

**New City  
Initiative**

# **Capital Controls:**

---

Preparing for the Unthinkable

## About the New City Initiative

---

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management..

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional “client-centric” approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

## About the Author

---



### Charles Gubert

Charles Gubert is a consultant to the NCI. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

## Contents

---

Foreword	5
Executive Summary	6
Introduction	6
Defining Capital Controls	7
Potential Causes of Capital Controls	8
Enabling Capital Controls	9
Impact of Controls on Asset Managers	10
Conclusion	13
New City Initiative Members	14

## Office

---

New City Initiative  
16 Babmaes Street  
London  
SW1Y 6AH

+44 (0)20 7484 1198  
[www.newcityinitiative.org](http://www.newcityinitiative.org)  
[secretariat@newcityinitiative.org](mailto:secretariat@newcityinitiative.org)  
[@NCityInitiative](https://twitter.com/NCityInitiative)

## Foreword

---



The idea of capital controls being implemented in a major developed market economy such as the UK seems improbable, but there are two events on the horizon which could cause such action to be taken and encouraged us to think about these risks:

1. A cliff-edge Brexit. The recent agreement for a transition period was disappointing in that it is conditional on there being a full withdrawal agreement. This conditionality raises rather than reduces the chance of a cliff-edge. An unprecedented event such as this provides no historical comparison with which to guide us, but in the paper we explore the imposition of capital controls elsewhere.

2. A Labour government. NCI is apolitical, but an independent, objective assessment of some of the policies currently being suggested by the Labour Party increase the risk of capital flight. We discuss these policies and the potential ramifications.

NCI cannot predict the probability of either event, but good risk management requires assessment of all types of risks, even those perceived to have a low probability of occurring. This paper is intended to provide members with food for thought, a trigger for some contingency planning should we be faced with the imposition of capital controls in the UK (or elsewhere for that matter). We assess the impact on the asset management industry, its customers and suppliers, the clearing and settlement process and we've used the case study of a UK fund vehicle with a global investment mandate to outline some key operational issues and provide suggested remedies which members and their customers should consider.

### **Jamie Carter**

Chairman, New City Initiative

Chief Executive, Oldfield Partners

## Executive Summary

---

It has been nearly four decades since capital controls were last seen in the UK, and for many people it is a concept that is alien. In an era where cross-border payments and transactions can be facilitated through mobile devices via online banking channels or new tech like Apple Pay, capital controls seem unimaginable.

A number of political risks exist on the horizon that could seriously derail the UK's economy, and were they to be severe enough, it is not unfathomable to suggest capital controls could be enacted. This paper takes a look at how the asset management industry could be impacted by capital controls, were they to be imposed again inside the UK.

## Introduction

---

This paper's origins can be traced to reports emanating from a handful of NCI members who had received inquiries from institutional investors asking them about how their businesses would react to capital controls being adopted in the UK, and what it would mean for their investments should such policies ever be implemented.

While this line of questioning has not been widespread, some members acknowledged they had discussed the risk of capital controls privately with counterparts at competitor organisations, and pointed out that these conversations had become more commonplace over the last six to eight months.

At present, the most likely cause for capital controls is a disorderly Brexit, namely a no-deal divorce without a transitional period commencing in March 2019. This paper looks at some of the background behind capital controls and assesses the implications of what such monetary policies could have on the fund management industry and its investors.

## Defining Capital Controls

---

Capital controls – as a tool – are designed to alleviate extreme economic pressure within a given country. The overriding purpose of such monetary policies is to contain the purchase and sale of local currency or to retain currency inside a jurisdiction. Capital controls therefore prevent any sudden exodus of cash from a market causing irreparable economic damage but they can also be used to manage unsustainable inflows which could potentially undermine economic wellbeing.<sup>1</sup>

A paper by Clifford Chance highlights that “controls might include a ban on the conversion of the proceeds of certain assets or by certain categories of person, an obligation to surrender foreign exchange proceeds to the central or local bank, authorisation requirements, minimum stay requirements, quantitative limits, restrictions on payments outside the country and/or restrictions on bank withdrawals; they may also include indirect methods such as tax charges on capital flows.”<sup>2</sup>

### Exchange Controls

Exchange controls are state-backed restrictions on the purchase and sale of currencies, deployed typically to remedy exchange rate volatility, or to prevent speculative activities against currencies. While exchange controls are different to capital controls, they are frequently implemented concurrently to one and other.

Exchange controls were imposed in Iceland during its banking crisis in 2008. Iceland – following agreement from the IMF – enacted exchange controls which included a ban on foreign exchange transactions between residents and non-residents if the Krona was involved.<sup>3</sup>

Recent history has shown that a number of governments are unafraid of implementing capital controls. The same Clifford Chance paper added that (as of 2015) around two thirds of the world's population was subject to some form of capital controls, despite the practice being largely discredited following the collapse of the Bretton Woods system in the 1970s.<sup>4</sup> Meanwhile, according to Bloomberg, 37 countries curtailed the free flow of capital between 1995 and 2010.<sup>5</sup>

### Recent Examples

A number of markets including China, Greece, Iceland, Cyprus, Argentina, Venezuela and Ukraine have all imposed capital control restrictions in the last decade. Such curbs on the movement of money have been introduced for a variety of reasons. Economic mismanagement precipitating currency flight prompted governments in Argentina and Venezuela to impose capital controls, whereas Ukraine implemented similar monetary policies in response to its ongoing conflict with Russia.

---

1 *Ibid*  
2 *Clifford Chance - May 2015 - The Euro Area and Capital Controls*  
3 *Norton Rose Fulbright June 2015 - Exchange and Capital Control Risk*  
4 *Clifford Chance - May 2015 - The Euro Area and Capital Controls*  
5 *Bloomberg - August 2015 - Capital Controls*

The dramatic collapse of domestic banking systems in Greece, Cyprus and Iceland respectively prompted capital controls as well. Meanwhile, China introduced restrictions on capital movements amid widespread volatility in its equity market, which was causing a flight of money out of the country. The nature, extent and severity of these restrictions is not uniform among these countries, but the decision to implement such constraints on capital movements is typically a measure of last resort.

Capital controls have not been a feature in UK monetary policy in almost forty years, and were abolished in 1979 by the then Prime Minister Margaret Thatcher. Memories of UK capital controls do not elicit a warm response from financial services' veterans from that era. One former banker working in London during the 1970s described UK capital controls as a severe impediment for businesses and everyday life more broadly, limiting people's ability to travel abroad or purchase foreign assets or financial instruments. It also made the UK a thoroughly unappealing destination for foreign investment.

The concept of capital controls is, however, fairly alien to anyone in the UK under the age of 45, and certainly to the highly mobile millennial market. At present, the UK has very few restrictions on moving capital overseas or inbound, barring the exception that travellers must declare any cash in their possession in excess of 10,000 euros upon arriving or leaving the country. The unimpeded movement of capital is something the UK – including its financial services industry – has taken for granted for almost four decades.

The political and economic situation in the UK over the next two to five years is likely to be highly volatile, meaning fund managers and their investors need to be prepared for all outcomes, including a number of improbable eventualities, such as the imposition of capital controls.

The implications of capital controls in the UK would be severe in today's highly connected international markets. "Pre-1979 when capital controls were in place in the UK, markets were far less internationalised, so the impact was not as serious. Today, the consequences of capital controls in the UK would be far more dramatic as the country is a systemically important financial centre," explained one capital markets expert.

## Potential Causes for Capital Controls

Admittedly, the immediate likelihood of capital controls appears remote, but a handful of financial institutions point to two key political scenarios, which could seriously destabilise the UK's capital markets in the next five years, and with it act as a catalyst towards the implementation of potential restrictions around the free movement of capital.

The first risk is a disorderly, or cliff edge Brexit. While a Brexit transition period has been agreed in principle, it is conditional on there being an agreement on a full withdrawal treaty. As one expert summarised it, the deal is an agreement based on an agreement, so the possibility of a cliff-edge Brexit remains.

If Brexit is sudden and very hard, it could trigger a dramatic decline in the value of sterling, something which may result in capital flight and a worrisome fall in foreign direct investment (FDI).

If the drop was severe enough and the Bank of England felt large-scale liquidity injections into the banking system were not sufficient to maintain market confidence, the government may be forced to act, and introduce capital controls to stem outflows.

The second capital controls scenario could be a consequence of a change of government. In 2017, the CME Group and Morgan Stanley published papers analysing what the possible consequences would be if a far left-wing government led by Labour Leader Jeremy Corbyn assumed power in the UK.

There are proposals being put forward by some members of the Labour echelon for full-scale renationalisation of major industries including water utilities, energy companies and railway infrastructure. Morgan Stanley warned investors with UK equity exposure that such a tectonic sea-change in economic and political policy would be seriously damaging.<sup>6</sup>

Set against the backdrop of potential bond market volatility and a resurgence of protectionism and tariffs in the US and the growing risk of trade wars between major economic powerhouses, a serious dislocation in UK politics could see a reversion to capital controls, should cash start leaving the country.

## Enabling Capital Controls

The imposition of capital controls is not something a government can enact without just cause. Such policies – if they are to have any legitimacy – must attain support from the international community. Under the International Monetary Fund's (IMF) Articles of Agreement, capital controls are divided into two categories – controls on capital movements and controls on payments for current transactions.<sup>7</sup>

The Clifford Chance paper acknowledged the lines were blurred between these two concepts, adding the IMF defined current transactions as payments which are not for the purpose of transferring capital, although said it could "incorporate payments in connection with foreign trade, payments in connection with short-term banking and credit facilities, interest on loans, payments on other investments and payments of a moderate amount of amortisation of loans and for depreciation of direct investments."<sup>8</sup>

Article VI (3) of the IMF's Articles of Agreement permits member countries to implement capital controls on condition they do not impact current transactions, although Article VIII(2)(a) states "no member shall – without the approval of the Fund – impose restrictions on the making of payments and transfers for current international transactions."<sup>9</sup>

<sup>6</sup> *Bloomberg - December 2017 - Morgan Stanley is right to fear Labour, Corbyn says*

<sup>7</sup> *Clifford Chance - May 2015 - The Euro Area and Capital Controls*

<sup>8</sup> *Ibid*

<sup>9</sup> *Ibid*

In other words, IMF approval for any policies at a member state level restricting current transactions must be obtained. One lawyer said IMF approval for the implementation of capital controls was not always guaranteed, and sign offs are usually only given in very extreme market conditions.

Inside the EU, Article 63 of the Treaty of the Functioning of the European Union (TFEU) bans “all restrictions on the movement of capital and on payments between member states and between member states and third countries.”<sup>10</sup> The European Commission does, however, provide exceptions to the principle of free movement of capital, namely if controls need to be established to prevent problems related to tax, supervision of financial institutions, public policy and security.<sup>11</sup>

For non-Euro members of the EU, Article 144 (1) allows for “necessary protective measures” to be implemented when faced with “a sudden crisis in the balance of payments if the EU itself fails to act sufficiently quickly though the European Council can amend or suspend those measures.”<sup>12</sup> With the UK now departing from the EU, and the terms and conditions dictating its exit unclear, the legality of unilateral capital controls – at least from an EU point of view – remains uncertain.

## Impact of Controls on Asset Managers

Qualifying the impact of capital controls – were they to be introduced in the UK – is not entirely straightforward. One expert acknowledged that because the causes of capital controls were unique, so were their application. In other words, each set of capital controls is different in nature, highly prescriptive and very legalistic. Capital controls imposed in one market may be quite loose enabling for certain overseas transactions to be executed, whereas others are plainly not.

As such, a number of variables exist with capital controls and this makes it quite difficult to predict what asset managers should do if they were pushed through in the UK. Perversely, only once capital controls have been enacted will organisations be able to understand how to navigate their businesses around them.

NCI, however, will assume for the sake of argument that UK capital controls – if implemented – are extremely restrictive and imposed very hastily. This assumption is not borne by any predictions NCI has, but is guided by the principle that managers should always test and prepare business continuity planning (BCP) exercises under worst case scenarios as opposed to optimal or less severe market conditions.

### Investor Impact

Most UK managers will typically operate a fund which is domiciled in an onshore EU (i.e. Luxembourg, Ireland) or offshore (Cayman Islands, BVI, Bermuda, Channel Islands) jurisdiction. The fund itself would not be directly impacted by capital controls as it is located in a third country. A UK manager with a non-UK domiciled fund and cash outside of the country could therefore instruct staff in a different jurisdiction or foreign subsidiary to execute cash transfers provided the cash or instruction chain does not include the UK.

<sup>10</sup> *Ibid*

<sup>11</sup> *EC - Capital Movements*

<sup>12</sup> *Clifford Chance - May 2015 - The Euro Area and Capital Controls*

However, paying dividends to UK investors could be problematic and funds may wish to offer investors the choice of receiving dividends in a currency other than sterling, and into a bank account outside of the UK, rather than one located in the UK as controls may prevent them from buying foreign currency again (an investor that holidays outside of the UK each year may find that a euro or US dollar denominated dividend paid to their bank account outside of the UK provides useful spending money!).

It is clear that capital controls would directly impact investment decisions pertaining to UK versus non-UK exposures, leading to a serious increase in administrative costs at domestic managers and performance impairment. It may be difficult for UK investors subject to capital controls to allocate into a fund if it is based in another country and has a base currency in something other than sterling. Finally, performance could be seriously compromised, an outcome which will impact public and private sector pension schemes struggling to close out deficits and meet liabilities.

Simultaneously, capital controls could also prove problematic for foreign investors looking to redeem money from UK-based funds, something which could lead to a dramatic crisis of confidence in the domestic industry. UK pension funds would also face challenges. As a lot of UK retirees reside abroad, there would be enormous political risk if pension schemes were unable to transfer proceeds overseas.

“Capital controls would result in foreign investors’ assets being trapped in the UK market. While a manager could reinvest those trapped assets in the domestic market, this might not be an attractive proposition if conditions are highly volatile. However, the implications of capital controls cannot be fully understood as the government – should they introduce such measures – may allow for certain carve outs or concessions. Such a monetary policy would certainly result in foreign investors putting more money to work in funds based in competitor jurisdictions instead of the UK,” said one capital markets expert.

### Clearing and Settlement

Most significantly, capital controls could impede managers and financial institutions from adhering to overseas clearing and settlement obligations, or meeting margin or collateral requirements with foreign counterparties. Such a scenario could cause serious damage to the world financial system and its underlying plumbing and infrastructure.

“Capital controls restrict firms from accessing foreign currency or exporting local currency, so this could restrict firms’ ability to convert currency. Some third countries may recognise exchange controls in foreign markets provided it has IMF approval. In other words, the market where the trade is settling may respect a firm’s inability to deliver the required currency if the inability results from capital controls which are IMF approved,” explained one UK-based lawyer.

One industry professional said capital controls would probably exempt existing open contracts or trades enabling for clearing and settlement to occur on those transactions but even this was not guaranteed. He added capital controls may only impact trades executed after the timed announcement. “There is also a possibility that a time limit could be placed on free capital movement for open positions, requiring managers to consider unwinding long- term obligations such as stage payments on property investments overseas or long-term hedging contracts,” said one expert.

## Supplier Impact

Norton Rose Fulbright acknowledged that businesses should consider the location of their financial investments and bank accounts in the event of capital controls ever being introduced in any market.<sup>13</sup>

“Businesses will also encounter various practical difficulties associated with capital and/or exchange controls. In particular, accounting and IT systems will need to be updated. In addition, suppliers, customers and distributors may themselves face issues and firms may wish to consider factoring in additional contingency to avoid interruptions in business,” read the Norton Rose Fulbright paper.

In extremis, this may require firms to pay foreign counterparties or suppliers in GBP into UK bank accounts, if they are unable to export capital, said one subject matter expert.

**Case Study:** The Impact of Capital controls on a UK-based OEIC with an international equity investment mandate

### Typical operational set up

- Overwhelmingly UK investors
- Base currency of the fund is in sterling and cash balances tend to be held in sterling
- The fund invests predominantly in non-sterling assets
- Each equity trade results in automated trade-related FX to and from base currency to limit currency exposure:
  - o Purchases of non-UK equities require a purchase of that local currency and sale of sterling to fund the purchase
  - o Sales of non-UK equities result in local currency proceeds which are repatriated to base currency
  - o A series of buy and sell trades over the course of a day or days, may be collected together for “netting” of exposures to minimise the number of FX required
- And/Or currency forwards are used to reduce or even eliminate all non-sterling currency exposure
- Dividends from underlying equity holdings are received in local currency and repatriated, via FX, to sterling
- Fund fees and expenses are paid to providers in sterling
- Dividends to fund investors are paid in sterling

### If controls were put in place

- All FX to and from sterling would initially be stopped.
- Future trade-related FX would be funded through the various non-sterling currencies.
- The process of currency management becomes manual, rather than automated
  - o For each underlying buy trade, a decision must be made about where to fund the currency required from.
  - o Sale proceeds will stay in local, non-sterling currency, until needed.
  - o The ability to “net” currency pairs and reduce FX is more limited.
- Presumption that standard currency forwards are no longer possible, but non-deliverable forwards and swaps may still be available to allow hedging of currency
- Dividends received from underlying equity holdings rather than swept into sterling base currency (because once swept, they cannot be used for anything else).
- Pre-existing sterling cash balances may be ring-fenced for paying fees, charges and investor dividends.
- Manual management of accumulated non-sterling cash balances (from dividend payments from underlying equities) is required to ensure sterling payments can be made.
- Fund investor dividends may be temporarily suspended to offer investors the choice of receiving dividends in a currency other than sterling (to a bank account outside of the UK)
- Fund subscriptions may be preferred, or even required, to be in currencies other than sterling.
- Internationally invested funds suddenly become far more attractive investments than UK only funds, but only if investors can still access them.

13 Norton Rose Fulbright - June 2015 - Exchange and Capital Controls Risk

## Conclusion

---

The imposition of capital controls – while seemingly improbable – would have negative consequences for the UK asset management industry and its customers. As capital controls tend to be enacted as an emergency measure with a very brief notice period, planning for such an eventuality is difficult.

The comparisons to a bank run are all too obvious, namely if enough people pull their money from the UK in a short period of time (or for that matter UK investors push their money elsewhere, as the Greeks did post financial crisis), a self-fulfilling spiral can develop (Northern Rock being a good example).

All industry participants and customers need to give some thought to the risk of capital controls and investigate how they would navigate it. While shifting operations out of the UK, re-domiciling funds or changing the way dividends are distributed to investors are options potentially available to impacted organisations, several NCI members acknowledged they would be an absolute last resort, and decisions that would not be taken lightly.

Nonetheless, the possibility of a disorderly Brexit or a dramatic change in government is real, and companies across the spectrum need to devote time to assessing their contingency plans to ensure they can react accordingly. Moving forward, it is likely investors will be scrutinising managers' BCPs to ensure they are fully prepared for the potential implementation of capital controls in the UK and the fall-out it may bring.



## New City Initiative Members

---

### UK Members

Bentley Reid & Co.	Brown Advisory	Cape Ann Asset Management	Cologny Advisors LLP
Crux Asset Management	Dalton Strategic Partnership LLP	Edgbaston Investment Partners	Findlay Park Partners LLP
Floreat Group	Independent Franchise Partners LLP	Kennox Asset Management Limited	Kestrel Investment Partners
Kiltearn Partners	Latitude Investment Management	LGT Vestra Wealth LLP	Longview Partners LLP
Majedie Asset Management Ltd	Mayfair Capital Investment Management Ltd	Montanaro Asset Management	Morant Wright Management
Northill Capital LLP	NS Partners Ltd.	Ocean Dial Asset Management Limited	Oldfield Partners LLP
Orbis Investments	Phoenix Asset Management Partners Limited	Polar Capital	RWC Partners Ltd.
Sanderson Asset Management	Sanlam Four Investments Ltd	Seaforth Land Holding Limited	Silchester International Investors
Somerset Capital Management LLP	Stanhope Capital LLP	Stonehage Fleming Family & Partners	S. W. Mitchell Capital LLP
Tellsons Investors LLP	Troy Asset Management Limited	ValuAnalysis Limited	Vestra Wealth LLP
Waverton Investment Management			

### Continental Members

Carmignac Gestion	Comgest S.A.	La Financière Responsable	Mandarine Gestion
Metropole Gestion	Moneta Asset Management	Montpensier Finance	Quero Capital
Skagen Funds	Société Parisienne de Gestion	Sycomore Asset Management	

