HM Treasury

Review of the Balance of Competences

# Single Market: Financial Services and the Free Movement of Capital

## call for evidence

October 2013

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# Executive summary

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| Subject: | This is a Call for Evidence regarding the EU's competences in the field of financial services and the free movement of capital. This paper provides background information on the EU's competences in this area, covering the legal basis and exercise of these competences in recent decades. |
| Scope of this paper: | The focus of this Call for Evidence is on financial services and the free movement of capital. The Treaty bases most relevant to this area – notably Articles 53, 63, 64, 65, 113, 114, 115, 127(6), and 352 TFEU – are summarised in Annex A. |
| Who should read this: | Anyone with knowledge of or views on the EU's competences in this area. We are keen to get evidence from a wide range of stakeholders across UK regions and the devolved administrations as well as from overseas. These stakeholders include – but are not limited to – large and small businesses, financial institutions, industry trade bodies, independent financial advisors, legal bodies, consumers and consumer interest groups, civil society groups, think tanks, academia, Parliament, other governments, and the EU and other international institutions. |
| Duration: | The call for evidence will run from 21 October 2013 to 17 January 2014. |
| How to respond: | If you have knowledge or experience of the application of EU competences in the field of financial services and the free movement of capital, please respond by emailing balanceofcompetences@hmtreasury.gsi.gov.uk by 17 January 2014. We will expect to publish your response and the name of your organisation (unless you ask us not to) but not your individual name (unless you wish it included), in line with standard procedures. Please base your response on answers to the questions on page 41. |
| Enquiries: | By email: balanceofcompetences@hmtreasury.gsi.gov.uk<br>By post:<br>Balance of Competences Review – Single Market: Financial Services and the Free Movement of Capital<br>HM Treasury<br>1 Horse Guards Road<br>Westminster<br>London SW1A 2HQ |
| Next steps: | We invite submitted evidence and expressions of interest from stakeholders, including for more information on events that we will be organising where stakeholders will be able to give their views. Launch events will be held in Manchester and London in October 2013, and further events will be held in the regions, devolved administrations and elsewhere in the EU by January 2014. Please send expressions of interest to the email address: balanceofcompetences@hmtreasury.gsi.gov.uk |

# 1 Introduction

## The Balance of Competence Review

1.1 The Foreign Secretary launched the Balance of Competences Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union (EU). The review will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of our EU membership and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It is not tasked with producing specific recommendations or looking at alternative models for Britain's overall relationship with the EU.

1.2 The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between autumn 2012 and autumn 2014. The review is led by the Government but will draw on evidence and experience from experts, practitioners, organisations and individuals. Foreign governments, including EU Member States and institutions, are also invited to contribute. The process will be comprehensive, evidence-based and analytical, and the review will be transparent, including with respect to the contributions submitted to it. The intention is that this work will provide everyone – those in government, in Parliament and, most importantly, the British people themselves – with a better understanding of an important aspect of the UK's relationship with the EU.

## What will this review involve

1.3 This review will examine the EU's competences – the powers to act conferred on it by the EU Treaties – in the field of financial services and the free movement of capital, and consider whether these powers are appropriate and are being exercised appropriately, alongside consideration of the UK's competences and powers in this area. HM Treasury (HMT) is leading this review as the department responsible for financial services and securing stability and consumer protection in the sector, as well as ensuring the sector contributes to the economy in terms of growth, employment and government revenue. The free movement of capital and of payments is of significant importance to financial services as well as to investment and the trade in goods and services across broader business sectors. In this regard, HMT has lead responsibility for macroeconomic issues and the efficient allocation of capital within the UK and UK-owned capital internationally.

1.4 This review will focus on competences and legislation that affect, among others, banks, insurance companies, pension companies, asset managers and market infrastructure providers operating either exclusively in the UK or across borders. It also considers the EU competences on the free movement of capital and the effect of developments in the use of these competences on the financial services sector and broader economy. Annexes A, B and C respectively summarise the EU Treaty provisions and key pieces of EU legislation that are relevant for this review, and set out 'boundary' issues that other Balance of Competences reports will be covering, to help clarify what is in and out of scope of this report.

## Call for evidence

1.5 This public call for evidence requests input from anyone with relevant knowledge, expertise or experience; and we welcome contributions from individuals, companies, civil society organisations including think-tanks, and governments and governmental bodies. We welcome input from stakeholders within the UK and also those in other countries. **The call for evidence will run from 21 October 2013 to 17 January 2014.** Please send your evidence and related enquiries to balanceofcompetences@hmtreasury.gsi.gov.uk.

1.6 Please base your response on answers to the questions set out on page 41. You do not have to answer all of the questions – please feel free to answer as many or as few as you like. Your evidence should consist of objective, factual information about the impact or effect of the EU's approach to financial services and the free movement of capital. Where possible, please give specific examples. Where your evidence is relevant to other Balance of Competences Review reports, we will pass your evidence over to the relevant report teams.

1.7 We will expect to publish your response and the name of your organisation unless you ask us not to (but please note that even if you ask us to keep your contribution confidential we might have to release it in response to a request under the Freedom of Information Act 2000). We will not publish your name unless you wish it to be included. In responding, it would be helpful if you could indicate whether you are responding as, for example, an individual, a business, a trade union, a civil society organisation or a research institution.

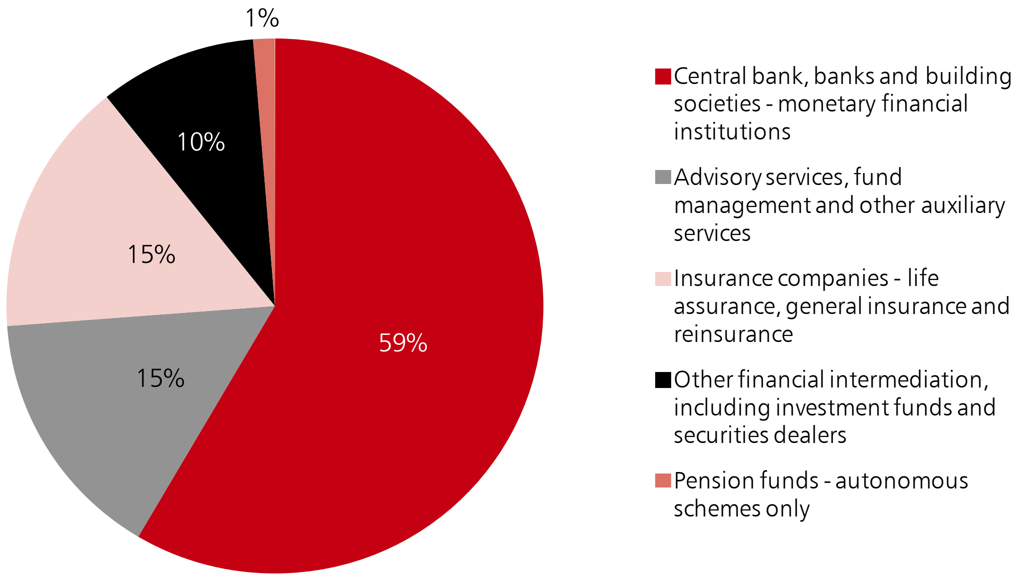
1.8 As part of the call for evidence process, we will also be holding stakeholder events where you will be able to give your views. To register your interest in attending one of these events, or to ask any questions about the call for evidence process, please email balanceofcompetences@hmtreasury.gsi.gov.uk.

## The role of the financial services sector and capital flows in the UK economy

1.9 The financial services sector is critical for the UK. It plays a key role in providing essential services to individuals and businesses and in its contributions to growth, trade, tax revenues and employment. It includes banks, building societies, credit unions, asset management firms, insurance and reinsurance companies, pension funds, advisory firms (including independent financial advisors), trading exchanges, market infrastructure and other firms that contribute to the functioning of financial markets.

1.10 From the perspective of individuals, the financial sector provides essential services from bank accounts and mortgages, through to car and home insurance, and to pensions. From a business perspective, the sector plays a critical role in providing access to finance (from start-up capital for smaller firms to debt/equity issuances for major corporations), products to help firms guard against risks (for example, price or interest rate changes), as well as the various constituent parts that help to ensure an efficient marketplace – all of which are provided to both UK and non-UK firms.

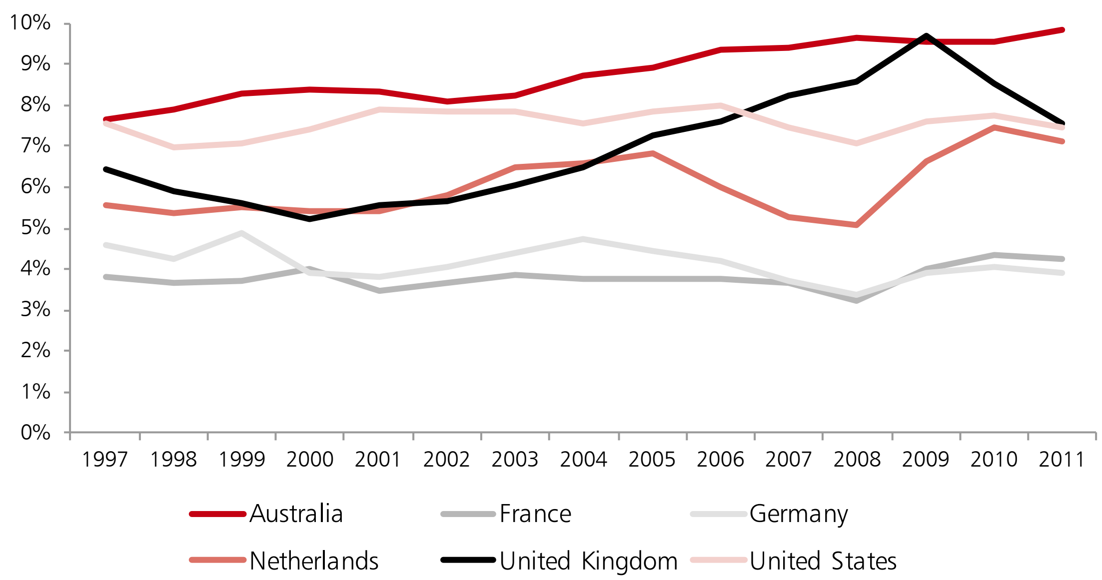
**Chart 1.A: Composition of the UK financial services sector[1] by value added, 2010**




*Source: Office for National Statistics (ONS) Index of Services.*

1.11 The sector makes important contributions to the economy through supporting growth, trade, tax revenues and employment, and – as Chart 1.B below shows – the UK financial services sector contributes more to the UK economy than respective financial services sectors do to most other major economies.

**Chart 1.B: UK financial services contribution to GDP, compared to other major economies**



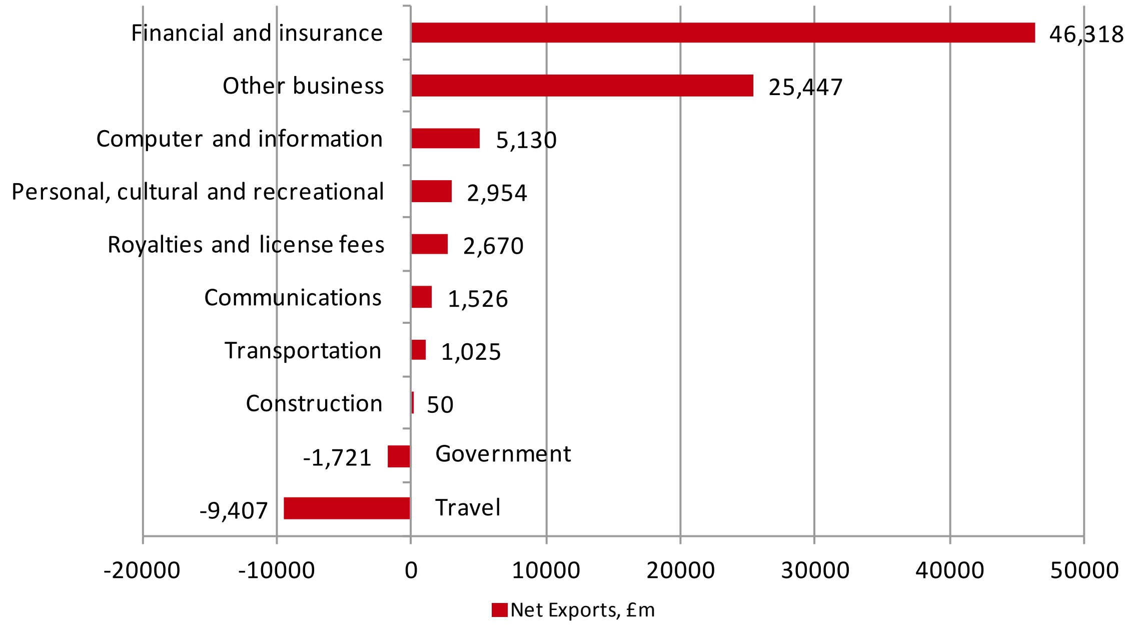

*Source: Organisation for Economic Co-operation and Development (OECD)*

[1] Based on Standard Industrial Classification 2007

1.12 According to the International Monetary Fund (IMF), the UK is also the largest net exporter of financial services, insurance and pensions in the world, with a trade surplus that is around three times that of any other country – in 2012, UK net exports in these sectors were $67 billion compared to $23 billion in the US, $21 billion in Luxembourg, $19 billion in Switzerland and $9 billion in Germany.

1.13 The UK financial and insurance services trade surplus also constitutes 63 per cent of the UK's total trade surplus in services of £74 billion – this is many times higher than the next biggest industry (see Chart 1.C). [2]

**Chart 1.C: UK trade surplus in services, 2012**




*Source: ONS Pink Book 2013*

1.14 The EU is the largest destination for UK exports of financial services, with around a third of the UK's trade surplus in financial and insurance services in 2012 coming from trade with other EU Member States – of the total £46.3 billion UK financial and insurance services trade surplus, £15.2 billion was with the EU, £14.5 billion with the US and £1.7 billion with Switzerland.[3] The UK's membership of the EU Single Market is a contributory factor to this relationship, in that it has facilitated UK access to the world's largest single market with GDP of €12.5 trillion and 500 million people.[4]

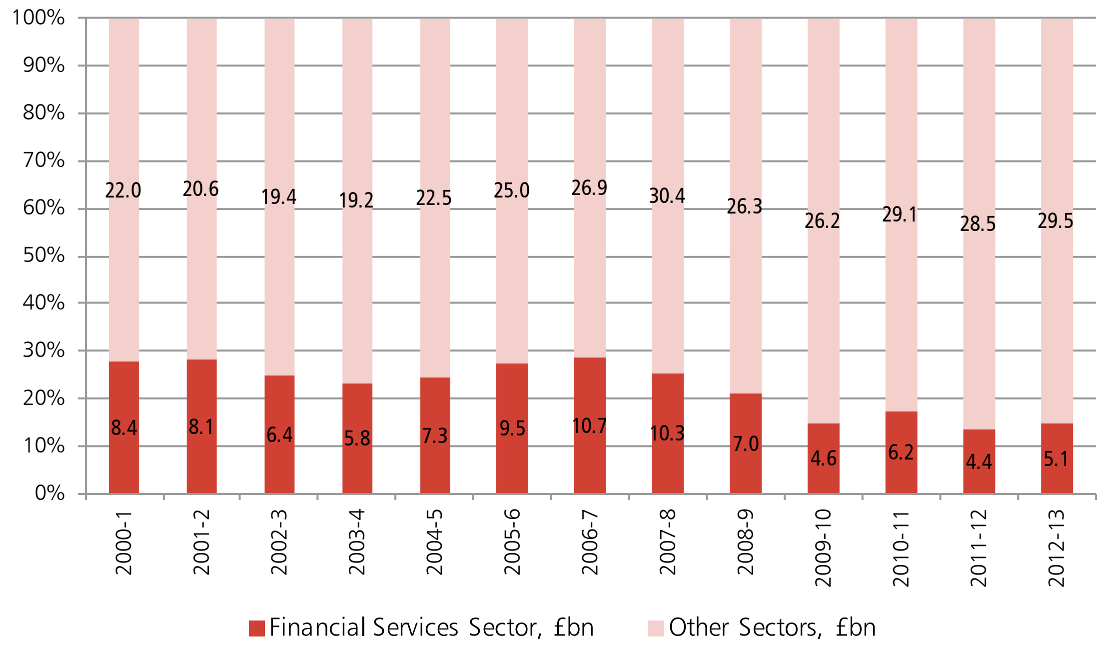
1.15 The UK financial services sector also provides a significant contribution to government revenues.[5] There are challenges in identifying the precise size and share of the overall contribution to tax revenues as sectors for different taxes are defined differently and so these sets of figures are not directly comparable.[6] Total Pay As You Earn (PAYE) Income Tax and class 1

[2] ONS Pink Book 2013
[3] Ibid
[4] Eurostat
[5] For more information on Pay As You Earn Income Tax and National Insurance contributions and Corporate Tax receipts from the banking sector, see http://www.hmrc.gov.uk/statistics/banking.htm
[6] It is not possible to attribute directly all revenues paid by the financial services sector across tax bases. For instance, HMRC does not require businesses in the financial sector to report the total amount of VAT that they incur if they are exempt – a 2010-11 survey suggested the sector paid £5-6 billion of irrecoverable VAT. In addition, HMRC does not hold information on the amount of businesses rates or vehicle excise duty paid by the financial sector as these are collected by other government departments, and it does not have a sectoral breakdown of customs duties, environmental taxes or transport taxes. Industry estimates, for example PWC analysis, suggest that the financial sector contribution to overall tax revenues is in the order of 12 per cent.

National Insurance contributions (NICs) received by HM Revenue and Customs (HMRC) in respect of employee and employer liabilities for the financial sector[7] were £27.5 billion in 2011-12, which represents 12 per cent of the total £230 billion of PAYE Income Tax and class 1 NICs received that year.

1.16 On corporation tax, HMRC estimate that the financial sector[8] paid a total of £5.1 billion in 2012-13,[9] representing 15 per cent of the total £34.7 billion of onshore corporation tax paid that year (an additional £1.6 billion was also paid by the financial services sector in 2012-13 as part of the Bank Levy, which was introduced from January 2011). However, this proportion is some way below the peak contribution in the last ten years of 29 per cent of all corporation tax receipts in 2006-7 (see Chart 1.D).

**Chart 1.D: Financial services contribution to onshore corporation tax receipts**




*Source: HMRC*

1.17 In 2008, the financial services sector was estimated to provide 1.4 million jobs,[10] of which around one million people worked directly in financial services and around 400,000 people were indirectly employed by the financial services sector in ancillary services, for example, legal, accountancy and consulting.[11]

1.18 The importance of the UK financial services sector extends beyond national borders to Europe and the rest of the world – the UK was considered the world's leading financial services centre according to the Global Financial Centre Index in 2013.[12] This interconnectedness with international markets means that the benefits of the UK sector – for instance, access to finance

[7] Based on the ONS Standard Industrial Classification definition of the financial sector
[8] Based on the Summary Trade Classification definition of the financial sector
[9] Life assurance is excluded from this financial sector figure, as life assurance companies are taxed on a different basis to companies in other sectors.
[10] ONS: Annual Business Inquiry (2008); Business Register and Employment Survey (2008); Independent Commission on Banking: Interim Report (April 2011).
[11] See Independent Commission on Banking: Interim Report (April 2011) Annex 8 for methodology which suggests that direct employment in wholesale financial services is around 300,000 people, and that around 160,000 of those indirectly employed in ancillary services supported wholesale financial services.
[12] The Global Financial Centres Index 13, Z/Yen Group / Long Finance's 'Financial Centre Futures' Programme / Qatar Financial Centre Authority

and employment – accrue to many other countries, while UK firms across the sector benefit from these international linkages and access to other markets:

- The UK is the world's largest centre for cross-border borrowing, with 258 foreign banks operating in the UK in 2012 (more than in any other EU country);[13]
- The UK insurance industry is the largest in Europe and third largest in the world (after the US and Japan);[14]
- With an estimated £5.2 trillion of assets under management at end-2012, the UK is the largest asset management centre in Europe (accounting for around 36 per cent of the European market) and the second largest centre in the world;[15]
- The UK is the second largest global centre for hedge fund managers[16] and pension fund assets[17] after the US; and
- The UK is the largest centre of foreign exchange and over-the-counter (OTC)[18] interest rate derivatives activity with 41 per cent and 49 per cent of global turnover respectively in April 2013.[19]

1.19 The UK financial services sector also benefits from the "cluster effect", in other words the ability to source complementary professional services, such as legal or accountancy, in one location. Other factors, among many, that have contributed to the sector include: the quality and ease of using the English legal system; the integrity and enforcement of contracts; the UK's position as the central global timezone; the widespread use of the English language; London's position as a major transport hub with a wide range of links; and the general ease of doing business in the UK.

1.20 The recent financial crisis and the subsequent fragility in the global economy has, however, highlighted that the benefits of a large and interconnected financial services sector also come with risks, especially in the event of inadequate rules, safeguards or supervision. The impact of the crisis at the global, regional and national level – and the subsequent need to repair the damage and address the underlying causes of sectoral weaknesses – provides a stark reminder of the importance of financial stability and the need for robust regulation and supervision.

1.21 The UK works closely with other countries and in international fora, such as the G20, Financial Stability Board (FSB) and other standard setting bodies, to raise global financial regulatory standards in an internationally consistent and non-discriminatory way. Broadly speaking, these are then legislated at an EU-level and implemented by Member States, although the EU also takes forward much financial services legislation that is not specified in global standards (see Chart 2.A below).

1.22 In developing and implementing new standards and regulations in financial services, the UK Government seeks to achieve a range of different objectives, including financial stability, consumer protection, growth, competition, market efficiency, competitiveness, innovation, fiscal sustainability (for example, to help address long-term challenges such as pensions and long-term

[13] Bank for International Settlements (BIS) and European Central Bank (ECB)
[14] OECD Insurance Statistics 2012, measured by total gross premiums written from 2011
[15] UK Trade & Investment (UKTI) / Investment Management Association (IMA)
[16] UKTI
[17] OECD
[18] "Over-the-counter" derivatives refer to when these instruments are traded bilaterally, rather than electronically over platforms such as the derivatives exchange, Liffe.
[19] BIS – *Triennial Central Bank Survey: Foreign exchange turnover in April 2013 preliminary global results*, September 2013; *OTC interest rate derivatives turnover in April 2013: preliminary global results,* September 2013

care) and fiscal responsibility (notably to protect taxpayer resources from being required to support financial institutions).

1.23 The free movement of capital and payments is critical for the UK financial services industry, as well as other parts of the economy. It underpins the Single Market and allows the import and export of goods and services, facilitating the efficient use of capital and enabling firms and individuals to increase the returns on their investments and, through diversification, reduce risks. In the last 20 years, there has been an increase in the geographical diversification of UK citizens' assets, and over 40 per cent of the investments by UK pension funds, insurance firms and investment trusts in the corporate sector are now in overseas corporations.[20]

1.24 Some forms of capital movements may generate even broader economic benefits. For example, Foreign Direct Investment (FDI) is seen as particularly valuable in diffusing and increasing the return on innovations, by allowing strong, efficient and inventive companies to expand their operations overseas. In 2010, foreign-owned companies employed one in five private sector workforce employees in the UK, up from just over one in ten in 1997.[21] The UK has also attracted more FDI from the rest of the EU than any other Member State, and is the second largest source, within the EU, of FDI to other Member States.[22]

1.25 However, by increasing the interconnectedness of the financial sector, shifting the control of critical sectors of the economy, and increasing the complexity of companies' and individuals' income streams, international capital flows and payments generate a range of risks and challenges for the UK.

1.26 **Overall, the UK financial services sector plays a critical role in both the national and global economy, and the relationship with the EU and the Single Market has been a factor in the development of this. The free movement of capital underpins the Single Market and the interactions of firms – in both the financial services sector and others – that are based in the UK with EU Member States, as well as with other countries. This review seeks evidence and contributions from stakeholders with knowledge or experience of EU competences – and the exercise of these – in the field of financial services and the free movement of capital.**

[20] ONS Pension Trends 2013
[21] Nesta
[22] Eurostat

# 2 EU competences in financial services and the free movement of capital

2.1 This chapter sets out what we mean by competence, how the competences related to financial services and the free movement of capital have been used, and some of the key themes that have emerged in recent decades. These themes include: the approach to harmonisation of Single Market rules on financial services; institutional integration and the shift towards regional supervision, including through banking union; the challenges in the policy-making process, including consultations, impact assessments and ensuring there is proper and democratic due process; and the deepening of markets as a result of EU legislation on the free movement of capital, alongside the impact of exceptions from these rules.

## What does competence mean?

2.2 For the purposes of this review, we are using a broad definition of competence. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the Treaties give the EU competence to act, including the power to legislate, to adopt non-legislative acts, or to take any other sort of action. It also means examining areas where the Treaties apply directly to the Member States without needing any further action by the EU institutions.

### The Treaty Framework

2.3 The EU's competences are set out in the EU Treaties, which provide the basis for any actions the EU takes. Article 5(2) of the Treaty on European Union (TEU) sets out the principle of conferral which means that the EU can only act "within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein", and where the Treaties do not confer competences on the EU they remain with the Member States. The two main Treaties – the TEU and the Treaty on the Functioning of European Union (TFEU) – set out the legal basis for EU action in relation to various policy areas such as the Single Market, economic and monetary policy, and energy policy.

2.4 There are different types of competences: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy, unless the Member States are expressly empowered by the EU to act. In areas of shared competence, such as the Single Market, environment and transport, either the EU or the Member States may act, but the Member States may be prevented from acting once the EU has done so. In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act, but action by the EU does not prevent the Member States from taking action of their own. The Treaty bases most relevant to financial services and the free movement of capital – notably Articles 53, 63, 64, 65, 113, 114, 115, 127(6) and 352 TFEU – are summarised in Annex A.

2.5 The EU must act in accordance with fundamental rights as set out in the Charter of Fundamental Rights (such as freedom of expression and non-discrimination) and with the principles of subsidiarity and proportionality. Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the Member States to do so because of the scale or effects of the proposed action. Under the principle of proportionality, the content and form of EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.

**Box 2.A: What is the Single Market?**

The original concept in the Treaty of Rome, which came into force in 1958, was to create a common market covering the six members of the then European Economic Community (EEC). This involved a Customs Union and the free movement of goods, as well as provisions on the free movement of workers, freedom of services and establishment and (in a limited form) free movement of capital, known as the 'Four Freedoms'. There was limited evolution in the system until the mid-1980s when efforts to make a reality of the plans in the Treaty for a genuine single market for Europe received political impetus. In 1985, the Commission submitted to the Milan European Council a White Paper, *Completing the Internal Market*, which listed 279 specific legislative measures to be brought into force by 1992 and essentially set the agenda for the Single Market as we know it today. By 1992, almost all of the 279 measures had become law. However, in reality the Single Market was far from complete. The 20 years since 1992 have seen progressive deepening of integration with respect to the Four Freedoms.[1]

## The development of rules for the Single Market in financial services

2.6 One vision of the Single Market in financial services is one in which all national legal and regulatory obstacles to the cross-border sale or purchase of financial services across all Member States have been removed. To support the goal of a common market, the EU has taken two broad approaches:[2]

- **A system of mutual recognition**, so that each Member State recognises the regime applied in another Member State as broadly equivalent – this system relies on achieving an adequate set of core EU rules, and on them being applied objectively by Member States; and
- **The replacement of national rules with EU rules** – this approach relies on Member States being confident that the result will not weaken protective measures or introduce disproportionate and costly regimes.

2.7 In addition to helping to create a Single Market, these rules also help the EU and Member States achieve a range of broader objectives. These include protecting consumers, countering financial crime and ensuring financial stability. However, these same rules may also create barriers to firms establishing themselves in different countries – for example by imposing disproportionate regulatory burdens – and, once there, may inhibit firms from providing services in new or competitive ways.

### The international context

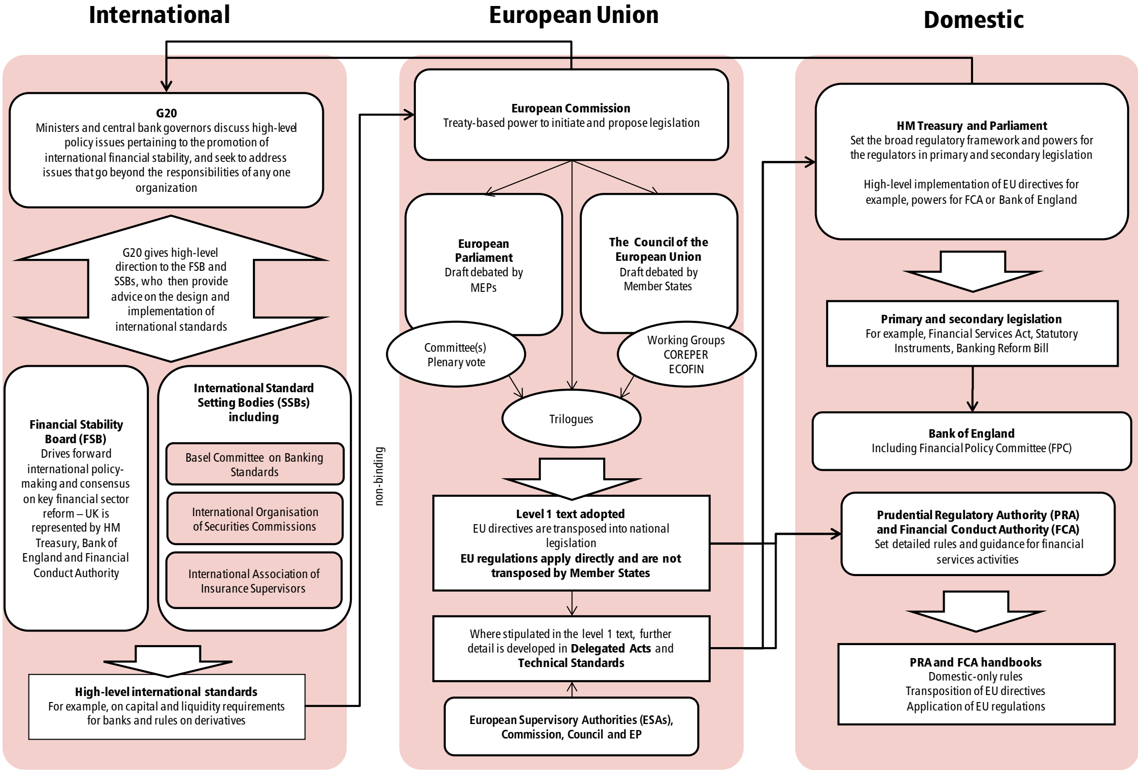
2.8 Efforts to find the right balance between these objectives are affected by the fact that commitments and standards to ensure the safety and soundness of the financial system, as well

[1] See *Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market* for a more detailed history of the development of the Single Market.

[2] The EU has also, in limited areas, adopted a 29th regime, i.e. an EU-level regime that does not harmonise Member States' laws, but sits alongside them, providing an alternative legal order. An example of a 29th regime is the European Company Statute, which provides for an undertaking to be incorporated in any Member State under the EU's Company Statute.

as individual financial institutions, are set at a global level through fora such as the G20, FSB and Basel Committee on Banking Supervision.

**Chart 2.A: Simplified and stylised diagram of international, EU and UK financial services policy-making process**




*Source: HM Treasury*

2.9 Global standards are essential in a world of globally-integrated capital markets where risk in one part of the world is transmitted quickly to the balance sheets of firms across the world. As a result, global standard setting bodies have been mandated to identify sources of risk and agree provisions that will effectively mitigate them. These are then given legal force by governments and regulatory authorities across the world and in the EU through legislation which is binding on the Member States. The intention is that these high-level, global commitments should give rise to broadly consistent standards and a framework of high minimum requirements across the world. These standards and requirements should then frame competition, rather than be a source of competitive advantage themselves.

2.10 International standards serve a further important function. In their absence, it is likely that there would be significantly greater divergences in supervisory practices, and these divergences would make it far harder for supervisors to understand the health or otherwise of firms and to agree on common supervisory programmes across supervisors. Furthermore, an absence of common standards would encourage countries to impose their own standards on firms based in other jurisdictions but whose operations still affected those countries. This practice of applying rules across borders is known as “extra-territoriality”, and there have been notable examples – including since the crisis – of countries seeking to assert their jurisdiction extra-territorially and of other countries seeking to prevent such assertion.

## Early steps towards European harmonisation

2.11 The first set of EU Directives in the field of financial services in the 1970s required Member States to impose an authorisation or licensing requirement on banks and insurers.[3] This set a foundation for market opening but did not make markets any more open or competitive, as a bank or insurer that wanted to establish a branch in another Member State would still be subject to that country's full regulatory control.

2.12 The early 1990s saw the next stage of harmonisation. National authorisation of banks and insurers was replaced by a system of home state authorisation and prudential supervision, which meant that the Member State in which a branch was established (the 'host state') no longer had significant prudential responsibilities or powers, and instead relied on the 'home state' authority to perform the necessary prudential supervisory functions (see Box 2.B below). This was followed by the harmonisation of conduct of business rules in the securities and markets sector.

[3] The first non-life directive was adopted in 1973 (73/239/EEC), the first life directive in 1979, (79/267/EEC) and the first banking coordination directive in 1977 (77/780/EEC).

**Box 2.B: The EU's Branching Regime**

The right to establish a branch is a fundamental freedom which the Treaty provides to firms. A branch is part of a company, and so it does not have a separate legal identity nor does it have its own capital. Furthermore, customers of a branch are customers of the company of which the branch is a part, and in an insolvency the creditors of the branch have a claim on the assets of that company. By contrast, a subsidiary is a separate corporate entity which is wholly or majority owned by another company. Because it is a separate legal entity, it has its own balance sheet (which is separate from that of its parent group) as well as its own regulatory capital. In the event of an insolvency, creditors of the subsidiary will have to look to the assets in that subsidiary and not to those of the parent company.[4]

The corporate structure which a firm chooses to adopt has important implications for supervisory control, consumer protection, competition and efficiency of resources. The EU's branching regime permits a bank incorporated in one Member State (the 'home state') to set up a branch in another Member State (the 'host state') or provide services remotely there – for example, through the internet – subject only to the authorisation and prudential oversight of the home state. Branching, therefore, offers firms the benefits of more streamlined corporate structures, more efficient use of capital, and the benefits of complying with fewer sets of duplicative rules. In competitive markets, these benefits should result in lower costs for consumers and other end users.

Transferring prudential responsibilities and powers over branches to the home state prevents host states from applying an authorisation requirement, or imposing capital or any other requirements concerning the competence of management, business strategy, or adequacy of systems and controls in any given firm. The EU's branching regime means that host states and their consumers must look to the home state for such protection. This protection will be credible only to the extent that the rules are adequate and are applied effectively. The collapse of Landsbanki during the financial crisis and the failure of Iceland to provide consumers with the compensation specified under EU law raised questions regarding the adequacy and sustainability of the EU's branching regime. Consumers in the UK and the Netherlands found themselves being compensated by UK and Dutch taxpayers rather than the deposit compensation arrangements in Iceland. It also raises questions around the relationship the EU and its institutions has with the EEA-EFTA states[5] and the EFTA Court.

2.13 By the end of the 1990s, there was concern that the Single Market project launched in 1986 had still failed to create a single market in financial services, and that the high costs of raising capital compared to other markets would hinder economic growth, especially in the new knowledge economy. This concern led to the adoption of the Financial Services Action Plan (FSAP), under which the European Commission brought forward a range of measures affecting Europe's financial sector.

## The Financial Services Action Plan: single rule-book for firms and consumer-focused action

2.14 At the start of this century, the development of the Single Market in financial services focused on three areas and has remained focused on these since:

[4] For a legal definition of a branch, subsidiary and holding company see the Glossary of definitions in the FCA Handbook: http://media.fshandbook.info/content/FCA/Glossary.pdf

[5] The European Free Trade Association (EFTA) is an intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its non-EU Member States: Iceland, Liechtenstein, Norway and Switzerland.The European Economic Area (EEA) comprises the EU Member States plus Iceland, Liechtenstein and Norway, and allows the EFTA-EEA states to participate in the EU Single Market.

- **The harmonisation of rules** so that firms could provide services throughout the EU on the basis of the same rules, thereby reducing the costs of complying with different rules and avoiding regulatory arbitrage (for example, public authorities could lower their own standards to win business to their market);
- **The convergence of supervisory practices** so that national supervision would not provide a barrier to the Single Market, supervisory arbitrage would be avoided, and similar supervisory objectives and outcomes would be pursued and achieved; and
- **The adequate identification of risks and appropriate mitigating actions** as part of EU-wide rules and supervisory practices.

2.15 Progress towards achieving these objectives has depended on how EU-level rules have been given effect by national authorities. Two tools have been deployed to address the risk of arbitrage: the creation of more EU-level rules; and the creation of three EU agencies (one for each financial sector) who have a predominantly system management role and have been charged with overseeing the effectiveness of supervision and the level of convergence (see Box 2.G on the European Supervisory Authorities). The challenges in fully harmonising EU rules are set out in Box 2.C on the EU single rule-book. In assessing the balance and use of EU and UK competences in these developments, it is necessary to consider the extent to which the right balance has been struck between the various objectives of financial regulation. It is also important to consider the kind of rules the UK would implement in the absence of an EU competence in this area and the extent to which UK rules would differ from existing legislation, bearing in mind the existence of global standards in financial regulation.

2.16 The convergence of EU supervisory practice has also raised some fundamental issues about how to ensure there is both effective supervision and coordination between the supervisors, for instance: the kind of rules needed to underpin supervision; the levels of institutional integration needed for euro area and non-euro area countries respectively; and whether the objective of convergence should be on ensuring identical supervisory practices or on the achievement of comparable supervisory outcomes. These issues are very current and are considered in paragraphs 2.40 to 2.42 below on banking union.

**Box 2.C: Creating a single rule-book for firms**

The creation of a single set of rules for firms in 28 Member States is an ambitious project. Over the last ten years, there has been a roughly ten-fold increase[6] in the volume of EU law on financial services as international standards have become more detailed and national rules have been replaced by EU-level rules, many of which are additional to rules that legislate and implement global commitments. Creating a single EU level rule-book raises a number of issues and tensions, notably:

- **The range of exemptions from rules**, where Member States may resist losing national discretions and get agreement from EU institutions to their continuation. For example, there are over 100 discretionary measures in the Capital Requirements Directive, which give banks in some Member States a competitive advantage over banks in others;
- **The proportionality of rules**, given that they operate within a framework of industry structures and behavioural practices that vary widely across the EU. As a result, a single set of rules may lead to significantly different outcomes across Member States;
- **The level of resources devoted to the economic analysis of financial markets** within the EU, and how to ensure that adequate assessment of the impact of rules is conducted prior to rules being adopted;
- **The extent to which the rules facilitate the use of new technologies or approaches to promote competition and permit innovation**, for example, fostering the development of market-based rather than bank-based financing;
- **The degree of harmonisation of rules**, and whether EU requirements should provide a floor below which no Member State is permitted to fall (minimum harmonisation) or should fully harmonise all requirements (maximum harmonisation) which would prevent Member States from introducing additional requirements and may limit their ability to address fully the financial stability risks posed by firms;
- **The form which the rules take and the respective benefits of Directives or Regulations**. Directives (which need to be transposed into national law) provide a degree of flexibility to national authorities. On the other hand, Regulations (which are directly applicable in Member States and are increasingly common in financial services legislation) provide greater consistency across the EU, although specific characteristics of national markets may not be recognised and legal ambiguities cannot be remedied by Member States;
- **The feasibility of the project**, as it may not be necessary to have identical rules for all aspects of all operations of all EU firms to secure the economic benefits of providing finance efficiently to the wider economy; and
- **Ensuring the policy-making process is robust and follows due process** (covered in paragraphs 2.44 to 2.48 below), given the centrality of this to the quality of legislation, especially with regard to Regulations where the legal quality cannot be improved by national implementation.

[6] HM Treasury analysis

**Box 2.D: Providing financial services to consumers**

Retail financial services[7] play an important role in the lives of EU citizens, and the retail financial market provides a wide range of services to consumers, such as current accounts, personal loans, mortgages, pensions and savings, and investment and insurance products.

In its 1999 Financial Services Action Plan, the EU set out objectives to create a single wholesale market and open and secure retail markets. The difference between a single wholesale market and a plurality of open and secure retail markets reflects the fact that some markets are naturally international, some national and some highly local. There are various reasons why markets may be national or local, including:

- the willingness of consumers to travel large distances (insurance broking and investment advice are often very local markets);
- the extent to which consumers are willing to establish a relationship with a firm whose name they do not know and trust;
- the high fixed costs for a firm seeking to enter a market, possibly because distribution channels are difficult to develop;
- local anti-money laundering laws, which may make the remote identification of a new client difficult and expensive; and
- the exposure to risk for firms when they provide services remotely, for example, property laws in the country of the consumer will determine how many years it may take to repossess a home when a mortgage holder has defaulted.

Consequently, while the idea of a single market in retail financial services may sound like a worthwhile goal, in practice there are significant challenges, including the preferences of consumers themselves. In its 2007 Green Paper on future EU policy on retail financial services, the European Commission acknowledged that financial retail services were not fully integrated and stated its aims of enhancing consumer welfare, facilitating cross-border financial activity, and helping individuals make sound financial choices.

EU initiatives that address the interests of consumers have done so by promoting the soundness and integrity of firms providing retail financial services, and/or setting out the frameworks for rules that govern interactions between firms and their customers in certain areas. An example is the Markets in Financial Instruments Directive (2004/39/EC), which includes provisions setting out the organisational and conduct of business requirements that should apply to investment firms, and harmonises certain investor protection provisions.

The manner in which retail financial services have developed on largely national grounds raises a variety of questions, including whether action to promote a single market in retail financial services would be effective and proportionate, whether further action in some areas (for instance, payments and retail banking) would be possible and useful, and whether the most effective tools would not be the use of harmonising laws but would instead be to identify and tackle anti-competitive structures and practices.

[7] "Retail" financial markets provide services to individuals and small businesses. In contrast, "wholesale" markets generally concern transactions between larger entities such as financial institutions, investment firms such as pension funds, public sector organisations, and large companies.

## The impact of the financial crisis

2.17 The financial crisis is likely to be viewed as a pivotal event in the financial and economic history of the twentieth and twenty-first centuries, due not only to the scale of the crisis – perhaps $9 trillion globally in lost output by the end of 2010[8] – but also in its unexpectedness. In the years leading up to the crisis, financial institutions, central banks, supervisory authorities and international regulatory standard-setters were increasingly confident that the business cycle could be tamed and that risk could be effectively mitigated.[9]

2.18 The crisis demonstrated the inadequacy of regulation and supervision across a range of areas, and – critically – a failure by key players to understand in full the nature of the risks that were being taken on. Those who supervised and ran the financial system failed to: notice or respond to the build-up of risk (including the excessive growth of credit and leverage); understand the impact of poor governance structures in financial organisations and excessive incentives for taking risks; and question the belief that all relevant risks were captured in market prices. They also maintained the belief that financial deepening, deregulation and the use of sophisticated instruments and models combined to make the financial services industry safer than it had ever been.

2.19 The financial crisis made clear that banks had been grossly undercapitalised and had been reckless in taking on risks which they did not understand and could not manage, that central banks had ignored the build up of credit and growth in asset prices, that supervisors had failed to consider that the financial system as a whole needed supervision (and not just individual firms), and that governments had failed to create mechanisms for resolving failing banks without tax-payer bail-outs.

2.20 The crisis caused a fundamental rethink, designed to make financial institutions – especially banks – safer. It triggered two global responses, and one further response that was specific to the EU. The two global responses were:

- **The reform of global governance** – the G20 replaced the G7/8 as the key political forum for economic and financial policy making, and membership of the international standard-setting bodies was opened up to reflect this change, for example in the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors; and
- **The reform of regulatory standards to address weaknesses the crisis had exposed** – the FSB, under the political direction of the G20, set the policy agenda for the international standard setters to reform the regulatory regime for financial services.

2.21 Beyond implementing international standards, the EU's particular contribution was to address weaknesses in the quality of national supervision by transferring powers from the national to the EU level. There was agreement that the EU level should have a system management role (see Box 2.G below on the European Supervisory Agencies). However, there is not a settled consensus between the European Parliament, the Commission and individual Member States about the future role, scope and powers of the new EU level supervisory bodies.

[8] *Crisis: Cause, Containment and Cure*, Thomas Huertas, Basingstoke, 2nd ed. 2011, page 1. Subsequent research published by the Federal Reserve Bank of Dallas has estimated that the final cost of the crisis through lost output for the US alone is likely to lie between $6 trillion and $14 trillion, i.e. equivalent to between 40-90 per cent of one year's output – see: *How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis*, T. Atkinson, D. Luttrell and H. Rosenblum, Federal Reserve Bank of Dallas Staff Papers No. 20, 2013: http://dallasfed.org/assets/documents/research/staff/staff1301.pdf

[9] The IMF's Global Financial Stability Report in 2006 summed up conventional wisdom in stating that: "The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks may be less vulnerable today to credit or economic shocks."

This lack of consensus is reflected in most negotiations over individual EU financial services Directives and Regulations.

2.22 Since the agreement to new international standards at the global level, the EU – alongside other jurisdictions – has been intensely legislating and implementing regulation on a vast range of financial services issues. In this regard, there has – arguably – been a shift at the EU level from a pre-crisis focus on identifying and removing obstacles to the free movement of financial services to a new, current focus on enshrining financial stability and consumer protection and addressing the risk of regulatory and supervisory arbitrage. Notable examples of recent EU legislation include regulation on the quantity and quality of capital and liquidity, the clearing of over-the-counter (OTC) derivatives, the supervision of credit rating agencies, market infrastructure, deposit insurance, and bank resolution.

2.23 The EU has not, however, merely copied international standards. In some areas, there has arguably been under-implementation, such as on the definition of regulatory capital. In other areas, such as remuneration, the EU has gone beyond international standards and brought in rules to prevent banks paying a bonus larger than 100 per cent of a salary, or 200 per cent with shareholder approval. Annex B provides a list of legislation across financial services sectors that has been agreed since the crisis or is still pending. In addition, Box 2.E below provides an overview of challenges that UK has made to the Court of Justice of the European Union (CJEU) on recent EU financial services legislation.

**Box 2.E: Current UK challenges with the Court of Justice of the European Union**

The UK has launched a number of challenges to EU financial services legislation:

- The UK is challenging **Article 28 of the Short Selling Regulation (EU 236/2012) at the CJEU**. Article 28 confers powers on the European Securities and Markets Authority (ESMA) to restrict or ban short selling. The UK contends that the Regulation unlawfully confers powers on ESMA, in contravention of the principle in the Meroni case (a piece of case law which established that an EU agency cannot be given a discretionary power that may make possible the execution of economic policy) because of the broad nature of the powers conferred on ESMA with few limits on ESMA's discretion to decide when or how to exercise its powers. The UK also queries whether Article 28 is compatible with the legal base of Article 114 of the TFEU;
- The UK is challenging the **July 2011 location policy of the European Central Bank**, and related subsequent documents. The location policy specifies that clearing-houses that clear euro-denominated financial instruments above a certain threshold must be located in the euro area. The UK contends that this policy restricts fundamental Treaty freedoms important to the Single Market, relating in particular to freedom of capital, choice of establishment, and proportionality;
- The UK is challenging the **January 2013 Council decision authorising eleven Member States to proceed with a financial transaction tax (FTT)** under the enhanced cooperation procedure. The UK's principal grounds relate to the extraterritoriality of the FTT being authorised. The UK has also submitted that the authorising decision breaches Article 327 TFEU (respect for non-participants' competences, rights and obligations), is not consistent with customary international law, and is contrary to Article 332 TFEU because it authorizes enhanced cooperation for an FTT, the implementation of which will inevitably cause costs to be incurred by the Non-Participating States; and
- The UK is challenging the **lawfulness of the bonus cap ratio provisions in Article 94 of the Capital Requirements Directive** (Directive 2013/36/EU – "CRD IV") and other related remuneration disclosure provisions in Article 450 of the Capital Requirements Regulation (Regulation EU 575/2013 – "CRR"). The UK position is that the legislation lacks an evidence base, is not fit for purpose, and will not improve stability across the banking system – and that the proposals will lead to an increase in fixed salaries which would do the opposite.

2.24 These changes at both the global and EU level have focused on making the financial system stronger and more resilient. In parallel, there has been a need to clean up the impaired balance sheets of Europe's banks, ensuring that losses are recognised and that additional regulatory capital is raised. Capital raising has been particularly challenging for some banks, especially in those euro area countries which are fiscally stretched. Banking union is one policy response to this challenge. It is notable that businesses in Europe are significantly more dependent on bank finance than those in the US, where there is a deeper and more active securities market for debt. It may be that a further policy response to the weakness of Europe's banks should lead the EU to consider whether and how to diversify sources for lending to the wider economy.

## Third Country access to the Single Market in financial services

2.25 As the EU has worked to replace national rules with EU-level rules, attention has focused on whether the EU should also have a harmonised regime in terms of whether and how firms located outside the EU (known as "Third Countries") can access EU markets.

2.26 Traditionally, EU law allowed each Member State to decide whether, and on what terms, firms from Third Countries could provide services in the EU.[10] This was based on the fact that the costs of financial system failure are borne by national, not EU, budgets and that Member States have financial industries of vastly different size and sophistication with differing customer needs.

2.27 Two broad approaches have been followed by Member States: one based on a policy preference for liberalised, open markets; the other based on the principles of equivalence and reciprocity. Equivalence means that firms only have access to the EU where their home state has regulatory standards that are equivalent to those of the particular Member State, and reciprocity means that firms from the Member State need to be granted equal access to the markets of the Third Country. The UK has historically adopted a more liberalised approach, which has often been considered a key factor in the UK's standing as a leading global financial centre.

2.28 Since the financial crisis, there has been a change in the Commission's policy from allowing each Member State to determine for itself the level of access for Third Country firms, to enforcing a common approach based on the principles of equivalence and reciprocity. However, these principles raise a number of complex issues, including the degree of equivalence that is deemed sufficient and the kind of obstacles reciprocal treatment needs to consider, such as legal barriers, anti-competitive market practices and private sector monopolies.

2.29 **The issues in this section raise a number of complex questions about the appropriate balance of powers between the EU and the UK (as well all Member States), on which this review welcomes views and evidence. These issues include:**

- **the impact of EU action in financial services on UK organisations and individuals;**
- **the quality of legislative output and the impact of EU rule-making, including the balance between various objectives such as financial stability, growth, competitiveness and consumer protection;**
- **whether national rule-making would provide better or worse outcomes and the balance between global commitments and regional implementation;**
- **the impact of the EU's approach to Third Country access on UK firms and other stakeholders, including the impact of greater harmonisation on the flow of financial services and capital between the EU and the rest of the world;[11] and**
- **the legislative and non-legislative steps the EU should take over the next five years to ensure that the wider economy is able to secure the funding it needs.**

[10] These decisions have been subject only to two limitations: first, that a Member State could not offer access to Third Country firms on a more advantageous basis than it offered firms from other Member States; and second, that a Third Country firm could not use the EU passport without first incorporating in a particular Member State, and thereby becoming an EU national.

[11] The *Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment*, led by the Department for Business, Innovation and Skills, covers the UK's broader trading relationship with non-EU countries (including Free Trade Agreements).

## Changes in the allocation of powers between the EU and national levels

2.30 The rules of the Single Market in financial services allocate powers and responsibilities between Member States. This allocation of responsibilities is determined by whether the firm chooses to operate in a Member State as a subsidiary, branch or a provider of services remotely (for example, by e-mail, the internet or the telephone) or instead has established the group's head office in that Member State. A firm's choice of corporate structure will thus determine what powers a Member State may exercise over it, and therefore the elements of financial stability or consumer protection which are provided by another Member State. As a result, the rules require some Member States to exercise specific powers over financial institutions and prevent others from doing so.

2.31 Given the various interactions by financial services firms across Member States, the competitive benefits of the Single Market are sustainable only if the key rules are the same and the quality of supervision is broadly comparable. There are two important elements to this, both of which the EU is currently seeking to address: one is to ensure that national supervisors have the same set of powers; the second relates to the use of powers in practice.

### Harmonising the powers of supervisory authorities

2.32 The last decade has seen a significant harmonisation of powers, with EU Directives in the banking, securities and insurance sectors requiring Member States to ensure that their supervisory authorities have a common minimum set of powers. This has recently been extended to the area of enforcement. See Annex B for a list of key EU legislation that has supported the harmonisation of supervisory powers.

### Application of supervisory powers

2.33 The other aspect of supervisory convergence is the way the powers are used, and there are broadly three views. The first is that a given risk should be addressed by supervisors using the same tool with the same intensity, meaning that a firm would receive identical treatment wherever in the EU it happened to be located. Supporters of this view argue that it is the only way to ensure consistent standards of supervision and to prevent supervisory arbitrage.

2.34 The second view is that the focus should be on the convergence of supervisory outcomes rather than processes. In other words, that the focus should be on maintaining financial stability and protecting consumers, and that the use of different tools to different degrees is justifiable so long as the same, appropriate outcomes are achieved. Supporters of this view argue that there is no evidence on the impact of supervisory tools, and that the supervisory judgement needed to mitigate risks would be constrained if EU law removed such discretion for different approaches.

2.35 The third view is that a single European supervisor (or one for each sector) would ensure consistent supervision across the EU or at least consistent standards. This approach is being adopted as part of the banking union. The European Central Bank (ECB) is developing a Supervisory Manual that those within the banking union will be bound to follow, which will significantly increase supervisory convergence among participating Member States, as the ECB will become responsible for the prudential supervision of banks based in those Member States. In addition, the European Banking Authority is responsible for developing a non-binding Single Supervisory Handbook which will "set out supervisory best practice in methodologies and processes"[12] for all EU Member States.

[12] At the time of writing, the amendment to Article 8 of the EBA regulation has not been published, but it is expected that Article 8 will be amended to reflect this point: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-212

## Responsibility for supervision

2.36 Until this century, financial services supervision remained a wholly national competence. This was justified on the basis that, in the event of a financial crisis, only national governments and their taxpayers could provide financial support to institutions as there is no "EU taxpayer" and the size of the EU budget and the use to which it may be put are strictly limited by Treaty. Therefore, fiscal responsibility and responsibility for supervision and resolution should be aligned.

2.37 Those who argue that supervision should be transferred to the EU level point to the fact that, just as a single currency requires a single central bank, so the EU could not create a true single market in banking, securities or insurance and pensions without a single supervisor in each of those areas. The financial crisis has also highlighted that many Member States cannot afford to support their financial institutions especially in the banking sector (although see Box 2.F below on state aid when they have chosen to provide financial support), that there has been a need for burden-sharing through loans from some Member States to others, and that considerable support from the ECB has been necessary. Given the need for such burden-sharing, it has been argued that there should be a shift towards euro area-level supervision to align fiscal and supervisory responsibility and avoid the risk of moral hazard (ie that one Member State will adopt more risky behaviour because they know that another will help them to cover their losses). This is an argument which has particular resonance within the euro area (see paragraphs 2.40-2.42 below on banking union).

**Box 2.F: State aid and the EU banking sector**

State aid rules prevent Member States using taxpayers' money to give their own business sectors an unfair competitive advantage over other undertakings. The European Commission has exclusive competency to decide on the compatibility of state aid with EU rules and to formulate state aid guidelines.

During the recent crisis, the EU state aid framework for banks was relaxed and special temporary rules were adopted to allow Member States to support the banking system. The Commission adopted a framework to ensure financial stability while minimising distortions of competition between banks and across Members States in the Single Market. Between October 2008 and October 2012, the Commission approved a total of €5 trillion[13] (equivalent to 40 per cent of EU GDP) of state aid to the EU banking sector. This support was spread across a wide range of institutions across the EU, including Royal Bank of Scotland, Banque Populaire, Dexia and Commerzbank. These state aid rules have been regularly updated, where necessary, to adapt to the evolution of the crisis. On 1 August 2013, the European Commission published and introduced a revised set of guidelines, as they felt the previous framework was creating market fragmentation and was no longer fit for purpose.

State aid rules are central to the EU banking resolution framework and banking union discussions, and also have specific implications for cases where the UK Government has provided state support during the crisis. At some stage, the European Commission is expected to re-establish a permanent framework for banking sector state aid. Issues that may need to be considered, specifically for the banking sector, include: whether there should be a stand-alone state aid framework for banking, given the potential impact of banking failure on the real economy; how rules can help prevent moral hazard; and how the framework reflects broader EU resolution tools and burden-sharing principles.

2.38 In 2000, amid concern that Europe's securities markets were too fragmented and that the cost of capital to the wider economy was hindering economic growth, the Commission set up a 'Committee of Wise Men'[14] chaired by Baron Lamfalussy to identify reforms. The Committee recommended streamlining the legislative process, making more use of subordinate legislation and entrenching better regulation disciplines. It also considered the argument that the creation of a single market in securities required a single EU securities supervisor. The Committee concluded that most of the benefits of a single supervisor could be achieved by establishing a network of national supervisors. This network was established through the creation of three EU committees – one for each of securities, banking and insurance/occupational pensions.

2.39 Following the financial crisis, it was argued that the quality of supervision across the EU needed to be increased, and that this would be best achieved by giving the European level powers over national supervisors. The three EU supervisory committees were accordingly turned into EU agencies, under the collective name of the European Supervisory Authorities (ESAs), and given an enhanced role that focused on the management of the European supervisory system as a whole. National supervisors remained responsible for day-to-day supervision, although there are legal rules which set out both what supervisors must do and the oversight that the ESAs have to ensure supervisors coordinate their actions appropriately and do not breach EU law (see Box 2.G).

[13] European Commission

[14] Lamfalussy Report – see http://ec.europa.eu/internal_market/securities/lamfalussy/report/index_en.htm

**Box 2.G: European Supervisory Authorities (ESAs)**

The three ESAs are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).[15] Their tasks and responsibilities reflect their system management role and are to: deepen the Single Market through drafting rules and guidelines as mandated by EU Directives and Regulations; enhance the consistent application of EU law by investigating possible breaches; raise standards of supervision; identify EU-wide risks through stress tests and analysis of market trends; and undertake direct supervision in limited areas.

The ESAs also have some powers to take decisions binding on national supervisors and, in limited circumstances, on firms. The ESAs form part of the European System of Financial Supervision (ESFS) alongside national supervisors, the ECB in its future supervisory function in the banking union, and the European Systemic Risk Board (ESRB). While the ESAs are agencies, the ESRB is an EU committee and therefore its powers are limited. It undertakes macroprudential analysis of the EU's financial markets and may issue warnings regarding risks to the financial stability in all – or just a part – of the EU and make recommendations to mitigate such risk.

## Banking union

2.40 The recent euro crisis drove a realisation that a single currency requires greater political, economic and institutional integration than was originally envisaged. There is now agreement that monetary union requires a banking union – this is due to the intimate interconnection between currency stability and the stability of banks within a currency union. Steps have already been taken to establish both a single supervisory mechanism (SSM) and a single resolution mechanism (SRM) so that failing banks can be restructured, sold off or wound down in an orderly way with minimal cost to tax-payers or the wider economy.[16] This would also be underpinned by one or more resolution funds and a fiscal back stop provided by the European Stability Mechanism. The Commission has also envisaged that there will be a third element of banking union – a common system for deposit guarantees.

2.41 Even though many aspects of banking union have yet to be determined – and the UK government has been clear that it will not participate in banking union – it is evident that this deepening integration will have a profound effect on the Single Market and the UK's relationship with the EU in financial services as well as in other fields. Non-participating Member States, including the UK, have secured a measure of protection against the risk that the members of the banking union ignore the interests of the Single Market. These protections include: a prohibition on discrimination by the ECB; a requirement by the ECB to enter into a memorandum of understanding with supervisory authorities of non-participating Member States; voting safeguards in the EBA to address the risk that banking union members vote as a bloc; and a requirement for EBA members to strive for consensus.

2.42 It is possible that over time there will be a divergence of policy interests between participating and non-participating members. While the ultimate impact of banking union is hard to predict at this stage, it is likely to pose a number of challenges to the UK's interest in maintaining a central role of influence in an internationally competitive financial market in the

[15] The European Supervisory Authorities (also including the European Systemic Risk Board) were established in 2010 by Regulations of the European Parliament and of the Council numbered 1092/2010/EC, 1093/2010/EC, 1094/2010/EC and 1095/2010/EC.

[16] Final agreement to the regulations establishing the SSM is likely this autumn, and the Commission is aiming for the Council and Parliament to agree a general approach to the SRM Regulation by the end of this year.

EU. This will be especially pertinent if the number of non-participating states falls to four or fewer. At that point, the Commission will review the voting arrangements in the EBA designed to protect the interests of the Single Market (as perceived by non-participating Member States) from those of the euro area.

2.43 **Together, these steps towards institutional integration at the EU level – whether through the emerging role of the ESAs or the developments in banking union – are expected to have a profound impact on the UK as the largest financial centre in the EU, even though it is not a member of the euro area and is not participating in banking union. This review seeks evidence from stakeholders on the benefits and challenges that these developments have already created – and may create going forward – and the implications of these regarding the balance and use of EU competences in this area.**

## The policy-making process for EU financial services legislation

2.44 Since the crisis, there has been a very large EU legislative work programme on financial services. This has been accompanied by a drive, in part from international commitments, to design and implement new regulation as swiftly as possible. In light of this – and the critical need to ensure a high standard in rule-making if desired objectives are to be achieved – the quality of the policy-making process for EU legislation has become a key issue for financial services.

2.45 Policy-making in financial services is complex and requires an objective approach, high-quality evidence and extensive consultation, none of which are necessarily easy to achieve. At the outset, there should be clear identification of the issue the proposed policy is intended to address and the options for doing so, both of which require adequate consultation. It is then necessary to understand the impact of each option, including costs, incentives, unintended consequences, and the likelihood that proposals will achieve their objectives. This requires good data, which may not be readily available, as well as an assessment of options which may be technically complex. There are also risks that impact assessments may be drafted to justify a policy selected on other grounds. Consultation thereby helps to ensure the quality of the impact assessment. Finally, there should be objective evaluation after implementation to understand the effect of the chosen policy, and to learn about and avoid repeating any mistakes in future.

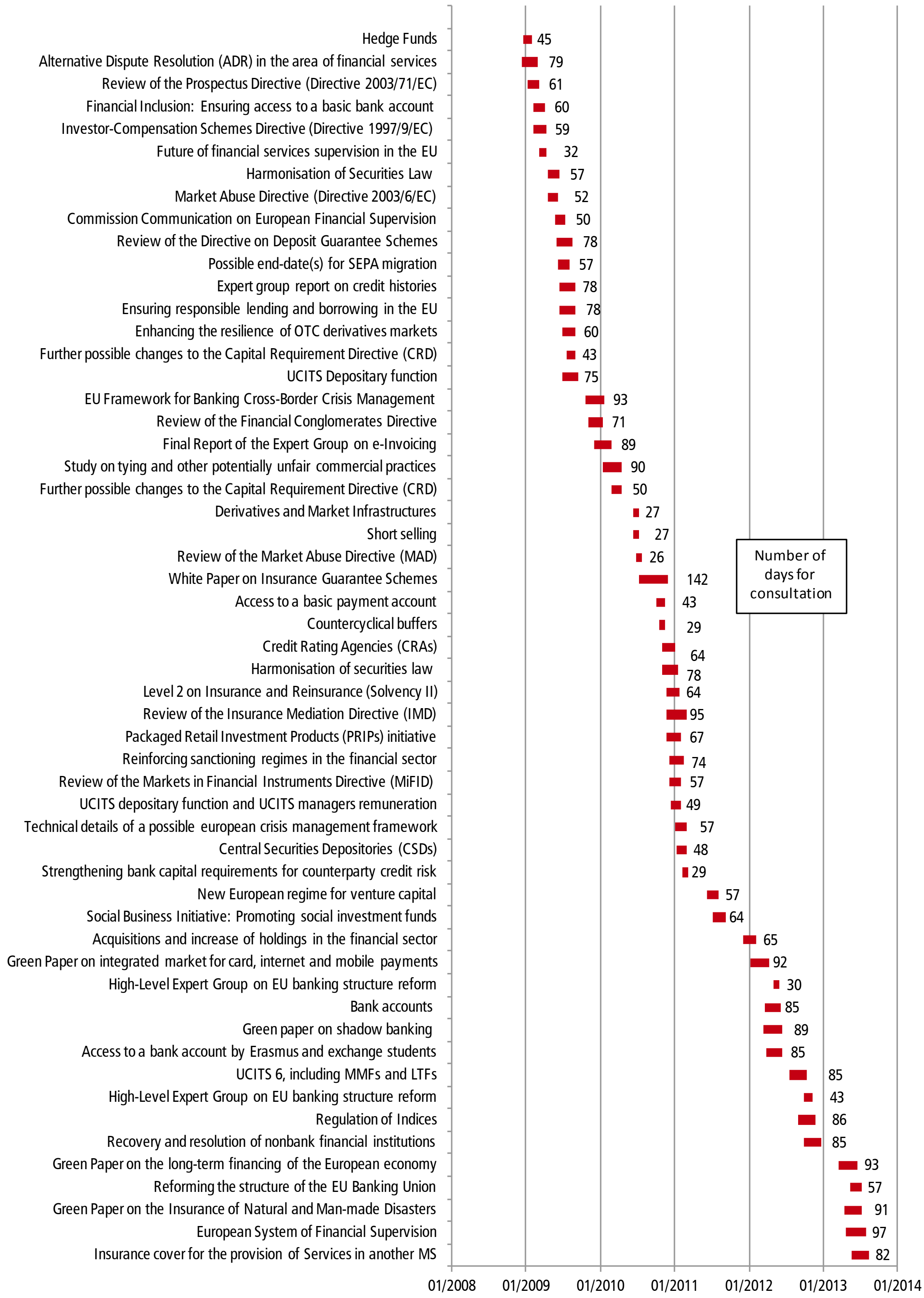
2.46 The European Commission has the sole right to propose new or revised EU financial services legislation (as opposed to national legislation), and therefore to decide whether legislative or non-legislative tools will be used – it is important for policy makers always to bear in mind that there are other tools beside legislation that may achieve a policy objective more effectively, for example action by competition authorities. The Commission is required to consult publicly before making formal proposals – see Chart 2.B for information on recent key public consultations on financial services legislation – and to undertake impact assessments to understand the potential consequences of its proposals. These are designed to gather evidence on the advantages and disadvantages of possible policy options by assessing their potential impact. The resulting impact assessments, which are published online, should also explain why action is necessary at the EU level and why the proposed response is appropriate and proportionate. The process is also intended to help bring transparency and accountability to the preparation of legislation. However, the Commission considers that it can publish an impact assessment only with its legislative proposal. This creates a risk that relevant information may be overlooked and a full range of options may not be considered.

2.47 Once the Commission's proposal is published, it is considered simultaneously by the two co-legislators – the Council (which comprises Member States) and the European Parliament. Under the ordinary legislative procedure, which applies for most financial services issues, the European Parliament is on an equal footing with the Council. Voting in the Council is by a qualified majority of Member States, with the larger Member States having more votes than smaller ones. Voting in the Parliament is by simple majority, with larger Member States having more Members of the European Parliament (MEPs) than smaller ones.

2.48 Both the Council and the European Parliament may amend the Commission's proposal and add substantive provisions which have not been subject to consultation or an impact assessment. Frequently, Regulations and Directives will contain legislative delegations, permitting the Commission to adopt subordinate legislation. Under the Treaty of Lisbon – and in the area of financial services – this subordinate legislation takes one of two routes:

- The delegation may be direct to the Commission, in which case the Commission does not have to consult or undertake an impact assessment, and the Council may prevent these rules being adopted only if there is a qualified blocking majority of votes against the proposal;
- The second route requires the relevant ESA to draft rules – known as Binding Technical Standards (BTS) – for the Commission to adopt with or without amendment. In recent years, the ESAs have had to draft a large number of BTS, some to very short deadlines. Although the ESAs are required to consult and undertake cost benefit analysis on them, the volume of BTS and the short deadlines contained in the empowering legislation may affect the quality of final rules.

## Chart 2.B: Key public consultations undertaken by European Commission on EU financial services legislation, 2009-13




*Source: European Commission*

**Box 2.H: The growth in importance of the European Parliament for financial services**

The origins of the European Parliament go back to the Parliamentary Assembly, provided for under the original Treaty of Rome in 1957, where it had a limited consultative role with regard to legislation and an oversight power over the Commission, including a power to question it and censure it. Since then, a series of changes have increased the legislative role for the European Parliament,[17] culminating most recently in the Treaty of Lisbon, which extended its co-decision powers – now entitled "ordinary legislative procedure" – as well as its powers with regard to subordinate legislation and delegated acts.

The Parliament's term, like the Commission's, runs for five years. Most of its business is conducted through 20 standing committees. The Economic and Monetary Committee (ECON) is the lead committee for financial services. Parliament can undertake own-initiative reports, but much of its work is legislative. Each Commission proposal is considered by the relevant sub-committees, and each of these will choose one of its members to be the 'rapporteur'. The rapporteurs draft their reports (in effect a set of amendments) to which other amendments are added by other MEPs. On important dossiers, 2000 or more amendments to the Commission proposal may be tabled. Members of each committee debate these and agree on a consolidated committee response. These committee reports are then voted on by the whole Parliament in a plenary session to achieve a single Parliamentary position. If there is political pressure to reach a first reading agreement, trilogues will be held with the Parliament, Council and Commission to negotiate an agreed single text. In the area of financial services, the European Parliament has therefore become the equal of Member States in terms of legislative power, and those MEPs who are members of ECON and take an interest in financial services have a significant influence on the content of laws which will apply in all Member States.

2.49 **Devising legislation in an area as complex as financial services and ensuring that it is appropriate across all Member States is challenging. The high volume of legislation and the drive to create a Single Market rulebook in financial services have also contributed to the challenge for policy-makers. Separately, the relative shift in legislative powers between European institutions has affected the policy-making landscape. This review would welcome any views on the quality and effectiveness of the process and the contribution this makes to the effective use of EU competences.**

## The development and impact of the Free Movement of Capital

### The Maastricht Treaty and scope of the free movement

2.50 The free movement of capital is one of the four fundamental freedoms which the Treaty safeguards, and it refers to all movements of capital from payments, portfolio investments and direct investment in a country to loans for the purchase of tangible property, bank-notes and financial guarantees. Prior to 1993, Member States were required to abolish restrictions on the free movement of capital, but only to the extent necessary to ensure the functioning of the common market. As a consequence, the free movement of capital was widely perceived as a necessary – but somewhat supporting – right compared to the other Treaty freedoms. However,

[17] For instance: the Single European Act (1987) gave the Parliament an effective legislative role (the "co-operation procedure") for those proposals based on the internal market treaty provision; the Treaty of Maastricht (1993) ushered in the European Union with a three pillar structure and introduced co-decision, which in the legislative areas agreed by co-decision made the Parliament co-equal with the Council, while also giving the Parliament a role in approving the Commission's appointment; the Treaty of Amsterdam (1999) extended the application of co-decision to most legislative areas in the Community pillar – the most notable exception being those connected to Economic and Monetary Union; and the Treaty of Nice (2003) saw a further extension in the legislative areas subject to co-decision.

the Maastricht Treaty (and specifically Article 63 TFEU) which came into force in 1993, moved the free movement of capital from the margins to centre stage by prohibiting all restrictions on the movement of capital and on payments.

2.51 There are some specific exceptions permitting Member States to impose restrictions on the free movement of capital (see below, paragraphs 2.62-2.69), but these are interpreted narrowly in accordance with the general approach of the CJEU. There are also some additional requirements on the form of some capital flows, with respect to the type of financial institution or market infrastructure which must be used to facilitate the transfer.[18]

2.52 The UK abolished exchange controls in 1979, 15 years before the Treaty of Maastricht prohibited inward and outward restrictions on the free movement of capital. The domestic impact on the UK of this Treaty freedom has, therefore, been limited. The UK policy of open markets means there were already very few restrictions on ownership of land, direct or portfolio investment, or the ownership of companies. As a result, from a UK perspective the dismantling of restrictions on the free movement of capital is a story of the deepening of the Single Market and the opening up of national markets in other Member States to competition.[19]

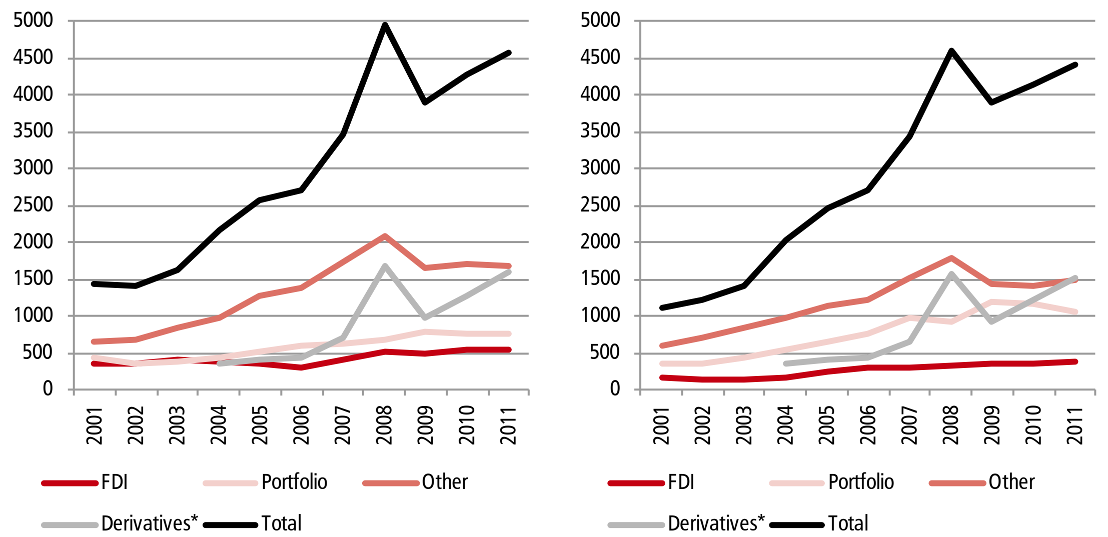
## The importance of the Free Movement of Capital

2.53 Cross border movements of capital and payments generate a range of benefits for firms, but also come with some associated risks (for example, see Box 2.I on capital controls). Greater freedom to allocate capital should increase the capital efficiency and output of national economies, while greater scope for overseas market entry and expansion by firms should increase benefits by increasing competition within national markets. The processing of payments and capital movements is a central function of the financial sector. Therefore, the free cross-border movement of capital and payments is essential for the development of a financial services industry – like the UK's – that is large relative to the rest of the economy and which serves numerous firms and individuals as well as the regional and global economy, as deeper economic integration requires cross-border payments to be made easily and cheaply.

[18] For example, under new EU legislation (Regulation on OTC derivatives, central counterparties, and trade repositories) movements of ordinary derivatives must be facilitated by a centralised clearing counterparty, such as LCH.Clearnet. This is in accordance, however, with an international G20 commitment designed to increase the resilience and transparency of global derivatives markets.
[19] This has also been underpinned by Economic and Monetary Union, an area that will be addressed in a separate report in the fourth semester of the Review of the Balance of Competences.

**Chart 2.C: UK financial account position with the EU**

Assets (£bn) Liabilities (£bn)




*Source: ONS; * ONS first began reporting on the UK international derivatives position in 2004*

2.54 Since the Treaty of Maastricht, the rate of cross-border investment activity involving the UK and other EU countries has increased. However, this period also saw greatly increased global trade in goods and services, including the substantial opening up of large parts of the world to international trade, as well as a series of innovations in financial markets. As a result, there are challenges in determining the precise impact of EU legislation regarding the free movement of capital. Although the UK is part of global agreements on capital movements – for example, the OECD undertakings with regard to capital movements – the TFEU articles on the free movement of capital are by some distance the most wide-ranging and binding, with respect to both other Members States and third countries.

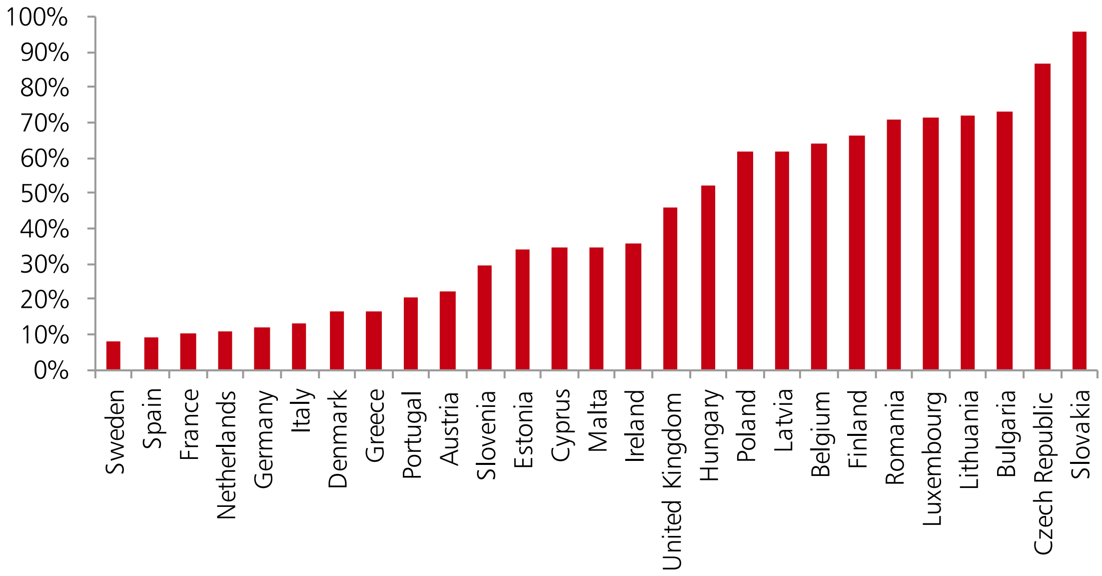
2.55 The following sections focus on some of the key areas affected by the Article 63 TFEU provisions on the movement of capital, including foreign direct investment, portfolio investments, cross-border assets and other financial investments. As completely free movement of capital may, in some cases, erode the ability of national governments to pursue legitimate objectives, there are specific and general exceptions to the free movement, which are set out below.[20]

## Developments in cross-border bank assets and other financial investments

2.56 The UK has the largest banking sector in the EU, measured by assets, and the largest level of cross-border banking activity, by some margin, with around triple the extra-EU claims of any other EU national banking sector. The share of foreign bank assets in the UK banking system is greater than most in the EU, and – outside the newer Member States – is only exceeded by Belgium, Finland and Luxembourg (see Chart 2.D below)).

[20] The *Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment*, led by the Department for Business, Innovation and Skills, covers extra-EU foreign direct and portfolio investment; this report covers all other extra-EU capital flows (given that these tend to be instruments structured by the financial sector) and all intra-EU capital flows.

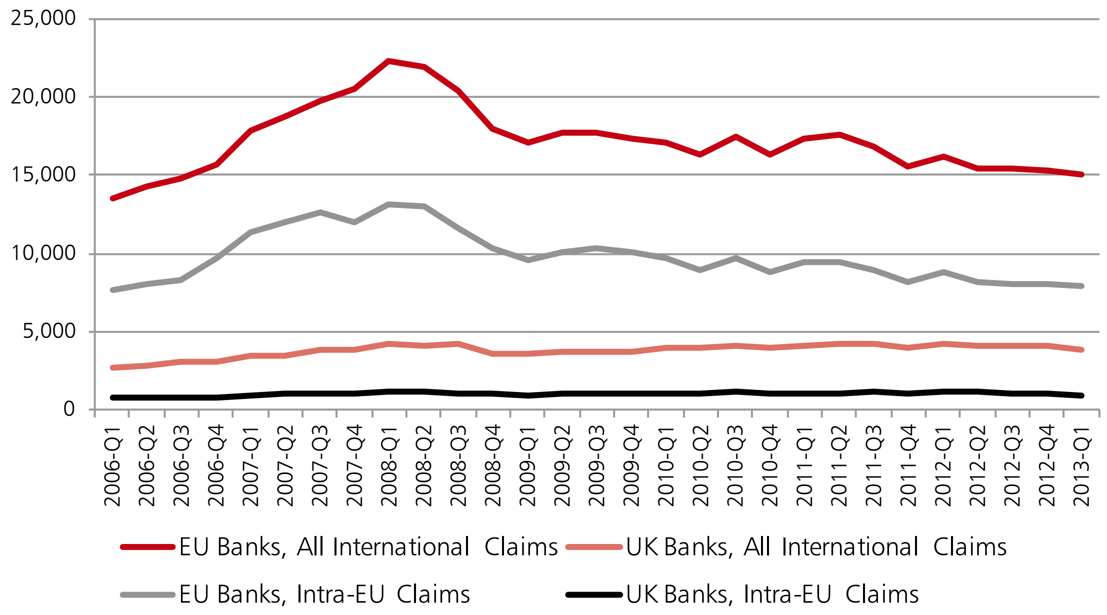
**Chart 2.D: Share of Foreign-Owned Bank Assets in EU Member States, 2012**




*Source: ECB*

2.57 After the Maastricht Treaty came into force in 1993, there was a rapid expansion of cross-border banking in EU countries, particularly on an intra-EU basis. This developed primarily on the basis of cross-border interbank lending, although much of this supported lending to the real economy. However, the resulting interconnectedness of the EU banking sector increased systemic risk and left much of the sector highly exposed to a shock to wholesale funding sources, including the interbank market. Since the financial crisis, the level of cross-border banking by EU banks has gone sharply into reverse, both in absolute terms and relative to total banking assets (see Chart 2.E below).

**Chart 2.E: Development of Intra and Extra-EU Bank Claims ($bn)**



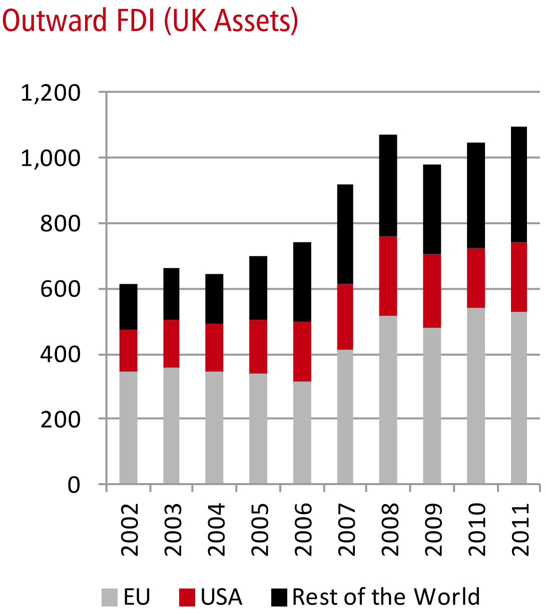

*Source: HMT analysis based on Bank of International Settlements data*

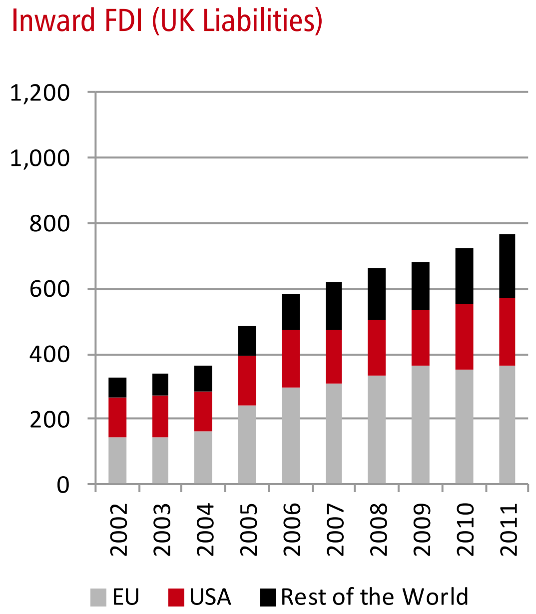
2.58 In some cases, this was a requirement of Commission state aid decisions, for instance, where the Commission required a scaling back of foreign activities (which were perceived as non-core for troubled banking groups) when those banks had required government assistance. National biases on the part of bank management and home regulators may also have played a role, as well as the perceived risks of redenomination within the euro area.[21] The level of cross-border banking by UK banks has been subject to much smaller relative and absolute decline than banks domiciled in the rest of the EU as a whole.

## Developments in Foreign Direct and Portfolio Investments[22]

2.59 Although the UK financial sector plays a role in facilitating foreign direct investment (FDI) – and indeed itself attracts a degree of FDI from the EU – the most important aspects of intra-EU FDI for the UK are in relation to other sectors. For example, the UK's largest FDI holdings in the EU are in the information and communication sector, while the UK retail and wholesale trade sector has received the most FDI from the rest of the EU. FDI enables efficient and innovative companies to expand overseas, transferring knowledge in the process, with resulting benefits to the domestic economies both receiving and generating a particular investment.

**Chart 2.F: UK FDI Stocks (£bn)**




*Source: ONS*

2.60 The proportion of the UK's FDI attributable to the rest of the EU has remained broadly stable in the last decade: around half of the UK's inward FDI is from the rest of the EU; and the EU has provided the destination for just over half of the UK's outward FDI. The net surplus of FDI that the UK holds with the rest of the EU has also remained broadly unchanged at around £200 billion. Compared to the UK, intra-EU inward and outward FDI forms a slightly higher proportion of total FDI in the rest of the EU.

[21] See, for example, Bank of England Financial Stability Paper No. 22, *Which way do foreign branches sway? Evidence from the recent UK domestic credit*, Hoggarth, Hooley and Korniyenko, and *Cross Border Banking* in the Bank of England Financial Stability Report, December 2009

[22] Foreign direct investment (FDI) is defined as an investment involving management control by the investor in the project, where management control involves a ten per cent or greater share of control of the company receiving the investment; while portfolio investment covers all other investment securities.

2.61 Bilateral investment protection treaties (BITs) constitute a common element of efforts to facilitate foreign investment by reducing the regulatory costs and uncertainties associated with foreign investment. The UK is signatory to 11 BITs with current EU Members States, and there are around 180 other BITs that exist between EU Member States. Intra-EU BITs exist almost exclusively between one of the 13 most recent Member States and one of the older Member States. The European Commission has argued that because these bilateral treaties apply only to investments involving two specified Member States (and are not available to all Member States) they are not compatible with the EU Single Market and so should be brought to an end. However, some Member States disagree with the Commission's interpretation of intra-EU BITs.

## Exceptions to the Free Movement of Capital

2.62 The free movement of capital under Article 63 TFEU is not an absolute freedom. In addition to the "grandfathered"[23] provisions on restrictions to the movement of capital, Member States may intervene in the movement of capital on the basis of a number of specific public policy concerns, notably: macroprudential regulation and capital controls; tax differentiation; public policy, public security, national security and defence; and financial sanctions.[24] Apart from the area of financial sanctions, the last decade has seen incremental additional limitations, as a result of CJEU rulings and EU Directives, on the ability of Member States to intervene in the free movement of capital to achieve goals in these areas.

### Macroprudential regulation

2.63 Cross-border banking activity played an important aspect of both excessive exuberance leading up to the financial crisis and in excessive pessimism following it. Some European banks tried to expand rapidly into non-domestic markets with which they were unfamiliar. As a result, they often took on imprudent credit risks. For example, the major UK-owned banks lost around fifteen times more on non-UK mortgages than on domestic mortgages, and around three-quarters of aggregate losses to UK banks during the financial crisis have been on their non-UK balance sheets,[25] particularly with respect to the Republic of Ireland. This has highlighted the need for banks to hold more capital and for regulators to identify and take action to limit bouts of excessive financial sector exuberance or pessimism.

2.64 Macroprudential regulation, one of the exceptions to the free movement of capital,[26] aims to increase the resilience of the financial system. As threats to financial stability emerge – for example, during episodes of rapid credit growth – regulatory requirements on financial corporations may be varied to smooth the financial and, hence, economic cycle. Within the UK, the Bank of England's Financial Policy Committee (FPC) will set macroprudential policy and the FPC has stated that its initial macroprudential policy tools will be the ability to vary the amount of additional buffer capital required across the banking sector in general and with respect to particular exposures banks have in a particular lending sector.[27]

2.65 When macroprudential authorities intend to put in place new measures, they should notify the European Parliament, the Council, the Commission, the ESRB and EBA, setting out the

[23] Article 64 TFEU has the effect of allowing any restrictions that existed under national or EU law on 31 December 1993 to be applicable to the movement of capital to and from third countries involving direct investment as well as establishment, provision of financial services or the admission of securities to capital markets.

[24] Restrictions placed on the movement of capital and payments to achieve foreign policy objectives were covered in The *Review of the Balance of Competences between the United Kingdom and the European Union: Foreign Policy* led by the Foreign Office and which reported in Summer 2013, and restrictions on the movement of capital and payments to achieve public security objectives will be covered in The *Review of the Balance of Competences between the United Kingdom and the European Union: Police and Criminal Justice* led by the Home Office and which will report in 2014.

[25] Speech by External Monetary Policy Committee Member Ben Broadbent on 15 March 2012.

[26] Article 65 TFEU safeguards some powers of Member States, including macroprudential supervision of financial institutions, so long as these powers are exercised in a non-discriminatory and non-restrictive way.

[27] A counter-cyclical capital buffer increases the requirement for banks to hold additional capital when risks are considered high.

reasons for the measures. Acting by qualified majority, the Council has the power – subject to certain criteria – to reject the national macroprudential measures proposed. Although it is envisaged that the rejection by Council of any national-macroprudential measure will be the exception rather than the rule, the allocation of this power to Council represents a potential restriction on national regulators.

**Box 2.I: Capital controls**

There is an international consensus that – in a limited set of circumstances, involving either capital inflows or outflows that are very large relative to the national economy[28] – formal, temporary controls on external capital flows can be beneficial for financial stability. However, countries like the UK – which have their own, free floating currency and deep, well-developed financial systems – are not likely to be subject to substantial risks as a result of sudden large capital inflows or outflows. If such flows do occur, such countries should be better able to manage them using market and more nuanced regulatory responses.

This is not necessarily the case for some other Member States, and exceptional and temporary capital controls can be implemented to deal with risks to financial stability. Cyprus implemented strict controls on the transfer of capital outside of the country to prevent bank depositor flight, following the bail-in of bondholders and depositors in the two largest Cypriot banks in March 2013. This is, to date, the only EU member state with a previously fully liberalised capital flows to impose generalised capital controls.

## Tax differentiation

2.66 Article 65 TFEU sets out that the liberalisation of capital movements and payments inside the EU and with third countries does not prejudice the right of Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation, regarding their place of residence or location of their capital investment. In practice, however, a series of judgments by the CJEU has limited this discretion for Member States. The CJEU has determined that differential tax rates relating to the same tax instrument – based solely upon the location of capital or residence of the individual – are discriminatory and breach one or more of the four freedoms.[29]

## Controls related to national, security, defence and public policy issues

2.67 Following the implementation of Article 63 TFEU, numerous controls remained in place relating to the direct investment in private companies deemed important to national public policy, security, and defence objectives.[30] In many cases, these controls were exercised by "golden shares" held by governments in particular companies. These golden shares enable EU national governments to maintain rights to name board members or have veto rights on commercial decisions without the level of ownership in the company that would conventionally confer such rights.

2.68 The UK has called for the removal of most golden shares arrangements for enterprises where there is no very significant national security and defence justification for continued

[28] See for example *The Liberalization and Management of Capital Flows: An Institutional View*, IMF

[29] See for example the *Manninen* case, where the CJEU ruled that a Finnish taxpayer should be granted a tax credit by the Finnish state on a dividend paid by a Swedish company, which had been taxed in Sweden, as such a credit would have been available upon a dividend paid by a Finnish company, taxed in Finland, and the differential treatment discouraged the free movement of capital.

[30] Article 65(1)(b) TFEU sets out that, notwithstanding the right to the free movement of capital and payments, Member States may take measure that are "justified on grounds of public policy", while Article 346 TFEU allows Member States to take action to protect their vital security interests which are connected with the production of, or trade in, arms, munitions and war material.

controls by the national government. Much of this movement was voluntary, for example, the removal of the government golden share in BT in 1997. However, in some instances the removal of golden shares have been forced by Court decisions, for example the removal of the golden share in the British Airport Authority (BAA).[31] Over the last decade, other Member States have also been required by the Commission to remove discretionary controls from firms including banks, car manufacturers and energy companies. In bringing these cases, the Commission has argued that these controls were not a proportionate way to achieve public policy objectives and should instead have been accomplished by transparent national regulation. As a consequence, the scope for discretionary action on changes in ownership and management in key domestic firms has been considerably reduced. Currently most of the private sector companies with golden shares held by the UK government have very significant roles in the production of defence materials, such as BAE Systems, Rolls-Royce and the Atomic Weapons Establishment. Many other Member States maintain similar controls in this area.[32]

2.69 By opening up more areas of the national economy, and by making key appointments more dependent on professional expertise than nationality or political connections, the removal of golden shares and controls could be expected to increase the efficiency of firms and the domestic economy. However, there have been concerns that controllers of a large part of the UK equity market could concentrate excessively on short term returns, to the detriment of focusing on long term stewardship of companies.[33] This, in theory, may generate a positive potential role for the national government to act in the long-term national interest and prevent changes in ownership and control within key private sector companies, where such changes cannot be expected to generate long-term value.

2.70 **The use of exceptions to the free movement of capital has been highly limited and has become increasingly restrictive over the last few decades. This review welcomes any evidence on the effectiveness of these in meeting their intended policy objectives, as well as on any unintended consequences across the broader economy which may have implications for the EU's competences – and exercise of its powers – in this area.**

[31] Case C-98/01 Commission vs UK

[32] See paragraph A.17 in Annex A for more legal background.

[33] See, for example, *The Kay Review of Equity Markets and Long-Term Decision Making: Final Report*

# 3 Call for Evidence

3.1 We welcome views on the balance of competences on financial services and the free movement of capital, in response to the following questions. For all questions, please try to give specific examples and provide evidence to support your view.

1. How have EU rules on financial services affected you or your organisation? Are they proportionate in their focus and application? Do they respect the principle of subsidiarity? Do they go too far or not far enough?

2. How might the UK benefit from more or less EU action? Should more legislation be made at the national or EU level? Should there be more non-legislative action, for example, competition enquiries?

3. How have EU rules helped or made it harder to achieve objectives such as financial stability, growth, competitiveness and consumer protection?

4. Is the volume and detail of EU rule-making in financial services pitched at the right level? Has the use of Regulations or Directives and maximum or minimum harmonisation presented obstacles to national objectives in any cases?

5. How has the EU's approach to Third Country access affected the ability of UK firms and markets to trade internationally?

6. Do you think that more or less EU-level regulation in the area of retail financial services would bring benefits to consumers?

7. What has been the impact of the shift towards regulation and supervision at the EU level, for instance with the creation of the European Supervisory Authorities? Should the balance of supervisory powers and responsibilities be different?

8. Does the UK have an appropriate level of influence on EU legislation in financial services? How different would rules be if the UK was solely responsible for them?

9. How effective and accountable is the EU policy-making process on financial services legislation, for example how effective are EU consultations and impact assessments? Are you satisfied that democratic due process is properly respected?

10. What has been the effect of restrictions placed on Member States' ability to influence capital flows into and out of their economy, for example to achieve national public policy or tax objectives?

11. What may be the impact of future challenges and opportunities for the UK, for example related to non-membership of the euro area or development of the banking union?

12. Do you have any further comments about issues in addition to those mentioned above?

# A Overview of Treaty provisions particularly relevant to this review

## Single Market: Financial Services

A.1 Various Treaty bases have been used, or are available to be used, to bring forward measures to promote the Single Market for the full range of financial services, including banking, insurance, investment and payment services as well as to regulate markets and market infrastructure. Most of these allow EU measures to be adopted using the "ordinary legislative procedure" (sometimes referred to as the "codecision procedure") described in Articles 289(1) and 294 TFEU. This involves a vote on the measure by the Council acting by qualified majority and the European Parliament. Others require agreement using a special procedure, which are described below where relevant.

### Article 53 TFEU

A.2 To make it easier for people to take up and pursue activities such as self-employment, Article 53 TFEU enables Directives to be adopted – using the ordinary legislative procedure – concerning the mutual recognition of diplomas, certificates and other evidence of formal qualifications. It also allows for the coordination of provisions laid down by law, regulation or administrative action in Member States related to the taking up and pursuit of activities as self-employed persons.

A.3 In the field of financial services, this Treaty basis has been used, for example, for the adoption of the Directives concerning capital requirements for credit institutions and investment firms and deposit guarantee schemes. [1] This Treaty base was initially used for all financial services legislation, but much legislation is now adopted under Article 114 TFEU because of the increasing trend towards instruments which harmonise the rules in a specific area and the preference for Regulations, which cannot be adopted under Article 53 TFEU.

### Article 113 TFEU

A.4 Article 113 TFEU confers on the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, a power to adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation. This power may be used only to the extent that such harmonisation is necessary to ensure the establishment and functioning of the Single Market and to avoid distortion of competition. Article 113 TFEU has been considered in *Review of the Balance of Competences between the United Kingdom and the European Union: Taxation*, but it is noted in the context of this report as the Treaty base for the Commission's proposal for a harmonised Financial Transaction Tax.[2]

[1] The Capital Requirements Directive 4 (CRD4) has Article 53 as its Treaty base, and the Capital Requirements Regulation (which is part of the CRD4 package) has Article 114 as its Treaty base.

[2] The proposal and information about the status of the proposal is available on the Commission's website: http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector

## Articles 114 and 115 TFE

A.5 Articles 114 and 115 TFEU relate to the establishment and functioning of the Single Market generally, and are not expressly linked to a particular freedom, right or sector. Broadly speaking, they provide for the 'approximation' of the laws of the Member States to improve the functioning of the Single Market. In other words, they allow for harmonisation measures to that end (which may take various forms[3]).

A.6 Article 114 TFEU allows for approximation measures "which have as their object the establishment and functioning of the internal market". The power to legislate in Article 114 has been central to the development of the Single Market, as it permits Directives, Regulations or Decisions to be adopted by a qualified majority (under the ordinary legislative procedure). It is, however, subject to certain express exclusions – for example, it may not be used to adopt fiscal provisions.[4] Although Article 114 TFEU is undoubtedly broad, there has been controversy about its outer limits. The CJEU has clarified that it is not enough simply to show that there are disparities between national laws. It must also be shown that removing those disparities would improve the functioning of the Single Market.[5] Article 114 TFEU has been relied on as a Treaty basis in a number of areas related to financial services, for example, the Financial Collateral Arrangements Directive, the Regulations establishing the European Supervisory Authorities (ESAs), and the current proposal for a Regulation on central securities depositories and improving securities settlement in the EU.

A.7 Article 115 TFEU is not subject to the same express exclusions that apply to Article 114 TFEU. However, Article 115 TFEU is more restrictively expressed and requires that only national laws that "directly affect the establishment or functioning of the internal market" may be approximated or harmonised. Furthermore, Article 115 TFEU is subject to unanimity, may only be used to adopt Directives, and is subject to the special legislative procedure, requiring unanimous agreement in Council and consultation with the European Parliament.

## Article 127(6) TFEU

A.8 Article 127(6) TFEU (ex-Article 105 EC) confers on the Council, acting unanimously by means of Regulations in accordance with a special legislative procedure,[6] a power to confer specific tasks upon the European Central Bank (ECB) concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

A.9 This legal basis was used for Council Regulation (EU) No 1096/2010 conferring specific ancillary tasks on the ECB concerning the functioning of the European Systemic Risk Board (one of the ESAs) which is responsible for the macro-prudential oversight of the financial system within the EU but is not an EU institution or agency. Article 127(6) TFEU is also the Treaty base for the proposed Regulation establishing the ECB as the supervisor of credit institutions in the euro area and those non-euro area Member States who choose to participate in banking union.[7]

[3] See, for example, *Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market*, paragraphs 2.53ff; https://www.gov.uk/government/consultations/call-for-evidence-on-the-governments-review-of-the-balance-of-competences-between-the-united-kingdom-and-the-european-union.

[4] Article 114(2) TFEU. The other expressly excluded categories relate to free movement of persons and the rights and interests of employed persons.

[5] Case C-376/98 Germany v. Parliament and Council (tobacco advertising I) [2000] ECR I-8419. See further, The Single Market Report, ibid., paragraphs 2.46 to 2.52.

[6] The Council is required to consult with the European Parliament and the European Central Bank before voting.

[7] The Commission's original proposal and information about banking union is available from the Commission's website: http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm

## Article 352 TFEU

A.10 Article 352 TFEU confers on the EU a general "residual" competence. This allows the Council to adopt appropriate measures where EU action should prove necessary within the framework of policies defined in the Treaties (such as the Single Market), and to attain one of the objectives set out in the Treaties, but where the Treaties have not provided the necessary specific powers. The Council can only use this by acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament. Article 352 TFEU could be used in relation to financial services. However, no examples currently exist of the use of this legal basis in this policy area.

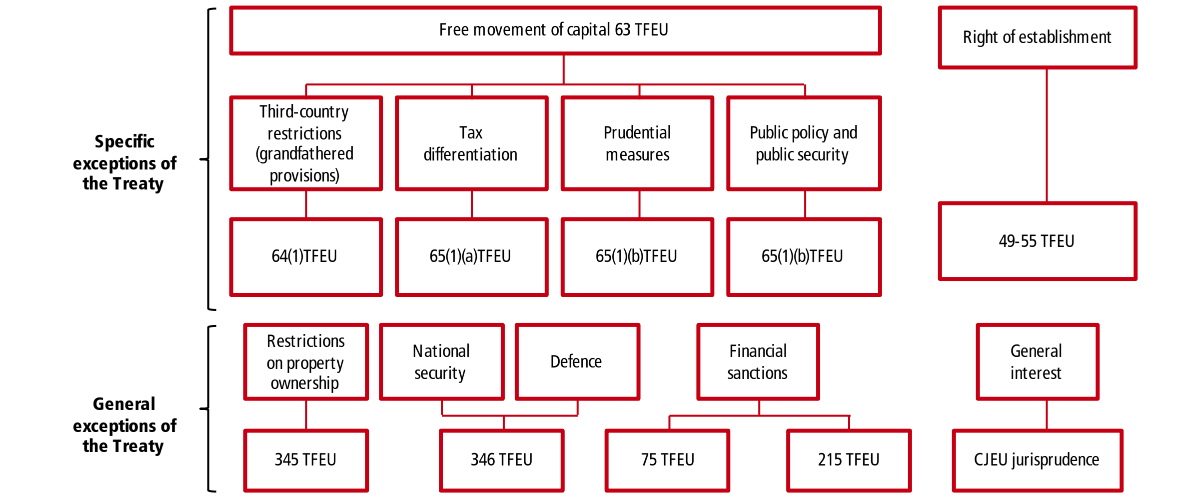
# Single Market: Free Movement of Capital

A.11 Article 63 TFEU specifies that, within the framework of the provisions set out in Chapter 4 of Title 4 of Part 3 TFEU, all restrictions on the movement of capital and on payments between Member States and between Member States and third countries shall be prohibited.

A.12 Notwithstanding the generality of Article 63 TFEU, Article 64 has the effect of grandfathering any restrictions under national or EU law which exist on 31 December 1993[8] that are applicable to the movement of capital to and from third countries involving direct investment as well as establishment, provision of financial services or the admission of securities to capital markets. The Council has power under Article 64(2) to adopt measures applicable to the movement of capital to and from third countries in the same areas, with the proviso (Article 64(3)) that measures involving a "step backwards" require unanimity and consultation of the European Parliament. Neither of these latter powers has been exercised.

A.13 Article 65 TFEU safeguards the powers of Member States, in particular in the areas of taxation and prudential supervision of financial institutions, so long as these powers are exercised in a non-discriminatory and non-restrictive way. Article 65(1)(b) also contains safeguards for measures justified on ground of public policy and security.

**Chart A.1: Exceptions to the Free Movement of Capital**




*Source: European Commission*

A.14 Prior to the Treaty of Maastricht, the EC Treaty contained a number of mechanisms for adopting safeguard measures in respect of capital movements. All these powers have now been

[8] I.e. prior to the entry into force of the Treaty of Maastricht or the date of accession in the case of newer Member States.

swept away, with the exception of what is now Article 66 TFEU. This provides for the Council to take safeguard measures with regard to third countries for a maximum of six months "in exceptional circumstances" and if such measures are "strictly necessary". This power has not been exercised.

A.15 The scope of Article 345 TFEU – relating to some of the "general" exceptions of the Treaty – has been very narrowly circumscribed by the case law of the Court of Justice. Although the system of property ownership continues to be a matter for each Member State under Article 345 TFEU, the Court has said that that provision does not have the effect of exempting the Member States' systems of property ownership from the fundamental rules of the Treaty. For example, Member States may choose how to exercise their ownership of public resources but Article 345 does not relieve them of their duty to comply with the rules relating to the free movement of capital. Nor can Member States invoke Article 345 to justify obstacles to investment in privatised undertakings. Free movement of capital, as a fundamental principle of the Treaty, may be restricted only by national rules which are justified by reasons referred to in Article 64(1) TFEU or by overriding requirements of the general interest. Furthermore, in order to be so justified, the national legislation must be suitable for securing the objective which it pursues and must not go beyond what is necessary in order to attain it, so as to accord with the principle of proportionality.

A.16 Other TFEU provisions empower the EU to adopt sanctions or preventative measures having an effect on the right of individuals to property. That is the case, in particular, in the fields of competition and of commercial policy as well as under the specific sanctions powers in Articles 75 and 215 TFEU.

### "Golden Shares"

A.17 In a series of cases known as the "Golden Share" cases, the CJEU held that the retention of government control in otherwise privatised undertakings was a restriction on the free movement of capital which could not be justified except in very limited and defined circumstances (for example, security of energy supplies: C-503/99 *Commission v Belgium*). In Case C-367/98 *Commission v Portugal* the Court said that what is now Article 63 TFEU "goes beyond the mere elimination of unequal treatment, on grounds of nationality, as between operators on the financial markets". So even though the rules in issue may not give rise to unequal treatment, they are liable to impede the acquisition of shares in the undertakings concerned and to dissuade investors in other Member States from investing in the capital of those undertakings. They are therefore liable, as a result, to render the free movement of capital illusory. In the second wave of Golden Share cases decided in 2003, in Case C-463/00 *Commission v. Spain* and Case C-98/01 *Commission v. UK*, the UK government ran the argument that a principle laid down in the *Keck* and *Mithouard* co-joined cases (Cases C-267 & 268/91) applied, suggesting that rules requiring prior authorisation from the national authorities before major structural changes occurred in newly-privatised companies or before more than a certain number of shares were acquired in those companies did not restrict access to the market and so did not affect the free movement of capital. The Court disagreed, adding that the restrictions "affect the position of a person acquiring a shareholding as such and are thus liable to deter investors from other Member States from making such investments and, consequently, affect access to the market".

# B Key EU financial services legislation

**Table B.1: Banking Sector**

| Regulatory capital |
|---|
| **Level 1**<br>• Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Capital Requirements Directive IV ("CRDIV")).<br>• Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (Capital Requirements Regulation ("CRR")).<br>• Repealed: Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast); Directive 2009/49/EC on the capital adequacy of investment firms and credit institutions.<br>• The above two Directives were together referred to as "the Capital Requirements Directive" and had been amended by the following Directives which are also no longer in force having been superseded by CRDIV: CRD III: Directive 2010/76/EU; and CRD II: Directive 2009/111/EC. |
| **Treaty Base**<br>• CRDIV has as its Treaty base Article 53 TFEU, the CRR has as its Treaty base Article 114 TFEU. |
| **Description**<br>• CRDIV, together with the CRR, contain rules on the authorisation of banks and investment firms, and the prudential supervision of banks and investment firms. They include prudential rules on such matters as capital, liquidity and credit risk, and set the framework for supervision by national competent authorities. |
| **Prudential supervision of financial conglomerates** |
| **Level 1**<br>• Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Directive 2002/87/EC) ("FICOD").<br>• FICOD has been amended by: Directive 2005/1/EC; Directive 2008/25/EC; Directive 2010/78/EU; Directive 2011/89; and Directive 2013/36. |
| **Treaty base**<br>• Article 47(2) TEC (now Article 53(1) TFEU). |
| **Description**<br>• FICOD sets out the rules for the prudential supervision of financial conglomerates and promotes closer coordination between the supervisory authorities for the individual sectors and the exchange of information between them. |
| **Deposit guarantee schemes** |
| **Level 1**<br>• Proposed Directive to amend Directive 2009/14/EC (under negotiation); Directive 2009/14/EC amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay; Directive 94/19/EC on deposit guarantee schemes ("DGSD"). |
| **Treaty base**<br>• Article 47(2) TEC (now Article 53(1) TFEU). |

**Description**

- The DGSD sets out requirements for Member States to establish deposit guarantee schemes to cover insured deposit balances to a specified limit in the event of the failure of a deposit-taking institution.

**Reorganisation and winding up of credit institutions**

**Level 1**

- Directive 2001/24/EC of on the reorganisation and winding up of credit institutions ("CIWUD").

**Treaty base**

- Article 47(2) TEC.

**Description**

- The CIWUD sets out the rules concerning bankruptcy proceedings in relation to credit institutions with branches in other Member States. In such cases, where a credit institution fails, the winding up process will be subject to a single bankruptcy proceeding initiated in the Member State where the credit institution has its registered office (known as the home state) and governed by a single bankruptcy law, that of the home state.

**Recovery and resolution of credit institutions and investment firms**

**Level 1**

- Proposed Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (under negotiation) ("RRD").

**Level 2**

- Various level 2 measures envisaged in the proposal.

**Treaty base**

- Article 114 TFEU.

**Description**

- The RRD establishes a common set of rules concerning the recovery and resolution of credit institutions and investment firms. In particular, it will require Member States to ensure that their resolution authorities have a common minimum set of resolution tools. The RRD also makes provision for resolution financing arrangements in the Member States.

**Single Supervision Mechanism**

**Level 1**

- Commission proposals dated 12 September 2012 for: a Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions ("ECB Regulation"); and a Regulation amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions ("EBA Amending Regulation"). Final agreement is expected in autumn 2013.

**Treaty base**

- The ECB Regulation has as its Treaty base Article 127(6) TFEU, and the EBA Amending Regulation has as its Treaty base Article 114 TFEU.

**Description**

- The ECB Regulation establishes the Single Supervision Mechanism ("SSM") for Member States participating in the banking union (participation in which is mandatory for euro area Member States and optional for non-euro area Member States) under which the ECB will become the prudential supervisor of credit institutions established in those States.
- The EBA Amending Regulation makes amendments to the Regulation establishing the European Banking Authority consequential on the establishment of the SSM.

**Single Resolution Mechanism**

**Level 1**

- Commission proposal dated 10 July 2013 for a Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending the EBA Regulation (EU) No 1093/2010 ("SRM Regulation"). The Commission anticipates that a general approach will be agreed by the Council in late 2013.

**Level 2**

- Various level 2 measures envisaged in the proposal.

**Treaty base**

- Article 114 TFEU.

**Description**

- The SRM Regulation will establish the Single Resolution Mechanism for those Member States participating in the Single Supervision Mechanism. Under the SRM Regulation, a new EU agency, the Single Resolution Board, and the Commission, will be responsible for taking certain decisions concerning, for example, recovery planning, resolvability assessments and the resolution of credit institutions established in the participating Member States.

**Table B.2: Insurance and pension sectors**

| Occupational retirement schemes |
|---|
| **Level 1**<br>• Directive on the activities and supervision of institutions for occupational retirement provision (Directive 2003/41/EC) ("IORP").<br>**Treaty base**<br>• Article 45(2) EC and Article 95(1) EC<br>**Description**<br>• For occupational retirement schemes, addresses cross-border, prudential and governance issues. |
| **Sale of insurance and reinsurance** |
| **Level 1**<br>• Commission proposal for a Directive on Insurance Mediation (recast), replacing Directive 2002/92/EC ("IMD2"), published 3 July 2012<br>**Treaty base**<br>• Article 53 TFEU<br>**Description**<br>• The original IMD established common standards and a registration regime for the sale of insurance and reinsurance across the EU by intermediaries and brokers, covering professional requirements, pre-sale disclosures and consumer protection measures. The proposed IMD2 extends the scope of the regime to include direct sales and imposes new requirements intended to increase consumer protection, particularly for insurance investment products. |
| **European Insurance Contract Law** |
| **Level 1**<br>• (Pre-proposal expert group stage)<br>**Treaty base**<br>• Article 114 TFEU is expected to be the legal base when a proposal is submitted by the Commission. It is the base for the Common European Sales (of goods) Law proposal, which is analogous to this.<br>**Description**<br>• The Commission has convened a working group of experts to discuss a possible new "optional" system of European insurance contract law, which parties to the insurance contract could select as the governing law for the contract. This seems likely to lead to a Commission legislative proposal eventually. |
| **Supervision and stability of insurance providers** |
| **Level 1**<br>• Solvency II – Directive (EC) No. 2009/138. Although Solvency II is technically in force already, the substantive provisions do not yet apply. Consequently, the current substantive law in this area is still set by the pre-Solvency II Directives, which are listed below. Amendments to Solvency II are currently being negotiated as part of the Omnibus II package (see below). Solvency II is currently due to apply from 1 January 2014, although further postponement of this date to January 2016 has been openly discussed.<br>• Pre-Solvency II Directives (currently in force, but due to be repealed when Solvency II applies): 64/225/EEC; 73/239/EEC; 73/240/EEC; 76/580/EEC; 78/473/EEC; 84/641/EEC; 87/344/EEC; 88/357/EEC; 92/49/EEC; 98/78/EC; 2001/17/EC; 2002/83/EC; and 2005/68/EC<br>**Level 2**<br>• None as yet, although EIOPA is developing interim guidelines, which will be issued on a comply or explain basis, with the intention of helping Member States converge in their preparations for Solvency II implementation. It is expected that Solvency II will be substantially amended by Omnibus II (see below), including with regard to the preparation and adoption of level 2 legal acts. |

**Treaty base**

- Articles 47(2) and 55 TEC (now Articles 53(1) and 62 TFEU).

**Description**

- Solvency II is in part a consolidation of many existing measures, but it also contains many new elements. Solvency II introduces a fundamental reform of European insurance regulation and will create a single rulebook and single market for EU insurers. Solvency II introduces market-consistent valuation of assets and liabilities as well as a risk-based approach to supervision, with the overarching aim of enhancing the stability of insurers to ensure strong policyholder protection.
- It provides for the supervision of insurance entities, the information which much be provided in order to request supervision, various requirements as to the provision of capital and how the measures of capital must be assessed on an ongoing basis, the supervision of groups, the equivalence of third countries' regulatory arrangements, group supervision, reorganisation and winding up.

**Table B.3: Markets and securities**

**Investment Firms and Trading Venues**

**Level 1**

- Markets in Financial Instruments Directive (Directive 2004/39/EC) ("MiFID")

**Level 2**

- Commission Directive 2006/73/EC implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
- Commission Regulation (EC) 1287/2006 implementing Directive 2004/39/EC as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

**Treaty base**

- Article 47 TEC (now Art 53 TFEU)

**Description**

- MiFID replaced the Investment Services Directive (93/22/EC) ("ISD") and came into effect in November 2007. The principle change in the balance of competencies introduced by MiFID was the EU regime for the regulation of markets and in particular the introduction of the multilateral trading facility significantly changed the structure of financial markets in the EU.
- MiFID applies to investment firms providing investment services and activities in the EU, though many of its provisions apply to credit institutions (i.e. banks) when performing those services and activities. MiFID requires the authorisation of investment firms, sets conduct of business rules for them (to protect investors) and provides for transparency of equity transactions through the publication of pre and post trade information. MiFID also provides for the authorisation and regulation of Regulated Markets and Multilateral Trading Facilities, which are trading venues operating in a multilateral and non-discriminatory fashion. Finally, MiFID extended and made more usable the ISD "passporting" rights of EU investment firms to undertake their business anywhere across the EU, provided they were authorised for those activities in their home state.

**Investment Firms and Trading Venues**

**Level 1**

- Commission Proposals (currently in the legislative process) for: New Markets in Financial Instruments Directive (MiFID2); New Markets in Financial Instruments Regulation (MiFIR); and the MiFID II & MiFIR Package.

**Level 2**

- Various level 2 measures envisaged in the proposals.

**Treaty base**

- Article 53 TFEU (MIFID2) and Article 114 TFEU (MIFIR).

**Description**

- The review of MiFID has led to proposals for a new Directive and Regulation to further integration of the regulation of financial markets. MiFID2 proposes to build on MiFID obligations for the authorisation of investment firms, conduct of business obligations (investor protection), in addition to continuing the regime for the authorisation and regulation of Regulated Markets and Multilateral Trading Facilities. It proposes to continue the right to passport services across the EU. MiFID2 proposes to introduce the regulation of a new type of trading venue, the Organised Trading Facility to increase the use of transparent venues for trading. Organised Trading Facilities will differ from other authorised venues in that they may exercise discretion in their operation, though access to them must be available on a non-discriminatory basis MiFID2 also proposes to introduce requirements on trading venues to impose position limits on commodity trades and to provide for a third country authorisation regime whereby third country firms would be able to be recognised in the EU and receive similar passporting rights to provide services across the EU as EU firms enjoy. In addition, MiFID2 proposes the regulation of providers of financial market data reporting services.
- MiFIR, which will be directly applicable in all Member States when it takes effect, proposes to extend the existing trade transparency rules (currently in MiFID) to cover non-equity markets and the new Organised Trading Facility. MiFIR proposes to implement the G20 agreement to require certain derivatives to be traded on trading venues (which complements the obligation to clear certain derivatives under EMIR (648/2012/EC)). It also provide for rights of access to trading venues, central counter parties and benchmarks to facilitate competition in the market. MiFIR also proposes provisions to support the proposed MiFID2 regime for investment firms for third countries. Finally, MiFIR proposes powers of intervention for the European Securities and Markets Authority to set position limits on commodity trades or intervene to restrict financial activities in emergency situations.
- The MiFID2 and MiFIR package of legislative proposals are complementary. The elements which have been placed in MiFIR are to ensure absolute harmonisation of regulation across the EU. The package is currently in the EU legislative process. Once agreed and adopted the entire package will be in effect thirty two months later. Compared to the scope of MiFID, the principle areas where MiFID II and MiFIR would significantly change the balance of competencies between EU regulation and that enjoyed at a national level would be the proposed third country firm recognition regime and the proposed powers of ESMA to intervene in financial markets in an emergency.

**Listing/admission of securities**

**Level 1**

- Listing Directive – (Directive 2001/34/EC)

**Treaty base**

- Articles 44 and 95 TEC (now Articles 50 and 114 TFEU).

**Description**

- This Directive consolidated provisions of a number of earlier directives relating to the admission of securities, listing particulars, and publication of relevant information by issuers. It has been partially superseded by the Prospectus Directive and the Transparency Directive, but continues to apply in relation to the admission of securities.

**Issuance of securities on regulated markets**

**Level 1**

- Prospectus Directive – (Directive 2003/71/EC, amended in 2010 by Directive 2010/73/EU.

**Level 2**

- Regulation (EC) No. 809/2004 relating to the information to be contained in prospectuses, the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements (amended in 2012 by Directive 862/2012).
- Regulation (EC) No. 1569/2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC.

**Treaty base**

- Articles 44 and 95 TEC (now Articles 50 and 114 TFEU).

**Description**

- The Directive establishes common rules across the EU for the issuance of both equity and non-equity securities on regulated markets, the requirement for a prospectus and the content of that prospectus. In particular, the Directive, together with the Level 2 Regulation adopted pursuant to it, establishes detailed rules regarding the information which is to be provided to potential investors and the way in which it is to be provided. In recognition of the investor-protection function of this measure, less onerous standards are applied when an issue is targeted only at qualified investors. It also introduced the ability for a prospectus once approved in one Member State to be valid across the EU, giving issuers a 'passport' across the EU capital markets. The measures have been fully incorporated into FSMA. Significant amendments were made to the Directive in 2010, and correspondingly to FSMA and FSA rules in 2011 and 2012. These amendments improved and simplified the application of the Directive, and included changes to reduce administrative burdens on issuers whilst maintaining investor protection.

**Collateral**

**Level 1**

- Financial Collateral Arrangements Directive (Directive 2002/47/EC)

**Treaty base**

- Article 114 TFEU (at time of adoption, Article 95 EC)

**Description**

- Provides for the recognition and enforcement of title transfer and security financial collateral arrangements. The Directive provides, amongst other things, that member states may not impose formality requirements on financial collateral arrangements and for collateral to be realised in accordance with the terms of the agreement.

**General transparency requirements for listed companies**

**Level 1**

- Transparency Directive – (Directive 2004/109/EC (as amended by Directive 2008/22/EC, Directive 2010/73/EU, Directive 2010/78/EU)) A further amending Directive is due to be published in the OJ in autumn 2013. Member States will have two years to implement the amendments.
- Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.
- Regulation (EC) No. 1569/2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC
- Regulation (EC) No. 1289/2008 regarding equivalence of third country GAAPs.
- Regulation (EU) No. 310/2012 amending Regulation (EC) No 1569/2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC.

**Treaty base**

- Articles 44 and 95 TEC (now Articles 50 and 114 TFEU).

**Description**

- The existing Transparency Directive provides for the harmonisation of transparency requirements across the EU by requiring issuers of securities admitted to trading on a regulated market to disclose a minimum level of information to the public. It built on and amended the Admissions Directive (2001/34/EC) (see above). The main requirements of the existing Transparency Directive include:
    - companies to publish periodic financial reports (an annual report, a half yearly report and two interim statements for each half of the financial year);
    - major shareholders to disclose their holdings and entitlements to shares when these cross certain thresholds and the relevant company to disclose this information to the market.; and
    - companies to release information useful to investors on a fast and pan-European basis. The Directive also establishes a framework for the central storage of such information.
- The new Transparency Directive aims to improve the existing regime, and its main provisions include:
    - abolishing the requirement for interim statements, and clarifying the circumstances in which member states can require the publication of periodic financial information on a more frequent basis than annual financial reports and half-yearly financial reports;
    - amendments to a member state's ability to impose stricter or additional requirements in connection with notification thresholds, aggregation of holdings of voting rights and exemptions to the notification requirements;
    - broadening the definition of financial instruments subject to notification requirement, and setting out the process for calculating voting rights in relation to financial instruments with similar economic effect to holding shares and entitlements to acquire shares which provide for cash settlement;
    - clarifying the disclosure obligations in relation to payments made to governments by extractive industries (e.g. as oil, gas and mining) or loggers of primary forests;
    - amendments to the definition of home member state aimed at ensuring all issuers are supervised by a competent authority of a member state; and requiring the development and establishment by January 2018 of a web portal providing an EU level access point to regulated information.

## Shareholder rights

**Level 1**

- Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies

**Treaty base**

- Articles 44 and 95 TEC (now Articles 50 and 114 TFEU).

**Description**

- This Directive aims to protect investors by ensuring minimum standards relating to the exercise of shareholder voting rights, such as ensuring that proxy votes may be exercised easily by non-residents, casting votes in advance of the meeting, putting items on the agenda and proxy voting.

## Market Abuse

**Level 1**

- Market Abuse Directive – Directive 2003/6/EC. A new market abuse package, replacing Directive 2003/6/EC, is in the process of adoption by the EU legislature and will consist of a Market Abuse Regulation ("MAR") and a Market Abuse Directive ("MAD").

**Level 2**

- Directive (EC) No. 2003/124 relating to the definition and public disclosure of inside information, and the definition of market manipulation; Directive (EC) No. 2003/125 relating to the fair presentation of investment recommendations and the disclosure of conflicts of interest; Regulation (EC) No. 2273/2003 relating to exemptions for buy-back programmes and stabilisation of financial instruments; Directive (EC) No. 2004/72 relating to accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions; and Directive (EU) No. 2010/466.
- MAR mandates and envisages the adoption of Level 2 Regulations by the Commission on the basis of draft binding technical standards proposed by ESMA.

**Treaty base**

- Article 95 TEC (now Article 114 TFEU); MAR – Article 114 TFEU; MAD – Article 83(2) TFEU.

**Description**

- This measure build on previous Directive 89/592/EEC in relation to coordination of measures to prevent insider dealing, as well as introducing some coordination of measures to prevent market manipulation. The Directive closes certain loopholes in relation to insider dealing, as well as providing for measures across the EU against market manipulation. The Directive provides only for administrative measures, and is reflected in Article 118 of FSMA. The Directive sets a minimum level of harmonisation. UK has gone further in a number of respects, including maintaining criminal provisions under the Criminal Justice Act. The application of this Directive across the EU has been varied, leading to calls (including from UK) for an improved package.
- The new package consists of a Regulation providing the core measures and the civil prohibitions. The new Directive requires MSs to establish criminal penalties for the most serious market abuse cases. This is the first attempt by the European Commission to create minimum criminal standards with respect to market abuse across all EU member states.
- The package strengthens the level of harmonisation between Member States, and broadens the scope of insider dealing and market manipulation. In particular:
    - the move from Directive to Regulation ensures greater consistency across the EU;
    - the new measures apply to a wider range of trading venues;
    - a wider range of activities (including benchmark manipulation) fall with market manipulation; and
    - stronger sentencing provisions should ensure a more credible regime across the EU.
- The proposed MAD is to be adopted under the JHA Chapter of the TFEU, as it relates to the approximation of criminal sanctions. A consequence is that UK must decide whether to opt in to this measure when it has been adopted. The Government decided not to opt in at the start of negotiations, a decision driven by sequencing rather than substance (MAD is contingent on MAR and MiFID, which were still in early stages of discussion). The UK has committed to review the decision of whether to opt-in once MAD has been agreed.

**Credit Ratings Agencies Regulation**

**Level 1**

- Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies as amended by Regulation 513/2011

**Treaty base**

- Article 95 TEC (now Article 114 TFEU)

**Description**

- The Regulation establishes a common regulatory approach in order to enhance the integrity, transparency, responsibility, good governance and reliability of credit rating activities. In particular, as a result f the amendments made by the amending Regulation, the European Secuities and Markets Authority is exclusively responsible for the registration and supervision of Credit Rating Agencies in the European Union.

**Short Selling Regulation**

**Level 1**

- Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps

**Treaty base**

- Article 114 TFEU.

**Description**

- The Regulation establishes harmonised reporting requirements in relation to short positions. Article 28 of the Regulation confers powers on the European Securities and Markets Authority (ESMA) to restrict or ban short selling.

**Table B.4: Clearing and Settlements**

## Clearing

**Level 1**

- Regulation EU No 648/2012 of the EP and Council on OTC derivatives, central counterparties and trade repositories ("EMIR").

**Level 2**

- Commission Delegated Regulation 149/2013 on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivative contracts not cleared by a CCP; Commission Delegated Regulation 152/2013 on capital requirements for CCPs; Commission Delegated Regulation 153.2013 on requirements for CCPs; other RTSs are also in preparation. A substantial number of level 2 measures in the form of regulatory technical standards have also been adopted further to the requirements of EMIR.

**Treaty base**

- Article 114 TFEU

**Description**

- Includes: (i) new obligation to clear standardised OTC derivatives through a CCP; (ii) a new harmonised regulatory framework for central counterparties including requirements for authorisation and prudential, organisational and conduct of business requirements, and (iii) regulation of interoperability arrangements between CCPs.

## Settlement

**Level 1**

- Proposed Regulation on improving securities settlement in the EU and on central securities depositories ("CSDR")

**Treaty base**

- Article 114 TFEU.

**Description**

- Requires securities to be issued in electronic book entry form; requires settlement within two days of trading; bodies operating securities settlement systems (CSDs) must adopt measures to reduce settlement failures; introduces a new harmonised framework for the regulation of CSDs including authorisation, operational, governance and prudential requirements; allows CSDs to passport into other EU States.

## Settlement Finality

**Level 1**

- Directive on settlement finality in payment and securities settlement systems (Directive 98/26/EC), as amended.

**Treaty base**

- Article 114 TFEU (at time of adoption, Article 100a EC)

**Description**

- Aims to reduce the systemic risk associated with participation in payments and settlement systems, and in particular the risk linked to the insolvency of a participant in such a system. It contains provisions on the treatment of transfer orders, on insolvency and on netting and collateral.

**Table B.5: Asset Management**

**Individual portfolio management**

**Level 1**

- Recast Directive on Markets in Financial Instruments repealing Directive 2004/39/EC ("MiFID2"); and Markets in Financial Instruments Regulation ("MiFIR").

**Treaty base**

- Article 53 TFEU (MIFID2) and Article 114 TFEU (MIFIR)

**Description**

- Individual portfolio management is an "investment service" under MiFID/MiFIR – see separate summary in "Markets" section.

**Collective investment schemes**

**Undertakings for collective investment in transferable securities**

**Level 1**

- Undertakings for Collective Investment in Transferable Securities Directive 2009/65/EC ("UCITS IV").
- UCITS V (Commission proposal dated 3 July 2012).
- UCITS VI (consultation document published 26 July 2012).

**Level 2**

- Directive 2007/16 (eligible assets); Regulation 583/2010 (key investor information); Regulation 584/2010 (intra-EEA marketing and supervision); Directive 2010/42 (fund mergers, master-feeder structures); and Directive 2010/43 (organisational requirements, conflicts of interest, conduct of business, risk management, depositary agreements).

**Treaty base**

- Article 53 TFEU.

**Description**

- Harmonised framework of investor protection and product regulation for UCITS funds and UCITS fund managers. Funds complying with the Directive requirements can market their units freely across the EEA on the basis of a single authorisation in their home Member State. Managers authorised to manage UCITS in one Member State can similarly offer their services across the EEA.

**Alternative investment funds**

**Level 1**

- Alternative Investment Fund Managers Directive 2011/61/EC ("AIFMD")

**Level 2**

- Regulation 231/2013 (supplements AIFMD in a number of areas including exemptions, general operating conditions, depositaries, leverage, transparency and supervision); Regulation 447/2013 (procedure for opt-in of sub-threshold AIFMs); and Regulation 448/2013 (determining the Member State of reference of non-EU AIFMs).

**Treaty base**

- Article 53 TFEU.

**Description**

- Establishes a new harmonised regulatory framework for managers of investment funds not already authorised under the UCITS Directive. AIFMD was primarily targeted at the hedge fund and private equity sectors but covers many other categories of fund including real estate and several retail schemes.

**Venture Capital Funds**

**Level 1**

- Regulation on European Venture Capital Funds 2013/345/EU ("EUVeCa" funds).

**Treaty base**

- Article 114 TFEU

**Description**

- Lighter-touch harmonised regime for managers of funds investing in social enterprises, who are not required to comply in full with AIFMD. Managers who comply will be able to market their EUSEFs across the EEA on the basis of a single registration.

**Social Entrepreneurship Funds**

**Level 1**

- Regulation on European Social Entrepreneurship Funds 2013/346/EU ("EUSEFs")

**Treaty base**

- Article 114 TFEU

**Description**

- Lighter-touch harmonised regime for managers of funds investing in social enterprises, who fall outside the scope of AIFMD. Managers who comply will be able to market their EUSEFs across the EEA on the basis of a single authorisation.

**Long Term Investment Funds**

**Level 1**

- Commission proposal for a Regulation on European Long Term Investment Funds, published 1 July 2013.

**Treaty base**

- Article 114 TFEU.

**Description**

- Aims to increase the pool of funds available for infrastructure investment by creating a harmonised framework of product regulation for funds investing in "long-term assets", suitable for retail as well as professional investors.

**Money market funds**

**Level 1**

- Commission proposal for a Regulation on Money Market Funds, published 4 September 2013

**Treaty base**

- Article 114 TFEU.

**Description**

- Harmonised framework for European Money Market funds, with requirements relating to investment policy, liquidity and valuation among other things.

**Packaged retail investment products ("PRIPs")**

**Level 1**

- Commission proposal for a Regulation on key information documents for investment products, published 3 July 2012.

**Treaty base**

- Article 114 TFEU.

**Description**

- Requires the provision of a standardised Key Information Document to retail investors before they purchase specified types of investment product (other than UCITS, for which a KID is already required pursuant to the UCITS Directive).

**Table B.6: Payment and E-Services**

**Payment services**

**Level 1**
- Commission proposal for a Directive on payment services, replacing Directive 2007/64/EC ("PSD"), published 24 July 2013. Possible adoption end of 2013.

**Level 2**
- Commission proposal for a Regulation on interchange fees for card-based payment transactions ("MIF Regulation"), published 24 July 2013. Possible adoption end of 2013.

**Treaty base**
- Article 114(1) TFEU (both PSD and MIF).

**Description**
- The PSD established regulatory regime for certain payment service providers ("PSPs") (excluding, inter alia, credit institutions and e-money institutions), with a view to establishing a level playing field in the EU in the provision of "payment services" as defined in the PSD . Those PSPs to which the PSD applies have to be registered and comply with certain prudential regulation requirements as to capital and ring-fencing of clients' funds. Further, the PSD imposes certain rules on the manner in which all PSPs conduct their business.
- PSD2 widens the scope of regulation to include third party payment providers and small payment institutions. Third party payment providers provide payment initiation services, which are ways for customers to make on-line payments without a card (the merchant connects directly to the customer's online bank account). In addition, PSD2 includes new consumer protection rules such as stronger refund rights for direct debits, increased security requirements, and prohibiting surcharging for 95% of EU card-based transactions.
- The draft MIF Regulation caps the level of interchange fee at 0.2% of the value of the transaction for consumer debit and 0.3% for credit cards. Interchange fees are set by the credit card network and paid by the merchant's bank to the customer's bank for the acceptance of card-based transactions. They are passed on to the retailer in the form of a service charge and, in general, passed onto all consumers (not just those paying by card) in the form of higher prices. This has led to policy concern that non-card users subsidise card users, and that this is exacerbated as card issuers have an incentive to increase interchange fees in order to persuade banks to use their cards. There has been significant competition concern that, given their position in the market, retailers have no power to negotiate interchange fees down. The MIF Regulation follows long-running antitrust cases (at both the Member State and EU level) against Mastercard and Visa that resulted in similar interchange fee caps being imposed on a cross border basis only.
- The MIF Regulation also seeks to address issues such as tying-in practices (honour all cards rule) and co-branding of cards.

**E-money**

**Level 1**
- Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions. There are no immediate plans to amend this Directive; it may be revisited after PSD2 has been adopted.

**Treaty base**
- Article 114(1) TFEU

**Description**

- The Directive has the same rationale as the PSD: to regulate the provision of e-money services. The Directive establishes an authorisation regime for certain e-money issuers and makes them subject to certain prudential requirements.
- “Electronic money” is electronically (including magnetically) stored monetary value as represented by a claim on the electronic money issuer which is: issued on receipt of funds for the purpose of making payment transactions; accepted by a person other than the electronic money issuer; and not excluded under the Directive. The exclusions under are monetary value stored on instruments that can be used to acquire goods and services only in or on the electronic money issuer’s premises; or under a commercial agreement with the electronic money issuer, either within a limited network of providers or for a limited range of goods or services. Monetary value used in transactions executed through telecommunication, digital or IT devices, where the goods or services purchased are to be used through such a device, are also excluded, provided that the operator does not only act as an intermediary between the payment service user and the supplier of goods and services.

**Table B.7: Regulations establishing the European Supervisory Authorities**

| European Banking Authority (EBA) |
|---|
| **Level 1**<br>• Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority).<br>**Treaty base**<br>• Article 114 TFEU.<br>**Description**<br>• Regulation to establish the European Banking Authority. |
| **European Securities and Markets Authority (ESMA)** |
| **Level 1**<br>• Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority).<br>**Treaty base**<br>• Article 114 TFEU.<br>**Description**<br>• Regulation to establish the European Securities and Markets Authority. |
| **European Insurance and Occupational Pensions Authority (EIOPA)** |
| **Level 1**<br>• Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority).<br>**Treaty base**<br>• Article 114 TFEU.<br>**Description**<br>• Regulation to establish the European Insurance and Occupational Pensions Authority. |
| **European Systemic Risk Board (ESRB)** |
| **Level 1**<br>• Regulation (EU) No 1092/2010 on European Union macro-prudential oversight and establishing a European Supervisory Authority (European Systemic Risk Board).<br>• Council Regulation (EU) No 1096/2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.<br>**Treaty base**<br>• Article 114 TFEU and, for the Regulation conferring specified tasks on the ECB, Article 127(6) TFEU.<br>**Description**<br>• Regulations to establish the European Systemic Risk Board. |

# C Interdependencies with other reviews

C.1 There are a number of issues associated with financial services and the free movement of capital that are being considered by other reports in the government's Balance of Competence review. The following sets out some of the key areas that fall out of scope of this review and into the scope of others:

## Semester 1

- Single Market: considered the Single Market as a whole, including financial services, and in particular explored the level of market integration thought to be necessary for an effective Single Market.
- Taxation: covered the Financial Transaction Tax and other taxes relating to financial services firms (for example, stamp duty in asset management).

## Semester 2

- Single Market: Free Movement of Persons: looking at the impact of the EU on the ability of UK nationals to work, access benefits and access services in other Member States, including those that work in the financial services sector.
- Trade and Investment: considering extra-EU foreign direct investment and broader securities investment, as well as extra- and intra-EU trade (including Free Trade Agreements).
- Research and Development: covering the EU's funding of, and its impact on, technological development in all sectors.

## Semester 3

- Single Market: Free Movement of Services: will cover all areas of services, with the exception of financial services, in part because the EU tends to deal with financial services on a sectoral basis.
- EU Budget: will include a reference to the European Supervisory Authorities as it comprises a small amount of the EU budget.
- Competition and Consumer Protection: will cover issues relating to competition and consumer protection aside from financial services.
- Energy: will cover regulation relating to wholesale energy market integrity and transparency.
- Fundamental Rights: will reference the Commission's proposal for the right for all EU citizens to a basic bank account.

## Semester 4

- Economic and Monetary Union: will cover the broader issue of the challenge of euro area integration.

- **Police and Criminal Justice**: will look at issues around financial crime, including asset freezing, terrorist financing and money laundering.
- **Information Rights**: will cover the generality of data protection issues, including those relating to use of personal data by companies.

C.2 Further details and how you can contribute evidence to these reviews can be found on the balance of competences review web page at: https://www.gov.uk/review-of-the-balance-of-competences.

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This document can be downloaded from www.gov.uk

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