a similar two-step strategic approach.

[44] Invest Lithuania. 2016. Shared Service Centres Industry overview. Vilnius: Invest Lithuania. *http://www.investlithuania.com/wp-content/uploads/2016/08/Business-Services-Sector-Handbook.pdf*

[45] CEE Shared Services and Outsourcing Awards. 2017. 25 winners at 5th annual CEE shared services awards. *http://ceeoutsourcingawards.com/2017/winners.html*

[46] Schwab, K. & Sala-i-Martin, X. 2016. The Global Competitiveness Report 2016–2017. Geneva: World Economic Forum. *http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf*

First, they created mechanisms to attract well-known big corporations. Both countries strived to create favorable conditions through investments in education, ICT and real estate infrastructure, and gave those pioneer companies a wide range of incentives and grants. Those grants included tax breaks on both country and local levels, co-investment in personnel training, specific capital investment programs using European and regional funds. Once those corporations started their operations in their chosen locations, governments through their investment agencies and municipalities, continued to work closely with them by further improving infrastructure, creating shared services tailored university programs and fulfilling other company specific requirements. The goal of the undertaking was to build an industry-wide reputation as a desired location for shared services centers and assure that corporations were willing to transfer more activities into already existing SSCs, thus further improving country's attractiveness.

In the second stage, governments and municipalities limited the number and amount of company-specific incentives, as newly arriving corporations could benefit from the existing ecosystem, developed and tailored to their needs.

Today, in light of Brexit, Lithuania is attempting to follow in the footsteps of Poland and Ireland, and Latvia can also benefit from the same example. Given the small size of the country's workforce and high competition among neighboring countries, Latvia should focus on specific niches in the shared services' industry, such as the second-tier regional banks already present in Latvia. As the examples of Poland and Ireland show, in order to be successful, it is important to understand the needs of those institutions, working in partnership with them and providing them with the best possible support. In return, Latvia would benefit from stable long-term employment opportunities for the young graduates, improved reputation in European financial services industry and wider shared services industry set to grow in double digits over the next five years.

CONCLUSION

Two major forces will drive the relocation of financial services firms from the United Kingdom to other European countries. One is a regulatory and compliance force, which is Brexit driven. Latvia is unlikely to benefit from this type of relocation, as financial institutions will search for a location which will most closely resemble London with its sophisticated financial infrastructure and regulatory framework capable of accommodating their complex requirements. The other is the cost optimization force, accelerated by Brexit but caused by decreasing profitability levels of financial institutions and threats related to digitalization and automation. Financial institutions are forced to optimize their cost structures and search for lower-cost locations for their back office operations. In Europe, Central and Eastern European countries are the key beneficiaries of this trend. Latvia can also potentially benefit from this trend, but the level of competition between countries in this area is very high. Governments of many Central and Eastern European countries are keenly aware of the long-term benefits of hosting shared services organizations – good employment opportunities for the younger generation, contributions to countries' social security budgets as well as likely improvements in their overall business infrastructure and reputation.

Latvia has important drawbacks when compared to some other regional contenders. Labor availability, taxation and skills are the most important deterrents for financial and other institutions interested in Latvia (and its Baltic neighbors) as the hosts for their SSCs. Overcoming these drawbacks is possible, and will require concerted efforts from central government and local municipalities. Given the small size of Latvia's workforce, it is advisable to focus on specific niches in shared services' industry, such as second-tier regional banks, already present in the country. Creating such a niche offering will allow Latvia to build its reputation in the shared services industry which is set to grow in double digits over the next five years, improve its reputation in the European financial services industry and provide a steady and quality high employment opportunity for Latvia's workforce.

Author:

Marina Le Clere
Marina le Clere teaches financial analysis and company valuation at Riga Business School and the Stockholm School of Economics in Riga. Prior to embarking on her career in higher education, she worked for the investment bank Goldman, Sachs & Co. in New York (mergers & acquisitions), the US technology conglomerate Honeywell in Prague and Brussels (European strategy and business development) and others. She holds an MBA from INSEAD Business School in France and a BA from the State Finance Academy in the Russian Federation.

Latvia's economic growth can only be achieved through joint efforts. *Certus Think Tank* engages with entrepreneurs, researchers and public sector decision-makers to generate ideas to drive Latvia's economic growth, balancing the principles of a liberal market economy with focused state support for the development of Latvia's most competitive economic sectors.

Riga. Certus Think Tank. 2017.

© Certus Think Tank. 2017
ISBN 978-9934-8679-2-7