Europe Economics

EU Financial Regulation

A report for Business for Britain

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Executive Summary

This report was commissioned from Europe Economics by Business for Britain. Chancellor George Osborne recently stated: "*If we cannot protect the collective interests of non-eurozone member states then they will have to choose between joining the euro, which the UK will not do, or leaving the EU.*" This report considers whether the concern Osborne raises is applicable to EU-level setting of finance and financial services regulation and, if so, what reforms might address it.

We argue that prior to the Eurozone crisis, the general thrust of EU financial services measures reflected the UK's traditions of liberalisation, competition and the encouragement of trade. This was particularly so in the ways EU-level financial regulation affected other Member States much more than it affected the UK, because EU rules mirrored pre-existing UK rules. We illustrate this with the examples of the Markets in Financial Instruments Directive and the Takeover Directive. Furthermore, there was a traditional reluctance to over-rule the EU on financial services regulation as the UK was the centre of the largest finance / financial services industry in Europe, whilst the EU in turn offered UK firms large and growing financial services export opportunities.

Since the financial crisis of 2008 and especially since the Eurozone crisis of 2010 onwards, the UK's influence on EU-level financial services regulation has declined markedly. In many parts of the EU the financial crisis and thus the Eurozone crisis are blamed upon "light touch" regulation failing the discipline the activities of "Anglo-Saxon" financiers in the US and UK. For many in the EU, the UK's pre-crisis influence upon financial regulation is seen as malign.

Both in the UK and in the rest of the EU, there has been a significant change in the spirit and thrust of regulation since 2008. But whereas in the UK the change has been towards increasing quality of supervision and strengthening market incentives, at EU level the focus has been much more upon extending scope of regulation, curbing specific behaviours, and protecting the integrity of the Eurozone. The Eurozone is now set to have the collective weight in qualified majority voting to impose any financial regulation it chooses upon the UK, and its significantly divergent interests mean it may do so.

This considerable loss of UK influence is exemplified by the UK being reduced to pursuing four legal cases in the financial services regulation area at the European Court of Justice — at least three of which it seems likely to lose. At the same time, opportunities for financial services exports outside the EU are now growing (and expected for the foreseeable future to grow) much more rapidly than inside the EU, increasing the cost to UK exporters of an EU focus, whilst the main threats of regulatory arbitrage to the UK are less and less from other European countries and more and more from outside the EU.

We consider potential reforms to EU-level setting of financial services regulation, including the extension of "double majority voting" (whereby changes to Single Market rules would require a majority of both Eurozone and non-Eurozone members to pass) and specific undertakings for forbearance from other EU Member States in respect of financial and financial services regulation. We argue that although such measures may offer some protection in the very short term (up to around 2018) they are unlikely to be sustainable over the longer term because almost all current non-Eurozone members of the EU intend to join the euro by 2020, meaning "double majority voting" would become very close to a UK veto on any new financial regulation — and thus unacceptable to Eurozone members.

To make such reforms to voting procedures viable over the longer term would require a large influx of new EU members that would not be required or expected to join the euro for many decades. Given the change to the nature of the EU that would result and the pool of countries from which such an influx would have to come, the challenges of achieving such a large expansion would be very significant indeed.

These are complex issues, and further research would be warranted in a number of areas. But we believe the central message is clear: For EU-level setting of finance/financial services to be in the UK's interests long-term, as well as amendments to a number of existing EU regulations, there would also need to be a set of new principles for how EU financial regulations are agreed. Even then that would be unlikely to be viable unless the long-term membership of the Eurozone and non-Eurozone EU are much closer to balance than is currently planned.

1 Introduction

This report was commissioned from Europe Economics by Business for Britain. Business for Britain sought:

- A general analysis of the case that the way the EU determines financial services sector regulation needs to be reformed for the UK to continue to be an EU Member State.
- A set of general principles guiding reform of EU-level financial services sector regulation-setting.

1.1 Osborne's Fork

In January 2013, Prime Minister David Cameron announced that the UK Government would try to negotiate changes in Britain's relationship with the EU and that the results would be put to the UK electorate in a referendum:

> With courage and conviction I believe we can achieve a new settlement in which Britain can be comfortable and all our countries can thrive.

The concerns which would animate that renegotiation and the specific objectives were left as broad principles though, such as competitiveness and flexibility. More specific issues for renegotiation were set out by the Chancellor of the Exchequer, George Osborne, in his speech of 15 January 2014.[1] Osborne pointed specifically to the dangers that the UK's interests might be compromised following the Eurozone crisis, as its members could outvote non-Eurozone Member States like the UK and had specific needs that did not reflect the UK's interests.

> [A]s the Eurozone undertakes the integration required to make the euro work, we need constitutional reforms to make sure that those countries which are not in the euro can remain in the EU, confident that their interests and rights will be protected.

In addition to obvious familiar concerns about "policy discipline" and "accountability", he identified two key threats to the interests and rights of non-Eurozone EU members:

> "First there is a danger that the euro members could start to use their collective voting weight in the EU to effectively write the rules for the whole EU by Qualified Majority Vote". *[For example]* "Under the Lisbon Treaty, from 2016, the Eurogroup on its own will have sufficient votes to pass any financial services legislation for the whole of the EU."
>
> *[The second danger is]* "discriminatory treatment of non-eurozone Member States." *[He gave the following example:]* "the European Central Bank's policy of forcing clearing houses with large euro-based transactions to move to the eurozone."

This led him to spell out the UK's dilemma in the form of a "fork":

[1] https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe

> If we cannot protect the collective interests of non-eurozone member states then they will have to choose between joining the euro, which the UK will not do, or leaving the EU.[2]

In this report, we will examine the extent to which those concerns are valid with respect to the financial services sector: is there a risk to the UK's competitiveness in financial services, and is there a specific threat emanating from a cohesive Eurozone block with differing interests from those of non-Eurozone EU Member States in general and the UK in particular?

The core of our case will be that although it might reasonably be argued that in the 1990s and early 2000s the UK was able to secure a significant part of the potential advantages of EU-level setting of financial regulations, with relatively few of the disadvantages, that has changed markedly since the financial crisis and Eurozone crisis and is likely to worsen in the future. More specifically, during the 1990s and early 2000s, UK influence over EU financial regulation-setting was very significant and at the same time the EU was a large and growing financial services market. But since the financial crisis and Eurozone crisis the UK's influence over EU financial regulation-setting has diminished markedly and is likely to diminish further, the goals and scope of financial regulation in the EU is likely increasingly to serve the interests of the Eurozone (which are no longer closely aligned with those of the UK), and the potential for the UK financial services sector to grow its business serving EU financial services is likely to be markedly less than the growth potential outside the EU.

1.2 Structure of this Report

In Section 2 we examine how influential the UK was in financial services regulation-setting prior to the Eurozone crisis and the scope for growth in the UK financial services sector provision of financial services to businesses, consumers and governments in EU Member States.

In Section 3 we explain how both the policy and market contexts have changed significantly since the Eurozone crisis.

In Section 4 we explore a number of potential options for reform.

Section 5 concludes.

An Appendix sets out proposals for further study.

[2] It is worth observing that Osborne's Fork is thus not a dilemma in the form: "Should the UK stay in the EU or leave?" but, rather, in the form: "Will there or will there not be any sustainable status, over the long term, for any Member State (not just the UK), of being in the EU but not in the euro?"

2 Before the Eurozone Crisis

Before the Eurozone crisis, there was a traditional view that the setting of financial regulation at the EU level benefitted the UK. That view rested on the following five propositions:

- EU-level policymaking allows British regulatory concepts to influence regulation in other Member States. Since Britain is traditionally a pro-trade country, the impact of its influence will tend to be to increase opportunities for trade in financial services, to the benefit of British firms and British consumers.
- When financial services regulation is improved in other Member States, thanks to British influence, those other Member States grow faster. That increased demand leads to opportunities for British businesses in other non-financial sectors, as well.
- Without EU-level setting of regulation, some EU Member States might set regulation below the ideal minimum level, with the objective of attracting businesses to locate away from Britain. This threat is known as "regulatory arbitrage".
- Compliance costs may be lower for companies operating across borders within the EU, if they have only one set of common EU regulations to deal with.
- A straightforward system of common regulation means that the UK can be used as an entry point to the EU for global investors and financial services firms from outside the EU.

Supporters of EU-level setting of financial regulation contended that these advantages outweighed the following five potential drawbacks:

- Regulation might not be set in Britain's national interest. For example, Britain could be outvoted on a measure that creates greater costs than benefits in the UK, because the balance of costs and benefits is different in other Member States.
- Regulation set at EU level might be technically inferior to British-set regulation. For example, designing regulations that are applicable across all Member States might result in messy compromises on certain technical points, creating anomalies and loopholes.
- Compliance costs might be higher for firms focused upon Britain, because EU-level regulations might, by the nature of applying across 28 states, have greater complexity and greater redundancy (with respect to UK-focused business) than UK-focused regulations.
- The loss of regulatory competition (countries comparing their regulation with each other and businesses seeking to locate where regulation is most effective and cost-effective) might undermine the long-term quality of regulation and lead to over-regulation. Quality might decline because of the lost ability of regulatory to learn from the mistakes and successes of others. Over-regulation might arise because the threat of regulatory arbitrage tends to keep regulation at a low level, offsetting natural bureaucratic and democratic tendencies to over-regulate. Furthermore, Britain could be a beneficiary from regulatory arbitrage if all other relevant countries had a natural tendency to overregulate — i.e. ideal regulation could be the attractive regulatory minimum.
- There might be more difficulty in dealing with and attracting foreign investors and foreign financial services firms from outside the EU in respect of global activities.

FURTHER RESEARCH

Further research could identify the extent to which regulation set at the EU level might differ from the regulation that would be set at the UK level.

Which regulations have been implemented in the UK which would not have been if it were not a Member State of the EU? And which regulations would have been different?

The most important benefits are the result of Britain's influence in Europe: our ability to improve financial regulation in other European economies and thereby create opportunities for trade and greater growth in those Member States (which creates further opportunities for trade). The most important drawback is the potential that Britain will be outvoted on regulations that are either technically poor or not in Britain's interests.

2.1 Strong British Influence

The stated ambition of EU directives and regulation and judgements of EU competition authorities and the European Court of Justice (which we will refer to hereafter as 'EU level decisions') has mostly been liberalisation in most industries. More specifically, it has been to strip away government subsidies, government-created monopoly power, and legal impediments to trade and competition (both explicit and implicit).

It is, of course, strongly disputed how ideal or complete EU-level decisions are in delivering upon these stated objectives. However, as a sweeping generalisation, one might observe that EU directives and regulations quite often increase the level of regulation in the UK, but reduce it in many other Member States. This reflects the fact that for many Member States, participation in the Single Market programme is a mechanism for delivering liberalisation that would not be chosen by purely domestic political processes. But for the UK, there was a much longer-standing tradition of liberalisation that was domestically-driven. So, Britain would very often choose, for itself, at least as liberalised rules as those delivered at EU level.

The key gain for Britain, then, has never been conceived as that the EU would deliver liberalisation within Britain that Britain could not deliver for itself. Rather, it has been that (a) by being involved, Britain would influence policy positively, so that it delivered more and better liberalisation than would be delivered absent British ideas; (b) where the final result distinguished between the treatment of different parties (e.g. between firms within and outside the EU), by being involved in the decision, Britain would be more likely to be on the more advantageous side of the line (e.g. by not being subject to tariff or non-tariff barriers).

It can be argued that the ways in which, influenced significantly by British ideas, EU-level decisions were liberalising for other countries was, in the period up to the Eurozone crisis, the most significant benefit to the UK of EU-level decision-making. This is particularly true in the financial services sector in respect of the Financial Services Action Plan (FSAP) of 1998-2006, which sought to create and deepen the Single Market in Financial Services.

2.1.1 The Financial Services Action Plan

The potentials benefits of creating and completing a Single Market in Financial Services were explored by the Lamfalussy group of "Wise Men", who identified in particular the following:[3]

- Improved allocation of capital — through more efficient, deeper and broader security markets enabling savings to flow more efficiently to investment; lower transaction costs and improved market liquidity; more diversified and innovative financial systems; and more opportunities to pool risk.
- More efficient intermediation between savers and investors — through intensified competition among financial intermediaries across Europe, leading to fewer inefficiencies; giving users greater freedom of choice; and the opportunity to reap economies of scale and scope across a larger market.
- Hence, a stronger and faster-growing European economy.

The European Parliament's ex-post evaluation of the FSAP[4] identifies the following as the most material FSAP measures:

[3] See *Creating a Single European Market for Financial Services – a discussion paper* – City of London

- For the Banking sector:
  - Directives relating to money laundering;[5] and
  - The Capital Requirements Directive.[6]
- For the Insurance sector:
  - The Insurance Mediation Directive;[7] and
  - The Solvency I framework.[8]
- For the Securities sector:
  - The Markets in Financial Instruments Directive;[9]
  - The UCITS directives;[10] and
  - The Prospectus Directive.[11]
- For Financial Conglomerates:
  - The Financial Conglomerates Directive.[12]

FURTHER RESEARCH

Further research could investigate how different sectors of the City (e.g. banks, securities and broking, insurance, asset management) are affected differently by EU financial regulation.

A number of these directives were significantly influenced by British thinking — indeed, in many key respects they sought to conform the regulation in other Member States to pre-existing British regulations — and significantly liberalising for many Member States.

One of the key goals of the FSAP was increased liberalisation and competition. Where the FSAP has enhanced competition, the single most important mechanism is that the FSAP increased openness to foreign firms, which can lead to enhanced competition directly through an increase in the number of firms in the market, or by the threat of entry.

The main European Parliament evaluation of FSAP found that its impact on Italy was particularly significant, leading to enhanced competition in banking, insurance, securities services and in relation to financial conglomerates. The FSAP was also found to have resulted in increased competitiveness in the banking sectors of Poland and Spain.[13]

FSAP (and Financial Services White Paper) directives and regulation, when implemented in full, were predicted to lead to a significant lowering in the cost of equity capital for Italy.[14] The key drivers of this were seen as being reductions in transaction costs and reductions in servicing costs as liquidity increases. Transaction costs in Italy were relatively high and liquidity low, compared, for example, with the UK. A fall in the cost of equity was also expected to lead to an increase in the use of equity.

However, the largest impact of the FSAP was seen in New Member States, though it is difficult to disentangle the impact of the FSAP from other impacts, including the Member States' accession to the European Union.

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[4] *The Impact of the New Financial Services Framework* – IP/A/ECON/ST/2005-86, report prepared by Europe Economics for the European Parliament
[5] …particularly 2001/97, the "second money laundering directive"
[6] 2006/48/EC and 2006/49/EC
[7] 2002/92
[8] …particularly 2002/13 and 2002/83. The report also identifies the Solvency II framework, but this is part of the FSWP, not the FSAP.
[9] 2004/39
[10] 2001/107 and 2001/108
[11] 2003/71
[12] 2002/87
[13] The term "competitiveness" is used here in relation to the relative efficiency and attractiveness of the output of domestic firms compared with foreign firms.
[14] Europe Economics (2007), "The Impact of the New Financial Services Framework. A Report by Europe Economics for the Internal Policies Directorate of the European Parliament".

Table 2.1: Illustrative Impacts of FSAP on Italy, Poland and Spain

	Italy	Poland	Spain
Key liberalising effects	• Increase in competition in banking, insurance, securities services and financial conglomerates. • Increase in competitiveness in banking, insurance, securities services and financial conglomerates • Increase in consumer protection in banking and insurance • Large fall in the cost of equity capital	• Increase in competition in banking, insurance and securities services • Increase in competitiveness in banking • Increase in consumer protection in banking and securities services	• Increase in competition in banking • Increase in competitiveness in banking

Source: European Parliament, The Impact of the New Financial Services Framework — IP/A/ECON/ST/2005-86

2.1.2 When British influence worked: MiFID

A clear illustration of British influence upon directives in the Financial Services Action Plan can be seen in arguably the single most important component of the FSAP: the Markets in Financial Instruments Directive (MiFID), introduced in 2004 and effective from 2007. MiFID is a directive that sets out how Member States must regulate "investment services". By "investment services" we mean activities such as trading shares or bonds or commodity derivatives on behalf of other people, or running a stock exchange where other people trade, or virtually any other investment service apart from a small number of foreign exchange activities. The firms affected included[15]:

- investment banks;
- portfolio managers;
- stockbrokers and broker dealers;
- corporate finance firms;
- many futures and options firms; and
- some commodities firms.

MiFID aimed to:

- increase harmonisation, in particular in order to limit the ability of Member States to set regulation above the EU standard (under the directive that MiFD replaced — the Investment Services Directive — states had been entitled to gold plate the EU regulations, and many did in ways that the EU authorities regarded as protectionist);
- increase the ease (and reduce the cost) of trading across borders within the EU;
- increase competition;
- protect investors;
- increase efficiency; and
- increase transparency.

[15] For details, see http://www.fsa.gov.uk/pages/About/What/International/mifid/background/index.shtml

For our purposes here we do not need to come to a comprehensive judgement about MiFID: how successful it was in its aims, or how costly it has been to comply with. But what is of interest is to see (a) how its form was heavily influenced by pre-existing UK regulation; and (b) that it was materially liberalising for a number of other Member States.

Two illustrations of the influence of UK thinking are the ways MiFID requires firms to categorise their clients; and some of the forms of trading MiFID says must be permitted.

Categorisation

MiFID requires firms to categorise clients into three groups:

- "eligible counterparties"
- "professional clients"
- "retail clients"

As one might expect, the level of consumer protection in the regulation increases as one goes down this list, i.e. is greater for professional clients than eligible counterparties and greater still for retail clients.

Before MiFID, UK regulation, set by the Financial Services Authority (FSA), had required firms to categorise clients into three very similar groups:

- "Market counterparties"
- "Intermediate customers"
- "Private customers"

The MiFID groups were not precisely the same as the pre-existing FSA categories (e.g. certain FSA "market counterparties" counted as MiFID "professional clients"). But the choice of categories in the MiFID was consciously made so as to closely reflect the pre-existing UK regulations, and to learn from them.

Permitted forms of trading

Before MiFID, a number of countries (e.g. France, Italy, and Spain) had what were called "concentration rules". Concentration rules stated that if an ordinary investor ordered an investment firm to buy or sell shares on her behalf, that order could only be "executed" (i.e. carried out) on a "regulated market", which in practice meant the main exchange. Put less technically, that meant that if you asked an investment bank to buy shares for you, that bank was only permitted to buy them at the stock exchange.

Britain, by contrast, had for some time permitted certain firms to act as "systematic internalisers" (what used to be referred to in the UK as "market makers" were operationally similar to "systematic internalisers", though MiFID itself defined a "market maker" as a separate and slightly different category). To make things concrete and simple, let us think of a systematic internaliser in some shares. A systematic internaliser will have some clients that want to sell and other clients that want to buy the same shares. Instead of executing the buy orders on the main stock exchange, and then the sell orders on that same stock exchange, a systematic internaliser can simply match up those seeking to buy with those seeking to sell. Instead of going "externally" — to the stock exchange — it "internally" matches up between its own orders.

MiFID required all countries to be like Britain, in permitting systematic internalising. This was a large change — a significant liberalisation introduced by EU regulation — as, prior to MiFID, even in Member States where systematic internalising was not specifically forbidden, it was effectively so by the complex

interplay of other regulations. And even in some Member States where there was some systematic internalising (e.g. Germany), it was much less widespread than in the UK.[16]

MiFID was an extensive and complex piece of regulation, affecting many areas of investment business. The above two areas are simply examples of the widespread ways in which MiFID was heavily influenced by, and conceived itself as learning from, pre-existing British financial regulation.

2.1.3 Another example of the UK model being exported: The Takeover Directive

Another example of a pre-financial crisis regulation which affected most other Member States much more dramatically than the UK was the Takeover Directive of 2004, required to be implemented throughout the EU by 2006. Analysis conducted for the European Commission, summarised in the table below, found that the Takeover Directive either altered the balance of regulation (making it more shareholder or stakeholder-oriented) or made substantial changes in the rules in all Member States except the UK, Austria, Denmark, Sweden.[17] It is of interest to note that three of these four relatively unaffected states are non-Eurozone members.

Table 2.2: Mapping the changes introduced by the Takeover Directive and their direction

	Significant changes	Some changes	No significant changes
More shareholder-oriented	Cyprus, Czech Republic, Estonia, [Germany], Greece, [Hungary], Luxembourg, Netherlands, Poland, Slovakia, Spain	Belgium, Finland	[Germany], Romania
More stakeholder-oriented	[Hungary], Italy	France, Ireland, Portugal	
Neutral			Austria, Denmark, Sweden, UK

Source: Clerc, C., Demarigny, F., Valiante, D. & Mirzha, M. A. *A Legal and Economic Assessment of European Takeover Regulation*, 2012

2.2 Limited risk of being over-ruled

As mentioned above, one of the potential drawbacks of EU-level setting of regulation is the risk that Britain is over-ruled in some fundamental aspect of financial services regulation with regards to which its concept of the regulation differs from that of other EU Member States.

Through most of the period of Britain's membership of the European Union and its forerunners, this risk was relatively limited. There were three key reasons why:

- The thrust of EU regulation has been liberalising, pro-trade, and pro-competition. This has meant that, although Britain might have preferred the details of certain regulations to be different, some compromise provided the opportunity, most of the time, to extend British concepts at the EU level.

[16] In Germany, internalisation was allowed, but investment firms were required to obtain explicit permission for every order before internalising trades.

[17] In some cases – for example, Germany –changes were introduced before the Directive itself was passed, partly in anticipation of the transposition of the Directive. Hungary and Germany are therefore included twice in the table below to reflect the position of the Directive relative to various stages in the development of financial regulation in those economies prior to its introduction.

- EU policymakers, particularly at the European Commission, have been highly influenced by British thinking and typically regarded British financial regulation as definitive of international best practice.
- It has long been understood that financial services, particularly at the wholesale level, were an industry in which Britain had a particular specialism and was much the leading player in the EU, and there was a general reluctance at EU level to over-rule a country that was especially dominant in the industry concerned.

This last point, regarding the reluctance to over-rule, is worth dwelling upon, because it is critical to how conditions have changed since the financial crisis and how Britain's position could be restored. Shortly after qualified majority voting (QMV, i.e. the process of over-ruling national vetoes by a weighted vote of all Member States) was introduced, President de Gaulle came to power in France. He regarded qualified majority voting as an impingement upon the sovereignty of France, and there was an extended "empty chair" crisis in 1965, when France refused to participate in European Council proceedings. This led to the Luxembourg Compromise of 1966. According to the Luxembourg Compromise:

> "Where, in the case of decisions which may be taken by majority vote on a proposal of the Commission, very important interests of one or more partners are at stake, the Members of the Council will endeavour, within a reasonable time, to reach solutions which can be adopted by all the Members of the Council while respecting their mutual interests and those of the Community."

The Luxembourg Compromise was never formally accepted by the European Commission or the European Court of Justice, and was widely regarded as becoming largely obsolete with the Stuttgart Declaration of 1983, in which the French accepted the principle of widespread curtailing of national vetoes. However, the French have occasionally subsequently invoked the Luxembourg Compromise to prevent themselves being over-ruled in agriculture,[18] and the Compromise was in place for so long that it became part of the institutional culture, still informally curtailing or at least influencing the conduct of QMV. As the Member State with much the largest presence in wholesale financial services, and very large involvement in other financial services activities as well, the cultural echo of the Luxembourg Compromise was for many years a significant protection for the UK.

Another traditionally important reason why British financial regulation concepts were influential and there was limited risk of Britain being over-ruled in anything fundamental with respect to financial sector regulation was the understanding that the City of London, as a global player in the financial services sector, was an asset to the European Union.

Before the financial crisis, in the mid-2000s, it was estimated that London provided 41 per cent of all City-type financial services activity in the European Union, and had a dominant international market share in six of eight major international financial product areas. If London's financial cluster did not exist, it was estimated that the cost of financial services in the EU would rise sixteen per cent and EU GDP would be €33bn lower in the short term, €23bn lower over the medium term, with the loss of 100,000 jobs.[19]

Of course, the benefits of the financial sector to the broader EU go far beyond the simple generation of jobs and activity in the City.[20] The financial services sector makes a much broader contribution, to how

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[18] Indeed, the British government position is that the Compromise is still in place, and the possibility of the UK's applying the Luxembourg Compromise to financial services regulation was floated by Mark Hoban at the Treasury Select Committee on 8 November 2011 (see: http://uk.reuters.com/article/2011/11/08/uk-britain-financial-hoban-idUKTRE7A74WO20111108).

[19] *The City's Importance to the EU Economy 2005*, City of London & CEBR, February 2005

[20] See, for instance, *The Value of Europe's International Financial Centres to the EU Economy*, Report prepared for the City of London Corporation and TheCityUK by Europe Economics, July 2011, http://217.154.230.218/NR/rdonlyres/583EB1BD-3CAE-4EAD-8BEA-41B2CEC1EFD6/0/BC_RS_ValueofEUsFinancialCentres_FullReport.pdf

business investment is funded, including small local businesses; how pensions are paid for; how companies manage to buffer themselves against bad times, to hedge against risks, and insure against disaster; how broader access to financial services enables households to smooth consumption during periods of unemployment, unexpected drops in income (e.g. short-hours working) or family surprises (illness, divorce, babies) and hence to deliver greater overall macroeconomic stability (contrary to much recent discussion); how interventions in distressed businesses can preserve value and restore long-term jobs; how governments use international financial centres to borrow to service public spending in periods when tax revenues are temporarily depressed.

Such contributions are not confined to one Member State. Citizens of other Member States gain returns on their investments in the UK; others travel to the UK to work in the City. And the benefits of the business activities carried out in the City are not accrued only by UK firms. The activities of London's financial centre benefit car companies in Sweden, pharmaceuticals manufacturers in France, clothes manufacturers in Italy, agribusinesses in Poland, and so on.

2.3 Entry point for a growing European market

The EU has been seen as an area in which financial services would have strong growth opportunities, which businesses in London could exploit or which international businesses could use London as a natural beachhead to exploit. Indeed, during the 1990s and 2000s the EU financial services sector grew strongly.

Volumes of business increased, as well. By the mid-2000s, EU business supported 22 per cent of London's City-type activities and EU companies owned about one third of the foreign banks operating in London.[21] By comparison, about 15 per cent of UK GDP is exported to the EU across all sectors.[22]

While the amount of leverage and volume of financial services activity varied between Member States, before the financial crisis the 2000s was a decade of increased integration in financial services between Member States and growth in the volume and global pre-eminence of EU financial services. It was reported in 2005, for example, that, in 11 out of 15 categories of financial services, trading and activity increased in the EU relative to the US between 1998 and 2004. The same report also noted the $33 trillion of commercial banking assets in Europe were nearly four times the $9 trillion assets of the US commercial banking sector at end-2003.[23]

Increased financial development creates opportunities for liquidity-constrained households to obtain better access to credit. Increased credit provides a stock of debt that wholesale financial intermediation optimises (e.g. by investing into an appropriate mix of risk-and-return, and hedging), creating an increase in finance sector activity in this optimisation process.

Increased leverage, in turn, tends to support increased household spending and business investment, which (at least until private sector leverage becomes excessive — at point which may have been exceeded in certain Member States in the 2000s[24]) boosts economic growth, encouraging further provision of financial services.[25]

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21 *ibid*

22 Source: www.uktradeinfo.com

23 http://www.thecityuk.com/assets/Uploads/EuropevsUS2005.pdf

24 See http://www.europarl.europa.eu/RegData/etudes/note/join/2010/433453/IPOL-JOIN_NT(2010)433453_EN.pdf in which Ireland, Spain, the UK (and, to a lesser extent, Cyprus, Denmark and Portugal) were noted as countries with high to potentially excessive household debt.

25 See http://www.bis.org/publ/work352.pdf for more details on how moderate debt increases growth but excessive debt can damage it.

2.4 Strengthening growth in other Member States

Academic research confirms that when financial sectors are more developed, economies grow faster, and that the greater development of the finance sector is a key cause of that faster growth. Increased financial sector development in the rest of Europe will have led to improved economic growth, and therefore enhanced opportunities for British firms to trade.

Table 2.3 quantifies how much financial development increased over the 2000s in selected Member States.

Table 2.3: Increasing financial development over the 2000s (selected Member States)

	Index of financial development in 2000	Index of financial development in 2008	Change: 2000-2008
Germany	1.15	1.02	-11.3%
Greece	0.42	0.92	119%
Spain	0.65	1.72	165%
France	0.81	1.06	30.9%
Italy	0.71	1.03	45.1%
Luxembourg	0.96	2.11	120%
Netherlands	1.25	1.93	54.4%
Poland	0.25	0.41	64.0%
Portugal	1.18	1.72	45.8%
UK	1.21	1.89	56.2%

Source: Europe Economics research for Open Europe

It can be seen in this table that financial development increased over the 2000s in many Member States (Germany being the one exception), and that development increased much more rapidly in some Member States (e.g. Spain) than others (e.g. France, Italy). Indeed, in some Member States (e.g. Spain and Portugal), just prior to the 2008 crisis finance had reached a similar level of development to that in the UK and the Netherlands — countries with a long history of significant finance and financial services industries.

This increase in financial development, resulting in part from Britain's influence in the European Union, will have increased expected economic growth for those countries, in turn expanding opportunities for finance and financial services exports further as firms expanded investment and consumers saved.[26]

2.5 Conclusions

Our purpose in this section has not been to contend that all EU-level financial regulation has been to the UK's benefit, or even that EU-level setting of financial regulation has, overall, been to the benefit of the UK. We have merely sought to sketch out what we regard as the key planks of the case that would be offered if one were indeed arguing that EU-level setting of regulation benefitted the UK in the circumstances before the Eurozone crisis.

We needed to identify these key planks because, in the next section, we shall contend that key elements of the case no longer hold. In particular, we shall contend that UK influence over EU financial services regulation-setting has diminished markedly and that the EU is no longer as attractive, relative to non-EU opportunities, as a growth area for exports from the UK financial services sector.

[26] For further details, see http://www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf

Overall, during the period of rapid expansion in EU financial services, there was at least a case to be made that the benefits of EU membership to the EU financial services sector outweighed the costs. The question we shall ask the next section, however, is whether this remains the case. Is the EU financial services sector likely to be a significant growth area over the next decade or so, relative to financial sectors in other parts of the world? Does Britain maintain the same level of influence over the setting of EU financial regulation? And will firms from other parts of the world regard London as a natural beachhead for their activities in other parts of the EU as has been the case in the past?

3 After the Eurozone Crisis

In the previous section, we identified the key planks upon which an argument that EU-level setting of financial regulation has, over the past couple of decades, been to the UK's benefit might rest. In this section, we shall explore the risk that these very same factors that, in the past, might have supported that case, might over the next decade suggest that the UK would not benefit from EU-level setting of financial regulation.

There is necessarily enormous uncertainty in any discussion of the likely future path of regulatory policy. There are a wide range of economic and political developments which could change the circumstances we describe. An element of judgement is necessary in assessing the materiality of the risks we identify, and in deciding how best to respond, and the area would benefit from further research in ways we shall explain. However we believe that the general pattern since the onset of the financial crisis and the resulting crisis in the Eurozone is clear and UK policymakers need to consider how they will respond.

3.1 Change in Spirit and Thrust of Regulation

The Financial Crisis of 2007 onwards, and in particular the collapses in the banking sector of late 2008 and early 2009 led to a sea-change in attitudes to financial sector regulation across Europe and the United States. This has partly been reflected in certain specific regulatory changes in the banking sector — changes already announced and a number of changes yet to come. But more fundamentally it has driven a significant change in the thrust of financial services regulation at EU level.

Whereas we have argued in previous sections that during the 1990s and 2000s the thrust of EU-level regulation across the EU (if not always in the specific case of the UK) has been liberalisation and the encouragement and facilitation of cross-border trade within the EU, from 2009 onwards, and particularly once the Eurozone crisis commenced, the key driving force became the extension of the net of regulation; increasing restriction in financial services regulation; limiting the activities of financial sector firms; and taking greater control over the activities of the financial sector.

There are, of course, important reasons for this change. Under the pressure of the financial crisis, particularly in late 2008 and early 2009, many widespread principles of regulation were overthrown. Procedures for mergers were set aside in the urgency of events (for example, in the case of Lloyds TSB and HBOS). Rules limiting state support to particular companies (regarded as anti-competitive and protectionist) were set aside.

At the national level, such principles were simply blown away by events. But in many of these areas the ultimate authority lay with European Union institutions. It is not as widely appreciated as perhaps it deserves to be that the European Union rules were left much more intact than were national frameworks. This partly reflects the fact that the EU rules were embedded in Treaties, and so not straightforward to sweep away in one heated and hasty Parliamentary vote. Partly it reflects their international nature. And partly it reflects the fact that the European Union Single Market rules are intrinsically insulated from the day-to-day pressures of public opinion — they exist precisely to deliver liberalisation, competition, and the removal of barriers to trade between countries that either would not, for most Member States of the EU, be passed by Member State democratic institutions if left to themselves, and to resist the erection of

barriers to trade and competition, and state aids, that might naturally arise as politicians respond to day-to-day demands that "something must be done" and then, once in place, are only slow removed (if at all).

The European institutions, therefore, to some extent ensconced in their ivory tower and deliberately insulated from day-to-day political pressures, could not and did not abandon the principles laid out in the EU Treaties. By and large they did not seek to obstruct the neglect of merger procedures or the institution of anti-competitive state aids. Instead, they issued memoranda of forbearance, and entered into agreements with Member States about the timescales over which state aids would be unwound and more competition would once again be introduced. For example, the Government in the UK has been required to divest itself of its shares in the nationalised banks, starting with Northern Rock (the first bank to be nationalised), and the state aids provided to RBS and Lloyds banking group have driven mandated divestments and restrictions upon dividend payments.

Thus, although we are about to argue that EU-level regulation will, over the next few years, be a source of de-liberalisation and reduced trade in the financial sector, this should be understood as a delicate judgement. The underlying deep structure of the Single Market is still present in the Treaties and in the institutional set-up, and this deep structure has been a pro-competitive pro-liberalising force in respect of the UK as well as elsewhere — that is to say, in certain respects and at certain times, it has forced the UK to be more liberal and pro-competition than the UK might have found it easy to choose to be for itself. It is thus not enough, to conclude that the EU is de-liberalising, to show that EU-level policy-setting will imply the introduction of de-liberalising regulation. One would also have to show that the de-liberalising regulation introduced would be more de-liberalising than the regulatory changes the UK would be likely to choose for itself, and that this more-than-offsets the liberalising character of the Treaty-embedded principles that have forced, and will probably continue to force, the UK government to be more liberal, more competitive, and more pro-trade, in certain respects, than it might find easy to choose for itself.

3.2 Extension to the Scope and Depth of Regulation

The financial sector has in recent years experienced an unprecedented wave of new regulation, and regulatory and tax changes. These include:

- Measures that had only recently been implemented prior to the crisis, and had probably not yet been fully absorbed into behaviour, prices, demand or market structure, are already being revised in light of these events. These include the Capital Requirements Directives (implementing Basel II and Basel III) and the Markets in Financial Instruments Directive.
- Measures that had been planned before the crisis but scheduled for introduction shortly afterwards. These include the Solvency II Directive and the Clearing and Settlement framework.
- Measures introduced at least partly in response to the banking crisis which affect the broader financial sector rather than the banks themselves. This includes in particular the Alternative Investment Fund Managers Directive, the proposed Financial Transactions Tax, and the EU bonus cap.
- Measures introduced, proposed or debated in response to the crisis affecting mainly the banking sector. These include measures requiring or effecting:
    - new arrangements for cross-border supervision and crisis management;
    - changes to capital and liquidity requirements even under existing regulatory;
    - structures and new measures such as changes to trading book capital requirements;
    - new special administration regimes or other resolution mechanisms;
    - new mechanisms for the treatment of bondholders in the event of administration (e.g. "bail-ins" — debt-equity swaps);
    - the restriction or separation of activities (e.g. as per the retail / investment banking separation / ringfencing discussed by the Vickers Commission, with proposals now to consider such separation at EU level, as well);

  - restrictions on remuneration or dividend policy;
  - caps on size, connectedness, concentration or complexity;
  - accounting changes;
  - taxes or stability fees; and
  - macroprudential oversight.

- Measures introduced at Member State level, in response to particular crises, such as restrictions on the short selling of bank equities or on sovereign credit default swaps.
- Measures introduced by groups of Member States, such as the Financial Transactions Tax being implemented by 11 countries.

The central issue for our discussion here is not whether any or all of these measures are justified and appropriate regulatory improvements. It is that they are clearly not liberalising, deregulatory trade- and competition-promoting measures. Their central goal is to restrict and control the activities of the financial sector.

It is also the case that a significant tendency has arisen for different Member States to enact their own new measures of financial regulation. Obvious examples of this are the various country-specific bans on the short selling of banking stocks or various trades in sovereign CDS. There have also been country-specific moves in areas such as the treatment of banking sector bonds (e.g. Denmark has taken a different approach on this question from, say, Belgium, which has in turn treated such bonds differently from Ireland). Groups of countries have also introduced new rules in order to bypass opposition from countries such as the UK. For example, a Financial Transaction Tax is being introduced in eleven countries, though dissent from the UK and others has stopped it being implemented across the EU, which is expected to cost British savers €4.4bn thanks to its impact on investor returns in those eleven countries.[27]

FURTHER RESEARCH

Further research could identify a list of regulations to which the UK is subject as a result of EU-level setting of financial regulation and which produce net disbenefits.

That list would implicitly be a list of those regulations which the UK might want to change as a part of any potential renegotiation, alongside others where the implementation created unnecessary costs despite net benefits.

Furthermore, the crisis has inspired the creation of a number of new EU institutions, such as ESMA, EBA and EIOPA.[28] The UK has objected to the granting to ESMA of broad-based powers (proposed on credit rating agencies, defining appropriate technical standards on equity and non-equity trading, and on product bans).

Without, at this stage, committing either way on the efficacy of these measures, we aim to highlight that — in deep contrast to the general liberalising thrust of financial services regulation in the 1990s and 2000s — the thrust of financial services sector regulation at present is quite the reverse. And this is, at the time of writing, expected to remain the case for much of the next decade.

It is, however, worth observing that at least some important components of this rise in regulation originate from global institutions, rather than the EU. Examples include:

- the revisions to the capital requirements directives (which reflect — though amplify upon — the Basel III global rules); and

[27] London Economics *The Effects of a Financial Transaction Tax on European Households' Savings* report for the City of London Corporation, February 2014

[28] ESMA is the European Securities and Markets Authorithy. EBA is the European Banking Authority. EIOPA is the European Insurance and Occupational Pensions Authority.

- revisions to MiFID (which have been heavily influenced by G20 initiatives in derivatives trading and transaction reporting).

3.3 Reduced Influence of the UK

In previous sections we have emphasized how influential United Kingdom regulatory models were upon EU-level financial services regulation in the 1990s and 2000s. There has now been a significant change in this area. There are three key aspects to this:

- Partly this reflects a reaction to the financial crisis, and its widespread characterisation on the Continent as having been the consequence of an "Anglo-Saxon" light touch, low supervision deregulatory approach to the financial services sector.
- Partly it is a consequence of a change in the balance of initiative in European Union institutional policy-setting, with the European Parliament gaining codecision-making powers.
- Partly, this reflects the fact that certain forms of financial regulatory change have been developed in response to Eurozone-specific issues, to which British concerns are regarded as peripheral at best.

The UK has always relied on influencing the direction of regulation, rather than successfully opposing measures proposed. Research by Business for Britain has found that since the mid-1990s the UK has not managed to prevent a single proposal placed in front of the Council from becoming European law. The UK has opposed 55 measures since 1996, but all have gone on to become British law. And the UK's representation in all of the EU's bodies has declined dramatically. Since 1973 the UK's voting power in the Council of Ministers has decreased from 17 per cent to 8 per cent, in the European Parliament it has decreased from 20 per cent to 9.5 per cent and in the European Commission it has decreased from 15 per cent to 4 per cent.[29]

At the same time, the relative involvement of UK citizens in devising and enforcing policy within EU institutions has declined. In 2013 the House of Commons Foreign Affairs Committee noted[30]:

> In relation to its share of the EU's population (12.5%), the UK remains significantly under-represented among the staff of the major EU institutions, and its presence continues to shrink. We were seriously concerned to learn that the number of UK nationals on the staff of the European Commission has fallen by 24% in seven years, and now stands at 4.6% of the total. This compares to 9.7% for France, which has almost the same share of the EU's population. In the increasingly-powerful European Parliament, the UK's share of administrator-grade staff has fallen from 6.2% to 5.8% since 2010 (while France's has risen from 7.5% to 8.6%); and in the General Secretariat of the Council of the EU the UK's share of administrator-grade staff fell from 4.8% to 4.3% over the same period (while France's fell from 7.7% to 6.9%).

The decline in influence is reflected in the UK increasingly dissenting and being overruled in Qualified Majority Voting (QMV) decisions. Table 3.1 shows that, whereas in 1988 the UK was fairly close to the median in terms of dissent, by 2008 the UK was by some margin the most common dissenter In the sample. The UK was being over-ruled in QMV more than twice as often as any other Member State.

[29] Business for Britain *Measuring Britain's influence in the Council of Ministers*, BfB Briefing Note 3

[30] See http://www.publications.parliament.uk/pa/cm201314/cmselect/cmfaff/219/219.pdf

Table 3.1: Distribution by member states (in % of legislative acts dissented from)[31]

	1988	2008
Spain	3.75	1
Denmark	3.1	2
Greece	2.5	1.5
Ireland	1.9	1.5
UK	1.9	3.5
Italy	1.6	1
France	1.25	0.5
Portugal	0.9	1
Germany	0.9	2
Netherlands	0.6	1
Belgium	0	2
Luxembourg	0	1.5

That loss of influence can also be seen in the UK Government disagreeing with the final outcome to the point of taking legal action in the European Court of Justice (ECJ) against a number of policies, particularly:

- New regulations over short selling, which it argued transferred to much power to the ESMA from national regulators. Despite the Court's Advocate General issuing an opinion supporting the UK's position, the Court rejected all of the UK's claims in that case.
- Proposals for a Financial Transactions Tax, where it argued that the use of enhanced co-operation and the extra-territorial nature of the tax (which means, for example, that a UK bank transacting a Spanish bank in US securities is liable to pay Spanish FTT)[32] infringes on the UK's competency with respect to tax policy. The case has been dismissed as premature.
- An ECB "location policy" which required central counterparties that handle more than 5 per cent of the market in euro-denominated financial products to be based within the Eurozone. It argued that the policy "contravenes European law and fundamental single market principles".
- A cap on bonuses in the banking sector. It argued that the regulation of pay "in this manner goes beyond what is permitted in the EU Treaty". More broadly, the UK Government argued that the new rules were "rushed through without any assessment of their impact" and, by increasing salaries, will "make banks themselves riskier rather than safer."

To summarize: Facing new regulations which it believes are prejudicial to the interests of the UK, the Government is so far failing to shape regulation before it is proposed to the point where it supports that regulation; failing to stop the progress of the resulting regulations which it does not support; and then failing to win the resulting legal cases when it attempts to challenge them in the courts.[33]

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[31] Source: http://www.eng.notre-europe.eu/media/Etud88_EN-QualifiedMajority-Voting-Novak.pdf

[32] http://www.kpmg.com/uk/en/services/tax/corporatetax/pages/european-financial-transaction-tax.aspx

[33] We have also investigated cases where the UK was in a minority in European Council votes relating to Economic and Monetary Affairs (the area that includes most finance and financial services questions). Since 2009, of 63 measures considered, the UK voted against the majority in four cases, whereas no other Member State voted against the majority in more than one case. We are unable to identify pre-2009 data and thus cannot establish that the UK has lost influence as such, but this data reinforces the picture of a country that, despite its pre-eminent role in financial services, is over-ruled more often than others.

We note that this is part of a broader pattern in which, across all policy areas, the UK was in a minority 65 times out of 565 votes (more than 10 per cent of the time) with the largest minority votes for other Member States being Germany, at 35, Austria at 31, and the Netherlands at 26 — illustrating that across the policy spectrum the UK is in a minority nearly twice as often as any other Member State.

3.3.1 Changed spirit of regulation

In response to the financial crisis of 2007-on, financial regulation has changed internationally, in the UK, and at EU level. There are, however, very important differences in the direction of travel of new regulation between the UK and EU.

The UK analysis has been that, although some new rules and restrictions are necessary, the main flaws in the regulatory structure that the financial exposed were (a) that the regulatory framework either distorted market forces or did not provide an adequate basis for allowing market forces to function properly; (b) that the supervision of regulated firms and of the market as a whole was inappropriate or inadequate. Reflecting this analysis, UK regulation has moved in the direction of re-empowering market forces and re-emphasizing the role of supervisory relationships (as versus rules or regulatory principles).

Thus, for example, the UK removed the "tripartite" system of banking supervision (including the three parties — the Treasury, Financial Services Authority, and Bank of England) to restore most banking supervision to the Bank of England. The Bank of England has also established a Financial Policy Committee to oversee market developments as a whole.

The Bank of England has argued, indeed, that an enhanced supervisory relationship is likely to make it more feasible to enforce regulatory change than would be more detailed regulation. As Mervyn King put it, addressing the Parliamentary Joint Committee on the Draft Financial Services Bill[34]:

> I give two examples of where we think it will be important for regulators to exercise judgment and why we need to make a break from the style of regulation we have seen in the past. One is that I would like [Bank of England supervisors] to be able to say to a bank—this is a hypothetical example but is clearly relevant to what happened before the crisis—"Your leverage has gone up from 20 to one to 40 to one in the past four or five years. You have not broken any rules. Nevertheless, this is a highly risky set of activities to undertake, and we want you to reduce your leverage." The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules.
>
> Another example would be to say to a bank, "The structure of your bank is so complex and opaque, with so many offshore and onshore legal entities, that we don't understand the risks you are taking. We are not entirely confident that you do either, but certainly outside investments cannot assess it. We think that degree of opacity is inconsistent with a sensible and stable contribution to financial stability." These institutions are operating not only for themselves; they are big enough to affect the economy of the whole country. Therefore, the regulator has to be free to make a judgment about that degree of opacity, even though nothing is done that could be said to violate a specific detailed rule. That degree of judgment is vital.

Regarding the re-empowering of market forces, the UK has emphasized the role of bail-ins and the firm denial that there is any implicit guarantee of banks or bank deposits beyond the levels explicit in regulation. It has also sought to empower market forces more by making it more credible that the government would not intervene to save investment banking activities by "ring-fencing" such activities from the more consumer-facing "retail" functions of banks, as discussed in the so-called "Vickers proposals".

[34] 3 November 2011, http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/Ucjcdfsb031111ev11.pdf

By contrast, at the EU level the dominant themes of new regulation have been increased control of the market by extending the scope of regulation; curbing specific "undesirable" behaviours; protecting consumers and taxpayers; and enhancing Eurozone solidarity (which we discuss in more detail in the next section). Even where regulatory developments have been relatively similar, such as in the European Commission's bank resolution and bail-in measures, the philosophy has been more about the protection of consumers and taxpayers and less the re-empowering of market forces. Across much of Continental Europe, the financial crisis is seen as having been the consequence of an "Anglo-Saxon" light touch, low supervision deregulatory approach to the financial services sector.

The following table compares and contrast new UK versus new EU regulations in various specific areas, illustrating the difference in philosophy and priorities.

EU		**UK**	
Philosophy / Goal	**Examples**	**Philosophy / Goal**	**Examples**
Extending scope of regulation	• AIFM • Requiring certain clearing house functions to be located in the eurozone	Increasing quality of supervision	• Transfer of supervision to Bank of England • Creation of Financial Policy Committee
Curbing specific behaviours	• Short-selling ban • Bonus cap • FTT	Strengthening market incentives	• Bail-in provisions • Encouraging bank 'switching'
Eurozone solidarity	• Banking union • Fiscal pact • FTT	Ring-fencing	• Ring-fencing of retail banking services

Even in respect of international regulatory changes, such as the Basel III rules, which affect the UK and EU along with the rest of the world, there have been some differences of philosophy, between the UK and EU authorities, in respect of how the international changes should be implemented. Far from EU-level regulation following British regulation in this area, it has even been seen as actively an obstacle. This was discussed for example regarding some of the Vickers proposals — in particular, the giving of bite to the ringfencing proposals by associating them with differences in capital requirements. During his evidence to the Parliamentary Joint Committee on the Draft Financial Services Bill, Mervyn King touched on this point with David Mowat MP:

> **FURTHER RESEARCH**
>
> Further research could assess the extent to which international regulation (such as Basel rules) might be implemented differently by the UK from its implementation via EU-level regulation.

Q769 David Mowat: My final question is about the Capital Requirements Directive *[the EU directive implementing the Basel rules]* and the way we co-ordinate with Europe on that. At one time it looked as though it might make it difficult for us to impose higher capital requirements on our institutions than the Europeans would find acceptable.

Sir Mervyn King: It is still a problem. The Commission's current proposals still want to impose maximum harmonisation. I am completely baffled as to why they want to do it. I can think of no logical or economic reason why you would want to have maximum harmonisation, other than a theology of convergence for the sake of it. But the whole spirit of the agreement under Basel I, II and III was to

have a level playing field in terms of common minimum requirements. No one could conceive of any reason why you would object to a country wanting to impose higher requirements, for example to protect their taxpayers. At the European Systemic Risk Board the vast majority of the people round the table were equally baffled as to why there was a case for maximum harmonisation, and I believe that an increasing number of governments in Europe will come to the same view. This is a problem.

The Commission takes the view that some of the things we want to achieve by implementation of the proposals of the Vickers Commission, or macro-prudential regulation through the Financial Policy Committee of the Bank, could be done through what is known as pillar 2 of the capital requirement. Again, that seems rather bizarre to us, because it is clear from the legal basis of pillar 2 that this is for individual institutions, but clearly that is not macro-prudential. Macro-prudential is something that applies to all banks, and that is naturally pillar 1. I cannot see any reason why anyone should object to a country using pillar 1 to have higher capital requirements. I absolutely agree there need to be common minimum capital requirements, and it is good that Europe is now taking this through the European Parliament to get European legislation. We are ahead of other countries in this respect, but I am completely baffled as to why they see any need or reason for having maximum harmonisation.

To put the point bluntly: at EU level much of the concept has been fairly straightforwardly to write more rules. This is not altogether true: we have mentioned above the continuation of EU competition, state aid and merger rules, and it is also worth noting that the Vickers proposals in areas such as making bank debt "bail-in-able" (i.e. empowering banking administrators to convert bank debt into equity) were first proposed by the European Commission. But it does not, overall, mischaracterise the new spirit of EU regulation to say that it is consciously more sceptical of financial markets and actively seeks to curtail their activities.

Now we are clearly in a time of flux, and the possibility cannot yet altogether be ruled out that in due course EU and UK concepts in financial regulation might converge. But at present the UK's thought leadership in this area is much less clear than was the case in the past.

3.3.2 Increased relevance of Eurozone needs

As noted above, some financial sector measures recently introduced or considered have reflected particular issues in the Eurozone. Two early examples of this problem were restrictions on trading in sovereign CDS and proposals for a Financial Transactions Tax. Neither of these was a measure likely to be proposed within the UK. Each reflected particular issues in the Eurozone — in the case of sovereign CDS issues relating to concerns about whether assessments of sovereign creditworthiness reflected genuine analysis or were merely the result of manipulative speculation; in the case of the Financial Transactions Tax reflecting the need to obtain a revenue stream to fund future increased fiscal transfers within the Eurozone. But either proposal would have consequences for the UK.

More generally, the Eurozone's crisis revealed the high degree of financial interconnectedness and interdependence among euro members — e.g. the "contagion" route via which banking problems or sovereign debt problems in one part of the Eurozone led to the withdrawal of funds from banks and government debt in other member economies.

In his January speech, the Chancellor of the Exchequer identified two broad categories of problems which could continue to arise if the interests of non-Eurozone members of the European Union were not safeguarded:

- "First there is a danger that the euro members could start to use their collective voting weight in the EU to effectively write the rules for the whole EU by Qualified Majority Vote". For example, "under the Lisbon Treaty, from 2016, the Eurogroup on its own will have sufficient votes to pass any financial services legislation for the whole of the EU."
- The second danger is "discriminatory treatment of non-Eurozone Member States." He gave the following example: "the European Central Bank's policy of forcing clearing houses with large euro-based transactions to move to the Eurozone."

FURTHER RESEARCH

Further research could quantify the extent to which

- the interests of the Eurozone differ from those of the UK and other non-Eurozone members
- the Eurozone has in practice already begun to caucas
- the right regulatory choices for the Eurozone might mean lower economic growth in Britain

The AIFM Directive could be seen as an example of a regulation that may reflect the interests of the Eurozone but not the UK. The AIFM was expected – in the ex-ante evaluation – to reduce peak unemployment by 1.3 per cent but also reduce economic growth by 0.1 to 0.2 per cent and create one-off compliance costs of between €110m and €2.2bn.[35] Eurozone Member States might prefer enhanced stability, reflecting not just their more rigid labour markets but the threat which economic shocks pose to the stability of the currency area. By contrast, Britain might prefer more economic growth as it has both a more flexible labour market and no equivalent to the threat that a country might be forced out of the Eurozone.

There are other differences in needs between the typical Eurozone member and the UK, which are not directly related to the needs of the euro. Eurozone members may generally prefer greater integration across a wide range of policy areas, for two reasons:

- In order to achieve specific objectives, such as achieving an effective transfer union to give the currency area stability. Britain does not share the need for such institutions beyond its own borders.
- In order to create greater homogeneity in Eurozone markets and reduce the extent to which it is subject to asymmetric shocks, which are accommodated within the Eurozone, absent the ability to vary the external exchange rate, through difficult internal devaluations.[36] Britain does not share that need, with a floating euro to sterling exchange rate.

If Eurozone members constitute a cohesive block, then they are less likely to be influenced by British ideas and may not share Britain's interests.

3.3.3 Changed institutional balance

Another, non-trivial development has been a change in the relative powers of institutions within EU-level decision-making. Traditionally, the European Commission was especially sympathetic to UK thinking across a range of economic policy areas, but especially in the financial services sector, whilst the European Parliament was much less sympathetic.

In recent years, and especially with the Treaty of Nice, the power of the European Parliament has been enhanced. One example is the development of the "codecision procedure" whereby the European

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[35] See *Ex-ante Evaluation of the proposed Alternative Investment Managers Directive*, prepared for DG Internal Policies by Europe Economics, 2009

[36] For more on internal devaluation, see http://www.openeurope.org.uk/Content/Documents/Pdfs/Internaldevaluation.pdf

Parliament now has equal power with the Council, in its ability to amend and reject legislation.[37] Another is that, under provisions of the Treaty of Maastricht enhanced by the Lisbon Treaty, the European Parliament now has a right of legislative initiative that allows it to ask the Commission to submit a proposal.[38]

This enhanced role for the European Parliament has increased its influence over what legislation comes forward, also. An example is the Alternative Investment Fund Managers Directive (the AIFM Directive). This was a measure that the European Parliament repeatedly urged should be investigated from the mid-2000s onwards (with the European Commission repeatedly refusing), but which was only finally introduced in 2009, partly as a reflection of the financial crisis but also, and crucially, as a reflection of the increased institutional role of the Parliament.

There have also been a new set of European financial supervisory institutions, including the European Banking Authority[39], the European Insurance and Occupational Pensions Authority[40], the European Securities and Markets Authority[41], and the European Systemic Risk Board[42].

3.4 Global Opportunities versus EU Opportunities

In a customs union, the degree of trade diversion increases as the volume of trade that would occur with the rest of the world, but for the external tariff of the customs union, increases. That in turn depends on the quality of product produced outside the customs union, the cost of that product, and the volume available.

If the pre-tariff price of non-customs union products falls further below the customs union price and production capacity outside the customs union rises, the proportion of international trade accounted for will rise. Hence two indicators of an increasing risk of trade diversion are:

- An increasing proportion of international GDP and trade accounted for by countries outside the customs union (other things being equal[43]);[44]
- A fall in international tariffs imposed by countries outside the customs union.

There is also a dynamic aspect, especially in a Single Market affecting not only products (goods and services) are relevant but also the factors of production. That means relative investment expectations (relative, that is, between EU and non-EU sources) are another potential source (perhaps a key source) of benefits or costs.

There is good reason to think that, relative to the situation in the 1990s and 2000s, there are diminished opportunities in the EU and increased opportunities outside it. That would suggest that the harms created by trade diversion will have increased.

37 Previously, a measure proposed by the European Commission and supported unanimously by the Council could not be stopped by the European Parliament.
38 http://www.europarl.europa.eu/parliament/expert/staticDisplay.do?id=55&pageRank=13&language=EN
39 http://www.eba.europa.eu/
40 https://eiopa.europa.eu/
41 http://www.esma.europa.eu/
42 http://www.esrb.europa.eu/home/html/index.en.html
43 In particular, for invariant non-tariff barriers, which is clearly not the case for the EU.
44 To develop the intuition for why this is so, consider the following thought experiment. Imagine first that the customs union encompassed the entire world — in that case there would no trade diversion at all. Next imagine that the boundary of the customs union were contracted so that it covered fewer and fewer trading countries and hence a smaller and smaller proportion of the world with which one would otherwise trade — as more and more of international trade were conducted outside the customs union, the amount of trade diverted would, other things being equal, increase.

3.4.1 Diminished opportunities in the EU

As the Single Market developed and expanded, and as financial development advanced in many EU Member States, the 1990s and 2000s saw opportunities for UK businesses within the EU, particularly UK financial sector businesses.

It is not clear that this will remain the case over the next decade. In a number of Member States (e.g. Ireland, Spain), an important factor in enhanced financial development appears to have been over-indebtedness and over-expansion in banking sectors. The correction of this problem is likely to be associated with reductions in the volume and value of financial sector business, and recovery is unlikely to be associated with a rapid resumption of the *status quo ante*. Even simply the process of deleveraging — reducing indebtedness relative to the size of the economy — is likely to have the consequence of a fall in financial sector activity, as lower debt levels means less demand for the debt to be put to work adding value, and hence passing through financial intermediaries. But beyond that there has been considerable austerity at national level, reduced function of banking sectors and reduced appetite for experimenting with new financial sector firms or new innovations. These countries are unlikely to be as attractive growth opportunities for British financial sector firms as was the case in the past.

The financial crisis of recent years is unprecedented in the post-World War II era. It is an established empirical observation that major financial crises are followed by periods of deleveraging. The more substantial the financial crisis, other things being equal, the more substantial the deleveraging that follows.

Given the scale of the recent (and in some senses on-going) financial crisis, it is correct to anticipate a significant and extended phase of deleveraging. The McKinsey Global Institute analysed 45 historic episodes of deleveraging, finding that they on average last six to seven years and reduce the ratio of debt to GDP by 25 per cent.[45] This empirical finding suggests that households, businesses and governments may not be complete. An update in 2012 found that progress in deleveraging had been highly uneven globally and total leverage had actually increased from 2008 to Q2 2011 in Italy (by 12 percentage points), the United Kingdom (by 20 percentage points), Spain (by 26 percentage points) and France (by 35 percentage points).[46] Since then, further research by McKinsey for the BBC has found that the UK has begun to deleverage, but progress has been slow.[47]

In some Member States, the key form of deleveraging has been and may continue to be direct reductions in household indebtedness. For example, a European Parliament study in 2010 identified Cyprus, Denmark, Ireland, Portugal, Spain and the United Kingdom as "high household indebtedness" Member States, averaging 84 per cent household debt to GDP in December 2009.[48] That compared with average household indebtedness of just 56 per cent for Belgium, Germany, Luxembourg, Austria, Finland, France, Malta, Netherland and Sweden. A reduction of 25 per cent in household debt to GDP for the high indebtedness countries (in line with McKinsey's historical analysis) would take them to 60 per cent — close to the average for the lower-indebtedness group.

In other Member States (and to some extent even in the high household indebtedness states), a key mechanism of deleveraging is government austerity programmes. They deleverage both by reducing government debt and by increasing household tax commitments and reducing benefits, thereby making households less attractive to lenders, reducing their creditworthiness and so reducing the amounts they borrow.

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[45] http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/Debt_and_deleveraging_The_global_credit_bubble_Update

[46] http://www.mckinsey.com/insights/global_capital_markets/uneven_progress_on_the_path_to_growth

[47] http://www.bbc.co.uk/news/business-27108059

[48] *Household indebtedness in the EU*, Europe Economics on behalf of the CRIS Committee of the European Parliament, 2010.

Just as periods of increasing leverage are both effect and cause of growth in financial services, periods of deleveraging tend to be associated with and encourage contraction in financial services. Thus, this protracted period of deleveraging has reduced financial services activity. This follows both from a reduction in credit extended by financial services firms and a consequent reduction in economic activity and growth, further restricting demand for and provision of financial services.

The Eurozone, in aggregate, is not as heavily indebted as the UK or the US, and of course there are EU Member States outside the euro, such as the Czech Republic, which offer their own unique growth opportunities.

The point being made here is not that there remains no scope for an expansion in financial services within the EU, or that financial services sectors had become "just too large".[49] The central point is simply that, particularly if Eurozone economies continue to deleverage, opportunities for rapid growth in financial services within the EU are likely to be more limited than they have been in the past.

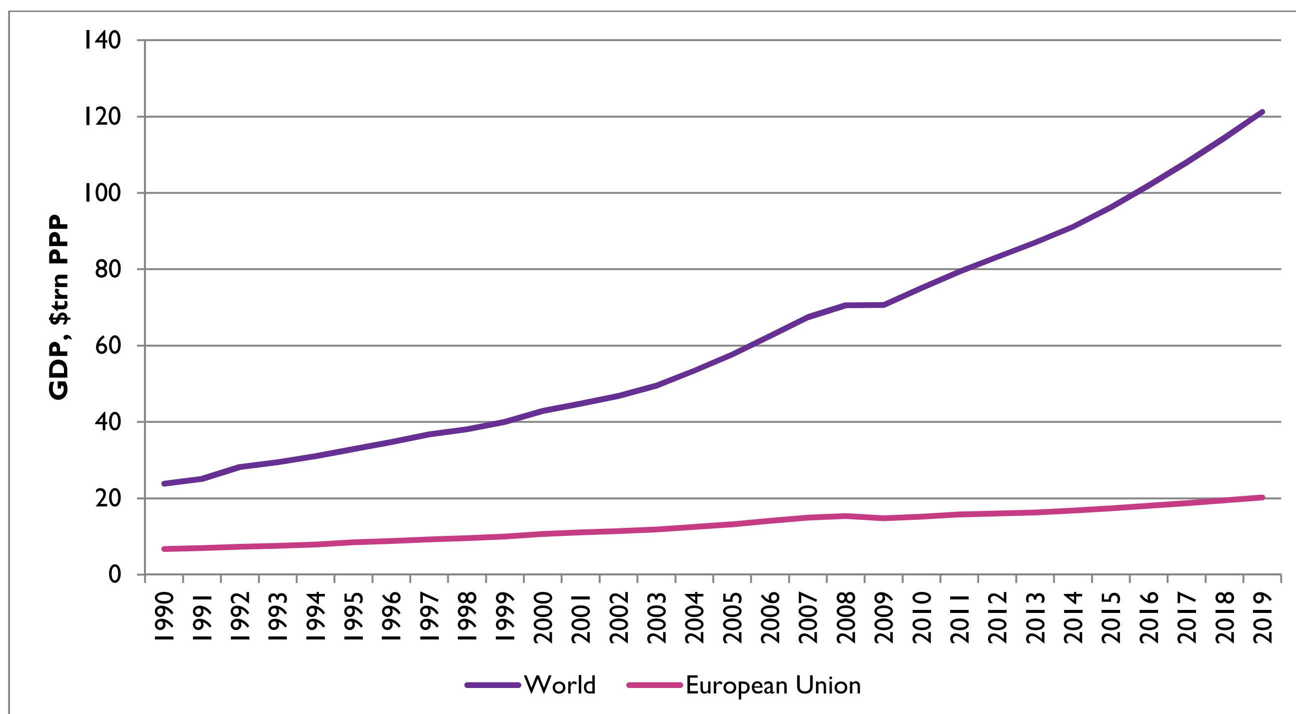
3.4.2 Enhanced opportunities in emerging markets

At the same time, financial services sector opportunities outside the EU may be growing more rapidly than before. The United States may offer some opportunities, as it always has done for many decades. But the new feature of recent years has been that financial services sector opportunities in China, India, Brazil, Russia, the Gulf region, Australia, and other countries outside the EU are expanding rapidly.

First aggregate economic growth has been, and is expected to continue to be, much stronger in the developing economies outside Europe than within the EU27. The global recession was much less severe and much shorter than the recession in the UK, Europe or the United States and the recovery has been much stronger. The recovery has also been stronger so far in the United States relative to the Eurozone or the United Kingdom.

[49] For example, Europe Economics' analysis for TheCityUK has suggested that, in all Member States except Ireland and the United Kingdom, the financial services sector is clearly below even fairly minimal notions of its efficient size — see paragraphs 2.65ff in http://217.154.230.218/NR/rdonlyres/583EB1BD-3CAE-4EAD-8BEA-41B2CEC1EFD6/0/BC_RS_ValueofEUsFinancialCentres_FullReport.pdf.

Figure 3.1: GDP, $trn PPP, 1990-2019



Source: International Monetary Fund, World Economic Outlook Database, *April 2014*

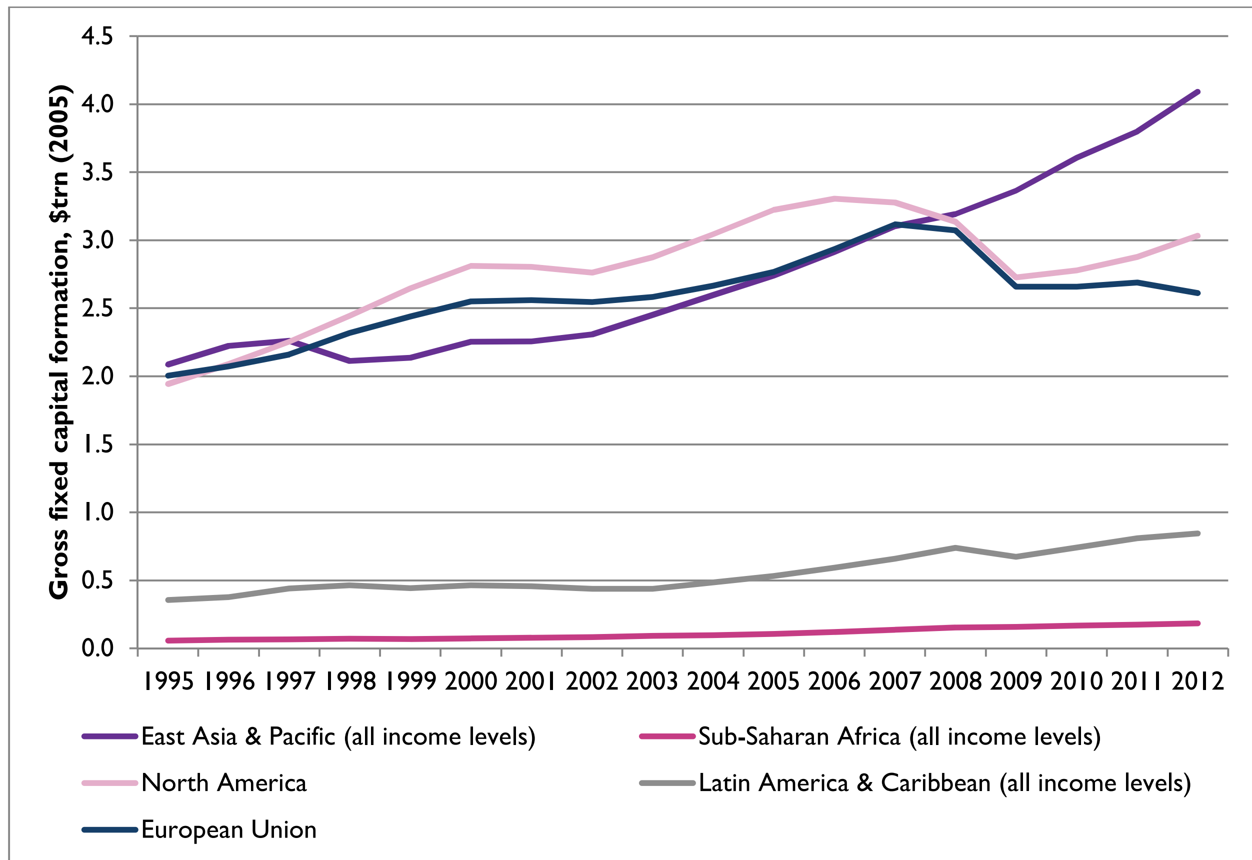
In 1990, the European Union represented 28 per cent of world output (in US dollars, at purchasing power parity). By 2002, the EU was still 24 per cent of world output — a relatively small drop. But, by 2019, the EU is forecast to be just 17 per cent of world output — a dramatic and rapid relative fall.[50]

General economic growth is one very broad measure of the scope for financial services growth. But more specifically, key forms of financial services sector activity include providing capital for business investment and providing intermediation services for household savings.

As Chinese and Indian businesses grow, they will need capital. They will need firms to broker deals for them to obtain capital. They will need advice on their capital structures. The rise of investment in East Asian and the Pacific, relative to the developed economies in North America and the European Union, can be seen in Figure 3.2.

[50] We observe that since some of this impact arises from especially strong growth in the emerging markets of Brazil, Russia, China and India, the relative share of other developed economies falls also — though EU growth is projected to be slower than growth in the US, Australia, and a number of other developed economies, so the overall impact is reduced. But even if the share of other developed countries fell even faster than that of the EU, that would not affect the central point being made, which is that as the share of EU trade in global trade falls, the trade diversion associated with the EU's customs union will tend to rise, regardless of whether that is trade with developed or emerging markets.

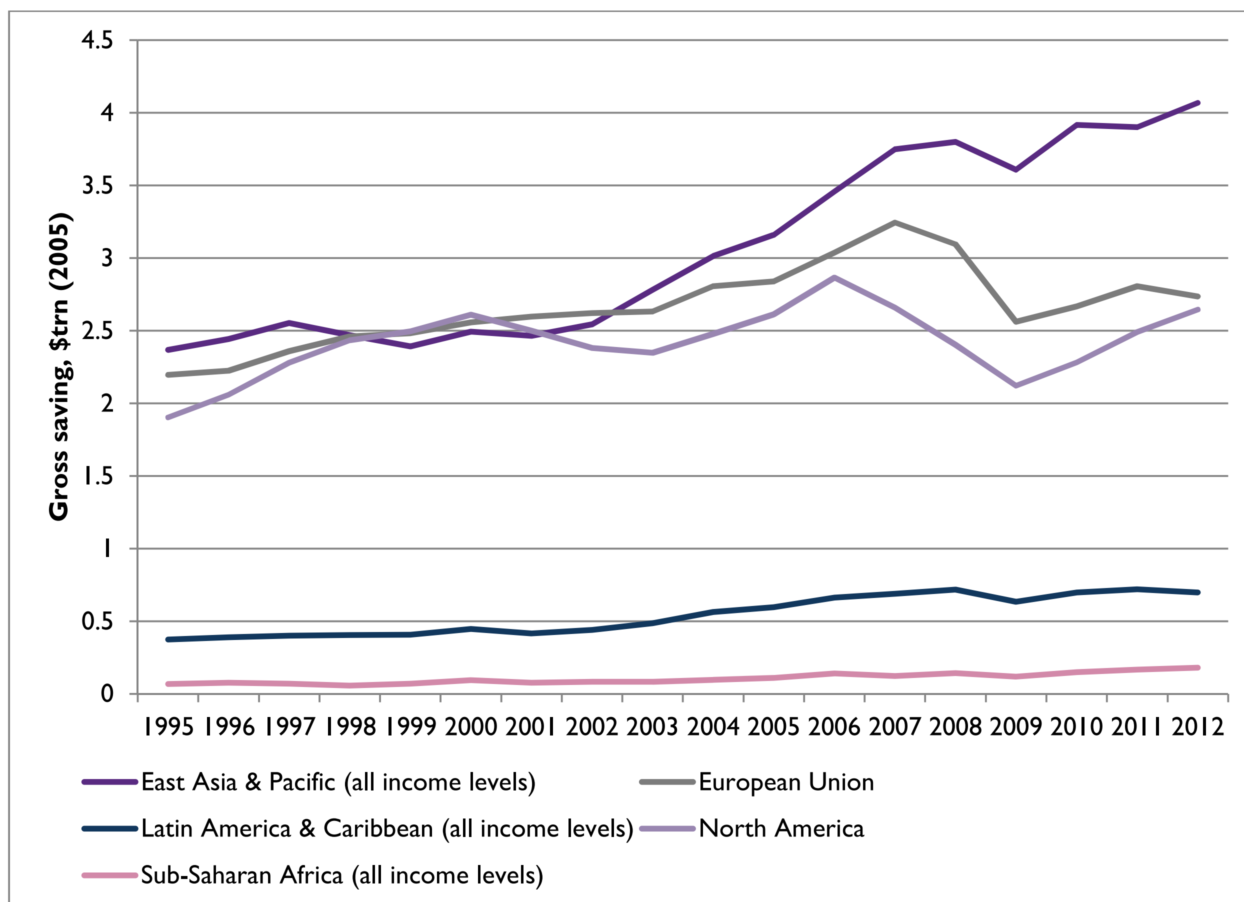
Figure 3.2: Gross fixed capital formation, $ trillion (2005), 1995-2012



Source: World Bank, *World Development Indicators, downloaded May 2014*

As the Chinese and Indian affluent middle classes expand, they will also require savings products and pensions, share portfolios, unit trusts, and insurance. The growing weight of saving in East Asia and the Pacific, particularly relative to the European Union, can be seen in Figure 3.3.

Figure 3.3: Gross saving, $ trillion (2005), 1995-2012



Source: *World Bank,* World Development Indicators, *downloaded April 2014*

Rising demand from individuals and businesses means growing financial institutions. The growth of Chinese banks, in particular, can be seen in the makeup of the top 20 global banks, by market capitalisation. Chinese banks have increased in number from none in the top 20 in 2003 to four in the top 10 in 2014. Three Australian banks have also joined the top 20; whereas there were none on the list in 2003. By contrast, the number of EU27 headquartered banks has declined over the same period from nine to five.

Table 3.2: Top 20 banks, by market capitalisation, 2003 and 2014

	Dec-03		Mar-14	
	Bank	Country	Bank	Country
1	Citigroup	United States	Wells Fargo & Co	United States
2	HSBC Holdings	United Kingdom	JP Morgan Chase & Co	United States
3	Bank of America	United States	ICBC	China
4	Wells Fargo	United States	HSBC Holdings	United Kingdom
5	Royal Bank of Scotland	United Kingdom	Bank of America	United States
6	UBS	Switzerland	China Construction Bank	China
7	JP Morgan Chase	United States	Citigroup	United States
8	Wachovia	United States	Agricultural Bank of China	China
9	Barclays	United Kingdom	Bank of China	China

	Dec-03		Mar-14	
10	US Bancorp	United States	Commonwealth Bank of Australia	Australia
11	BNP Paribas	France	Banco Santander	Spain
12	Banco Santander Central Hispano	Spain	Allied Irish Banks plc	Ireland
13	Bank One	United States	Westpac Banking Corporation	Australia
14	HBOS	United Kingdom	BNP Paribas	France
15	Mitsubishi Tokyo Financial	Japan	Royal Bank of Canada	Canada
16	Deutsche Bank	Germany	Lloyds Banking Group	United Kingdom
17	Fleetboston Financial	United States	Toronto-Dominion Bank	Canada
18	Lloyds TSB	United Kingdom	Australia and New Zealand Banking (ANZ)	Australia
19	BBVA	Spain	Mitsubishi UFJ Financial Group (MUFG)	Japan
20	Credit Suisse	Switzerland	US Bancorp	United States

Source: www.relbanks.com

The balance of advantage, over the next decade, could quite plausibly have shifted dramatically. Whilst EU Member States offer stagnant (or even in some sectors, declining) opportunities for UK firms, new opportunities are emerging elsewhere. This would be likely to imply increasing trade diversion risk.

3.5 Do the Key Threats of Regulatory Arbitrage come from within the EU, or without?

Many discussions of regulatory arbitrage in the EU financial services sector context focus upon the threat that, absent regulation providing a floor, there would be the risk of regulatory arbitrage between EU members. Perhaps some New Member State — say from Eastern Europe — might tempt business away from London to some other centre within the EU, still able to passport and trade within the EU, but subject to lower regulation.

However there are three important questions over whether that logic still holds, if it ever did:

- Is the most important regulatory arbitrage threat to London really from other EU Member States? Or, as a global player in financial services, should it be more concerned about international regulatory competition, from cities such as Hong Kong, Dubai, or Johannesburg?
- Of course, this way of framing the question assumes that London's role as a global player can be divorced from its position within the EU. In the past, it could perhaps be contended that London was able to exercise a global role partly on the back of leveraging scale benefits it secures from its EU markets. But even if correct in the past, whether that would remain the case if EU financial services sector declines over the next decade is less clear.
- When the EU was a force for liberalisation, the EU itself was a device of international regulatory competition, providing pressure to drive down regulation for the EU as a whole. But if the EU is now motivated by an ethos of increased regulation of financial services, does that make London (if subject to such increased EU-level regulation) more vulnerable to international regulatory competition from outside the EU?

Against this, it could be argued that the EU might, as a large and cohesive international player, be able to export its ideas internationally outside the EU (or even EEA). The EU is certainly attempting to do just that in other aspects of policy as a part of trade talks. A new jurisdiction adopting such a common rulebook would open up an additional revenue stream for City-based firms to exploit as they would have ready-made knowhow and scale compared to local firms adjusting to the new situation.

International coordination of regulation has downsides as well as upsides. When market participants become dependent upon regulators for assessing the robustness of institutions (once regulatory badging is widespread), then regulatory failure coordinates market failure — the regulator fails for the whole market at once. And if regulation is coordinated internationally, that can mean that market failure is coordinated internationally, also. Was it a coincidence that the peak of international coordination of banking regulation, with the introduction of the Basel II banking rules, coincided with the most internationally-coordinated banking crisis ever?[51]

Of course, regulatory badging and international coordination have upsides as well as these drawbacks, but the current environment of great uncertainty regarding the best way to proceed on financial regulation suggests there could be an unusually high value to regulatory competition — to different countries trying their own different paths in this new financial regulation world, learning from the successes or failures of others, and in due course adapting to the new best practice.

FURTHER RESEARCH

Further research could identify the net costs and net benefits of regulations to which the UK is subject, but which we do not expect it would be subject without EU-level setting of financial regulation.

That would help us understand the total cost of EU-level financial regulation, which could be set against the perceived value of influence over its setting.

3.6 Conclusions

While it is impossible to predict with certainty the future path of EU-level setting of financial regulation, there are clearly good reasons to believe the rules are being formed in a way that is less favourable to the interests of the UK and UK financial services firms. At the same time, the greatest opportunities for growth may no longer be trading with other EU Member States.

The Prime Minister has announced a renegotiation of the UK's position within the EU and restoring influence over the setting of financial regulation in some way, or safeguarding the UK against the possibility that Eurozone votes as a block as a key priority for that renegotiation.

[51] Legatum Institute and Taxpayers' Alliance *Financial regulation goes global: Risks for the world economy*, December 2010, http://www.taxpayersalliance.com/finreg.pdf

4 Policy Options

In this section we explore a number of potential options for reform of the EU that might address the problems raised in Section 3. The first two such options are clearly the two prongs of Osborne's Fork.

A. **EU Member States that are not members of the euro could join the euro**. This would render irrelevant the problems of being in the EU but outside the euro. For the UK, however, it would have (inter alia) the following considerable (probably overwhelming) drawbacks:

   i. It would leave in place the problem of the very different future goals and spirit of regulation between the UK and the rest of the Eurozone.

   ii. It would expose the UK to the "one size fits all" problem with a single Eurozone interest rate, and also worsen the Eurozone's own existing "one size fits all" problem made so manifest during the Eurozone crisis.

   iii. As the Eurozone integrated further towards its ultimate, explicit goal of forming itself into a full-blown political union currently referred to as an "EU Federation"[52], joining the euro would imply the loss of the UK's very different constitutional traditions from those in the Eurozone.

   iv. It is highly unlikely to be acceptable to UK public opinion, which has for many years reflected a settled will that the UK will never join the euro.

   Given these points, we consider this prong of Osborne's Fork a non-starter for the UK. It might, however, be an option for other EU Member States not currently members of the euro. Indeed, our expectation is that, absent the sorts of reforms set out below, all current EU Member States that are not members of the euro will (with the exception of the UK) join the euro. That is to say, unless there are the sorts of reforms we outline in this section, we do not expect there to be any enduring status of being in the EU but not in the euro with the EU as it is currently arranged.[53]

B. **The UK could leave the EU**. The Conservative Party has expressed an intention to hold a referendum on EU membership in 2017 and a bill has passed the House of Commons enacting in law a commitment to hold such a referendum (the bill subsequently falling in the Lords). Leaving the EU is clearly a complicated issue, an analysis of which would require an extensive discussion of transitional arrangements and of what alternative treaties and geopolitical arrangements the UK would seek outside — all of which goes beyond the scope of this current report.

The third option will be the main focus of this section, namely

C. **Reform the EU in some way that meant the UK could stay without joining the euro**.

It will be seen in the discussion below that for Option C to work, there would have to be extremely significant (perhaps implausibly significant) changes to the nature, functioning, and membership of the EU.

Other sorts of options occasionally floated, such as breaking up the euro or abandoning the project of promoting ever closer union within the EU, will not be discussed here.[54]

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[52] See http://europa.eu/rapid/press-release_SPEECH-12-596_en.htm

[53] If we are correct in this, one implication would be that, as matters stand, debates about whether the UK should leave the EU are rather moot. No status of being "in the EU but not in the euro" will exist for the UK to remain in.

[54] We note that proposing to reform the European Union so as to remove the commitment to "ever closer union" is rather like proposing that the rules of football be changed so that it no longer involves a ball.

4.1 Financial Regulation Aspects of an EU Reform Package that would Allow the UK to Remain in the EU and Outside the Euro

The process of reforming the EU or renegotiating the UK's position within the EU potentially covers many policy areas that fall outside the scope of this paper (e.g. foreign policy, EU military forces, the common criminal space, the requirement of belonging to the Council of Europe, etc.). Here we shall focus on potential reforms affecting the setting of financial regulation within the UK and the Single Market. These fall into three classes.

1) Changes to
   (a) the process of the setting financial regulation at EU level; and
   (b) the membership of the EU and the requirements placed on future members
   that remove or reduce the risk of the UK being continually out-voted by the Eurozone members in the setting of financial regulation.
2) Changes to the legal or other principles guiding European Commission, European Parliament, Council of Ministers and ECJ decisions in respect of EU financial and financial services regulation.
3) Repeal or amendment of specific Single Market regulation already in place.

4.2 Changes to How Financial Regulation is Set at EU Level

4.2.1 Reform to the process of setting financial regulation at EU level

In Section 3 we identified that a key challenge is that EU financial regulation is increasingly geared towards the interests and philosophy of the Eurozone rather than the UK, with the Eurozone already set to achieve a qualified majority if it votes collectively. We argued that this process was likely to become even more entrenched in the next few years as political, economic and financial integration in the Eurozone increases in response to the Eurozone crisis.

One idea of how to respond to this is to seek some reform to the way EU financial regulation is set, so as to reduce the risk UK interests are ignored or consistently over-ruled.

At the December 2011 meeting of the European Council, the UK Government attempted to secure various "safeguards" for the financial services sector, repatriating certain regulatory powers as a part of a treaty creating new fiscal disciplines, decision-making forums and other rules for Eurozone members.[55] The safeguards the UK requested included:

- Unanimous consent for any expansion of the powers of the European agencies; provisions that prevent member states imposing additional requirements (in the form of the higher capital requirements); the imposition of taxes and levies; and the location of European supervisory authorities.
- The powers of the European agencies to be set out clearly, so that they do not replace the discretion of Member State authorities.
- Not requiring third country institutions, which only operate in one Member State, to be supervised by that Member State instead of the European authorities if they do not need a passport to operate across the EU.
- No discrimination within the Single Market on the grounds of the Member State in which an institution is established.

[55] This treaty eventually proceeded as the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" without UK (or Czech) involvement. See: http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf

Those safeguards were rejected by other Member States and the UK Government therefore refused to participate.[56] An important subsequent development has been the December 2012 agreement on rules for the conduct of the European Banking Authority. That creates rules to apply across the 27 Member States (while the European Central Bank is responsible for supervising Eurozone banks). In order to safeguard the UK's financial services industry, the UK Government secured a commitment that the European Banking Authority's decisions would be subject to "double majority" voting. Under double majority voting, new rules need to be approved by:

a) a weighted majority of all EU members;
b) an unweighted majority of Eurozone members; and
c) an unweighted majority of non-Eurozone Member States.

In theory that provides a simple means by which to ensure that the interests of non-Eurozone Member States are respected. One idea for reform would be to extend double majority voting to financial regulation as a whole or to financial regulation applicable to key vulnerable sub-sectors of the financial services industry.

FURTHER RESEARCH

Further research could identify which sub-sectors within the broad financial services sector are most negatively potentially affected by EU-level setting of financial services regulation and to which it would be most relevant for procedures such as double majority voting to apply.

There are a number of concerns that might be raised about this idea, however. Two minor such concerns are:

i. Are non-Eurozone Member States a cohesive block, with cohesive interests, in the same way as the Eurozone might prove to be? If instead the non-Eurozone Member States have diverse concerns about the agenda presented by a cohesive Eurozone, they might be unable to form a coalition in order to defend their individual interests.
ii. Even within the realm of financial regulation, double majority voting may not be accepted beyond a narrow set of policies. For example, the Financial Transactions Tax is being implemented under enhanced cooperation as a taxation measure rather than a piece of financial regulation, though it clearly has significant consequences for the UK financial services sector.

Much the most significant objection, however, is that no voting procedure change, alone, is likely to be sustainable over the longer term (say, beyond around 2020) given the current rules of entry to the EU and the commitments of almost all current EU Member States to join the euro over the next few years. We shall explain that problem, and the only potential solution to it, next.

4.2.2 Reforms to the states setting financial regulation at EU level

The Eurozone had 11 members in 1999. Greece joined in 2001 (12), Slovenia in 2007 (13), Cyprus and Malta in 2008 (15), Slovakia in 2009 (16), Estonia in 2011 (17), and Latvia in 2014 (18). Lithuania is scheduled to join in January 2015 (19), Croatia in 2019 (20) and Hungary in 2020 (21). The Czech Republic aims to join in 2017 and Romania hopes to join in 2020. If that schedule is met, the Eurozone will have 23 members by 2020. That leaves only Bulgaria, Poland and Sweden as countries that have Treaty commitments to joining the Eurozone, but have neither a scheduled entry date nor an expressed target (though Poland still expresses an intention to join eventually) and Denmark and the United Kingdom, which have a permanent opt-out from currency union.

That means that the problems already identified regarding the importance of the Eurozone's interests in defining the scope, direction and philosophy of financial regulation; and of the Eurozone's collective power, under QMV, to force through its preferred regulations against any ability of the UK (in combination with

[56] The UK initially attempted to argue that because this was not formally an EU Treaty, EU institutions could not be involved in its implementation, but it later dropped that objection.

other non-Eurozone members) to block new rules will increase over time. Indeed, by 2020 they seem likely to be overwhelming.

Whereas in the EU of 2014, with 18 Eurozone members and 10 non-Eurozone EU Member States, it might seem plausible that some "double majority" type voting arrangement could at least potentially be made to work, in an EU of 28 or 30 members (with Serbia and Albania due to join in the next few years) in which only between two and five are non-Eurozone members, that is simply implausible. Under such circumstances, double majority voting would mean the UK could block any change to EU financial / financial services regulation with the support of just one or two other non-Eurozone Member State, whilst members of the Eurozone would need 11 other countries to side with them to achieve the same effect. Such an arrangement would clearly be enormously favourable to the UK, but it is most implausible that it would be acceptable to Eurozone members.

Indeed, the time-limited nature of double majority voting is already built into the EBA arrangements. Those rules state[57]:

> *By way of derogation from the third subparagraph* [i.e. the rules setting out the double majority voting principle], *from the date when four or fewer voting members are from competent authorities of non-participating Member States, the decision proposed by the panel shall be adopted by a simple majority of the voting members of the Board of Supervisors, which shall include at least one vote from members from competent authorities of non-participating Member States.*[58]

In other words, the EBA double majority rules already provide for an end to double majority voting if the non-Eurozone EU drops to 4 or fewer members — which could occur as soon as 2020.

Therefore, to make any reform to voting procedures viable over the longer term, it would be necessary, at the same time, to expand the non-Eurozone EU so that it reached a similar order of magnitude to the Eurozone. That would require both that the EU took on a large number of new members (say, of order twelve new Member States) and that those new members were not required to join the euro or expected to seek to do so for many years, perhaps combined with granting permanent opt-outs to certain current non-Eurozone EU members.

There are a number of reasons expanding the EU in this way is likely to be highly problematic. The first (and lesser) difficulty is that for the EU to accept that new Member States did not have to commit to joining the euro would represent a very considerable departure in philosophy. As matters stand, the philosophy is that there is one European project, of which the euro is a core component, driving ever closer union of economies, political systems and peoples. Two EU Member States that were members from before the euro was set up have an opt-out from the euro (the UK and Denmark), but all countries that have joined the EU since the framework of the euro set in the Maastricht Treaty of 1992 (which came into force in 1993) have been required to commit to joining the euro.

To introduce a dozen new Member States that did not have to join the euro and were not expected to seek to do so for many decades would create a clear two-tier European Union — a Eurozone tier and a non-Eurozone tier. That might have many implications for the ongoing process of integration within the Eurozone tier and for the role of the European institutions. For example, at present it is expected that the European Parliament will be the lower house of the legislature of the EU Federation (the political union into which the Eurozone will form) and the European Commission will be its federation-level bureaucracy /

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[57] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0005:0014:EN:PDF clause 24 (a)

[58] Clause (31) is also of relevance:
"*Article 81a*
Review of voting arrangements
From the date on which the number of non-participating Member States reaches four, the Commission shall review and report to the European Parliament, the European Council and the Council on the operation of the voting arrangements described in Articles 41 and 44, taking into account any experience gained in the application of this Regulation."

civil service. But if there were a two-tier EU with many members not intending to participate in the EU Federation, that would be threatened. Why should EU institutions such as the Parliament or Commission become political institutions of the Eurozone / EU Federation if that is only one component of the Union?

Such a departure in philosophy would be difficult for current EU leaders to sanction. It is, however, a relatively minor difficulty compared with the second problem: Are there twelve or so new potential EU members that even the UK (let alone Eurozone members) would want in the EU? The countries which surround the EU, from which new candidate members would presumably have to be drawn, include: Norway, Switzerland, Liechtenstein, Iceland, Ukraine, Belarus, Moldova, Turkey, Serbia, Albania, Israel, Egypt, Libya, Tunisia, Morocco. That list makes clear the enormous political challenge in a substantial expansion of the EU. In order for such a diverse set of countries to be included in any supranational organisation the ties within that organisation would necessarily need to be much looser than they are in the EU at present.

We emphasize again, however, that, notwithstanding the huge difficulties, such an expansion appears the only possible way to make any reform to voting rules sustainable over the longer term.

4.3 New Legal or Other Principles Guiding EU Financial Regulation Setting

A second plank to the reform process — to some extent complementary to the way financial regulation is set, but to some extent an alternate to it — would be to introduce new legal or other principles guiding how EU financial regulation is to be set.

We shall briefly consider three degrees of such principles, in descending order of comprehensiveness:

- A UK opt-out from financial or financial services regulation
- An explicit statement and enactment of the Luxembourg Compromise into EU law
- Specific rules and commitments from EU leaders to restraint in respect of out-voting the UK

We note at the outset that we consider all of these options implausible.

4.3.1 A UK opt-out from financial or financial services regulation

In essence, this option would mean that the UK would withdraw from the Single Market in respect of financial or financial services regulation. That would have the advantage that the UK could not have rules imposed on it regarding the conduct of UK finance or financial services firms within the UK. As a standalone proposal it would, however, have a series of material disadvantages:

- Since free movement of capital is one of the "four freedoms" of the Single Market (the others being free movement of goods, services and persons) it is near-inconceivable that withdrawing from finance and financial services regulation would be accepted as a standalone idea without the UK leaving the EU altogether. Obviously the latter course would have its own pros and cons (which fall outside the scope of this report) but such a decision should be made on the basis of an overall assessment, not as an accidental by-product of seeking to opt out of financial services rules.

- Much UK financial services sector business would continue to be with firms within the Eurozone. In respect of that business, Single Market rules would presumably continue to apply. This would limit the impact of such an opt-out unless some parallel bilateral agreement could be set up between the UK and the Eurozone. Such a bilateral agreement might well be plausible (even natural) if the UK were outside the EU altogether, but (even in the extremely unlikely even an opt-out were accepted) is less plausible in respect of an agreement between EU members — the more natural attitude would be likely to be "If you're opting out, you're opting out".

- As an ongoing EU Member State, even with an opt-out the UK would not be able to form trade agreements in respect of finance or financial services with non-EU countries — which is a competence of the EU. That means such an opt-out arrangement would entail the disadvantages of lost influence (even residual influence) over the direction of Single Market rules but without the advantages of the freedom to form new trading arrangements with other parties.

We consider this idea a non-starter.

4.3.2 Resurrecting and formally enacting the Luxembourg compromise

The Luxembourg Compromise has never been a formal part of EU policy. However, under this proposal it would be resurrected and formally enacted to provide the UK with a general power to reject any measure which it could establish would create substantial harm for London as an international financial centre, for as long as the UK maintained its pre-eminent position in EU finance and financial services. That power would be reflected in voting rules at the Council of Ministers (e.g. a new veto) and the European Parliament.

Relative to the opting out concept this proposal has the advantage that the UK would continue to be part of the Single Market in Financial Services and the Single Capital Market. But instead of being subject to QMV (and hence potentially outvoted by the Eurozone) the UK would have a veto. A narrower form of this proposal might be a somewhat expanded version of the UK's proposal at the December 2011 meeting of the European Council, described above in Section 4.2.1.

The most straightforward disadvantage of this proposal is that even the highly limited form of it proposed by the UK government in December 2011 was rejected out of hand, without any debate or extended discussion.

The other major disadvantage is that other Member States with important industries would be likely to seek similar favourable arrangements, undermining the EU's general liberalising tendency and risking unravelling the Single Market altogether. In European statistics, industrial activity is categorised into thirty-nine sectors. The sector that most closely approximates the financial services industry, as discussed in this report, is named "financial and insurance activities". In the European statistics, the UK dominates that sector, as expected, contributing around 23 per cent of gross value added in the EU28 in 2010.

However there are many other sectors where a Member State has an even higher share of European output than the UK does in financial services — and not only in respect of sectors where one-country domination is well-known. For example, as one might expect Germany contributes around 45 per cent of value added in the manufacture of motor vehicles and other transport equipment. But Germany also contributes 45 per cent in the manufacture of electrical equipment and 35 per cent in the manufacture of chemicals and chemical products. Perhaps counter-intuitively, by that measure France would not enjoy protection for agriculture (17 per cent of gross value added), but would for scientific research and development (32 per cent of gross value added).

If the UK is to have a veto in financial services on the basis of its 23 per cent of EU value added there, Italy might expect a veto respecting its manufacture of textiles, wearing apparel, leather and other related products, where it contributes 36 per cent of gross value added. The UK actually contributes a greater share of value added in the mining and quarrying sector, at 38 per cent of EU gross value added (presumably as a result of oil and gas extraction in the North Sea) — should it perhaps have an additional veto there?

Overall, in 17 of the 39 sectors, there is a Member State contributing the same or a higher share of gross value added than the UK does in financial and insurance activities. If the UK were to have a veto in its high-percentage of value added sector, why would others not get a veto in theirs?

Indeed, matters might be even more damaging than this for the project of achieving liberalisation via QMV. Smaller Member States might add to the above argument the objection that there are sectors which are critically important to their economy's performance, but a focus on percentage of EU output systematically favours the larger Member States. Financial and insurance activities contribute around 9 per cent of total value added in the UK but over 29 per cent in Luxembourg, for example. Protecting the financial services industry could therefore be seen as more of an imperative for Luxembourg than for the UK. There are eleven sectors in which a Member State has the same or a higher differential between the share of gross value added accounted for by that sector in their economy and the share it accounts for in the EU as a whole.

If Member States were able to claim vetoes in those sectors in which their share of total gross value added or the differential between the share of value added in their economy and in the wider EU was equal to or higher than that for the UK in financial and insurance activities, only 12 sectors out of 39 — less than one third — would not be subject to a veto.

Perhaps other routes to liberalisation than QMV could have been chosen. However, given the existing decades-long commitment to QMV as the basis of EU decision-making, and given what appears to be a high risk that agreeing the principle underpinning this proposal could lead to a wholesale unravelling of QMV-driven liberalisation across two thirds or more of the economy, we consider this idea unlikely to be agreed.

4.3.3 Specific Rules and Commitments

Under this concept the UK government could identify a set of discrete rules and procedures in order to safeguard the financial services industry. Such rules would probably have to develop as the level of integration continued to develop towards a new settlement in the Eurozone.

The advantages of such an approach are that it necessitates less fundamental change in Britain's relationship with the European Union than the two previous approaches. New safeguards could be sought that matched the degree and nature of integration within the Eurozone and the new powers granted to European institutions. Those safeguards would probably fit within two main categories:

- Limiting integration in areas where it does not fit with the UK's interests, such as the development of new taxation powers like the financial transaction tax.
- Ensuring that either rules are not created that discriminate between firms in or outside of a certain group of countries (like the ECB requirement for clearing houses to locate at least part of their operations in the Eurozone), or that the UK is on the right side of any discrimination.

Foreign Secretary William Hague set out in a letter to Richard Ottoway MP – Chair of the Foreign Affairs Committee – how such considerations led the proposed reforms of December 2011:

> The Eurozone Heads of State and Government made a statement on 21 July. Nothing in that required Treaty change, though the President of the European Council, Herman van Rompuy, was tasked 'to make concrete proposals by October on how to improve working methods and enhance crisis management in the euro area.'
>
> Nicolas Sarkozy and Angela Merkel wrote a letter on 17 August to Mr van Rompuy with their own ideas. There was no suggestion at this stage that those ideas would require a revision to the EU Treaties – indeed the letter refer to working 'under the provisions of the current treaties.'
>
> […]

> As is normal practice, the government considered a range of possible scenarios throughout the autumn. I advised that if there were a serious push for Treaty change to deliver the necessary institutional structure and powers for effective Eurozone crisis management, then we should be clear that we would need Treaty based guarantees to protect our interests.
>
> […]
>
> It was always our view that the safeguards we needed should have the same status as the changes the Eurozone were requesting.

A disadvantage of this concept is that it could lead to a rolling series of confrontations. The Eurozone might reasonably want to steadily increase the level of integration amongst its members beyond the initial fiscal commitments that have been put in place. If they are steadily doing that, based on a conception of 'ever closer union' that it would be difficult to any UK Government to accept, then there will be two consequences for the UK:

- It will have continuously to expend political capital fighting the direction of Eurozone policy on a range of measures and it therefore may be unable to secure its interests in the many other areas of EU policymaking.
- The disagreements are likely to lead to a steady worsening of the attitudes of the UK public and politicians to the EU; and vice-versa.

The UK may be particularly unlikely to see this option as credible if it has lost a number of cases in the European Court of Justice. The three remaining cases where the Government is testing its ability to enforce what it sees as firm limitations on the ability of other Member States to impose regulations that harm the interests of UK financial services sector will be important to the credibility of future commitments from Eurozone Member States and European institutions to restrain their own actions.

In our view, even if such specific undertakings could be made credible in the short term, they are most unlikely to be sustainable in the longer term in an EU in which the Eurozone constitutes 24 of 28 members – as is currently scheduled to be the case by 2020.

4.4 Repeal or Amendment of Specific EU Rules Already in Place

A third plank of renegotiation might be the repeal or amendment of certain rules already in place. Obviously, in principle it would not be necessary to have any fundamental reform to the EU for there to be amendments to specific pieces of legislation. Indeed, even mentioning any specific such pieces of legislative change might undermine negotiations for fundamental reform, distracting the debate on to the question of whether it is really proportionate to consider leaving the EU, joining the euro, or totally reforming the way the EU works simply in order to achieve this or that minor regulatory amendment.

We would therefore emphasize that the discussion in this report has not been about whether any specific Single Market measure is desirable or undesirable. The most natural fora in which to debate such questions would be in submissions to the European Commission or the EBA, ESMA, the Basel Committee, the FCA or other regulatory bodies, not in consideration of reforming the EU. The desirability or otherwise of specific pieces of legislation is not the point here.

FURTHER RESEARCH

Further research could identify a set of specific current EU financial services directives and regulations that might exemplify the key general issues raised in any process of EU reform and thus might be suitable candidates to be amended or repealed as part of such reform.

Nonetheless, and despite the danger that such discussions distract from the main point, it is all-but inevitable that any process of renegotiation will include narrow discussions about specific extant rules. The most obvious such rules would be the four areas where the UK has already introduced challenges at the ECJ, namely the financial transactions tax, short selling bans, bonus caps, and clearing and settlement rules. There could well be others. For example, it is possible that the UK might prefer to curtail the competence of the EU to regulate hedge funds (as per the Alternative Investment Fund Managers Directive) or to restrict EU rules setting capital requirements of banks to Eurozone members.

5 Conclusion

This paper has considered some key ways Britain could have benefitted from having financial services regulation set at EU level in the past. In particular we have focused upon the ways British ideas influenced EU financial regulation up to the 2008 crisis and the ways growth in European demand for financial services and enhanced financial development in many Member States created export opportunities for UK finance and financial services firms — acknowledging that an overall assessment of the degree to which the UK has gained or lost through EU financial regulation-setting would require consideration of a number of elements (such as the cost of compliance) not considered in any detail here. It has gone on to consider how, since the Eurozone crisis and into the future from here, British influence over EU financial services regulation and opportunities for British firms to export to other Member States have evolved and might evolve.

The key lesson drawn has been that, although UK influence upon EU financial regulation can be argued to have been present in the past, the likely future appears to be one in which British interests are increasingly and systematically over-ruled in favour of the (very different) interests of the Eurozone. Furthermore, the drawbacks of trade diversion arising from a focus upon the EU are likely to be rising, as the rest of the world grows more rapidly and saves and investment more than the EU.

If the UK finance and financial services sectors are to avoid the fate of systematic over-rule by Eurozone interests, without taking either the joining-the-euro or leaving-the-EU prongs of Osborne's Fork, there will need to be very considerable reform to the process of setting EU regulation. Specifically, non-Eurozone members of the EU would need some mechanism, beyond QMV, to block new financial services regulation that was manifestly against their interests. In our view

- new principles such as a UK opt-out or the resurrection of the Luxembourg Compromise are very unlikely to be accepted;
- a package of protections such as double majority voting combined with specific undertakings / memoranda or understanding from other Member State leaders and perhaps the institutions of the EU might offer some protection in the short term (say, up until around 2018) but are very unlikely to be a sustainable solution once those current non-Eurozone EU Member States intending to join the euro do so (i.e. by 2020);
- for any new structure in the EU to offer adequate and sustainable protection to the UK (and other non-Eurozone EU members) from being over-ruled by the Eurozone after the late 2010s, the EU would need to have a significant number of Member States that were not euro members and were not intending to join. That could only be achieved by having a significant number (perhaps twelve or more) new countries join the EU that were not required to join the euro and were not expected to seek to do so for many decades. That would imply a very considerable change in the philosophy of the EU, to a longer-term two-tier structure, and when one considers the list of potential countries from which such a new influx would have to come, the challenge of making such a large new influx acceptable to the UK (let alone to the Eurozone) seems very significant indeed.

These are complex issues, and further research would be warranted in a number of areas (as we have identified in the report). But we believe the central message is clear: For EU-level setting of finance/financial services to be in the UK's interests long-term, as well as amendments to a number of existing EU regulations, there would also need to be a set of new principles for how EU financial regulations are agreed. Even then that would be unlikely to be viable unless the long-term membership of the Eurozone and non-Eurozone EU are much closer to balance than is currently planned.

Appendix: Further study

To substantiate, hone, refute or develop the key points raised in this document, the following areas of further study could be useful:

Issue for Further Study 1. How, specifically, is EU financial regulation different from the regulation we would have in the UK if the UK were not in the EU? Where EU financial regulation is not the same as UK regulation would be outside the EU, which EU regulations benefit the City? What is the list that remains (the list of EU regulations that would not exist if the UK were outside the EU that is to the detriment of the City)?

Issue for Further Study 2. What are the specific future scenarios for EU financial regulation? How specifically do the interests of the Eurozone differ from those of the UK and what would be the growth impact on the UK of implementing the measures best for the Eurozone? Is there evidence that Eurozone members are already caucusing?

Issue for Further Study 3. Of those EU financial regulations that would not exist absent the EU and that currently, or will in our various future scenarios, benefit the City, what is the value of that benefit (e.g. how much money; how many jobs)? And similarly for those that are of disbenefit, what is the value of that disbenefit?

Issue for Further Study 4. Of those EU financial regulations that duplicate what would, otherwise, be introduced in the UK (either for domestic reasons or because of global agreements), what is the value of the higher or lower compliance costs arising through their in fact being introduced via the EU?

Issue for Further Study 5. What are the "second-round" costs / benefits of EU-level setting of financial regulation, including spillovers such as lost traditions of developing financial regulation (e.g. as occurred when prudential regulation was removed from the Bank of England in 1998) and the lost "option value" of being able to respond to international shocks and events by changing domestic regulation quickly?

Issue for Further Study 6. How are different sectors of the City (e.g. banks, securities and broking, insurance, asset management) affected differently by EU financial regulation?

Issue for Further Study 7. What would be the impacts upon the City (transitional and longer-term) if the UK were to leave the EU?