HM Government

Review of the Balance of Competences between the United Kingdom and the European Union

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

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Executive Summary

This report examines the balance of competences between the European Union and the United Kingdom in the area of financial services and the Free Movement of Capital, and whether this balance is appropriate to the national interest. It has been led by HM Treasury and reflects evidence submitted by experts, non-governmental organisations, businesses, Members of Parliament and other interested parties, either in writing or orally, as well as other relevant material. Where appropriate, the report sets out the current position agreed within the Coalition Government for handling this policy area in the EU. It does not predetermine or prejudge proposals that either Coalition party may make in the future for changes either to the EU or to the balance of competences.

Responses to the Call for Evidence, and evidence from relevant public sources, suggest that in the areas covered the balance of competences, as intended in the EU Treaties, is broadly appropriate, but is often undermined by poor policy-making. For the balance to be fully appropriate in the future, the EU should undertake significant reform of the existing EU policy-making framework and processes, take a more proportionate approach to legislation in all sub-sectors, and give greater consideration to the principle of subsidiarity in retail market sectors. This is supported by evidence that:

- **Access to the single market in financial services and the Free Movement of Capital provides significant benefits for the UK financial services industry and for consumers** – a number of industry stakeholders stressed the UK's access to the Single Market as a reason to locate in the UK and argued that further deepening of the Single Market would bring additional benefits;

- **There are, however, significant weaknesses in the EU's current approach to harmonisation and policy-making** – stakeholders considered the existing policy-making framework to have been inadequate for the type, volume and pace of legislation experienced in the last five years, and the quality of consultations, impact assessments and drafting of detailed rules to have not been sufficiently high; and

- **Focused reform is required to ensure the success of the Single Market and justify the current balance of competences** – a majority of respondents believed that a programme of reform is achievable and could correct current deficiencies, although wide concerns related to the development of the euro area and the banking union implied that Treaty change should remain an option, while some respondents argued for a repatriation of powers.

Chapter One sets out the historical development of the single market in financial services and the Free Movement of Capital. EU Directives in the 1970s, which were focused on regulating banks and insurers, established a foundation for market opening. However, by the end of the 1990s, a genuine single market in financial services had not been created, and the high costs of capital compared to other markets hindered economic growth. This led to the Financial Services Action Plan and a vision to create a single rulebook for firms. Subsequent changes, particularly in response to the globalisation of financial services and the financial crisis, have led to a shift from market opening to a focus on financial stability, consumer protection and reducing the scope for regulatory and supervisory arbitrage.

Chapter Two sets out the current legal framework and key pieces of legislation that regulate financial services and facilitate the Free Movement of Capital in the Single Market**.** It notes the various treaties that underpin measures to promote the single wholesale market for financial services, summarises the EU legislative processes, and describes the rationale and focus of the major pieces of EU legislation across financial services sectors.

Chapter Three considers the role and impact of financial services and the Free Movement of Capital on the UK's national interest. Based on the evidence submitted, it considers the balance and use of EU and UK competences and the benefits and costs to firms and individuals. In particular, the chapter considers four overarching themes:

A. **The importance of the financial services sector to the UK and the benefits of access to the Single Market and the Free Movement of Capital** – The financial services sector in the UK is larger and more important compared to the sector in other major EU Member States. It not only makes a significant contribution to the economy, but also presents a number of risks, as highlighted in the recent crisis. There was broad consensus in evidence and analysis about the benefits of access to the single market in financial services, although this was not felt equally across all sectors. Both the UK financial services sector and the broader UK economy benefit from the Free Movement of Capital, which is protected by EU Treaty, and it is important that exceptions to the freedom exist only where necessary;

B. **The global nature of financial services and its impact on the EU's approach to rules and markets** – The increasingly global nature of financial services has resulted in an international framework of regulatory standards. These standards have been significantly rewritten in the years since the crisis, providing the context for the EU's recent approach to regulation. Evidence emphasised that the UK needs to ensure it has adequate influence in financial services at both the global and EU level. There were also strong calls for the EU to ensure it facilitates access for financial services firms between EU and non-EU markets and does not adopt a protectionist approach;

C. **The impact of euro area developments, notably the banking union, and EU-level supervision on the Single Market** – Respondents broadly considered the establishment of the banking union following the euro area crisis to be necessary. However, stakeholders raised a number of concerns about the possible implications of these developments for the integrity of the Single Market and the UK's national interest. There were a number of calls for the EU to ensure that the development of the banking union does not come at the expense of Member States that choose not to participate. Similarly, the introduction of the new European System of Financial Supervision was generally considered a positive development, although there was some concern regarding its future role with regard to national authorities; and

D. **The EU's approach to rule-making following the financial crisis** – The shift in focus from market-opening to financial stability in the last five years has raised questions regarding the quality of the policy-making process and the resulting rules. Although there is broad consensus about the need for EU-level regulation to underpin the single market in financial services, evidence from stakeholders raised significant concerns regarding the recent pace, volume and focus of EU legislation, the failure to differentiate between financial services sub-sectors, the lack of proportionality, and insufficient recognition of the subsidiarity principle, especially in the retail sector.

Chapter Four considers in more detail, and in light of the volume of concerns and issues raised in evidence, the weaknesses in the existing EU policy-making framework and processes. It sets out the widespread view from submissions and other sources that the current legislative framework has not been adequate for the type, volume or pace of legislation experienced in the wake of the financial crisis. Evidence suggests that the quality of consultations, impact assessments and drafting of detailed rules has not always been sufficiently high, and that technical competence on financial services issues within EU institutions should be developed and strengthened.

Chapter Five considers future options and challenges relating to the EU's competences and, in light of concerns raised in evidence, suggests areas for further consideration and exploration. It considers issues related to the global, EU, euro area and national dimensions in turn, and in particular considers the implications of the international regulatory framework and global markets, the impact of the euro area and the banking union on the UK's future national interest, and how to improve the quality of EU-level rules.

Introduction

This report is one of 32 produced as part of the Balance of Competences Review. The Foreign Secretary launched the Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union. It will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of the UK's membership of the EU and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It has not been tasked with producing specific recommendations, looking at alternative models for Britain's overall relationship with the EU, or considering whether UK membership of the EU is in the UK's national interest.

The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between 2012 and 2014. More information on the review, including the timing of publication of reports, can be found at www.gov.uk/review-of-the-balance-of-competences.

The Nature of this Report

The analysis in this report is based on evidence gathered following a Call for Evidence from October 2013 to January 2014.[1] It draws on written evidence, notes of discussions, and existing material brought to our attention by interested parties, such as reports by parliamentary select committees or the European Commission.

Around 70 individuals and organisations, including trade associations on behalf of their members, submitted evidence – a full list can be found in Annex B, and all submissions are published alongside this report. A review of relevant public material, as well as opinions received in the course of regular Government business from a range of organisations, people and countries, has also been drawn on. Annex D sets out references and sources that informed this report.

An externally commissioned literature review on the Free Movement of Capital has also informed, and is published alongside, this report.

[1] HMG, *Balance of Competences Review: Single Market – Financial Services and the Free Movement of Capital, Call for Evidence* (2013). Evidence and material submitted after the end of the call for evidence has, wherever possible, been taken into account.

The Objectives of this Report

A broad definition of competence is used for the purposes of the review. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the EU Treaties give the EU competence to act, including the provisions in the EU Treaties giving the EU institutions the power to legislate, adopt non-legislative acts or take any other sort of action. It also means examining areas where the Treaties set out specific rules binding directly on the Member States without needing any further action by the EU institutions.

Definition of EU Competence

The EU's competences are set out in the EU Treaties, which provide the basis for any actions the EU institutions take. The EU may act only where the EU Treaties so provide and within the limits of the competences conferred on it by the EU Treaties. Where the Treaties do not confer competences on the EU, they remain with the Member States.

There are different types of competence: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy. In areas of shared competence, such as the Single Market, environment and energy, either the EU or the Member States may act, but the Member States may be prevented from acting once the EU has done so. In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act, but action by the EU does not prevent the Member States from taking action of their own.

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

This report focuses on the competences and legislation that affect the financial services sector, including banks, insurance companies, pension companies, asset managers and market infrastructure providers. It also considers the impact on end-users of the services and products provided by these firms – in other words, consumers and businesses – as well as impacts on the broader economy. In addition, the report focuses on EU competences related to the Free Movement of Capital and the impact of these on both the financial services sector and the broader UK economy. HM Treasury (HMT) has led on this report as the Government department responsible for financial services, macroeconomic issues and the efficient allocation of capital within the UK and UK-owned capital internationally.

Scope of this Report

Some issues associated with financial services and the Free Movement of Capital are considered in other Balance of Competence reports. The reports published in July 2013 include *The Single Market Synoptic* report, which considers the Single Market as a whole, and the *Taxation* report, which covers the Financial Transaction Tax and other taxes relating to financial services. The reports published in February 2014 include the *Trade and Investment* report, which considers extra-EU foreign direct investment and broader securities investment, as well as extra- and intra-EU trade (including Free Trade Agreements), and the *Research and Development* report, which covers technological development in all sectors.

Reports published at the same time as this one also cover issues associated with financial services: the *Single Market: Free Movement of Services* report covers all areas of services aside from financial services; the *Competition and Consumer Protection* report covers issues relating to competition and consumer protection aside from financial services; the *Energy* report covers regulation relating to the wholesale energy market; the *Fundamental Rights* report refers to the European Commission's proposal for the right to a basic bank account for all EU citizens; and the *Single Market: Free Movement of Persons* report considers issues related to the ability of UK nationals – including employees in the financial services sector – to work, access benefits and access services in other Member States.

The last set of reports, due for publication by end-2014, will also cover related areas: the *Economic and Monetary Policy* report will cover euro area integration; the *Police and Criminal Justice* report will look at financial crime issues; the *Information Rights* report will cover data protection issues, including the use of personal data by companies; the *Voting, Consular and Statistics* report will cover voting issues and the influence of the UK; and the *Subsidiarity and Proportionality* report will focus on these themes which are also considered as part of this report.

Chapter 1: Development of EU Competence

1.1 This chapter sets out the development of the single market in financial services and the Free Movement of Capital.

1.2 The EU's founding treaty, the Treaty of Rome, came into force in 1958. In it, the original six Member States agreed to a customs union and to four freedoms: the Free Movement of Goods, the Free Movement of Persons (including that of establishment), the Free Movement of Services and the Free Movement of Capital. The Member States made limited progress in giving operational effect to these four freedoms, not least because of the need for unanimous decision-making. It was only in 1985 that the EU took sustained action to create a genuine Single Market, agreeing to 279 specific legislative measures to be brought into force by 1992 and by agreeing that this EU legislation would be agreed not by unanimity but rather by majority voting, with larger Member States having more votes than smaller ones.

Single Market: Financial Services

1.3 In the area of financial services, the EU necessarily operates within a framework of global standards due to the fact that financial markets are global. The nature of that globalisation has been profoundly shaped over the last thirty to forty years by the collapse of the Bretton Woods system, the removal of controls on capital movements, and the revolution in communications and computing technology.[1] These developments have meant that markets have assumed a more central place in the functioning of economies, financial centres have become more concentrated and interlinked, the sectoral boundaries between banks, insurers and securities firms have broken down and the increase in the volume and speed of financial transactions has reduced response times for intermediaries, end users and public authorities. As a result, risks in one market may be quickly transmitted to other markets, as has been seen during the recent global financial and euro area crises.

1 The Bretton Woods system of monetary management established the rules for commercial and financial relations among the world's major industrial states in the mid-20th century (including the establishment of the International Monetary Fund and the World Bank), and was the first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states. The system came to an end in August 1971 when the US unilaterally terminated convertibility of the US dollar to gold and and saw the dollar become fiat currency. At the same time, many fixed currencies such as sterling also became free-floating.

1.4 The interconnected nature of markets and the risks they can generate require internationally agreed regulatory standards and a high level of supervisory cooperation and coordination. These are necessary to limit market fragmentation, the impact of regulatory arbitrage and the export of risk from one market to another.[2] They encourage the development of common rules and supervision and thereby make it easier for supervisors to understand the health of internationally active firms, agree on a common supervisory programme for them and – where necessary – support resolution of firms across borders.

1.5 There are global standard setting bodies (SSBs) covering the banking, securities and insurance markets, as well as international bodies developing accounting standards and standards to combat money laundering and terrorist financing, many of which report to the G20 heads of Government and finance ministers and central bank governors.[3] International standards are not legally binding. It is for each country to give effect to them within their jurisdiction as they see fit. Within the EU, it is EU institutions that must agree on any necessary implementation measures and thereby give effect to these international standards across the EU.

1.6 Until the financial and euro area crises, the focus of EU policy-making in financial services was on how to remove obstacles to the Single Market. The focus of global standard setters was on issues of market integrity and the safety and soundness of individual firms and market infrastructure providers, and on protection against financial crime and terrorist financing. Both EU policy-makers and global standard setters viewed issues of consumer protection as ones largely for national authorities and predominantly relevant in the EU to the extent that consumers needed to be protected against the risks related to 'branching', when a firm sets up a branch or provides services remotely.[4] The EU's single market in financial services, therefore, developed within a wider global framework of international standards that focused on the safety and soundness of financial institutions and the protection against financial crime.

1.7 As regards the deepening of the Single Market, the focus of EU policy-makers was on adopting rules that would result in the progressive elimination of obstacles to the free movement of financial services. These rules were based on the following policy propositions:

- Harmonised EU-wide minimum standards covering prudential and consumer protection requirements;

2 Regulatory arbitrage refers to differences in rules which confer a pricing advantage or penalty on market participants. Some differences may be accidental, but some may be deliberately designed to attract business. Lower standards, however, do not necessarily attract business. The UK has for many years imposed high disclosure standards on issuers, and this greater transparency is held to be one factor making the UK an attractive market for investors.

3 The main SSBs are itemised in Chapter Three, footnote 65 and Figure Nine. See also HMG, *Review of the Balance of Competences between the UK and the EU: Police and Criminal Justice*, published in Semester Four. This will consider financial crime issues.

4 See, for example, Recitals 4-5 of Directive 89/646/EEC (2BCD), Recitals 1&2 of Directive 94/19/EC (Deposit Guarantee Schemes), Recital 3 of Directive 93/6EEC (Capital Adequacy Directive), and Recital 7 of Directive 2006/48/EC (CRDI). Generally, there has been little consumer interest in cross-border shopping for financial services.

- Mutual recognition of those requirements by Member States in line with the judgment of the European Court of Justice (ECJ) in the seminal case of *Cassis de Dijon*;[5]
- The transfer of supervisory competences from one Member State to another, according to how the firm chose to structure itself in that market; and
- An assumption that all supervisors supervised thoroughly and competently and had an adequate set of powers and tools to do so.

1.8 The first Directives in the area of financial services did little more than require Member States to impose an authorisation requirement. The major step came in the 1990s when the EU developed its branching regime. This meant that where a firm chose to use its right to set up a branch or to provide services on a remote basis, for example, by telephone, e-mail or the internet, the local supervisor could not impose its own authorisation requirements or any prudential requirements.

1.9 Further segmentation of responsibilities followed, so that by the time of the financial crisis the supervisor in the Member State where the recipient of a cross-border service was based had only residual powers, and then only for consumers in areas such as unfair terms in consumer contracts.[6] Supervisors in the country of the branch were responsible for enforcing obligations on the conduct of business, though not for the systems which in practice would determine how well those requirements were complied with. Supervisors of groups, rather than subsidiaries, were responsible for validating the complex models that determined whether a firm was sufficiently capitalised.

1.10 Until the financial crisis struck, the primary focus of EU policy-making was on agreeing common rules that would make markets more open and contestable, and thereby lower the cost of raising finance for the wider economy. In 1998, Member States agreed to accelerate the development of the single market in financial services through the adoption of a Financial Services Action Plan – an initiative that comprised 42 measures, not all of them legislative. The objectives of the Action Plan were to develop a single wholesale market, open and secure retail markets, and state of the art prudential supervision.

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5 This French blackcurrant-based drink was at the heart of one of the ECJ's most celebrated decisions. In 1979, Rewe-Zentral AG, one of Germany's biggest food and drinks retailers, complained to the ECJ that the German authorities were making it difficult for the company to import and sell Cassis de Dijon. The Court ruled in the firm's favour and declared that under European law, if a company is allowed to make a product freely available for sale in one European Community country, then it must be allowed to do so in all Member States. As Cassis de Dijon was obviously already freely available in France, the Court argued that all other European citizens also had the right to buy and drink it. The ruling allowed the Community to develop the important principle of mutual recognition which in turn paved the way for the launch of the Single Market in 1993. See *Rewe-Zentral AG v Bundesmonopolverwaltung fur Branntein* Case C-120/78 [1979].

6 Host States retained the right to supervise: branch liquidity in banks until the Capital Requirements Directive (CRD) IV; and branch systems and controls for securities firms until the Markets in Financial Instruments Directive (MiFID).

1.11 At the same time EU policy-makers realised that the process of law-making required fundamental reform. The European Commission set up 'a Committee of Wise Men', chaired by Baron Alexandre Lamfalussy, which made a set of recommendations focused on better rule-making with enhanced consultation, the use of Directives setting out a framework of powers and objectives with the detail to be determined in subordinate legislation, and the creation of committees of national supervisors from the Member States to provide advice to the Commission and promote the convergence of supervisory practices and outcomes.[7]

1.12 The global financial and euro area crises that struck from 2007 changed the focus of EU rule-making from market opening to the safety and soundness of the whole financial system, as well as individual firms, and increased the attention paid to the protection of consumers and tax-payers. The Financial Stability Board (FSB), under the political direction of the G20 at the Pittsburgh summit in September 2009, took the lead in coordinating the agenda with the other Standard Setting Bodies (SSBs) to reform the regulatory regime, make the financial system safer, and deal with the problem of banks that are too big to fail or, in the case of some countries, to save.[8] Within the EU, heads of Government also agreed in 2009 that the EU should henceforth have a single rulebook for financial services. The Commission then used the implementation of the revised international standards to create the single rulebook by using, to a greater extent than before, Regulations rather than Directives[9] and by making more provisions maximum harmonising.[10] The implications of these shifts are considered in Chapters Three, Four and Five.

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7 The EU had, from its early days, adopted procedures to give the Commission limited rule-making powers, where a Directive or Regulation so provides. These rules were agreed in so-called Comitology Committees, and were designed to be quicker and easier to agree and amend than a full legislative process. The Lamfalussy changes envisaged that the detail which had previously been agreed through line by line negotiation would in future be dealt with by the Commission, and only the high level issues, objectives, scope, powers etc would go through the full legislative procedure. The Treaty of Lisbon put subordinate legislation on an explicit Treaty basis in articles 290 and 291 of the Treaty on the Functioning of the European Union (TFEU).

8 The financial and euro area crises have shown that countries may find it difficult to save banks whose balance sheets represent large multiples of that country's GDP.

9 Directives lay down the end results that must be achieved, but leave to national authorities the choice of form and method for achieving this within their domestic legal order, and so provide a degree of flexibility to national authorities. Regulations are directly applicable in Member States and provide greater consistency across the EU, although specific characteristics of national markets may not be recognised.

10 EU rules may permit Member States to impose additional requirements to the EU ones, thereby setting a floor (minimum harmonisation) or EU rules may forbid Member States from imposing additional requirements thereby setting a ceiling (maximum harmonisation). Minimum or maximum harmonisation, therefore, refers to the freedom of Member State to impose additional rules, not about how detailed, stringent, proportionate or evidence-based the rules are.

1.13 The large volume of legislation that resulted was mostly negotiated and adopted under the Lisbon Treaty,[11] which gave to the European Parliament powers equal to those of the Council of Ministers in all Single Market areas and also gave a clear EU Treaty basis to subordinate legislation adopted by the Commission ('Level 2' out of the four levels set out in the Lamfalussy report).[12]

1.14 The financial crisis also exposed the shortcomings in the EU's system of financial supervision and thereby triggered institutional changes.[13] In 2008, the Commission mandated a high-level group chaired by Jacques de Larosière to make recommendations on how to strengthen supervisory arrangements across the EU, of which the chief recommendation was to establish a European System of Financial Supervision comprising EU supervisory bodies for the banking sector, markets and securities, insurance and occupational pensions, and macro-prudential oversight. As a result, the EU reconstituted the committees of national supervisors established, following the Lamfalussy Report into EU agencies the European Supervisory Authorities (ESAs) – with powers to take decisions binding on national supervisors and, in limited circumstances, on firms.[14]

1.15 By 2010 it had become clear that the balance sheets of a significant proportion of the banking industry in the euro area were impaired. Funding both for sovereigns in peripheral euro area states and their banks dried up. It was recognised that extensive recapitalisation would be needed, but it was less clear where the capital would come from. The euro area crisis drove a realisation that a single currency requires greater political, economic and institutional integration than was initially envisaged, mainly because of the intimate interconnection between currency stability and the stability of banks within a currency union through their ability to amplify and transmit risk to other euro area countries. The logic of a single currency led to the Commission's proposals for the establishment of a banking union for the euro area, involving three key elements: a single banking supervisor; a single resolution authority and resolution fund; and a common system for deposit protection.[15]

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[11] The Lisbon Treaty entered into force 1 December 2009.

[12] For more information on the Lamfalussy Report, see: ec.europa.eu/internal_market/securities/lamfalussy/report/index_en.htm, accessed on 13 June 2014. The Lamfalussy Committee envisaged a four level structure to EU regulation. Level 1 would be principles based framework legislation decided by co-decision (under Lisbon the ordinary legislative procedure); Level 2 would be the detailed implementing decision decided under comitology (under Lisbon delegated and implementing acts); Level 3 would be advice to the Commission by national regulators in the Level 3 Committees (now the ESAs) who would also promote supervisory convergence; and Level 4 would be enhanced focus by the Commission on enforcement (now helped by the ESA role of investigating potential breaches of Union law). The Lamfalussy report focused on securities markets but was subsequently applied to banking and insurance and occupational pensions.

[13] For instance, the collapse of Iceland's banks – and the resulting losses on deposits in Germany, the Netherlands and the UK – highlighted that EU rules are not always enforced by national supervisors, and that this non-compliance was largely invisible and difficult to mitigate until it was too late.

[14] The three ESAs are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). The European Systemic Risk Board (ESRB) has also been established and is responsible for performing certain tasks relating to macroprudential oversight.

[15] Participation in banking union is mandatory for euro area Member States and optional for non-euro area Member States. The European Central Bank will become the prudential supervisor of credit institutions established in those states.

1.16 Steps have already been taken to establish a Single Supervisory Mechanism (SSM) for participating Member States with the European Central Bank (ECB) directly supervising the largest 128 banks in the euro area, and with powers of direction over the others. A Single Resolution Mechanism (SRM) has also been agreed so that failing banks in the banking union can be restructured, sold off or wound down in an orderly way with minimal cost to tax-payers or the wider economy. The Regulation establishing the SRM is accompanied by an inter-governmental agreement which includes arrangements for Contracting Parties to transfer contributions collected from the financial industry, for the purposes of resolution financing, from the national level to a Single Resoution Fund.[16]

1.17 The UK Government has been clear that it will not participate in the banking union, and non-participating Member States, including the UK, have secured clear provisions that, taken together, help protect the Single Market by ensuring non-discrimination and providing equal treatment between participating and non-participating Member States.[17]

1.18 Many operational aspects of the banking union have yet to be determined, but it is evident that this deepening integration will have a profound effect on the Single Market and the UK's relationship with the EU in financial services as well as in other fields.

The Free Movement of Capital

1.19 The Free Movement of Capital refers to all movements of capital from payments, portfolio investments and direct investment in a country, to loans for the purchase of tangible property, bank-notes and financial guarantees.

1.20 Prior to 1993, Member States were required to abolish restrictions on the Free Movement of Capital, but only to the extent necessary to ensure the functioning of the then common market. As a consequence, the Free Movement of Capital was widely perceived as a necessary but somewhat supporting right, compared to the other Treaty freedoms. However, the Maastricht Treaty, which came into force in 1993, brought the Free Movement of Capital from the margins to centre stage by prohibiting all restrictions on the movement of capital and on payments.[18]

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16 Contracting Parties are Member States participating in the banking union and other Member States who chose to be Contracting Parties.

17 Protections in the SSM Regulation that the UK and other non-participating Member States have secured include: a prohibition on discrimination by the ECB; a requirement by the ECB to enter into a memorandum of understanding with supervisory authorities of non-participating Member States; voting safeguards in the EBA to address the risk that banking union members vote as a bloc; a requirement for EBA members to strive for consensus; and a requirement that the EBA's powers apply to the ECB as banking union supervisor in the same way as they do to a national supervisor. Protections relating to the SRM Regulation include: the equivalent application of State aid rules to any use of the Single Resolution Fund as compared to national resolution financing arrangements in non-participating Member States; an explicit requirement that the Commission and Single Resolution Board (SRB) cannot discriminate against entities in non-participating Member States; the EBA will have the same remit over the Council, the Commission, and the SRB when they are performing their tasks under the SRM as it has over national resolution authorities in non-participating Member States; and the Commission must establish 'Chinese Walls' between its resolution tasks under the SRM and its other functions to ensure it is fully aligned with the rules which apply to national authorities involved in resolution decision-making under the Bank Recovery and Resolution Directive and international standards developed by the G20 and FSB.

18 Specifically Article 63 of the Treaty on the Functioning of the European Union (TFEU). See paragraphs 2.2 and 2.4 below for a description of the EU Treaties.

1.21 The last thirty years have seen the progressive relaxation of capital controls around the world. The Organisation for Economic Co-operation and Development's (OECD) Code of Liberalisation of Capital Movements requires the progressive, non-discriminatory liberalisation of capital movements among member countries. As part of this trend, the UK abolished exchange controls in 1979, 15 years before the Treaty of Maastricht prohibited inward and outward restrictions on the Free Movement of Capital.

1.22 The domestic impact on the UK of this Treaty freedom has, therefore, been limited. The UK's policy of open markets means there were already very few restrictions on ownership of land, direct or portfolio investment, or the ownership of companies. As a result, from a UK perspective the dismantling of restrictions on the Free Movement of Capital is a story of the deepening of the Single Market and the opening up of national markets in other Member States to competition.

1.23 The Free Movement of Capital is central to the functioning of financial intermediaries, such as banks, securities firms and fund managers, but it is also a precondition for foreign direct investment both by UK firms in the EU and by EU firms in the UK. UK firms have invested most heavily in the EU's information and communications sector, while the UK sectors that have received the most direct investment from the rest of the EU are those in retail and wholesale trade.

1.24 The TFEU does, however, allow limited exceptions to the Free Movement of Capital, including in relation to: macroprudential regulation and capital controls; tax differentiation; public policy; public security; national security and defence; and financial sanctions. The scope of some of these exceptions, however, has been subject to critical examination in a series of cases brought before the ECJ. Regarding capital controls, in March 2013 Cyprus became the first, and so far the only, Member State with previously liberalised capital flows to implement strict controls on the transfer of capital outside of the country. These capital controls were to prevent bank depositor flight, following the bail-in of bondholders and depositors in the two largest Cypriot banks.

Chapter 2: Current State of Competence

2.1 This chapter summarises current EU competences in financial services and the Free Movement of Capital, and is necessarily a high-level account of a complex area. It details the main legal provisions in the EU Treaties which define those competences, and identifies the key pieces of EU legislation which affect the provision of financial services and the movement of capital – further details on each of these are included in Annexes E and F. The institutional and policy-making frameworks which underpin and facilitate the exercise of the EU's competences in these areas are also outlined.

The Treaty Framework

2.2 The two core functional treaties which determine how the EU works and operates are the Treaty on the European Union (TEU), originally adopted as part of the Maastricht Treaty, and the Treaty on the Functioning of the European Union (TFEU), derived from the original Treaty of Rome.

2.3 The TFEU empowers the EU institutions, notably the European Council, the Council of Ministers ('the Council'),[1] the Commission and the Parliament,[2] to adopt legal acts. These can take the form of Regulations, Directives, or Decisions: Regulations are directly applicable and binding throughout the EU without further enactment; Directives lay down the end results that must be achieved, but leaves to national authorities the choice of form and methods for achieving this within their domestic legal order; Decisions relate to specific cases (unlike Regulations) and are binding on those to whom they are addressed. The ECJ interprets the Treaties and the legal acts which the EU adopts and, in the event of a reference to the ECJ, decides if an institution or body of the EU or a Member State has abided by them.

2.4 The EU may act only where the EU Treaties so provide. The provisions of the TFEU that provide the main possible bases for action by the EU in the area of financial services and the Free Movement of Capital are Articles 53, 63, 64, 65, 113, 114, 115, 127(6) and 352. These are described in more detail in Annex E.

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1 The Council of Ministers is organised according to the particular policy area. In the area of financial services the Council is called ECOFIN; but any Council formation is constitutionally permitted to take decisions on behalf of the Council, and financial services legislation can be formally agreed at a Council meeting of ministers responsible for quite different policy areas. The European Council refers to heads of government.

2 The European Parliament has established a number of specialist committees to cover particular policy areas. The Economic and Monetary Affairs Committee of the European Parliament (ECON) agrees draft reports on legislative proposals which are then adopted by the Parliament in Plenary session. The chair of ECON exercises considerable influence on the legislative process, as do the rapporteurs and shadow rapporteurs who are responsible for drafting the reports.

Institutional and Policy-Making Framework

2.5 The Commission has the sole right to propose new or revised EU financial services legislation (the 'right of initiative'). The Commission is required to consult publicly before making formal proposals and to undertake impact assessments to understand the potential consequences of its proposals. These are designed to gather evidence on the advantages and disadvantages of possible policy options by assessing their potential impact. The resulting impact assessments, which are published online, should also explain why action is necessary at the EU level and why the proposed response is appropriate and proportionate. The process is also intended to help bring transparency and accountability to the preparation of legislation.

2.6 Once the Commission's proposal is published, it is considered simultaneously by the two co-legislators – the Council and the Parliament. There are two over-arching legislative procedures: 'ordinary' and 'special'. Most of the legislative powers relevant to financial services allow EU measures to be adopted using the ordinary procedure formerly referred to as the 'codecision procedure' and described in Articles 289(1) and 294 TFEU.

2.7 The ordinary procedure involves a vote on the measure by the Council acting by qualified majority, with the larger Member States having more votes than smaller ones,[3] and the Parliament acting as co-legislator and by a simple majority of its members, with larger Member States having more Members of the European Parliament (MEPs) than smaller ones.[4] This procedure puts the Parliament on an equal footing with the Council. Other legislative powers require agreement using a special procedure, under which the Council may in practice be the sole legislator following a proposal from the Commission, though the Council must consult or seek the consent of the Parliament in specified cases.

2.8 Under the ordinary legislative procedure, both the Council and the Parliament may amend the Commission's proposal and add substantive provisions which have not been subject to consultation or an impact assessment. To reach joint first reading agreement on a final text, under an informal process known as a 'trilogue', compromise is sought through negotiations between representatives of the Council and Parliament, with participation from the Commission.[5]

2.9 Frequently, Regulations and Directives will contain legislative delegations, permitting the Commission to adopt subordinate legislation. In the area of financial services, the subordinate Level 2 legislation takes one of two routes:

- The delegation may be direct to the Commission, in which case the Commission does not generally consult or undertake an impact assessment and the Council may prevent these rules being adopted only if there is a qualified blocking majority of votes against the proposal;[6]

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3 Where legislation is adopted by Qualified Majority Voting, the total votes of Member States favouring the measure must be 260 or greater out of 352. The UK, Germany, France and Italy each have 29 votes. After the transitional period has ended on 31 March 2017, a qualified majority will always require 55 per cent of Member States, comprising at least 15 of them, and representing 65 per cent of the EU population.

4 As of the 2014 elections, there are 751 MEPs. The UK and Italy have 73 MEPs, France 74 and Germany 96.

5 While First Reading agreements via trilogues have become the normal approach to agreeing legislation, the TFEU provides for more extended consideration at a Second Reading, in circumstances where the Council and Parliament do not agree on the amendments each has made to the Commission proposal. If a Second Reading agreement is not reached, the Conciliation Committee is convened and has six weeks to find an agreement, which must then be approved as a package at Third Reading, failing which the proposal is not adopted.

6 The Commission may, however, be required to do so, for example, as a result of the application of a Comitology Procedure in relation to a specific Commission implementing act.

- The second route requires the relevant European Supervisory Authority (ESA) to draft rules, known as Binding Technical Standards (BTSs), for the Commission to adopt with or without amendment. In recent years, the ESAs have had to draft a large number of BTSs, some to very short deadlines. Although the ESAs are required to consult and undertake cost-benefit analysis on them, the volume of BTSs and the short deadlines contained in the empowering legislation may affect the quality of final rules.

Key Pieces of EU Legislation

2.10 In a modern economy, financial services perform a number of key functions, including:

- Allowing firms and individuals to make payments;
- Providing financial intermediation between savers and borrowers to allow individuals to smooth consumption over their lifetime, and between investors and businesses to help allocate capital efficiently within the economy;
- Creating markets for debt, equity, foreign exchange and commodity exposures to be bought and sold; and
- Providing insurance against future risks.

2.11 There are different risks surrounding the provision of these services, which countries have sought to mitigate through a wide range of rules. The creation of a single market in financial services in the EU requires Member States to remove obstacles to the purchase and sale of financial services. Many of these obstacles are national rules that have been developed to maintain financial stability, protect consumers and ensure markets operate fairly and cleanly. Removing these barriers to trade necessarily requires there to be effective EU-level rules instead. It is important that these rules address the risks that each sector presents in a proportionate and effective way. The following section sets out the key risks of each sector and the main pieces of legislation that have been designed to address these.

Banking

2.12 The business of banking centres on borrowing and lending money. Banks have relatively little money (shareholders funds) of their own. Most of the money they lend is borrowed, and much of that is repayable on demand (deposits) or raised for a fixed period of time (for example, five year bonds). However, much of what banks lend will not need to be repaid for two or more decades. The nature of banking, therefore, includes the risks that:

- Banks cannot repay borrowers on demand or pay back bondholders whose bonds have matured, because that money has been lent and is not due to be repaid for ten or twenty years;
- Banks that make large losses on their loans or trading activities will not have enough of their own money, and therefore those lending to banks (depositors and bondholders) may be exposed to the risk of loss;
- Lending practices that are rational for an individual bank will have a different impact if copied by the whole industry. For example, reducing lending in the expectation of a down-turn in the economy would tip an economy into recession if all banks behaved in the same way; and
- Troubled banks which are not in a position to raise additional funds from shareholders, will cut back the size of their loan book and this will disproportionately affect new customers, small businesses and others dependent on overdrafts and other forms of

short term borrowing. If a number of banks are stressed at the same time, the flow of credit will be reduced and the economy will contract.

Overview of the UK's Financial Sector

Banking

Retail and commercial banks, cooperatives, building societies and other mutual organisations (such as credit unions) offer a range of banking and related services to consumers and businesses. Related services include credit cards, business loans and mortgage lending. Investment banking includes equity underwriting, fixed income underwriting, mergers and acquisitions, and syndicated loan business.

Investment Firms and Markets

Investment firms (which include investment banks) trade equities, bonds and derivatives on the secondary markets. They act as brokers, market makers or deal on their own account. Brokers bring together potential buyers and sellers in financial markets across many different asset categories. Market infrastructure includes the exchanges and other trading venues (for example, the London Stock Exchange and the London Metal Exchange), clearing houses (for example, LCH Clearnet) and settlement systems (for example, CREST).

Asset Management

Fund managers manage funds on behalf of institutional clients (such as insurance funds and pension funds), retail clients and private clients. The industry also includes property funds, hedge funds and private equity funds.

Insurance and Pensions

The insurance industry provides long-term insurance (such as life insurance, endowment policies and annuities) and general insurance (such as motor or property insurance). In addition, the Lloyd's market, based in the City of London, is regarded as the centre of the world's insurance and reinsurance industry. The contracts traded on the Lloyd's market often involve higher exposure risks. Pension funds, which are attached to sponsoring companies, invest over the long term to provide employees with pensions when they retire.

Independent Financial Advisers

Independent Financial Advisers give consumers unbiased and unrestricted advice on a range of financial matters, including retirement plans, life policies and investments. Their advice needs to be based on a comprehensive analysis of the relevant market.

Professional and Support Services

The size of the UK's financial sector has created strong demand for complementary services, such as legal services, accountancy services, and consultancy and advisory firms.

2.13 Banks may make losses for a number of reasons, including because: their business plan exposes them to risks they fail to understand; their credit assessment of clients is faulty; they are over-exposed to particular sectors of the economy, for example, commercial property; their funding models expose them to foreign exchange risk, for example, if they raise money in one currency and lend in another; of interest rate risk, for example, if they raise money on floating interest rates, but lend at fixed rates; or of operational risk, for example, if they missell products and subsequently have to provide redress.

2.14 Regulation has therefore focused on ensuring banks mitigate these sources of risk by setting:

- Minimum levels of capital so that banks can absorb losses and reduce the risk of failing;
- Minimum funding arrangements, so that banks remain liquid and can repay depositors and other creditors;
- Flexible additional levels of shareholder funds to support them during more challenging parts of the economic cycle; and
- A range of other requirements, for instance relating to business plans, risk management systems, remuneration policies, IT systems and governance.

2.15 Within the EU, regulatory rules were amended to bring them into line with the revised international standards agreed by the Basel Committee on Banking Supervision (BCBS) in the wake of the financial crisis. The Capital Requirements Directive (CRD) IV and Capital Requirements Regulation (CRR) put into rules these updated standards and cover the authorisation of banks and subsequent prudential supervision of banks and investment firms, including through rules on capital, liquidity and credit risk. Many standards in CRD IV are, however, specific to the EU. Chapters Three and Four set out a number of criticisms in evidence regarding the implementation in the EU of these international standards.

2.16 Bank failures tend to occur when banks are no longer able to fund themselves. In the past, such failures have been rare. This is because banks are so interconnected to each other and to the economy as a whole that an outright failure of a large bank would risk causing major disruption to the wider economy. Governments have typically stepped in to prevent the knock-on effects of failure using public money. Since markets are aware that large banks are unlikely to be allowed to fail, market discipline against excessive risk-taking tends not to operate. One major global policy objective since the financial crisis has been to make it possible for banks and other systemically important financial institutions to fail in an orderly way without causing collateral damage to the rest of the economy.

2.17 This objective has led to two policy initiatives: to upgrade depositor protection so as to discourage a retail run on the bank where depositors, fearful that a bank may fail, rush to withdraw all their money and thereby trigger the event they fear; and to make it easier to resolve a failing bank without placing it into insolvency and thereby causing large scale disruptions to the wider economy.

2.18 Regarding this first initiative, the financial crisis highlighted that the level of compensation paid to retail depositors in the event that a bank failed was inadequate. Because the rules of the Single Market permitted a bank authorised and supervised in one country to borrow money from depositors in another Member State, without that Member State being able to supervise it prudentially or demand from it prudential information,[7] a harmonised deposit guarantee scheme was established with minimum compensation of €18,000. The collapse of the Icelandic banks and the run on Northern Rock highlighted the inadequacies of this limit, which was increased in a revision to the Deposit Guarantee Schemes Directive to €100,000 (£85,000) and which requires the money to be paid within 20 working days.[8]

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7 CRD IV harmonised liquidity requirements and changed the branching regime so that host states ceased to have responsibility for branch liquidity but in respect of significant branches do now have rights to information and to participate in defined areas of supervisory decision-making.

8 In the UK, depositors are paid within 7 days.

2.19 The second policy initiative was designed to make it easier to resolve a failing bank without placing it into insolvency and thereby causing large scale disruptions to the wider economy or a threat to public funds. In line with the international standards as set out by the FSB, the EU's Bank Recovery and Resolution Directive (BRRD) sets out a range of measures to help achieve this policy goal:

- First, by improving arrangements to help facilitate the recovery of institutions in difficulties, including through recovery planning and early intervention powers for supervisors, and to enhance resolvability, including through powers to require institutions and banking groups to take steps to facilitate the ease with which resolution tools may be applied in the event of failure;
- Second, by setting out a common set of resolution tools which may be applied in the event of failure as an alternative to insolvency; and
- Third, by placing those who lend to banks, especially bond-holders, at risk of being turned into shareholders and then having the value of that shareholding written down against the bank's losses.

2.20 Overall, these measures will help ensure that the authorities can restructure failing institutions to restore viability at little or no direct cost to the tax-payer. The BRRD also provides for resolution financing arrangements in Member States, and the EU's revised State aid rules require bond-holders to be bailed in as a condition for State aid.

Investment Firms and Markets

2.21 Banks are functionally characterised by the combination of borrowing large sums of money in relation to their own (shareholders') funds, and of their borrowings being for short periods of time while their lending is for much longer periods ('maturity transformation'). Securities markets, by contrast, avoid the risks associated with banking. They permit those with money to buy an equity exposure to a company in the form of shares or to provide debt financing in the form of bonds.

2.22 Over the last thirty years, banks found that their larger corporate customers were viewed as a better credit risk by the bond markets and so were able to raise money more cheaply than banks could do.[9] This phenomenon of 'disintermediation' pushed banks into protecting their franchise by seeking to become major players in the securities markets too. The institutional obstacles inhibiting fully fledged investment banking by commercial banks were removed in the UK in 1986 as a result of 'Big Bang' and in the US as a result of the repeal of the Glass-Steagall Act in 1999.[10]

2.23 Securities markets depend for their health on the quality of rules that promote price discovery, the ability to trade cheaply, fairly and quickly particularly at times of market

[9] The relative decline in the perceived credit-worthiness of banks was highlighted by their large losses on sovereign debt to Third World countries in the 1980s.

[10] 'Big Bang' is a phrase used to described the deregulation of UK securities markets on 27 October 1986. This involved the abolition of fixed commission, ending the sectoral demarcation between jobbers and stock-brokers, permitting them to be owned by outside corporations, moving the London Stock Exchange from open-outcry to screen-based trading, and turning it into a private limited company. The long term result of Big Bang was the purchase of jobbers, brokers and the small UK merchant banks by large international banks, paving the way for modern investment banking. The Glass-Steagall Act is the US banking legislation that was passed in 1933, which prevented securities firms and investment banks from taking deposits and prevented commercial banks from undertaking most kinds of securities business, including: dealing in non-governmental securities for clients, investing in non-investment grade securities for themselves, underwriting or distributing non-governmental securities, or permitting commercial banks to affiliate with securities firms or investment banks.

volatility, the robustness of arrangements for settling trades, for authorising and supervising intermediaries and for deterring market abuse. Securities markets are therefore characterised by extensive rules in these areas. Within the EU, there are harmonised requirements that are designed to create a single market through the adoption of common rules:

- The Prospectus Directive covers information which companies seeking to raise money (whether as equity or debt) need to provide to potential investors and the way in which it is to be provided;
- The Transparency Directive sets out detailed rules as to how companies that have issued securities must report to the markets in a timely way about their performance, in particular if an event arises that is likely to affect the value of their securities;
- The Markets in Financial Instruments Directive (MiFID) covers: the platforms for the trading of financial instruments, both exchanges and alternative venues; the trading of these financial instruments, in particular rules covering pre- and post-trade transparency; and the authorisation and conduct of intermediaries in financial markets;
- The European Market Infrastructure Regulation (EMIR) covers: the clearing of over-the-counter (OTC) derivative trades; the authorisation and prudential and conduct oversight of clearing houses and trade repositories; reporting requirements for derivative trades; and risk management requirements for OTC derivatives which are not suitable for clearing;[11]
- The Central Securities Depositories Regulation (CSDR), most of which is expected to come into effect in 2014, covers the settlement of trades and the authorisation and supervision of central securities depositories (the infrastructures on which trades are settled);
- The Market Abuse Regulation (MAR) covers the deterrence and punishment of market abuse, including insider dealing, market manipulation and unlawful disclosure of information, and updates the Market Abuse Directive 2003 by addressing regulatory gaps and broadening the scope of the market abuse framework to reflect market developments and other legislation. MAR is also accompanied by a Directive on criminal sanctions for market abuse which requires Member States to establish criminal sanctions for, at least, serious cases of market abuse committed intentionally;[12]
- The proposed Benchmarks Regulation relates to all benchmarks, including key ones such as LIBOR and EURIBOR.[13] Following the agreement by the International Organization for Securities Commissions (IOSCO) of principles for financial

[11] 'Over-the-counter' derivatives refer to derivative contracts that are traded bilaterally, rather than electronically over platforms such as the derivatives exchange, Liffe. OTC derivatives have an important role to play in allowing the broader economy to hedge risk, particularly where these hedges need to be bespoke. However, as part of the G20 commitment to improve the transparency of OTC derivatives markets, it was agreed that these instruments should be traded on exchanges or electronic trading platforms, wherever possible.

[12] The EU Criminal Sanctions against Market Abuse Directive (CSMAD) attracts an 'opt-in' for the UK under Protocol 21 to the Treaties. The Government decided not to opt-in at the start of negotiations due to sequencing. CSMAD is dependent on MAR and MiFID for its scope. Both those instruments were still at an early stage of negotiation which meant it was not possible for the Government to consider the potential implications of CSMAD.

[13] The London Interbank Offered Rate (LIBOR) and Euro Interbank Offered Rate (EURIBOR) are daily reference rates based on the average interest rate estimated by banks that they will offer to lend to other banks, within London and the euro area respectively.

benchmarks, the Commission published draft legislation in September 2013. The proposed Regulation aims to establish rules of good governance to ensure greater transparency, manage conflicts of interest and to ensure the representativeness of the benchmarks. It also seeks to establish a framework for the supervision of benchmarks, with penalties for non-compliance with established principles; and

- The Credit Rating Agencies (CRA) Regulation covers the authorisation and conduct of CRAs, organisations that assess the likelihood that an issuer of debt securities will be able to maintain its payments to bond-holders. Within the EU, CRAs are authorised and supervised not at the Member State level but by the European Securities and Markets Authority (ESMA).

Asset Management

2.24 Asset managers may provide advice to their clients about their portfolios or may manage such portfolios directly on a discretionary basis. They may also establish and manage collective funds which are then marketed to potential investors. Such asset management provides a way for clients to diversify their portfolio by buying a share in a company whose assets are shares or bonds of other companies (investment trusts), or by buying units in a fund comprised of the shares or bonds of other companies (open ended investment companies or unit trusts), considerable derivatives holdings (hedge funds) or shares that are not listed on an exchange (private equity funds).

2.25 The risks to investors who use asset managers are that: the advice is poor or the fund does not make clear what classes of assets it contains and their level of risk; investments are marketed to people for whom they are not suitable; the fund manager fails to abide by its proclaimed investment strategy; investments are bought and sold too fast, thereby generating fees for the intermediary but reducing value for the client; the fund fails to safeguard the assets it purchases or to keep proper records; or the actions of the fund managers are not supervised effectively by the fund management firm.

2.26 The EU has sought to remove obstacles to the sale and marketing of investment funds within the Single Market through two Directives, these are the Undertakings for Collective Investment in Transferable Securities Directive (UCITS), which is designed in particular for retail investors, and the Alternative Funds Management Directive (AIFMD), which covers all funds that are not UCITS.

2.27 The UCITS Directive (now on its fifth update) provides a harmonised framework of investor protection and product regulation for UCITS funds and UCITS fund managers. Funds complying with the Directive's requirements can market their units freely across the European Economic Area (EEA) on the basis of a single authorisation in their home Member State, subject to complying with the UCITS regime. Managers authorised to manage UCITS in one Member State can similarly offer their services across the EEA.

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

Insurance and Pensions

2.29 There are broadly two different kinds of insurance: general insurance, and long-term life insurance products. General insurance covers risk of loss resulting from fire, theft, accidents and so on. Long-term life insurance products are life insurance, pensions and annuities. The key risks for policy-holders are that an insurer fails and that legitimate claims are not paid out in full. In the case of life insurance products the impact of market failures, such as misselling of long term insurance products, is especially high, since any resulting detriment may not become evident for many years, by which time the policy-holders will not be in a position to buy alternative products.

2.30 Risks to policy-holders are mitigated by a prudential regime and a conduct regime. The prudential regime sets out how insurance companies should assess and mitigate the underwriting risks to which their business model exposes them, including standards relating to capital and investment. The conduct regime currently sets out how insurance products may be marketed and the standards that should apply to the provision of professional advice, although the scope of this regime is being extended to additional aspects.

2.31 Insurance companies are also major investors, including in equities and in corporate and Government bonds. The return on the insurance premia which they invest goes on to fund their obligations to policy-holders and is their major source of profit. Therefore, changes in rules on tax, accounting or prudential standards will have a significant impact on expected returns, on the costs and benefits passed on to policy-holders, on the asset classes insurers hold, and therefore on the investment finance provided to the wider economy.

2.32 The rules of the Single Market are designed to remove national obstacles to the freedom to buy and sell insurance services. This has been achieved in the prudential area by permitting insurers authorised and supervised in one country to establish a branch or provide insurance remotely on a services basis to prospective policy-holders in another Member State, without that Member State being able to impose its own authorisation or prudential requirements.

2.33 The EU's prudential regime for insurers is contained in the Solvency II Directive. The Directive introduces a modern prudential regime based around the three pillar approach of banking regulation. The first pillar provides a standard for valuing the liabilities an insurer has to policy-holders, and the capital insurers must hold to meet the insurance, investment and other risks to which they are exposed. The second pillar is the supervisory review, which focuses on whether the capital buffer is appropriate for the risks of the insurer and its control environment. The firm may be required to hold additional capital as a result. The third pillar is greater market discipline through disclosure by insurers of key data on capital, risks and their control.

2.34 EU Directives also provide minimum conduct standards. The Directive on Insurance Mediation (IMD) establishes common standards and an authorisation regime for the sale of insurance and reinsurance across the EU by intermediaries and brokers. The revision to the IMD – IMD II – extends the scope of the regime to include the direct sales forces of insurers and imposes new requirements intended to increase consumer protection, particularly for insurance investment products.

2.35 The single market for insurance services is incomplete. While Solvency II will create a level-playing field for the movement of insurance capital and services, this is not replicated for policy-holder protection, where the lack of harmonised minimum rules mean that insurance policy-holders in the EU are subject to differing compensation rules. This is an issue for the UK which offers high standards of protection to insurance policy-holders via the Financial Services Compensation Scheme.

2.36 The EU has also sought to set minimum rules for occupational pensions. However, while the removal of obstacles to the Single Market would greatly ease the provision of occupational pensions for multinational companies and make it easier for their employees to work in different Member States and remain in the same pension scheme, achieving such harmonisation is extremely difficult. This is because of the importance that tax and social and labour law plays in pension rules. The Directive on Institutions for Occupational Retirement Provision (IORP) seeks to address cross-border, prudential and governance issues in this area.

Retail

2.37 The Single Market Directives mentioned above will tend to benefit consumers by opening up national markets to competition from firms in other Member States and by ensuring core standards apply across the EU. There is some EU legislation that is specifically designed to enhance consumer welfare, in areas such as investment services, mortgages, payment services, distance contracts and a common disclosure regime for investment products.

2.38 The Mortgage Credit Directive (MCD) on credit agreements for consumers relating to residential immovable property was adopted in February 2014. This Directive aims to create an EU-wide mortgage credit market with a high level of consumer protection. The main provisions include consumer information requirements, principle-based rules and standards for the performance of services, provisions on early repayment, and a 'passport' for credit intermediaries who meet the admission requirements in their home Member State.[14]

2.39 The Consumer Credit Directive (CCD) was designed to establish the conditions for a genuine single market in consumer credit, ensure a high level of consumer protection and improve clarity by recasting existing Directives. The CCD applies to all providers of credit to consumers, such as banks and building societies and all credit intermediaries. Member States were required to transpose the Directive into national law by June 2010.

2.40 The Directive on Payment Services (PSD) provides the legal foundation for the creation of an EU-wide single market for payments. The PSD aims to establish a modern and comprehensive set of rules applicable to all payment services in the EU. The Directive also provides the necessary legal platform for the Single Euro Payments Area (SEPA).

2.41 The Distance Marketing of Financial Services Directive covers contracts for retail financial services (banking, insurance, payment and investment services, including pension funds) that are negotiated at a distance by any means which do not require the simultaneous physical presence of the parties to the contract, for example, by telephone, fax or over the Internet. The Directive also gives the consumer a cancellation right.

2.42 A Regulation on key information documents for investment products, Packaged Retail Investment Products (PRIPs) will require the provision of a standardised Key Information Document to retail investors before they purchase specified types of investment product, based on the existing disclosure document required under the UCITS Directive.

[14] 'Passporting' is the right of a financial services firms incorporated in one Member State to establish a branch or provide services remotely on a services basis in another Member State (including within the EEA), solely on the basis of their authorisation and prudential supervison by their state of incorporation.

Chapter 3: Impact on the National Interest

Introduction

3.1 This chapter considers the impact on the national interest of the existing balance of competences between the UK and the EU. It draws upon evidence submitted to the Call for Evidence (see Annex B) as well as reports and literature in the public domain (see Annex D). It does not, however, consider whether UK membership of the EU is in the UK's national interest.

3.2 The chapter considers the impact on the national interest under four broad themes:

A. **The impact of the financial services sector on the UK economy, and the benefits of access to the Single Market and the Free Movement of Capital** – This section notes the size and importance of the financial services sector in the UK compared to other EU Member States. This includes the major contribution it makes to the economy as well as the significant risks it presents, as was highlighted during the financial crisis. There was broad consensus in evidence about the strong benefits of access to the Single Market, including the ability for firms to 'passport' their services across all 28 Member States. This section also examines the Free Movement of Capital's wider role in the functioning of the Single Market, including the potential benefits and costs of open capital markets;

B. **The global nature of financial services and its impact on the EU's approach to rules and markets** – This section sets out the increasingly global nature of financial services, including the international regulatory framework which has been extensively redrawn in recent years and the stronger interlinkages between the international, regional and national dimensions. As a result, international developments have had a significant influence on the EU's approach to financial services regulation in recent years. This has not, however, prevented the EU from setting its own priorities and, in some instances, going beyond or falling short of international standards. This section also notes the strong calls in the evidence for the EU to facilitate trade for financial services firms between EU and non-EU markets and for the UK to ensure it has adequate influence in financial services at both the global and EU level;

C. **The impact of euro area developments, notably the banking union, and EU-level supervision on the Single Market** – This section sets out the introduction of the banking union following the euro area crisis and notes concerns in the evidence about the potential implications of this additional dimension to the Single Market and the UK. It also considers the introduction of the new European supervisory structure; and

D. **The EU's approach to rule-making following the financial crisis** – The shift in focus from market-opening to financial stability in the last five years has raised questions regarding the quality of the policy-making process and the resulting rules. Although there was broad consensus about the need for EU-level rules to underpin the single market in financial services and to have a financial stability objective in the wake of the crisis, evidence from stakeholders raised significant concerns regarding the recent pace, volume and focus of EU legislation, the failure to differentiate between different financial services sectors, the lack of proportionality, and insufficient recognition of the subsidiarity principle, especially in the retail sector. Chapter Four focuses in more detail on the EU rule-making process.

A. The UK Financial Services Sector, Access to the Single Market and the Free Movement of Capital

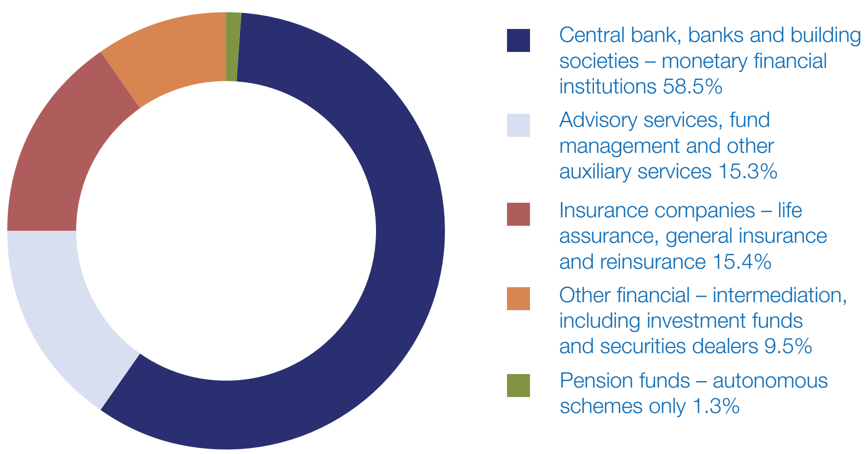
3.3 The UK financial services sector provides a range of benefits to the UK, EU and global economy. It also presents risks and challenges, as was highlighted in the recent crisis. There was broad consensus in the evidence that access to the Single Market provides benefits to UK financial services, although these are not felt equally by all parts of the sector and there were alternative views on the scope for the UK to operate outside the EU. The Free Movement of Capital, as protected by EU Treaty, was generally considered to provide benefits, although evidence did highlight the potential for exceptions to the free movement to act as barriers to trade.

The UK Financial Services Sector

3.4 The financial services sector is critical for the UK. It plays a key role in providing essential services to individuals and businesses and in its contributions to growth, trade, tax revenues and employment.

3.5 For individuals, the financial sector provides essential services from bank accounts and mortgages, through to car and home insurance, and to pensions. While for businesses, the sector plays a critical role in providing access to finance, products to help firms guard against risks, as well as the various constituent parts that help to ensure an efficient marketplace.

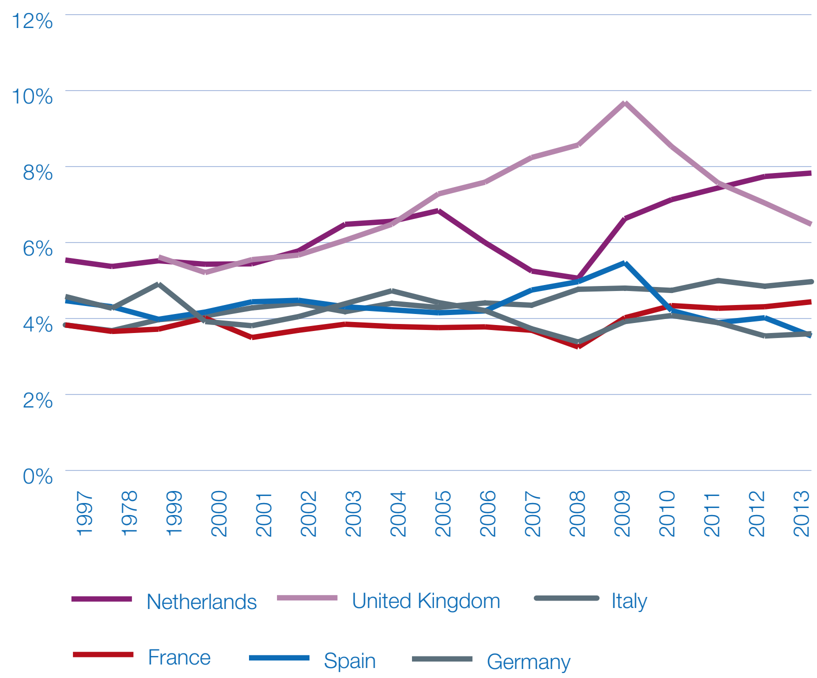
Figure One: Composition of the UK Financial Services Sector by Value Added, 2010[1]



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

[1] Based on Standard Industrial Classification 2007.

Figure Two: UK Financial Services Contribution to GDP, Compared to Other Major EU Economies

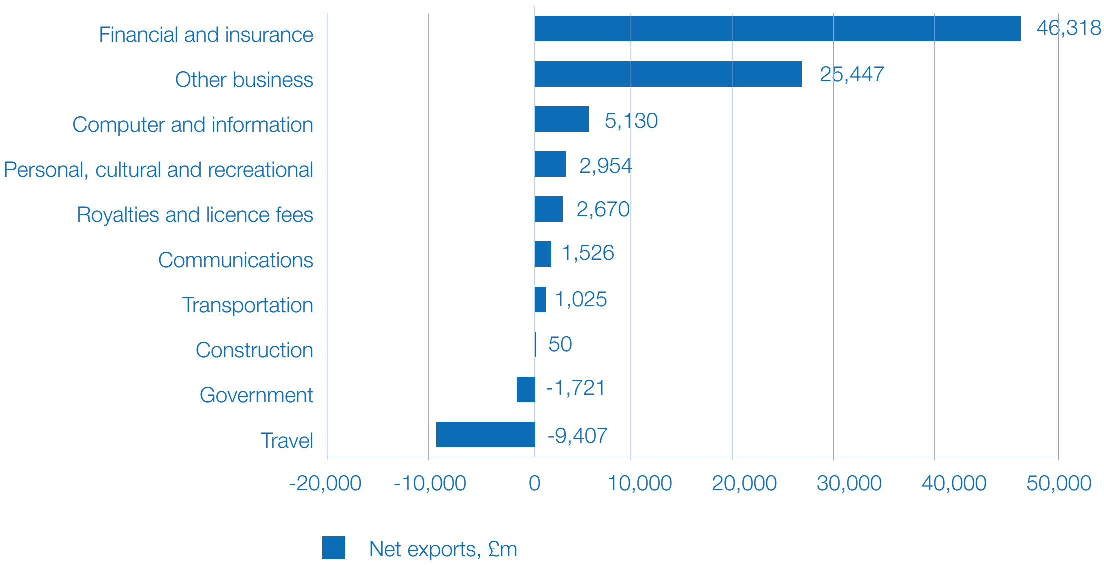


Source: *OECD*

3.6 The sector also makes major contributions to the economy through supporting GDP, trade, tax revenues and employment. Figure 2 shows the contribution of the sector to UK GDP, demonstrating the relative importance of the financial services sector within the UK compared to other major EU economies.

3.7 According to the United Nations Conference on Trade and Development (UNCTAD), the UK is the largest net exporter of financial services and insurance in the world, with a trade surplus that is more than double that of any other country. In 2013, UK net exports in these sectors were $71bn compared to $28bn in the US, $22bn in Luxembourg, $21bn in Switzerland and $13bn in Hong Kong.[2]

Figure Three: UK Trade Surplus in Services, 2012



Source: *ONS Pink Book 2013*

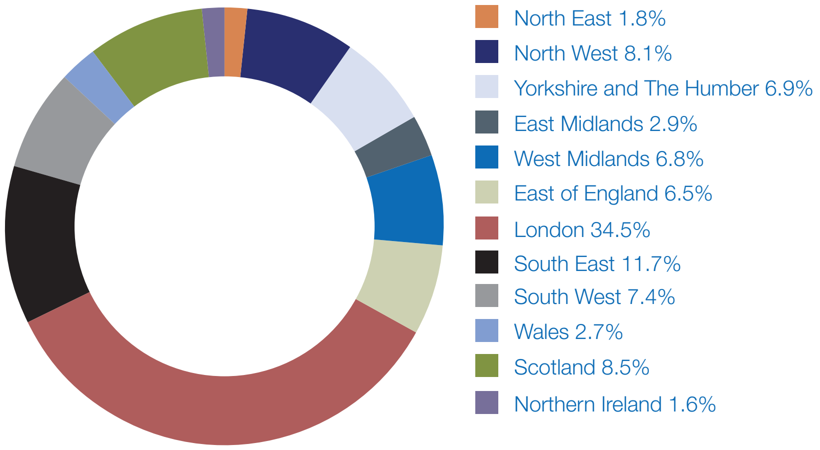
2 UNCTAD STAT data.

3.8 The UK financial services sector also provides a significant contribution to Government revenues. The financial sector represented 12% of the total PAYE Income Tax and class 1 NICs received in 2011-12, and for corporation tax, HM Revenue and Customs estimate that the financial sector contributed 15% of total onshore corporation tax receipts in 2012-13.[3] This is, however, some way below the peak contribution in the last ten years of 29% of all corporation tax receipts, which occurred in 2006-07.

3.9 In December 2013, the UK financial services and insurance sector accounted for over 1.1 million jobs, accounting for 3.4% of all jobs in the UK.[4] The sector also stretches far beyond the City of London, with two-thirds of financial services jobs being outside the capital (see Figure Four).

3.10 The financial services sector makes a particularly important contribution in Scotland in terms of its share of Scottish GDP.[5] This share is higher than the equivalent figure for any other region outside London and the South East. As highlighted by the submission from the Scottish Government to this review, Scotland's asset management sector is particularly successful. For instance, Aberdeen Asset Management became the largest independent asset manager in Europe, following its acquisition of Scottish Widows Investment Partnership. The Scottish Government also highlighted that Scottish life and pension firms account for nearly 30% of total UK employment in these industries.

Figure Four: Financial Services and Insurance Employment, by Region in December 2013



Source: ONS, *Labour Market Statistics, Workforce jobs by Region and Industry, April 2014*

3.11 The Welsh Government similarly emphasised the financial services sector's role as a significant employer and contributor to growth in Wales. Between 2002 and 2012 the number of financial services jobs in Cardiff grew by 60%.[6] Citi also noted in their evidence that the 'question of employment does not only affect the City of London... Citi itself employs a significant number of staff in Belfast'.

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3 Based on the Summary Trade Classification definition of the financial sector.

4 ONS, *Labour Market Statistics, Workforce Jobs by Industry* (2014). See Section K of SIC 2007 for a breakdown of Financial and Insurance Activities.

5 Based on TheCityUK 2012 estimates: TheCityUK, *Glasgow Factsheet* (2013); and TheCityUK, *Key Facts About the UK Financial and Related Professional Services* (2014).

6 Welsh Government, *submission of evidence*, p1.

3.12 Open Europe has highlighted the fundamental importance of the financial services sector to the UK economy: 'the UK did not export financial services it would have to choose between having an overall deficit of over £70bn a year (clearly unsustainable), radically reducing its imports or creating a new world class industry'.[7]

To describe financial services as important to the UK economy vastly understates their value – they are absolutely critical.

(Fresh Start)

3.13 However, while the financial sector undoubtedly brings large benefits to the UK economy, it also poses significant risks. As UK banking sector net exports grew from around £11bn in 2003 to £30bn in 2008, the aggregate balance sheet of the sector more than doubled in size from £3.5tn to £7.3tn.[8] The recent financial crisis demonstrated the significant damage that a failure in the banking sector can inflict on both the wider economy and public finances, with billions of pounds of tax-payers' money put at risk. The assets of the UK banking sector are currently around 492% of UK GDP, with banking assets in Scotland alone totalling around 1254% of Scotland's GDP.[9]

3.14 Since 2008 the Government has made a number of interventions in the banking sector in order to protect depositors, maintain banks' liquidity and capital and encourage lending to creditworthy borrowers.[10] Interventions have taken the form of loans, guarantees and share purchases. At its peak, total Government support for the banking sector, which includes contingent guarantees, as well as cash outlay, exceeded £1tn (76% of UK GDP).[11] Northern Rock and Bradford & Bingley were both taken into full public ownership in 2008, and between 2008 and 2009 the Government injected capital of £20.5bn and £45.8bn into Lloyds Banking Group and Royal Bank of Scotland (RBS) respectively. The latter case was the largest bank bailout in the world, and the Government currently holds around 80% of RBS shares. As of March 2013, the Government's total cash outlay was £115bn, with a further £26bn committed in guarantees.[12]

UK Financial Services in the Single Market

3.15 In addition to its domestic importance, the UK financial services sector plays a key role in the EU economy. Figures Five and Six highlight the UK's large share of EU activity across financial markets. This shows the extent to which the UK financial services sector is of greater national importance than the financial services sectors in many other Member States, although some smaller Member States, such as Luxembourg and Ireland, have

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7 Open Europe, *Continental Shift: Safeguarding the UK's Financial Trade in a Changing Europe* (2011).

8 See: Independent Commission on Banking, *Issues Paper: Call for Evidence* (2010), Annex. Figures taken from from ONS, *Pink Book* (2010).

9 HM Government, *Scotland Analysis: Financial Services and Banking* (2013). Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/200491/scotland_analysis_financial_services_and_banking_200513.pdf, accessed on 17 June 2014.

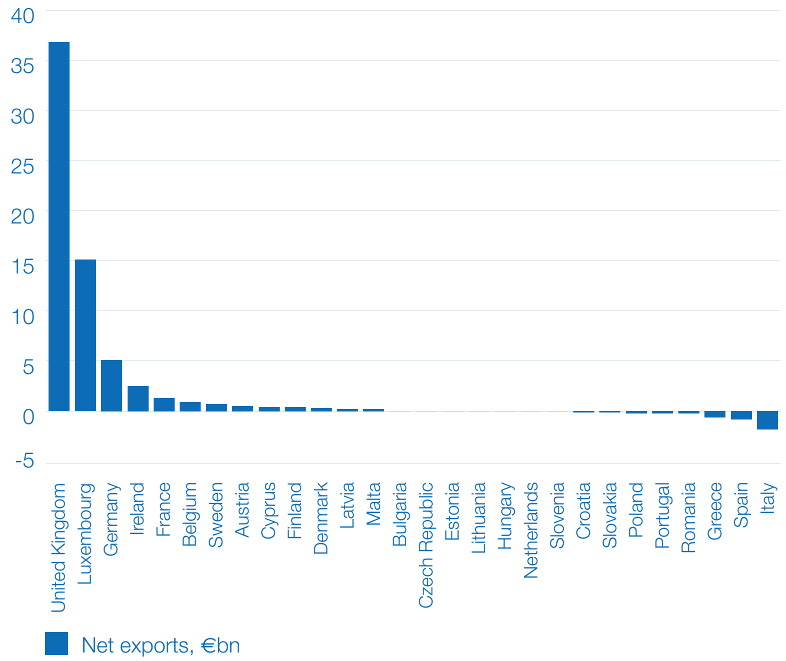
10 National Audit Office (NAO) www.nao.org.uk/wp-content/uploads/2013/07/HMT-Accounts-2012-13.pdf.

11 NAO, *The Comptroller and Auditor General's Report to the House of Commons* (2013). Available at: www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/, accessed on 10 June 2014. See also: Scotland Analysis: *Financial Services and Banking*.

12 For more information, see: www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/. Accessed on 13 June 2014.

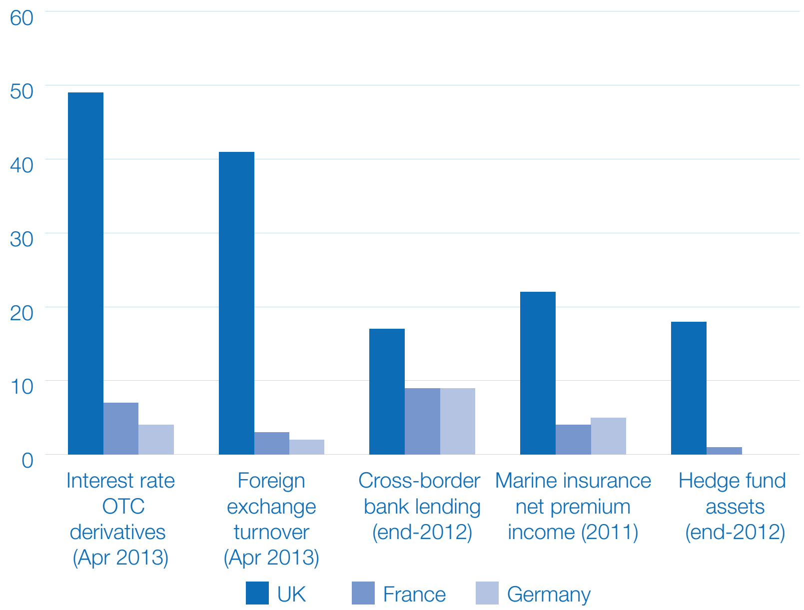
financial sectors that are larger as a proportion of GDP. Furthermore, Oliver Wyman/TheCityUK estimate that around £45bn out of a total of £58bn of European capital markets and investment banking revenue is transacted in the UK, again suggesting the share of UK activity in the EU is significant.[13]

Figure Five: International Transactions in Financial Services: Exports, Imports and Balance 2012 (€bn)



Source: Eurostat[14]

Figure Six: UK, Germany and France Share of Global Markets across Different Financial Services Sectors



Source: TheCityUK

[13] See evidence from TheCityUK, as an addendum to IRSG, *submission of evidence*.

[14] Eurostat: *International Transactions in Financial Services: Imports, Exports and Balance* (2013).

3.16 The size and depth of the UK financial services sector is important for the EU as a whole, bringing benefits to all Member States. It supports the development of businesses, investment in new technology, and growth and employment across the EU. And with London's position as a global financial centre, the UK acts as a hub and point of entry for non-EU firms into the Single Market.

3.17 The figures speak for themselves. The UK is the largest centre for cross-border borrowing, with 251 foreign banks operating across the UK in March 2011, more than in any other country worldwide, and around half of all European investment banking activity conducted in London.[15] The UK insurance industry is the largest in Europe and third largest in the world, after the US and Japan.[16] With an estimated £5.2tn of assets under management at end-2012, the UK is the largest asset management centre in Europe with around 36% of the European market and the second largest centre in the world.[17] The UK is the second largest global centre for hedge fund managers[18] and pension fund assets after the US.[19] And the UK is the largest centre of foreign exchange and OTC interest rate derivatives activity, with 41% and 49% of global turnover respectively in April 2013.[20]

3.18 This relationship has mutual benefits. The EU is the largest destination for UK exports of financial services, with over a third of the UK's trade surplus in financial services in 2012 coming from trade with other EU Member States.[21] The UK's membership of the Single Market facilitates access to the world's largest single market with GDP of €13tn and 500 million people and as its financial centre helps channel capital flows to the economies of Europe.[22]

3.19 The existence of the EU Single Market and UK access to it were considered in the evidence to be critical to the consolidation of the UK's position as a leading international financial centre. Respondents highlighted the importance of the EU as a market, the value of the passporting regime which enables firms to be authorised in the UK and then operate across Europe, and the role of the Single Market in facilitating access to non-EU markets. Evidence emphasised the UK's share of the single market in financial services, the link between the UK's position as a global financial centre and the development of the Single Market, and surveys setting out business support for access to the Single Market.[23]

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15 TheCityUK, *Key Facts about the UK As An International Financial Centre* (2013), p7.

16 OECD Insurance Statistics 2012, measured by total gross premiums written from 2011.

17 UKTI/IMA.

18 UKTI.

19 OECD, *Performance of Pension Funds*, (2012) p5, available at: www.oecd.org/daf/fin/private-pensions/PensionMarketsInFocus2012.pdf. Accessed June 2014.

20 Bank for International Settlements, *Triennial Central Bank Survey: Foreign exchange turnover in April 2013 preliminary global results* (2013); OTC, *Interest Rate Derivatives Turnover in April 2013: Preliminary Global Results* (2013).

21 TheCityUK estimates based on ONS data, *UK and the EU: A Mutually Beneficial Relationship* (2013), p4.

22 Eurostat, *Basic Figures on the EU: First Quarter 2014* (2014), pp. 3-4. Available at: epp.eurostat.ec.europa.eu/portal/page/portal/product_details/publication?p_product_code=KS-GL-14-001. Accessed June 2014.

23 See: Association of Corporate Treasurers (ACT), Association of Foreign Banks (AFB), Association for Financial Markets in Europe (AFME), AIG, Bank of America Merrill Lynch, Barclays, BATS Chi-X, British Bankers' Association (BBA), British Insurance Brokers' Association (BIBA), Sharon Bowles MEP, British Private Equity & Venture Capital Association (BVCA), Citi, the Confederation of British Industry (CBI), Franco-British Chamber of Commerce (FBCC), Financial Conduct Authority (FCA) Financial Services Practioners Panel, an insurance industry roundtable, International Regulatory Strategy Group (ISRG), International Underwriting Association (IUA), the Law Society of England and Wales and the Law Society of Scotland (the 'Law Societies'), JP Morgan, Lloyd's of London, Nomura, Royal Bank of Scotland (RBS) Group, Royal Sun Alliance (RSA), the Scottish Government and Standard Life, *submissions of evidence.*

Recent surveys which support this position include the CBI's which showed 78% of businesses supported the UK staying a member of the EU, with virtually no distinction between large businesses and SMEs; TheCityUK's survey of financial service business leaders reported that 84% wanted the UK to remain a member of the EU and 95% said access to the Single Market is important for the UK's future competitiveness; and the Engineering Employers' Federation published a report in the autumn of 2013 saying manufacturers supported the UK staying in the EU 'no ifs, no buts'.

(International Regulatory Strategy Group (IRSG))

3.20 There were positive views on access to the Single Market from across industry participants, most notably those that undertake cross-border activity, such as banks, insurers, asset managers, market infrastructure providers and end users of financial services.[24] Some multinational stakeholders specifically highlighted the UK's access to the Single Market as a factor in deciding to locate in the UK. Nomura, for instance, stated that, 'The Single Market has been a key attraction for us in choosing to locate in the UK'. Evidence from the Association of Foreign Banks (AFB) argued that:

Considering the volume of the UK's business with Europe itself, there is a need for the UK to remain in the EU and to influence the EU business environment and rules. If Britain withdraws from Europe, then foreign banks may reassess their reasons for maintaining their business in Britain and may decide to continue their business elsewhere.

(AFB)

3.21 However, evidence also suggested that these benefits are not felt equally across all sectors, notably areas of activity that are primarily domestic in nature. For instance, the Association of Professional Financial Advisors (APFA) noted that, 'The financial advice sector, being made up primarily of wholly UK based businesses with predominantly UK customers, does not use the benefit of a single market, yet suffers the costs of having to comply with EU directives'. The Building Societies Association (BSA) also noted that the lack of cross-border activity meant that access to the Single Market had not benefited their members.[25]

3.22 An alternative view was that there would be potential for the UK financial services sector to flourish outside the EU. Evidence from Business for Britain cited estimates that the EU financial services industry will spend €33.3bn on complying with regulation between 2012 and 2015, with a large proportion of this impacting on the City of London.[26] Some evidence also suggested that the likely negative impact on the UK financial services sector of leaving the EU had been exaggerated and that the UK should repatriate powers over financial regulation.[27] However, Sharon Bowles MEP cautioned that leaving the EU would

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24 See, in particular, ACT, *submission of evidence*, p2; BATS Chi-X, *submission of evidence*, p1; BVCA, *submission of evidence*, p8; CBI, *submission of evidence*, p8 and *Record of 11 December insurance industry stakeholder event*, p1.

25 BSA, *submission of evidence*, p2.

26 JWG Analysis Report, *Dirty windows: Regulating a Clearer View* (2012).

27 See: Lord Flight, *submission of evidence*, pp3-4; David Campbell Bannerman MEP, *submission of evidence*, pp1-4; and the Rt Hon John Redwood MP, *submission of evidence*, p1. Business for Britain, *submission of evidence*, pp6-7 also quotes Michael Spencer, CEO of ICAP, 22 August 2013: 'I do think that the UK and the City could thrive outside the EU. If we pulled out, we could quickly take away a lot of the regulatory burden which is imposed on the City. There would not be an exodus of business, an exodus of banks or an exodus of staff'.

curtail UK influence, noting that Norwegian representatives have had to lobby UK MEPs in an attempt to ensure EU rules took account of their interests.[28]

3.23 In summary, the financial sector makes a significant contribution to the UK economy in terms of services and products for businesses and consumers as well as growth, employment, revenues and trade. However, the recent crisis has highlighted that the financial sector also presents considerable and costly risks to the wider economy and public finances. Access to the EU Single Market is key for many financial services firms, and a number of stakeholders emphasised the importance of this in their decisions to locate in the UK.[29]

Importance of the Free Movement of Capital to the UK

3.24 It is important to recognise the critical role of the Free Movement of Capital in supporting the effective functioning of the single market in financial services and developing the UK, and London in particular, into a global financial centre.[30] The processing of payments and capital movements is essential for large financial centres, as deeper economic integration requires cross-border payments to be made easily and cheaply.

3.25 A review of the literature on the Free Movement of Capital commissioned by HMT and published alongside this report, also discusses evidence that capital liberalisation promotes the efficiency and development of the financial sector. For example, financial market liquidity may increase, and transaction costs decrease, where the international movement of capital provides for a greater number of market participants. The Free Movement of Capital also allows the banking sector to diversify country-specific risks, as banks can borrow and lend funds from and to a wider range of sources than would be possible in a less open economy.[31]

3.26 The UK financial sector's interconnectedness with EU and global financial institutions does present some risks, particularly when exposure is heavily skewed towards certain regions. It is well-documented that, in the run-up to the financial crisis, European banks were heavily exposed to mispriced securitised debt based upon loans to households and companies in the US.[32] So while open capital markets bring clear benefits to the UK's financial sector, an interconnected system also poses risks. Since the financial crisis, rule-making at both an EU and international level has focussed on addressing these risks.

3.27 The literature review also highlights financial instability as a key risk associated with global capital flows. However, it considers this against the numerous, substantial economic benefits arising from open capital markets.

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[28] Sharon Bowles MEP, *submission of evidence,* p20.

[29] A number of studies have sought to quantify the direct impact of the single market in financial services. For instance: Cecchini et al, *The European Challenge, 1992: The Benefits of a Single Market* (1988)*;* Heinemann, F and Jopp, M, *The Benefits of a Working European Retail Market for Financial Services* (2002)*;* London Economics, *Quantification of the Macro-Economic Impact of Integration of EU Financial Markets* (2002); and ECB, *Financial Integration in Europe* (2012). See also a range of studies on the Single Market and financial integration on the European Commission website: ec.europa.eu/dgs/internal_market/studies/index_en.htm and ec.europa.eu/internal_market/economic_analysis/reports/index_en.htm, accessed on 30 May 2014. However, this is a challenging area of research, in part due to links between the financial services sector and the health of the wider economy, with feedback loops that are difficult to capture and a lack of certainty over statistical data.

[30] IRSG, *submission of evidence*, p18.

[31] See, for example, John Springford, CER, *submission of evidence*, p4, and external MPC member Ben Broadbent's speech at the Institute for Economic Affairs (February 2014): Available at: www.bankofengland.co.uk/publications/Pages/news/2014/039.aspx, accessed on 30 June 2014.

[32] John Springford, CER, *submission of evidence,* p4.

3.28 The evidence also considered that the ability of capital to flow freely across borders is vital not only for the financial sector, but also for all other sectors where businesses operate across multiple jurisdictions. Free Movement of Capital and payments give businesses the freedom to make ordinary commercial transactions, arrange funding and make cross-border investments.[33] Firms can access a wider range of markets, reduce the cost of financing their business and reduce their operating risks. GlaxoSmithKline commented that EU initiatives have made cross-border payments faster and cheaper, and also simplified their cash management practices.[34]

3.29 The UK has a long tradition of open capital markets' policies. As noted in Chapter One, the UK removed all exchange controls in 1979, a full 15 years before Article 63 TFEU prohibited restrictions on the Free Movement of Capital and on payments within the EU. As a result, the impact of the TFEU on the UK's domestic capital policies has been limited, and so the development of the Free Movement of Capital largely relates to the opening up of national markets in other Member States to competition.[35]

3.30 The next section considers the impact of the Treaty freedom on the UK. To do so, it first assesses the extent to which the freedom achieves its objective of opening up capital markets across the EU. It then considers the impact of the fundamental freedom on movements of capital between the UK and countries outside the EU, noting that the Treaty freedom is more wide ranging and binding than other international frameworks.

Functioning of the Fundamental Freedom

3.31 The Free Movement of Capital under Article 63 TFEU is not an absolute freedom. Member States may intervene in the movement of capital on the basis of a number of specific public policy concerns, notably: macroprudential regulation and capital controls; tax differentiation; public policy, public security, national security and defence; and financial sanctions (see Figure Seven).[36]

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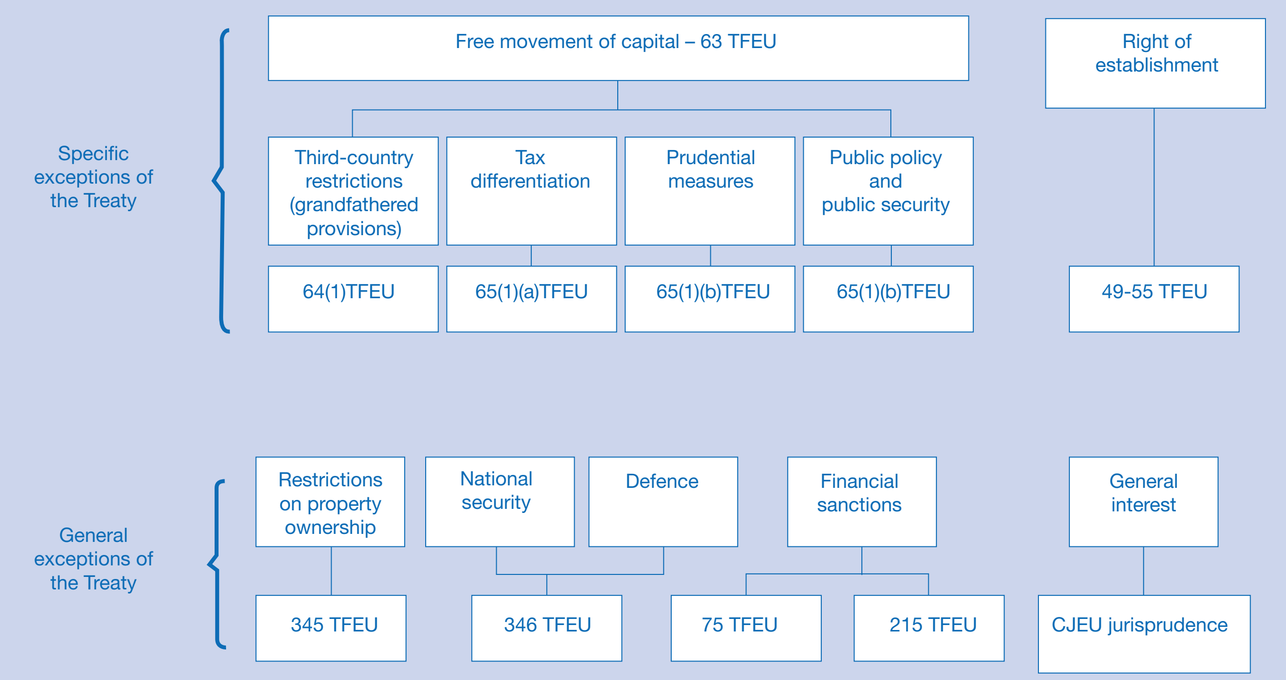
33 ACT, *submission of evidence*, p2 and GlaxoSmithKline, *submission of evidence*, p1.

34 GlaxoSmithKline, *submission of evidence*, p1.

35 This has also been underpinned by Economic and Monetary Union, an area that will be addressed in HMG, *Review of the Balance of Competences Between the UK and the EU: Economic and Monetary Policy*, published in Semester Four.

36 Restrictions placed on the movement of capital and payments to achieve foreign policy objectives were covered in HMG, *Review of the Balance of Competences Between the UK and the EU: Foreign Policy* (2013) and restrictions on the movement of capital and payments to achieve public security objectives will be covered in HMG, *Review of the Balance of Competences Between the UK and the EU: Police and Criminal Justice*, which will be published in the fourth semester.

Figure Seven: Graphic Overview of Exceptions Stipulated in the Treaty



Source: European Commission

3.32 Apart from the area of financial sanctions, the last decade has seen incremental additional limitations on the ability of Member States to intervene in the Free Movement of Capital to achieve public policy goals.[37] While some stakeholders noted the potential adverse impact on the UK national interest, others welcomed the removal of restrictions in helping to reduce the number of remaining barriers to the single market in capital. The views of respondents are set out below on the areas where restrictions on the Free Movement of Capital still apply: prudential measures; tax differentiation; and public policy. There is then a consideration of how the Free Movement of Capital under Article 63 TFEU differs from other multilateral and bilateral agreements on the Free Movement of Capital.

Prudential Measures

3.33 The financial crisis in particular highlighted the need for banks to hold more capital and for regulators to identify and take action to limit bouts of excessive financial sector exuberance or pessimism. In order to protect financial stability, prudential measures can be introduced as an exception to the Free Movement of Capital. Prudential measures include macroprudential regulation, which involves varying the regulatory requirements on financial institutions throughout the financial and economic cycle when threats to financial stability emerge, as well as capital controls.[38]

[37] As a result of ECJ rulings and EU Directives.

[38] Within the UK, the Bank of England's Financial Policy Committee (FPC) sets macroprudential policy. The FPC has stated that its initial set of macroprudential policy tools will include the ability to vary the amount of additional capital required across the banking sector in general and with respect to particular exposures banks have in a particular lending sector. A counter-cyclical capital buffer is a requirement for banks to hold additional capital when risks are considered to be building in the system, while the Sectoral Capital Requirement is limited to particular exposure classes.

3.34 A few stakeholders noted that this exception is not without limit with regards to macroprudential regulation. When macroprudential authorities intend to put in place certain new measures, they are required to notify the European Parliament, the Council, the Commission, the European Systemic Risk Board and the European Banking Authority, setting out the reasons for the measures. Acting by qualified majority, the Council has the power, subject to certain criteria, to reject the national macroprudential measures proposed. However, it is envisaged that the rejection by Council of any national macroprudential measure will be the exception rather than the rule. Other measures require less onerous procedures.

3.35 Reaction to the discretion afforded to macroprudential policy-makers was mixed. For example, Fresh Start expressed concern over the potential restriction on the ability of the UK 'to introduce more stringent regulation than the EU currently proposes, for example regarding capital requirements for banks [...] [given] the significant exposure of the UK economy to the banking sector – banking assets are 500% of GDP'.[39] On the other hand, HSBC was more generally concerned about national regulatory actions constraining banks cross-border activities and fragmenting the Single Market, and argued that 'many of the obstacles to capital flows are due to the existence of national discretions in EU rules and in prudential supervisory practices'.

3.36 There is broad international consensus that, in a limited set of circumstances involving capital inflows or outflows that are very large relative to the national economy,[40] formal, temporary controls on external capital flows can be beneficial for financial stability.[41] Cyprus implemented strict controls on the transfer of capital outside of the country to prevent bank depositor flight, following the bail-in of bondholders and depositors in the two largest Cypriot banks in March 2013. This is, to date, the only EU Member State with previously fully liberalised capital flows to impose generalised capital controls. A number of stakeholders emphasised the view that capital controls should remain reserved for only very exceptional circumstances and that Cyprus's existing restrictions should be removed as soon as possible.[42]

Tax Differentiation

3.37 Article 65 of the Treaty sets out that the Free Movement of Capital does not prevent Member States from distinguishing between tax-payers who are not in the same situation, regarding their place of residence or location of their capital investment.[43] However, a series of judgments by the ECJ has limited this discretion. In fact, the ECJ has determined

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39 See, in particular, Fresh Start, *submission of evidence*, p2 and p11. BBA, *submission of evidence*, p15, also noted this as a 'significant change' in the ability of Member States to influence capital flows.

40 In exercise of the public policy exception in Art 65(1)(b), countries like the UK – which have their own, free floating currency and deep, well-developed financial systems – are not likely to be subject to substantial risks as a result of sudden large capital inflows or outflows. If such flows do occur, such countries should be better able to manage them using market and more nuanced regulatory responses.

41 For example see: IMF, *The Liberalization and Management of Capital Flows: An Institutional View (*2012). Available at: www.imf.org/external/np/pp/eng/2012/111412.pdf. Accessed June 2014.

42 See: BBA, *submission of evidence*, p15; IRSG, *submission of evidence*, p21; and Sharon Bowles MEP, *submission of evidence*, p24.

43 In accordance with TFEU, taxation competence remains largely at the Member State level. In the area of direct taxation (broadly, a charge on the income, profit or property of people or companies), EU-level action is only justified where it would 'directly affect the establishment or functioning of the Single Market' (Article 115 TFEU). Member States must also exercise their competence in line with the fundamental freedoms. For further information see HMGs, *Review of the Balance of Competences between the UK and the EU: Taxation* (2013).

that differential tax rates relating to the same tax instrument based solely upon the location of capital or residence of the individual are discriminatory and breach one or more of the four freedoms.[44]

3.38 However, as with other areas, Member States can still justify discriminatory tax measures on overriding public interest grounds. Dr Thomas Horsley (Liverpool Law School) commented that these include 'securing the cohesion of the tax system' and 'effective fiscal supervision'. Nevertheless, he added that obstacles to the Free Movement of Capital may not be justified on purely economic grounds.[45]

3.39 Standard Life remarked that, 'the reserved nature of tax law can cause the Single Market to act in a suboptimal manner and can act as a de facto restriction on capital flows'. Paul Morton (Head of Group Tax, Reed Elsevier) further suggested that the ECJ's action in limiting the grounds on which a discriminatory tax measure can be justified had had a broadly positive impact for businesses, although the ECJ process was not always clear to UK businesses which could give rise to uncertainty in both the run-up to a judgment and the interpretation. He also noted that particular rulings do not translate immediately into uniformity across the EU.[46]

Public Policy, Public Security, National Security and Defence

> There continues to be broad scope for discretionary action by individual Member States to obstruct changes in ownership and management even in sectors with no clear public policy, national security or defence justifications.
>
> (Institute of Chartered Accountants in England and Wales (ICAEW))

3.40 Following the implementation of Article 63 TFEU, numerous controls remained in place relating to the direct investment in private companies deemed important to national public policy, security and defence objectives.[47] In many cases, these controls were exercised by 'golden shares' held by Governments in particular companies. These golden shares enabled EU national Governments to maintain rights to name board members or have veto rights on commercial decisions without the level of ownership in the company that would conventionally confer such rights. The UK has called for these arrangements to be removed where there is no very significant national security and defence justification for continued controls by national Governments.

3.41 More widely, ICAEW considered that there are a number of examples where Member State action has obstructed a change in ownership. Examples put forward include E.ON's bid for Endessa in 2007 and Yahoo's bid for a majority stake in Dailymotion in 2012.[48]

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44 See for example the *Manninen* case, where the ECJ ruled that a Finnish tax-payer should be granted a tax credit by the Finnish state on a dividend paid by a Swedish company, which had been taxed in Sweden, as such a credit would have been available upon a dividend paid by a Finnish company, taxed in Finland, and the differential treatment discouraged the Free Movement of Capital. Case C-319-02 *Manninen* [2004].

45 Dr Thomas Horsley, Liverpool Law School, *submission of evidence*, p6.

46 Paul Morton (Head of Group Tax, Reed Elsevier), *submission of evidence*, pp1-2, minutes from meeting with HMT on 23 January 2014.

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

48 See annex of ICAEW, *submission of evidence*, p6.

Capital Movements Between the UK and Third Countries

3.42 Among the EU's four fundamental freedoms, the Free Movement of Capital is unique in also applying to movements between Member States and non-EU countries, known as 'Third Countries'.[49] There are, however, some small caveats to TFEU's extension to Third Countries. The EU can adopt measures on the movement of capital to and from Third Countries which involve direct investment (including investment in real estate), establishment, the provision of financial services or the admission of securities to capital markets.[50] Where these measures constitute a step backwards in terms of the liberalisation of capital movements to and from Third Countries, the Council can still agree their adoption, provided this is done unanimously, although this option has not been exercised to date.[51] Furthermore, unlike for intra-EU movements, the Treaty permits the continuation of any existing Member State restrictions[52] which were already in place on 31 December 1993.[53]

3.43 Evidence to this review also considered the ECJ's approach to cases involving capital movements between Third Countries and EU Member States. Regarding taxation, Dr Thomas Horsley (Liverpool Law School) commented that, compared to intra-EU movements, 'the regulation of external capital movements at Union level has, in practice, had less impact on Member State autonomy'. Daniel Smit noted that if there is no binding agreement to allow the exchange of information between a Member State and a Third Country, then the need for effective fiscal supervision can justify a tax measure that would not be acceptable were it applied to another Member State.[54] Dr Thomas Horsley also suggested that if the ECJ does rule that a national tax measure concerning one or more Third Countries is incompatible with TFEU, i.e. it restricts the Free Movement of Capital, TFEU also grants the Council the ability to effectively overturn this ruling by unanimous decision.[55] Although this provision has not, to date, been invoked, in separate work Dr Thomas Horsley points out that its very presence is arguably enough to influence the ECJ's rulings.[56]

3.44 As with capital movements between Member States, the TFEU rules for Third Countries do not prevent Member States from adopting measures on the provision of financial services by Third Country firms, which restrict the Free Movement of Capital, where there are regulatory reasons for doing so.[57] The EU's approach to Third Countries in the financial

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49 Article 63(1) TFEU.

50 Article 64(2) TFEU.

51 Article 64(3) TFEU.

52 Under existing EU law and the OECD codes of liberalisation.

53 Article 64(1) TFEU. For newer Member States, this standstill clause operates from the date of accession. For example, in respect of restrictions existing under national law in Bulgaria, Estonia and Hungary the relevant cut-off date is 31 December 1999.

54 Daniel Smit, *submission of evidence*, p6. See also Dr Thomas Horsley, Liverpool Law School, *submission of evidence*, p7, on the general case of effective fiscal supervision. Directive 2011/77 EU sets out a framework for mutual cooperation between national tax administrations. However, because this is an instrument of EU law, the Directive only imposes legal obligations on Member States (and not Third Countries).

55 Article 65(4) TFEU. See Dr Thomas Horsley, Liverpool Law School, *submission of evidence*, p8.

56 Horsley, T., Death, Taxes and (Targeted) Judicial Dynamism: The Free Movement of Capital in EU Law, in A. Arnull and D. Chalmers (Eds.), *The Oxford Handbook of European Union Law* (forthcoming in 2014), p. 24.

57 Article 65(1)(b) TFEU. The implementation of any measures on financial services in respect of Third Countries must be in line with the EU's commitments in the WTO's GATS. In practice, most measures taken in financial services can be justified on the basis of the 'prudential carve out' in the GATS Annex on financial services (see part 2 'Domestic Regulation'). This 'carve out', which permits restrictions where they are justified on prudential grounds, is generally considered to be quite wide – see TheCityUK, *A Legal Assessment of the UK's Relationship with the EU – A Financial Services Perspective* (2014).

services context is discussed in Section B below.[58] In addition, the applicability of the Free Movement of Capital to a Third Country firm's provision of financial services may be limited by the fact that the activity can also concern the Free Movement of Services. If the principal fundamental freedom for a particular case is not the Free Movement of Capital then, because no other freedom has an external dimension, the right of free movement cannot be invoked by a Third Country entity. A good example of this is the Fidium Finanz case, which is discussed in the box below.

3.45 In addition to the TFEU provisions, the UK is a signatory to the OECD's legally binding Code of Liberalisation of Capital Movements and Code of Liberalisation of Current Invisible Operations, which stipulates progressive, non-discriminatory liberalisation of capital movements, the right of establishment and current invisible transactions in OECD and adhering countries. The UK also has 94 Bilateral Investment Treaties which provide protections for investments and investors, and typically include provisions which prevent host Governments from restricting capital flows.[59] Although the OECD Codes are the only international agreements on capital movements, they are not as wide-ranging and binding as the TFEU articles.

Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht[1]

In 2003 a Swiss firm, Fidium Finanz, argued that a German law effectively prohibiting Third Country firms from providing loans to German citizens contravened the free movement of capital.[2] However, the Court decided that '... the restrictive effect on the free movement of capital [was] merely an unavoidable consequence of the restriction imposed as regards the provision of services'.

The ECJ decided that the activity of granting credit on a commercial basis primarily affects the Free Movement of Services, and therefore the compatibility of German law with the Free Movement of Capital was not relevant. Because Fidium Finanz was based in Switzerland – a Third Country – it was not entitled to rely on the Free Movement of Services in bringing its case and so its claim was rejected.

1 *Fidium Finanz* Case C-452/04 [2006]. See also Cvria Luxembourg, Press Release No 81/06: Judgment of the Court of Justice in Case C-452/04 (3 October 2006). Available at curia.europa.eu/jcms/upload/docs/application/pdf/2009-02/cp060081en.pdf, accessed on 30 June 2014. Also: European Commission Legal Service, Summaries of Important Judgements, C-452/04 Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht, judgment of 3.10.2006 (2006). Available at ec.europa.eu/dgs/legal_service/arrets/04c452_en.pdf, accessed on 30 June 2014.

2 Third country firms without a central administration or branch in Germany. See Press Release No 81/06.

Impact of the Free Movement of Capital on the UK National Interest

3.46 Since the Treaty of Maastricht, the rate of cross-border investment activity involving the UK and other EU countries has increased. However, this period also saw a vast increase in global trade in goods and services, including through the substantial opening up of large parts of the world to international trade and a series of innovations in financial markets. As a result, there are challenges in determining the precise impact of EU legislation regarding the Free Movement of Capital.

58 See, for example, the box on Third Country access provisions in MiFID II.

59 HMG, *Review of the Balance of Competences between the UK and the EU: Trade and Investment* (2013) contains greater detail on Bilateral Investment Treaties. Following the Lisbon Treaty the responsibility for agreeing some investment provisions passed to the EU.

3.47 Globally, since the financial crisis, capital flows as a share of GDP have slumped. While part of this might represent a necessary correction from the very large positions that had built up before the crisis, an analysis by McKinsey Global Institute found that cross-border capital flows remained at 60% below their pre-crisis peak.[60] From 2009 capital flows began to recover, but since 2011 they have, again, declined.

3.48 McKinsey Global Institute suggests that the weak recovery of capital flows amongst advanced economies has in part been driven by banks slimming down the number of jurisdictions in which they operate, as well as the number of business lines that they offer.[61] Notably, since the start of 2007 almost half of the $722bn in assets that have been sold off by banks have been in foreign operations. McKinsey Global Institute argues that new regulations on capital and liquidity since the financial crisis, as well as pressure on banks from both shareholders and regulators to reduce risks, explains some of this activity. A 2013 Comission working paper found that the decline in international capital flows since 2011 seems to have been driven by a slowdown in private sector portfolio flows.[62] The Commission notes that, in 2011, European companies exhibited a greater preference for investing in their home markets, relative to other EU countries, compared to previous years. In other words, the share of foreign assets in their portfolios decreased. Merger and acquisition activity followed a similar pattern between 2009 and 2011, possibly as the uncertain economic outlook made foreign activity appear more risky than domestic activity.[63]

3.49 Foreign Direct Investment (FDI) is one category of capital flow that has proved more stable. Given FDI's longer term nature, these flows are less susceptible to sudden reversals, and so are less volatile than other types of flows such as portfolio investment.[64] Inward FDI can benefit the UK through a number of channels, such as technological innovation and diffusion. Figure Eight shows that the proportion of the UK's FDI attributable to the rest of the EU has remained broadly stable over the last decade. Around half of the UK's inward FDI is from the rest of the EU, and the EU has provided the destination for just over half of the UK's outward FDI.

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60 McKinsey Global Institute, *Financial globalization: Retreat or Reset?* (2013).

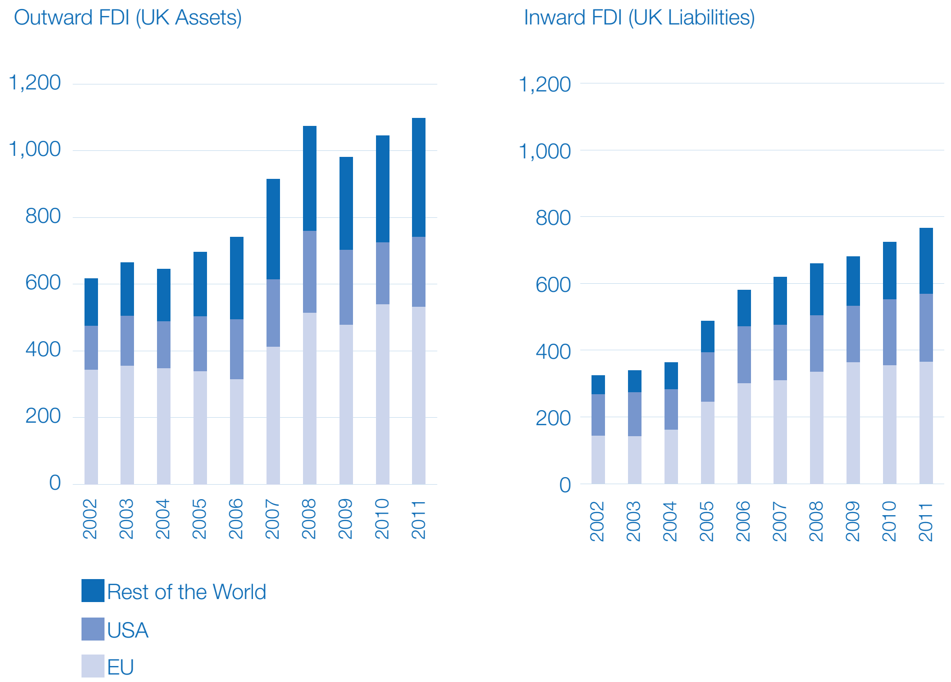
61 ibid, p5.

62 European Commission, *Commission Staff Working Document on the Free Movement of Capital in the EU* (2013), p5.

63 European Commission, *Commission Staff Working Document on the Free Movement of Capital*.

64 See European Commission *Commission Staff Working Document on the free movement of capital in the EU* (2013) as well as Lipsey, R.E. 'The Role of Foreign Direct Investment in International Capital Flows', in Martin Feldstein (ed.), *International Capital Flows* (1999), Section One, Chapter Six. The European Commission suggest that FDI is less prone to retrenchment than other types of capital flows. For example, it is usually more costly and time consuming for a company to close or relocate a factory than it is to rebalance their debt portfolio. Lipsey (ibid) also explains the relative stability of FDI flows in terms of the importance of retained earnings. While these do fluctuate, once a firm is well-established in a foreign jurisdiction, retained earnings rarely shift sharply into negative.

Figure Eight: UK FDI Stocks (£bn)



Source: ONS

3.50 In summary, the UK benefits from the Treaty's protection of the Free Movement of Capital within the EU, which is a wider ranging and more binding arrangement than the global agreements to which the UK adheres. While events such as the recent financial crisis have highlighted the role of open capital markets in financial instability, the Treaty does permit exceptions to the Free Movement of Capital aimed at addressing these risks. However, in general, exceptions to the Free Movement of Capital need to remain reserved for very specific circumstances and should be well calibrated. In some areas, unnecessary barriers to capital movements remain.

B. The Global Nature of Financial Rules and Markets

3.51 The international dimension has a significant impact on the EU's competence in financial services with regard to both rules and market access. The increasingly global nature of financial services has resulted in an international framework of regulatory standards. As these standards have been significantly rewritten since the crisis, this has created an important context for the EU's own approach to regulation in the last few years. The trend towards more globalised markets in the last few decades means that the EU's competence in defining the terms of trade in financial services for Member States with other non-EU countries is another important international dimension to the relationship between the EU and the UK.

Interaction between EU Rule-Making and the International Framework

3.52 The failure to have an adequate governance system to oversee the increasingly global nature of financial services was one cause of the financial crisis. It is, therefore, appropriate that efforts to set standards and address the weaknesses that were exposed are taken at a global level, including by the G20, FSB and the SSBs.[65] See Figure Nine for a simplified

[65] Key SSBs include: the Basel Committee on Banking Supervision (BCBS), which has developed the standards on capital and liquidity requirements; the International Organization of Securities Commissions (IOSCO), which has played a leading role in taking forward steps to improve the transparency and efficiency of markets, including greater reporting of derivatives transactions; and the International Association of Insurance Supervisors (IAIS), which has helped to develop high-level standards for insurance firms.

and stylised diagram of how the international, EU and national dimensions of financial services policy-making interact.

3.53 Since the financial crisis, these international bodies have become ever more important and influential through the major overhaul of financial regulation and supervisory practices. New global standards focused on, among many issues, the quantity and quality of capital and liquidity, the clearing of OTC derivatives, the supervision of CRAs, market infrastructure, and bank resolution. Some stakeholders, for instance the Wholesale Markets Brokers' Association (WMBA), considered international standard-setting to be more important to the UK than EU rule-making.[66]

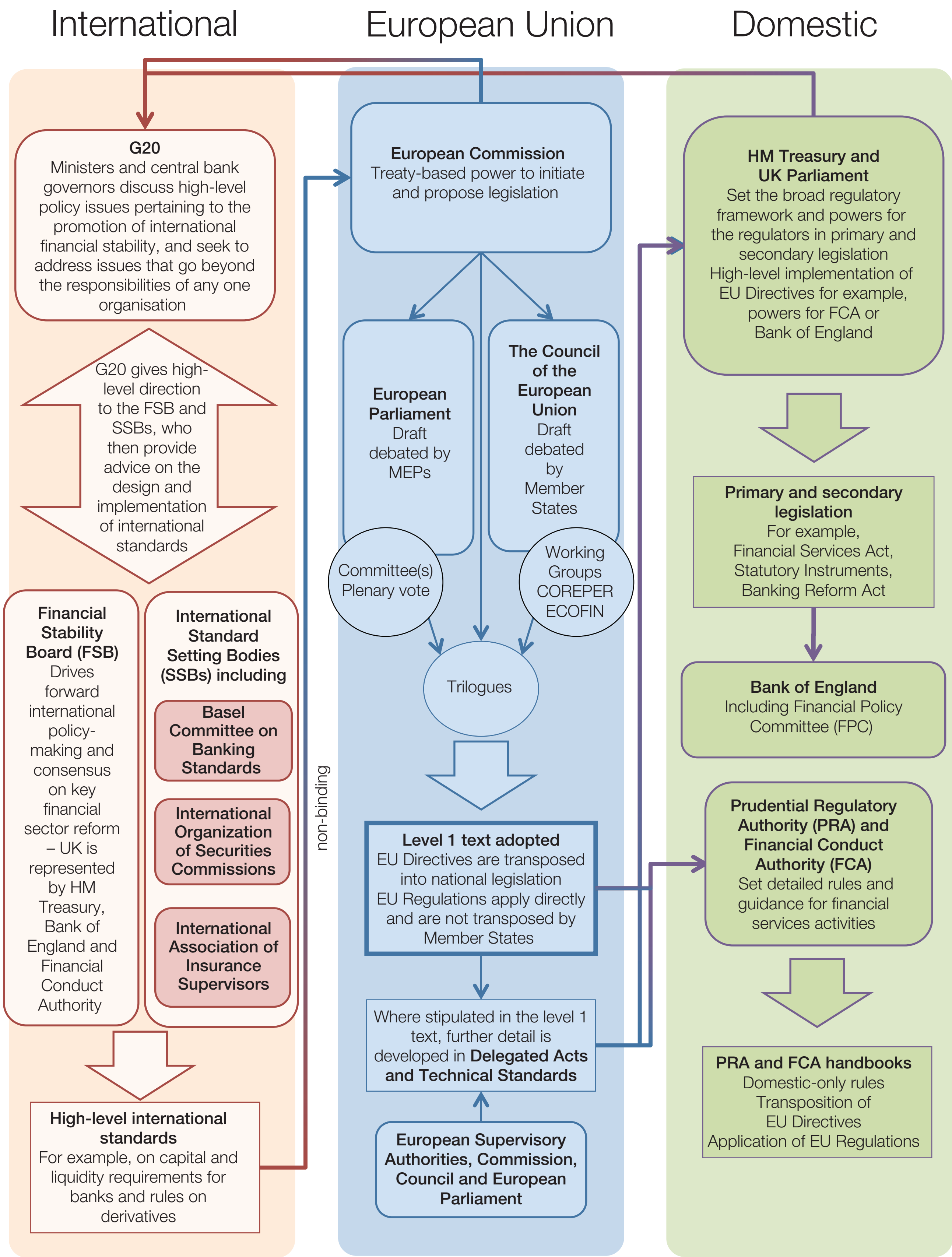
3.54 Evidence highlighted the importance of consistency at an international level.[67] For example, JP Morgan commented, 'The complexities of implementing globally coherent rules and the resulting implications for the wider economy increasingly require strong co-operation and co-ordination across jurisdictions'. A number of respondents emphasised the key roles of the G20, FSB and SSBs in facilitating cooperation and a coordinated approach to the design and implementation of standards.[68] While coordinated high-level commitments agreed at the global level should ensure that there is a degree of consistency in rule-making, tensions can arise as commitments are not strictly binding, can be interpreted differently, and can be implemented at different times.

66 WMBA, *submission of evidence*, p5.

67 See: Bank of America Merrill Lynch, *submission of evidence*, p3; Barclays, *submission of evidence*, p6; BBA, *submission of evidence*, p7; FBCC, *submission of evidence*, pp2, 4-5; HSBC, *submission of evidence*, pp2, 4-5; and JP Morgan, *submission of evidence*, p2.

68 Please see: Bank of America Merrill Lynch, *submission of evidence*, p3; BBA, *submission of evidence*, p7; FBCC, *submission of evidence*, p2; IRSG, *submission of evidence*, p3; Standard Life, *submission of evidence*, p2; and WMA, *submission of evidence*, p4.

Figure Nine: Simplified and Stylised Diagram of International, EU and UK Financial Services Policy-Making Process



Source: HM Treasury

3.55 Evidence emphasised the increasingly important role played by global policy-makers and regulators, and the need for a sufficient degree of accountability and democratic control in relation to these international bodies, given the significant impact they have on jurisdictions around the world.[69] Stakeholders also noted that a large proportion of EU-level legislation has been the necessary implementation of rules that originated at the international level.[70] In this regard, criticism of European legislators for proposals or processes relating to certain pieces of legislation can sometimes be misdirected when the EU has been seeking to respond to the significant number of international standards agreed by the G20 and other global bodies.[71]

3.56 However, evidence also drew attention to measures in which the EU has not confined itself to following the specifics of international agreements and has departed from global standards. Notable examples include the proposal for a Financial Transaction Tax (see box), the Commission's proposed Regulation covering benchmarks,[72] and remuneration measures in CRD IV[73] which are inconcsistent with international best practice as set out in the FSB Principles for Sound Compensation Practices.[74] Other aspects of CRD IV have also attracted criticism from third parties for inconsistency with the international standards as set by the BCBS.[75]

3.57 Evidence also raised concerns that EU markets regulation was disproportionate in some areas compared to the global level, and argued that deviations from international standards can create scope for market fragmentation, regulatory arbitrage, weaken competitiveness with firms based in other countries, and contribute to challenges in agreeing terms of access between EU and non-EU countries. Stakeholders also highlighted the lack of policy coherence which can create barriers to firms conducting business internationally.[76]

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[69] NAPF, *submission of evidence*, p4.

[70] See: City of London Law Society Regulatory Law Committee (CLLS), *submission of evidence*, p2; HSBC, *submission of evidence*, p7; IRSG, *submission of evidence*, p3; the Law Societies, *submission of evidence*, p3; NAPF, *submission of evidence*, p6; and RBS, *submission of evidence*, p2.

[71] See: Sharon Bowles MEP, *submission of evidence*, p12; and CLLS, *submission of evidence*, p2.

[72] See: Business for Britain, *submission of evidence*, p2; BCCL, *submission of evidence*, p4; CLLS, *submission of evidence*, p13; HSBC, *submission of evidence*, pp2, 5; Nomura, *submission of evidence*, p3; and WMA, *submission of evidence*, p6.

[73] For more information see: www.financialstabilityboard.org/publications/r_090925c.pdf, accessed on 12 June 2014.

[74] See: BBA, *submission of evidence*, p10; Business for Britain, *submission of evidence*, p5; CBI, *submission of evidence*, p13; and CLLS, *submission of evidence*, p15.

[75] Business for Britain, *submission of evidence*, p3. The ESRB opinion to the Commission and the co-legislators on CRD IV also highlighted the importance of amending the proposed legislation to permit national authorities 'flexibility in the set of available policy tools to both prevent and mitigate specific risks'. The BCBS's interim peer review of the draft text of CRD IV also found it was 'materially non-compliant' regarding the definition of capital and the Internal Ratings based approach to credit risk. In its Financial Stability Review, the Bank of England drew attention to the number of exemptions the EU had introduced regarding credit valuation adjustment (CVA) charges requirements: 'EU legislators have increased the number of counterparties that banks can exempt from such requirements. Credit quality deterioration was a major source of loss during the crisis. Under Basel III, the only exemptions are for transactions with a central counterparty and securities financing. CRD IV contains broader exemptions... leaving a significant gap in the CRD IV framework. A preliminary estimate, based on data from a small sample of banks, suggests that the impact of these exemptions might reduce a bank's CVA charge by up to 50%'. See Bank of England, *Financial Stability Review* (2013), p42. Available at: www.bankofengland.co.uk/publications/Documents/fsr/2013/fsrfull1306.pdf, accessed on 14 June 2014.

[76] See: IRSG, *submission of evidence*, p12; and Barclays, *submission of evidence*, p6. The latter identifies measures under EMIR which are either only partially in force in a small number of jurisdictions or have yet to be brought into force as international standards have yet to be finalised.

Financial Transaction Tax and Extraterritoriality

The proposal for a Financial Transaction Tax (FTT) aims to create a common system of taxation for financial transactions across participating Member States. It is being taken forward by 11 Member States under the enhanced co-operation procedure which is set out in the Treaties and allows nine or more Member States to take forward a proposal to apply to do so where agreement cannot be agreed amongst all 28 Member States, provided the requirements set out in the Treaties are met.[1] The UK is not participating in the FTT under enhanced co-operation, and has serious legal concerns about the territorial reach of the tax as proposed.

The FTT was considered as part of the Taxation report in semester one of the Balance of Competences Review. However, it was raised as a key issue in many pieces of evidence to this report.[2] They draw attention to concerns about the FTT relating to extraterritoriality, proportionality, the impact on growth, competitiveness and employment in both the UK and EU, the use of enhanced cooperation procedures in ways that may damage the Single Market and the rights of Member States, the poor use of impact assessments, and other damaging and unintended consequences.

Evidence from the Law Societies emphasised, among other above concerns, the extraterritorial effect posed by the tax which will have an adverse effect on Member States not imposing the FTT as well as countries outside the EU.[3] The UK Government has also voiced concerns that the tax will also apply to entities in non-participating Member States where their trading counterparty is headquartered in the FTT area, regardless of the place of issuance of the instrument being traded. Evidence from Business for Britain, as well as reports from the House of Lords European Union Committee, referred to risks of the FTT driving business offshore. Business for Britain highlighted the experience of Sweden in the 1980s where a similar transaction tax resulted in around 80% of business going offshore and that the tax was repealed within a few years.[4] The IRSG also cited evidence it commissioned which estimated that the cost of the FTT on the UK Government would be £3.95bn.[5] Evidence from Fresh Start also provides a detailed case study on the FTT.

1 These requirements are notably set out in Articles 20 TEU and 326-327 and 332 TFEU, and include respecting the competences, rights and obligations of those Member States which do not participate in it.

2 See: AIG, David Campbell Bannerman MEP, BATS Chi-X, British Chamber of Commerce for Luxembourg, BBA, CLLS, FCA Practitioners Panel, FBCC, Fresh Start, Lord Flight, IMA, IRSG, the Law Societies, NAPF, RBS, Standard Life and WMA, *submissions of evidence*.

3 The Law Societies, *submission of evidence*, p7.

4 Business for Britain, *submission of evidence*, p2.

5 See: IRSG, *The Impact of a Financial Transaction Tax on Corporate and Sovereign Debt* (2013).

3.58 In light of the new international commitments following the crisis, there has been an increasing focus in jurisdictions on the more detailed and technical implementation of standards and the translation of these into national laws. It is perhaps inevitable, given the different regional and national characteristics of markets and financial institutions, that commitments and standards will be implemented in different ways.

3.59 The challenge is to ensure that, even if implemented differently, there is at least a high degree of consistency between rules in various jurisdictions and that conflict is avoided. A failure to do so can create fragmented markets, inhibiting firms from transacting across borders and creating scope for arbitrage. Concerns over the inappropriate application or absence of common standards can also encourage countries to impose their own standards on firms based in other jurisdictions (‘extraterritoriality’).

3.60 A notable example of potential fragmentation and extraterritoriality raised in evidence relates to the discussions on the treatment of OTC derivatives between the EU and the US. Evidence from a roundtable hosted by the Franco-British Chamber of Commerce noted that, 'Despite strong standard-setting bodies, markets were still fragmented [...]. There isn't a sufficiently strong international framework. IOSCO and the FSB come out with good guidelines, but implementation in the EU and US lead in different directions'.

3.61 Structural banking reforms were also highlighted in evidence as an area that may give rise to fragmentation, given the scope for different approaches across jurisdictions. Industry stakeholders emphasised the potential costs and challenges in trying to ensure they are compliant with all relevant regulation. They also questioned the appropriateness of the EU bringing forward legislative proposals on structural banking reforms at the start of 2014 given uncertainty that the new Commissioners and new MEPs, due to be in post from the middle of 2014, will support the same approach.[77]

3.62 Most stakeholders regarded the G20 and SSBs as the appropriate fora for resolving issues of fragmentation and extraterritoriality, although there were doubts that the existing framework and structures are sufficient to facilitate action in a timely manner to address these problems.[78]

Differences Between Global, EU and National Rules

3.63 Given the global nature of financial markets and the international framework which establishes overarching standards for financial services regulation, some stakeholders considered how different rules would be in the UK if they were not subject to EU legislation.

3.64 Stakeholders generally regarded the UK as having strong influence and representation at the global-level bodies. For instance, the BBA commented that, 'The UK... maintains a leading voice in [international fora] discussions and it can therefore be argued that the UK has materially shaped the parameters of debate before the EU implementation process begins and remains well placed to continue to shape EU policy-making'. Evidence from Sharon Bowles MEP noted that, 'International level agreements often suit the UK well due to UK engagement at the international level and the fact that international standards setters are focussed on larger and systemic financial entities that correlates to the structure of much of the UK financial sector'.

3.65 On the basis that the global level is responsible for the high-level standards which set the direction for and shape of EU legislation and that the UK was considered influential at the global level, some stakeholders held the view that UK financial services regulation would not necessarily be particularly different from current rules if it was not subject to EU legislation. The extent to which UK rules would be expected to diverge from EU rules should, however, be considered in light of the extent to which the EU is considered to have departed from international standards (see previous section).

3.66 Evidence from Lloyd's of London noted that, 'UK prudential insurance regulation would not be very different if the UK was solely responsible for the rules'. In the banking sector, the BBA and RBS similarly considered that UK regulation would not necessarily be particularly different, given the UK's commitment to global standards. They did, however, highlight that if the UK had sole responsibility then implementation of rules may be swifter, as would be expected if only one Member State needed to agree the rules compared to 28. This

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[77] See: Barclays, *submission of evidence*, p4; HSBC, *submission of evidence*, p6; and IRSG, *submission of evidence*, p19.

[78] FBCC, *submission of evidence*, p2.

could make it easier to undertake equivalence assessments and agree access with other non-EU countries as well as reduce the scope for fragmentation and arbitrage.[79]

3.67 Others argued that the UK's ability to take advantage of greater flexibility in considering specific national characteristics when applying the rules would create some further benefits, especially in more domestic and local markets such as the retail financial services sector.[80] The British Private Equity & Venture Capital Association (BVCA) suggested that, given sole responsibility, the UK would take forward processes that are more 'evidence-based and principles focused [...] in contrast to the EU's "rules-based" approach'.

3.68 A number of stakeholders noted that in some cases, and based on past experience, UK rules may be tougher than EU regulation.[81] The IRSG referred to the UK's influence in the G20 and suggested that, 'Undoubtedly, there are some areas of EU rules where the UK would have taken a different approach. However, there are many examples where the UK would have taken a tougher stance', noting as an example, the structural banking reforms in the Financial Services (Banking Reform) Act 2013 compared to current European proposals.[82]

3.69 On the more critical end of the spectrum, HSBC noted that, 'UK-only regulation would not necessarily be better for the UK than EU regulation, with all its imperfections', while APFA anticipated that 'if the UK were solely responsible for the rules, they would not be very different to how they are now, and more heavy handed and onerous than the rest of Europe'.

3.70 As regards the UK's approach to its own rules in relation to EU regulation, there were also a number of criticisms in submitted evidence which focused on the use of flexibility, guidance, 'front-running'[83] and 'gold-plating'.[84] Evidence from APFA and the CBI emphasised that UK regulators have not provided UK firms and individuals with the same flexibility that EU regulators have afforded firms in other Member States.[85] Several stakeholders also encouraged the UK authorities to take a more active role in providing guidance in the interpretation of EU rules, and noted that UK regulators have publicly disagreed with the Commission, and that it has been useful for firms to have guidance from UK regulators on EU rules in order to help determine how to comply with them.[86]

3.71 Although some evidence referred to instances in which 'front-running' by the UK had effectively helped to shape EU-level regulation, there were many references to risks and potential disadvantages.[87] Evidence highlighted the costs and uncertainty it can cause for firms during the period where UK rules are in place but EU legislation is still being developed, as well as the need to use political capital to defend an existing UK

79 BBA, p13 and RBS, p5, *submissions of evidence*.

80 CBI, p12 and CLLS, p19, *submissions of evidence.*

81 APFA, p3, Sharon Bowles MEP, p19, HSBC, p8 and the IRSG, p16, *submissions of evidence*.

82 Proposals by the European Commission based on the recommendations from the Report of the European Commission's High-level Expert Group on Bank Structural Reform (the 'Liikanen report').

83 'Front-running' occurs when domestic legislation is proposed or enacted prior to the proposal or enactment of EU legislation.

84 'Gold-plating' is the layering by national authorities of additional requirements on top of those specified in EU legislation or the use of national discretions to apply additional requirements beyond the original requirements, i.e. over-implementation.

85 CBI, p12 and APFA, pp2-3, *submissions of evidence.*

86 BVCA, pp15-16 and CLLS, pp2 and 21, *submissions of evidence*.

87 The Law Societies on BRRD, p6; the IRSG on MiFID and MAD, p16; and BCCL on MiFID, IMD and PRIPs, p3, *submissions of evidence*.

approach.[88] Several stakeholders, including the City of London Law Society Regulatory Law Committee (CLLS) and the Policy Network, also drew specific attention to the mixed impact of the UK's development of its proposal for structural banking reforms following the recommendations of the Independent Commission on Banking (ICB).[89]

3.72 In addition, evidence drew attention to the potential weakening of UK standards if domestic legislation is overridden, where UK firms and practitioners are at a competitive disadvantage compared to those passporting in, or where consumers receive less protection than previously.[90] The Treasury Select Committee has, however, noted the challenges faced by UK regulators in relation to potential front-running: 'The FSA and its successor bodies will always be faced with difficult decisions over whether to proceed with UK specific legislation quickly, or wait until things have cleared at a European level'.[91]

3.73 Evidence from stakeholders also reflected concerns about 'gold-plating'. Respondents emphasised the detrimental impact this can have in terms of causing confusion, undermining the original objective of the legislation, creating additional costs, reducing the competitiveness of UK firms, and working against the purpose of the Single Market.[92]

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88 FCA SBPP, *submission of evidence*, p6, and BSA, *submission of evidence*, p2. BBA, *submission of evidence*, pp13-14, also refers to estimated costs to industry of the UK introducing bail-in on an earlier timeframe than the BRRD, as set out in the HMT, *Banking Reform Act 2013: Final Assessments – Impact Assessment: Bail-In* (2014). The cost impact of bail-in is, however, hard to estimate and observe; since the introduction of the Banking Reform Act in December 2013, there has been no observable impact in terms of higher costs due to bail-in.

89 The Law Societies, *submission of evidence*, p3, considered that 'front-running' EU legislation on structural banking reforms had created a degree of uncertainty and potentially increased costs of planning and restructuring for practitioners. However, the Policy Network noted in its December 2013 paper for the City of London Corporation, *Britain's Financial Services Industry in a Changing Europe* (2013), that the UK has had a sizable impact on the development of thinking in this area and so arguably has managed to be more influential than if it had not brought forward legislation. It also notes that the large size of the UK banking sector and the related risks of inaction merited swifter action in the UK than elsewhere.

90 CLLS, p17, Financial Services Consumer Panel, p1, and BSA, p2, *submissions of evidence*.

91 Treasury Select Committee, *Report on the Retail Distribution Review, 15th Report of session 2010-2012* (2011), paragraph 89. Available at: www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/857/857.pdf, accessed on 12 June 2014.

92 See: Royal Sun Alliance, *submission of evidence*, p4; Bank of America Merrill Lynch, *submission of evidence*, pp2-3; and FCA Practitioners Panel, *submission of evidence*, p7.

The UK Retail Distribution Review

Several respondents noted the UK's tendency to take a more comprehensive or tougher approach to regulation of retail markets, noting the Retail Distribution Review (RDR) as a specific example.[1] Many of these respondents were positive about the impact of RDR, citing it as an example of where the UK at a national level can move quickly to introduce new regulations that protect consumers. The rules, which came into force on 1 January 2013, aim to address conflicts of interest in retail financial advice by preventing product providers from paying commission to financial advisors. The rules also seek to raise the professionalism of the sector by increasing the qualification requirements for advisors. In its notification to the Commission, the then FSA justified these as necessary to deal with the risks posed by the relatively complex market in the UK.[2]

The British Chamber of Commerce for Luxembourg (BCCL) noted that the UK's regime had influenced legislation in other Member States and shaped Commission proposals.[3] However, the CLLS cautioned that European proposals rarely live up to the high standards in the UK, and claimed reforms 'specifically aimed at changing the conduct of retail business [...] have generally been at best harmless but equally have a propensity to damage the interests of UK retail customers [...] In the majority of instances they will be seeking to cover an area that is already adequately covered in the UK by existing UK domestic rules, resulting in 'layering' of Regulations'. APFA had stronger views and noted that this approach added to the complexity of the FCA rulebook, while WMA and Baillie Gifford pointed to the costs of having to 'dig up the road twice'.[4]

1 See: CLLS, *submission of evidence*, p17; Standard Life, *submission of evidence*, p3; WMA, *submission of evidence*, p5; and APFA, *submission of evidence*, pp1,3.

2 ec.europa.eu/internal_market/securities/docs/isd/implementation/uk_art_4_4_en.pdf.

3 BCCL, *submission of evidence*, p3.

4 APFA, *submission of evidence*, pp1, 3; WMA, *submission of evidence*, p5; and Baillie Gifford, *submission of evidence*, p2.

3.74 The box on the Retail Distribution Review provides further examples of concerns in evidence regarding the interaction of existing UK rules and new EU legislation. The FCA has also made public comments explaining its position on these issues from a regulatory perspective.[93]

93 For instance, in its October 2012 *Journey to the FCA* approach document, the FCA stated: 'We may take action to address domestic issues even if standards are due to be set internationally at a later date. An example of this is the Retail Distribution Review (RDR), which has led to the UK setting its own conduct rules in the retail investment market despite European standards being developed subsequently. We recognise this has implications for firms and that they may feel they have to implement similar sets of standards twice. In these situations, we will look to strike a balance and carefully analyse the most appropriate action as to whether to hold back domestically or press ahead with our own solutions'. And in its July 2013 follow-up *A response to Journey to the FCA – Your questions answered*, it responded to the point that 'some in the industry think we should consider going beyond the EU position in certain policy areas, but believe we should set safeguards around decisions to do this. Firms would like to see a level playing field for UK regulated firms compared with international competitors'. The FCA said that it 'will consider these factors when developing its positions on EU and international issues'.

The UK's Influence on Financial Services in the EU

3.75 The extent to which rules differ between the global, EU and UK levels is affected by the degree of influence that the UK exercises at the EU level. There were strong views in the evidence on this area, with a general consensus that the UK does have a degree of influence. For instance, evidence from Barclays noted that, 'the UK does maintain a level of influence, and in particular maintains a reputation as a source of technical expertise which provides it with an ability to lead discussion'.

3.76 However, there were concerns from a broad range of stakeholders that the UK has a disproportionately low level of influence considering the national importance of the UK's financial sector in terms of its size and contribution to the economy compared to other Member States. There were also references to the UK's depth of financial markets and expertise, suggesting that the UK is better placed, compared to many other Member States, to make a sizable contribution to supporting good outcomes from the EU policy-making process.[94]

3.77 Open Europe has argued strongly that although the UK accounts for 36% of the EU financial wholesale market and 61% of the EU's net exports in financial services, it has far less formal influence in EU institutions.[95] In comparison, the UK currently has 9.5% of seats in the Parliament and just over 8% of votes in the Council (see Figure Ten).[96] In response to comments that other countries with a dominant position in a certain industry are forced to accept similar trade-offs between national control and potential economic benefits from access to the European market, Open Europe has argued that other Member States have greater protection on regulation of their strategically important industries compared to the UK on EU financial regulation.[97] In light of this disparity between national interest and voting shares, there were also calls in some pieces of evidence for the UK to have, either in practice or in effect, a veto on financial services measures.[98]

3.78 Evidence also focused on the UK's influence in terms of the Council, Parliament and Commission. Stakeholders generally considered the UK Government to exercise a good degree of influence in the Council, although there were calls for earlier engagement with EU institutions, notably the Commission, in order to shape proposals at the preliminary

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94 See: ACT, *submission of evidence*, p5; AFB, *submission of evidence*, p5; AILO, *submission of evidence*, p2; BATS Chi-X, *submission of evidence*, p4; BBA, *submission of evidence*, p13; BSA, *submission of evidence*, p4; Business for Britain, *submission of evidence*, p6; CBI, *submission of evidence*, pp18-21; CLLS, *submission of evidence*, p19; Equity Release Council, *submission of evidence*, p6; and WMA, *submission of evidence*, pp11-12.

95 Open Europe, *Continental Shift (*2011), p7.

96 At present, where legislation is adopted in the Council by Qualified Majority Voting, the total votes of Member States favouring the measure must be 260 or more out of 352 – or 74% The UK, Germany, France and Italy each have 29 votes – or just over 8% The Treaty of Lisbon (Article 16 TFEU – Quality Majority Voting rules) changes the system of voting – it abolishes the weighting of votes and establishes a 'dual majority system' for adopting decisions. From March 2017 (after the transitional period has come to an end), the UK will effectively have just over 12.5% of votes in the Council. However, a qualified majority will be achieved if it covers at least 55% of Member States representing at least 65% of the population of the EU. As a result, even though the UK will see an increase in its voting share, the reduction in the threshold for agreement will make it more challenging for the UK to block a proposal. Where the Council does not act on a proposal from the Commission, the qualified majority should cover at least 72% of Member States representing at least 65% of the population. The Treaty of Lisbon also provides for a blocking minority composed of at least four Member States representing over 35% of the EU population. For more details on this and the 'Ioannina compromise' see: europa.eu/legislation_summaries/institutional_affairs/treaties/lisbon_treaty/ai0008_en.htm, accessed on 14 June 2014.

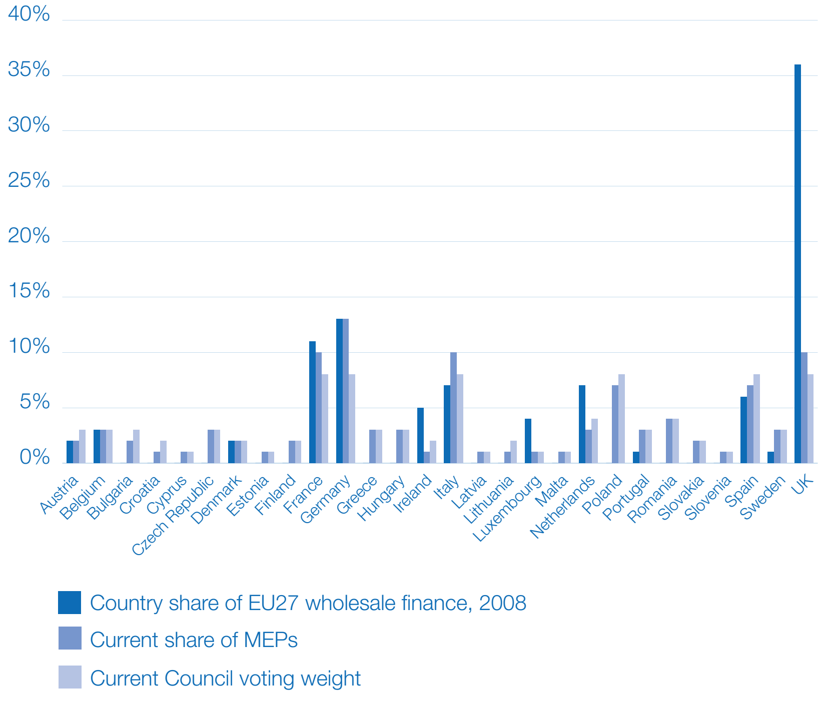
97 Open Europe, *Continental Shift*, p7.

98 See, in particular, Business for Britain, *submission of evidence*, pp 5-6.

stage and avoid having to expend political capital in amending proposals later on.[99] It was also suggested that the UK authorities should work further to establish alliances with other Member States, and not only other 'euro-outs' but also 'euro-ins' to help mitigate against caucusing.[100] Some stakeholders also questioned the UK Government's approach to negotiations on certain occasions,[101] and while UK regulators and experts were generally considered to be respected by and have influence with EU institutions, stakeholders highlighted the importance of effective coordination between different UK authorities.[102]

3.79 MEPs were widely recognised as having an important role to play in the policy-making process, in part due to the Parliament's increasingly influential role as co-legislator. There was recognition of the strong and effective role that UK MEPs had played in the ECON committee. However, there were some concerns that the UK's influence in the Parliament needed to be enhanced. For instance, the BBA noted that, 'The decisions taken on the UK MEP's participation in the European Parliament also continues to impact the ability of the UK to influence legislation in comparison to comparably sized Member States'. Stakeholders also commented that UK influence in the Parliament may become more challenging after the 2014 elections.[103]

Figure Ten: Member State Share of Wholesale Finance in the EU Compared to Council Voting Weight and Number of MEPs



Note: Wholesale finance data not available for Croatia.

Source: European Commission and London Economics analysis based on Eurostat data.

99 See: Sharon Bowles MEP, *submission of evidence*, pp5, 19; and Barclays, *submission of evidence*, p11.

100 See: IMA, *submission of evidence*, p6; CBI, *submission of evidence*, p20; and BIBA, *submission of evidence*, p6.

101 See: Sharon Bowles MEP, *submission of evidence*, pp5-6; and an unattributed member of the public, *submission of evidence*, p3.

102 See: CLLS, *submission of evidence*, p19; FCA PP, *submission of evidence*, p9; IRSG, *submission of evidence*, p15; and Lloyd's of London, *submission of evidence*, p8.

103 WMA, *submission of evidence*, p14.

3.80 Stakeholders had reservations about the UK's influence with the Commission, given the latter's significant degree of influence over the EU policy-making process, including through its sole right of initiative. In addition to calls for earlier UK engagement with the Commission, stakeholders called for more UK experts to be employed in or seconded to the Commission as well as other EU institutions:[104] The BBA, among others, noted the House of Commons report on staff in the EU institutions which sets out the relative under-representation of UK nationals in the Commission:[105] 'The number of UK nationals on the staff of the European Commission has fallen by 24% in seven years and now stands at just 4.6% of the total, against 9.7% for France, when the UK accounts for 12.5% of the EU population'. Relatedly, stakeholders also suggested that the UK should put an appropriate emphasis on language training to ensure that rules on languages do not prevent UK nationals from taking up posts in EU institutions.[106]

3.81 During the Call for Evidence, industry groups also stressed the importance of securing a UK Commissioner role with a major economic portfolio in order to support the UK's influence on financial services as well as broader economic issues. These groups also emphasised the importance of a UK Commissioner that can facilitate access and help represent UK interests across a full range of issues.

3.82 Several additional reasons were suggested in evidence as factors in the level of the UK's influence in the EU, including the perceived failure of the 'Anglo-Saxon model' of more open and lightly regulated markets in light of the financial crisis, the anti-free market lobby, the current debate on the UK's relationship with the EU and a perceived emphasis on sovereignty concerns rather than economic concerns.[107]

3.83 Given the importance of the financial services sector to the UK economy and the recent huge volume of legislation, largely in response to the financial crisis, it is perhaps unsurprising that there have been considerable challenges for the UK. However, notwithstanding some exceptions, such as on remuneration, stakeholders generally considered the UK's views to be respected and its major points usually taken into account. It was, however, generally considered that the UK needs to endeavour to influence both the high level direction and the detailed drafting of rules, an enterprise which will require careful and considered efforts to engage at different levels and with a range of different stakeholders.

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[104] See: ACT, *submission of evidence*, p5; BBA, *submission of evidence*, p14; CBI, *submission of evidence*, p21; HSBC, *submission of evidence*, p8; IRSG, *submission of evidence*, p15; Lloyd's of London, *submission of evidence*, p8; Nomura, *submission of evidence*, p3; RBS, *submission of evidence*, p5; and RSA, *submission of evidence*, p10.

[105] House of Commons Foreign Affairs Committee, *The UK Staff Presence In The EU Institutions* (HC 2013-14, 219).

[106] Evidence from the All-Party Parliamentary Group on Modern Languages highlights the need to ensure UK nationals and firms are able to create and develop relationships internationally, both within and beyond the EU, and also to ensure that the UK is able to secure adequate representation in EU institutions where there is a requirement for two EU languages.

[107] See, for instance, FBCC, *submission of evidence*, p5; and HSBC, *submission of evidence*, p8.

The EU's Approach to Third Countries

3.84 One area where the UK needs to exert more influence is EU policy towards Third Countries. The EU's approach to whether and how firms located in Third Countries can access EU markets is of critical importance to the UK's national interest. Indeed, without open access to market participants from all countries, the global markets that operate from the UK would move outside the EU. Third Country access is a key issue that arises during the negotiation of many pieces of financial services legislation.

3.85 Evidence highlighted the UK's traditional, liberalised approach to trade in financial services as a key factor in its development into a leading global financial centre.

> London has long acted as a natural bridge for Third Countries accessing the EU's large financial market, given its track record for facilitating international trade in financial and professional services [...] Currently there are over 1,400 financial services firms in the UK that are majority foreign-owned, from around 80 countries.[108] The UK is the leading recipient of financial services foreign direct investment in Europe: over 40% of financial institutions new to locating in Europe chose London as their headquarters in the past seven years.[109]
>
> (IRSG)

3.86 Evidence also drew attention to the important relationship between the EU and the UK in accessing markets in non-EU countries: the UK's position as a leading global financial centre means it acts as a gateway for firms to passport into and trade with other Member States; while the EU's approach to Third Country regimes and negotiating free trade agreements can facilitate the UK's ability to trade with the rest of the world.[110]

3.87 Evidence from Royal Sun Alliance (RSA) highlighted that, 'with 90% of global growth happening outside the EU [...] the Single Market needs to become more competitive and be open to business from outside its borders'.[111] Evidence from Fresh Start similarly drew attention to the fact that, 'Whilst in 2005 the UK, Germany, France, Spain and Italy accounted for 27% of global banking assets, PriceWaterhouseCoopers projects that in 2050 that will have decreased to 12.5%. PWC also projects that Brazil, Russia, China and India will see their share of global banking assets leap to 32.9% in 2050 from the 2005 figure of 7.9%'.[112]

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[108] City of London, *An Indispensable Industry: Financial Services in the UK* (2013). Available at: www.cityoflondon.gov.uk/about-the-city/what-we-do/Documents/an-indispensable-industry.pdf, accessed June 2014.

[109] Michel Barnier, *European Commission Speech/13/636 The Single Market in Financial Services: We Need the UK On Board 12 July 2013* (2013). Available at: europa.eu/rapid/press-release_SPEECH-13-636_en.htm, accessed on 12 June 2014.

[110] See: Sharon Bowles MEP, *submission of evidence*, p2; BVCA, *submission of evidence*, p 12; CBI, *submission of evidence*, p10; CLLS, *submission of evidence*, p14; and IRSG, *submission of evidence*, p13.

[111] TheCityUK, *UK and the EU: A mutually beneficial relationship* (2013), p4.

[112] PWC, *The World in 2050 – The Accelerating Shift of Global Economic Power: Challenges and Opportunities* (2011). Available at:www.pwc.com/en_GX/gx/world-2050/pdf, ACCESSED ON 12 June 104. See also the updated report at: www.pwc.com/en_GX/gx/world-2050/assets/pwc-world-in-2050-report-january-2013.pdf, accessed on 10 June 2014.

3.88 Given the UK's role as an international financial centre and the level of growth expected to take place outside the EU, especially in emerging market economies, stakeholders strongly emphasised that placing an appropriate value on access to global markets and avoiding a closed or protectionist approach to external trade would be to the EU and UK's mutual benefit.[113]

3.89 Traditionally, EU law allowed each Member State to decide whether, and on what terms, firms from Third Countries could access its markets.[114] This was based on the fact that the costs of financial system failure are borne by national, not EU, budgets and that Member States have financial industries of vastly different size and sophistication with differing customer needs. Two broad approaches have been followed by Member States: one based on a policy preference for liberalised, open markets; the other based on the principles of equivalence and reciprocity.[115]

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

3.91 Evidence emphasised strong concerns that a 'one-size-fits-all' approach, which relies on strict or 'line-by-line' equivalence whereby the rules in other jurisdictions need to be effectively identical to the EU's rules, could create tensions with Third Countries, including key emerging markets, increase uncertainty and inhibit competitiveness for firms, and be damaging to the interests of end-users and consumers in all Member States given that this approach does not take account of sectoral nuances.[116]

3.92 Responses also called for the greater use of mutual recognition and 'substituted compliance' with a focus on equivalent, but not identical, regulatory and supervisory outcomes. In other words, that the EU should rely more on Third Country laws, instead of EU requirements, where the outcomes are broadly the same.[117]

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[113] See: Bank of America Merrill Lynch, *submission of evidence*, p3; Barclays, *submission of evidence*, p6; CBI, *submission of evidence*, p10; CLLS, *submission of evidence*, p14; FCA PP, *submission of evidence*, p7; IMA, *submission of evidence*, p4; IRSG, *submission of evidence*, p13; and RSA, *submission of evidence*, p9.

[114] A Member State could not, however, offer a Third Country firm better access than one from another Member State.

[115] Equivalence means that firms only have access to the EU where their home state has regulatory standards that are equivalent to those of the particular Member State. Reciprocity means that firms from the Member State need to be granted equal access to the markets of the Third Country.

[116] See: AFB, *submission of evidence*, p4; BBA, *submission of evidence*, p10; Business for Britain, *submission of evidence*, p3; BVCA, *submission of evidence*, p12; CBI, *submission of evidence*, p10; CLLS, *submission of evidence*, pp14-16; FCA SBPP, *submission of evidence*, p6; HSBC, *submission of evidence*, p6; and WMBA, *submission of evidence*, p3.

[117] See: CBI, *submission of evidence*, p10; and HSBC, *submission of evidence*, p6.

Third Country Access Provisions in MiFID II

The Third Country regime in MiFID II, agreed in early 2014 by co-decision, will improve the way in which Third Country firms access the single market in investment services. Many Third Country firms who provide investment services in the EU will avoid having to seek separate authorisations in every individual Member States in which they do business, and will instead be able to register with ESMA to provide investment services in any Member State directly from its home jurisdiction or from one of its EU-based branches. While ESMA registration will require that the firm is from an 'equivalent' Third Country jurisdiction, the equivalence test should be focussed on regulatory outcomes. If a firm is not registered by ESMA, for instance because the Commission has not yet conducted the relevant equivalence assessment, it will still be able to provide investment services within the UK subject to UK rules.

This is a significant improvement on the Commission's original proposal, which would not have allowed national regimes to continue alongside the proposed EU-level regime. The original proposal also included stricter 'line-by-line' equivalence assessments and a fixed four year period for carrying out these assessments. The UK government expressed serious concerns over the practicality of this proposal, given the UK alone trades in investment services with over 100 different jurisdictions.

The City of London Law Society Regulatory Law Committee (CLLS) commented that this 'amounts to a significant new approach' that the UK should support strongly in future EU legislation. The Association of Foreign Banks (AFB), however, noted that 'the time taken to arrive at a satisfactory European solution regarding MiFID/MiFIR has created some uncertainty and may have caused Third Country firms to delay business decisions, or indeed, alter them'.

3.93 There were also strong concerns around the use of reciprocity, whereby access to the Single Market by firms in a Third Country is only granted if firms from the Member State are granted equal access to the markets of the Third Country.[118] For instance, the CLLS considered that an EU requirement for reciprocity 'would adversely affect the ability of UK firms to trade internationally'.[119] It was suggested in some evidence, however, that reciprocity has the potential to be useful as a negotiating tactic when seeking to prevent non-EU countries imposing extraterritorial measures on the EU.[120]

3.94 There were slightly different perspectives from the insurance sector, where many focused on the potential opportunities and risks related to the EU's approach to Solvency II with non-EU countries. Evidence from Standard Life cautioned that an international approach to the regime risked being overtaken by global developments;[121] the International Underwriting Association (IUA) noted the benefits of an EU approach in negotiating across the continent and the potential usefulness of an equivalence approach, even if it may currently be creating uncertainty;[122] while the British Insurance Brokers' Association (BIBA) called for a return to 'individual nations managing their own risks in trading with Third Countries'.

[118] BVCA, *submission of evidence*, p12.

[119] CLLS, *submission of evidence*, pp15-16.

[120] Sharon Bowles MEP, *submission of evidence*, p15.

[121] Standard Life, *submission of evidence*, p6.

[122] IUA, *submission of evidence*, p2.

3.95 The Commission has consistently highlighted that jurisdictions have implemented international regulatory guidelines in different ways in order to accommodate local specificities. One consequence is that this can create international competitive distortions and scope for regulatory arbitrage. To overcome the problem of not having fully harmonised national regimes, the Commission has adopted Third Country Equivalence Assessments as a key tool to assess whether Third Country regulation and supervision are equivalent to those that exist in the EU. If a Third Country is deemed equivalent, financial operators are able to operate in the EU without being subject to the full set of EU rules. However if a Third Country is not deemed equivalent, financial operators have to comply strictly with EU requirements.

3.96 Generally speaking, EU Third Country Equivalence Assessments take the form of either mutual recognition or direct compliance. The former is adopted when there are areas of strong international regulatory convergence, while the latter approach is adopted when financial operators provide cross-border services. The Commission has also promoted the concept that equivalence should be considered by a common EU assessment, rather than individual Member State assessments. As a result, these assessments are carried out by the ESAs. The Financial Services Practitioners Panel acknowledged that, 'there is a need to ensure that firms trading in EU markets are subject to high regulatory standards,' but they also went on to emphasise that, 'solutions must be found to ensure that those firms are not barred or discouraged from trading and interacting with UK firms'.

Crown Dependencies and Third Country Issues

The financial services sectors in Jersey, Guernsey and the Isle of Man – the three Crown Dependencies – are part of the Sterling Zone and the UK's payment and clearing system, although they have their own independent regulators and regulatory systems. As they are not members of the EU, they are Third Countries for the purposes of EU financial services legislation and the UK is responsible for their external relations. In light of this, the EU's approach to Third Countries regimes is of particular importance to the Crown Dependencies, especially as a large proportion of inward investment is sourced from outside the EU.

Joint evidence from the Crown Dependencies noted that, although in the past Member States have largely determined how to permit Third Countries' firms access to their markets, the EU is increasingly moving into the 'shared competence' space of trade and investment relations with Third Countries. In considering the future balance and exercise of competences between the EU and its Member States, the Crown Dependencies highlighted the importance of an EU Third Country policy that is aligned with international standards, is evidence-based, maintains investor confidence and is both transparent and consistent.

Their specific recommendations include that: impact assessments should more systematically expose any inconsistency between EU and international standards; the EU should use existing assessments by international institutions of Third Countries' compliance with international standards, and where assessments by international bodies are not available, should refer to existing peer review processes; where EU assessments of equivalence are still deemed necessary, the UK should have responsibility for determining equivalence in its dependent territories as the 'Member State of Reference'; and in the event of delays in EU equivalence decisions, the UK should be able to establish or extend transitional measures for access to its own market.

Free Trade Agreements and the Transatlantic Trade and Investment Partnership

3.97 Free Trade Agreements (FTAs) are another key way, alongside Third Country regimes, whereby the EU determines the terms on which Member States can trade in financial services with non-EU countries, as the EU has exclusive competence to negotiate trade agreements with provisions on services.[123]

3.98 FTAs were covered in *Review of the Balance of Competences between the UK and the EU: Trade and Investment*. This sets out the extent of EU Trade Agreements (see Figure 1.2 in particular) and also considered the advantages and disadvantages of alternative options to the EU exercising competence in negotiating FTAs, notably in Chapter Four of that report. A separate study by the Centre for Economic Policy Research (CEPR) considered in further detail the qualitative and quantitative advantages of the existing approach and the alternatives.

3.99 However, a number of submissions to this report drew attention to the importance of FTAs in supporting the ability of financial services firms headquartered in the EU to trade on a level-playing field with Third Countries. Many stakeholders emphasised that the UK can currently take advantage of the EU representing its interests in negotiations and wielding greater power compared to the influence the UK would have if it was negotiating bilaterally.[124] For instance, evidence from Graham Bishop on behalf of the European Movement (UK) noted that the, 'Benefits of the size of the EU Single Market as a negotiating bloc [...] should not be underestimated'.

3.100 Attention was drawn in evidence to the importance of the proposed FTA between the EU and the US: the Transatlantic Trade and Investment Partnership (TTIP).[125] The BBA noted the benefits of the EU negotiating as a single more powerful bloc with another market of such significance.[126] Respondents also commended the joint approach by the EU and UK in seeking to include financial regulation as a core element in the agreement, on the basis that it would help to mitigate risks of fragmentation and extraterritoriality.[127] CEPR has estimated that an ambitious deal on TTIP could increase the UK's total financial and insurance services output by 1-2% per year and exports by 3-4% per year.[128]

C. Development of the Banking Union and EU-Level Supervision

3.101 The evolution of the euro area, especially since the financial crisis, has introduced an additional dimension to the financial services regulatory framework. While the development of the banking union and the European System of Financial Supervision were generally welcomed by stakeholders as important responses to the crisis, there were also strong views that the UK, other Member States and the EU institutions should ensure that steps to support the stability of the euro area do not impair the integrity of the Single Market or act against the UK's national interest.

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[123] The sole exception to the EU's exclusive competence over trade in services is in the field of transport, which is an area of shared competence.

[124] See: BBA, *submission of evidence*, p7; Sharon Bowles MEP, *submission of evidence*, p2; Graham Bishop on behalf of the European Movement (UK), *submission of evidence*, p3; Citi, *submission of evidence*, p2; HSBC, *submission of evidence*, p6; IRSG, *submission of evidence*, p13; the Law Societies, *submission of evidence*, pp3-4; and JP Morgan, *submission of evidence*, p2.

[125] See: Citi, *submission of evidence*, p2; and JP Morgan, *submission of evidence*, p2.

[126] BBA, *submission of evidence*, p7.

[127] See: CBI, *submission of evidence*, p25; and IRSG, *submission of evidence*, p13.

[128] For further details please see: www.gov.uk/government/uploads/system/uploads/attachment_data/file/198115/bis-13-869-economic-impact-on-uk-of-tranatlantic-trade-and-investment-partnership-between-eu-and-us.pdf, accessed June 2014.

Banking Union

3.102 As set out in paragraph 1.15, the recent euro area crisis has emphasised that the monetary union requires a banking union due to the intimate interconnection between currency stability and the stability of banks within a currency union.[129] Although many aspects of the banking union have yet to be determined and the UK Government has been clear that it will not participate, it is evident that this deepening integration will have a significant effect on the Single Market and the UK's relationship with the EU in financial services as well as in other fields. In response to these developments, the Commission has emphasised the importance of preserving the Single Market in a 2012 communication: 'The creation of the banking union must not compromise the unity and integrity of the Single Market which remains one of the greatest achievements of European integration'.[130]

3.103 There was broad consensus in evidence that the banking union is a necessary and, in many ways, logical consequence of currency union.[131] Some argued that the UK, as the largest financial centre in the EU, could have a lot to gain from financial stability across the Single Market, although the benefits from euro area stability extend globally.[132] Others highlighted that the risks to the UK of being outside the banking union are smaller than the risks to those Member States that have joined the banking union.[133]

3.104 There was, however, a large degree of unease about the longer term impact of the banking union on the UK's interest in financial services and the Single Market more broadly. Although non-participating members of the banking union, including the UK, have secured a measure of protection against the risk that the members of the banking union ignore the interests of the Single Market, there was concern about the sustainability of such an approach in the future.[134] A number of respondents called for the UK and EU institutions to protect the integrity of the Single Market and ensure the pursuit of interests of those in the euro area and the banking union are not at the expense of those that are not.[135]

3.105 Evidence from Barclays noted that, 'The Banking Union does present an existential challenge to the UK, as there is the potential for diminished opportunity in the EU rule making process and a general marginalisation from the centre of influence'. Other stakeholders highlighted that this includes the risks of divergent views between 'euro ins' and 'euro outs' or caucusing by Member States participating in the banking union, and concerns that the technical rules developed by the EBA could be dominated by

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[129] HMG, *Review of the Balance of Competences between the UK and the EU: Economic and Monetary Policy*, published in Semester Four. This will consider further the implications for the UK of closer integration of the euro area.

[130] Communication from the Commission to the European Parliament and the Council, *A Roadmap towards a Banking Union*, September 2012, p4.

[131] See: IRSG, *submission of evidence*, p18; Nomura, *submission of evidence*, p2; Barclays, *submission of evidence*, pp3-4; and the *FCA Practitioners Panel*, p10.

[132] Sharon Bowles MEP, *submission of evidence*, pp7 and 24.

[133] Unattributed member of the public, *submission of evidence*, p3.

[134] See paragraph 1.17 and footnote 17 for detail on safeguards secured relating to the Single Supervisory Mechanism and the Single Resolution Mechanism.

[135] See: Bar Council, *submission of evidence*, p10; BBA, *submission of evidence*, p15; Sharon Bowles MEP, *submission of evidence*, pp7, 24; CBI, *submission of evidence*, pp24-25; FCA PP, *submission of evidence*, p10; HSBC, *submission of evidence*, p11; IRSG, *submission of evidence*, p 19; JP Morgan, *submission of evidence*, p3; and RBS, *submission of evidence*, p6.

the views of the ECB, as the supervisor of the banking union.[136] Evidence from Fresh Start emphasised the possible consequences of such developments, in that 'The UK could potentially be forced to accept new rules designed for and written by the eurozone countries'.

3.106 Evidence from the BBA elaborated on these concerns and possible steps to mitigate risks:

> It is evident ... that Banking Union will fundamentally alter the way the EU operates and there is a risk that there will be a divergence of interests between the 'ins' and the 'outs' and a consequential reduction in the UK's influence or attractiveness for Eurozone business. It is vital that the European Commission acts to protect the Single Market to ensure the Eurozone does not become a market within a market. The safeguards negotiated to the EBA decision-making process are very important in this regard but must be complemented by an increase in UK engagement in the policy making process to ensure UK influence is maintained.
>
> (BBA)

3.107 In his evidence, Lord Flight noted that, even with changes to the EBA voting structure and good cooperation between the Bank of England and the ECB, there remain risks that, if more EU members join the euro, the UK could find itself isolated and 'forced to adopt ECB regulation [...] which would be wholly inappropriate given that the size of the banking industry which the Bank of England/PRA regulates is of similar size to that of the Eurozone, for which the ECB is responsible'.

3.108 Some evidence argued that the development of the banking union might require Treaty change in order to embed appropriate protections for the UK, for instance through expanding the double majority vote or introducing veto powers for the UK on financial services legislation.[137] Evidence from others, for instance the Rt Hon John Redwood MP, argued that the banking union merits a full repatriation to the UK of EU competences that relate to banking, on the basis that UK tax-payers are the backstop to banking failures and that solvency and liquidity issues related to UK banks are matters for the UK authorities.[138]

The Single Resolution Mechanism and Inter-Governmental Agreement

3.109 Alongside calls from some stakeholders for any future Treaty change to be used as an opportunity to ensure the UK has sufficient protections in terms of the banking union, questions were also raised as to whether the existing Single Market Treaty base is suitable for proposed banking union measures.

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[136] See: Bank of America Merrill Lynch, *submission of evidence*, p5; BBA, *submission of evidence*, p15; BSA, *submission of evidence*, p5; CBI, *submission of evidence*, p24; John Springford CER, *submission of evidence*, p6; FCA PP, *submission of evidence*, p10; Lord Flight, *submission of evidence*, p3; and HSBC, *submission of evidence*, p11.

[137] Business for Britain, *submission of evidence*, p6.

[138] Rt Hon John Redwood MP, *submission of evidence*, p6.

3.110 The Regulation for the Single Resolution Mechanism (SRM) part of the banking union, which has now been agreed and establishes a central decision-making framework for the resolution of banks in the participating Member States, has Article 114 TFEU (establishment and functioning of the Single Market) as its Treaty base.[139] The SRM Regulation includes provisions establishing a Single Resolution Fund (the 'Fund') financed by levies raised from industry in the participating Member States, which could be used in connection with a resolution under the SRM. During negotiations at the end of 2013, significant consideration was given to the question of the suitability of the legal base for certain aspects of the Commission's original proposal, in particular the pooling of levies raised at the national level for the purposes of financing the Fund.

3.111 On the one hand, Germany argued that Article 114 TFEU could not be used for such provisions, whereas the Commission and the Council Legal Service maintained that Article 114 TFEU could be used. In light of the serious objections from Germany, the participating Member States ultimately agreed that aspects of the financing arrangements should be carved out of the SRM Regulation and set out in an inter-governmental agreement between the Contracting Parties in parallel with the Regulation.[140] The inter-governmental agreement includes arrangements for the transfer of national contributions to the 'Fund' and their progressive mutualisation over the eight-year transitional phase agreed under the Regulation. This approach to differentiated integration paths presents potential benefits and risks for the UK.

3.112 In terms of benefits, the use of Article 114 TFEU ensured that the interests of the Single Market were taken fully into account in the establishment of the SRM, notwithstanding that its scope relates primarily to the participating Member States. Therefore the interests of the banks, investors and other creditors in the UK were safeguarded, for example, as a result of the inclusion in the regulation of non-discrimination provisions and provisions ensuring the equal treatment as regards the application of the EBA's tasks and powers within and outside the banking union. The use of an inter-governmental agreement for the financing aspects also meant that it was clear that the UK and non-participating Member States would not be liable to contribute.

3.113 However, in terms of possible risks, the use of the inter-governmental agreement highlights the fact that, where the EU has not yet exercised competence, it may be easier for relevant Member States to agree measures outside the Treaty framework instead of persuading the Commission to change the Treaty base for its proposal or to present a new proposal.[141] In such cases the co-legislators and non-contracting Member States, would be denied a formal mandate to shape those measures, notwithstanding that they may be closely associated with EU measures, potentially leading to suboptimal outcomes from the perspective of the EU as a whole and potential risks to the Single Market. So although the use of an inter-governmental agreement in this case was broadly satisfactory from the perspective of the UK, future proposals to use inter-governmental agreements must be viewed with caution.[142]

[139] The proposals for banking union currently consist of the Single Supervisory Mechanism, a Single Resolution Mechanism and a common deposit guarantee scheme for all euro area Member States and non-euro area Member States who choose to participate. A formal proposal for a common deposit guarantee scheme has, however, yet to be brought forward.

[140] Member States participating in the banking union and other Member States who chose to be Contracting Parties; the UK is not a Contracting Party.

[141] For example, under Article 352 TFEU in the absence of a more suitable Treaty base.

[142] HMG, *Review of the Balance of Competences between the UK and the EU: Economic and Monetary Policy*, published in Semester Four. This will consider the use of inter-governmental agreements.

European Central Bank Location Policy

The location policy of the European Central Bank (ECB), which the UK is challenging at the General Court of the European Union is a further example of a proposal related to the euro area that impacts on the Single Market and the interests of all Member States, not just those in the euro area. The location policy specifies that clearing-houses that clear euro-denominated financial instruments above a certain threshold must be located in the euro area. The UK contends that this policy restricts fundamental Treaty freedoms important to the Single Market, relating in particular to freedom of capital, choice of establishment and proportionality.

Evidence from stakeholders highlighted that the ECB location policy could have a detrimental impact on the EU market. For instance, the AFB noted, 'this could have a significant impact on the location of Euro transactions and restrict business'. In addition, HSBC highlighted that, 'Mandatory clearing of Euro-denominated contracts with a local central counterparty could fragment the clearing market; make it more expensive (as there would be less competition); and break netting arrangements, which could increase systemic risk'.

A pan-EU framework for the regulation of clearing-houses already exists via the EMIR Regulation, including College arrangements to enhance cooperative oversight between relevant authorities. The ACT noted that, 'we still need to ensure that EU rules and the EU approach are pan European, to avoid a disjointed Europe. Geographic bias in the rules or mandating certain activities as permitted only in the Euro area or particular locations are not appropriate'.

Open Europe[1] has also noted that the proposed policy 'risks not only undermining the City of London, home to more clearing houses than any other EU capital, but also blatantly undercuts the single market [...] Market participants also warn that the ECB's policy would spell the end for multi-currency clearing in general, fragmenting CCPs among national jurisdictions and raising costs for users, as they would lose the benefits of clearing in a central venue.[2] Some believe the policy could actually increase systemic risk, with a wide array of institutions in different countries setting up clearing services without the required risk management expertise'.[3]

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1 Open Europe, *Continental Shift Safeguarding the UK's Financial Trade in a Changing Europe*, (2011).

2 In negotiations on new EU regulation, known as EMIR, for OTC derivatives, the UK won a concession which inserted language that refers to not discriminating on the grounds of location or currency.

3 Risk.net, Risk.net Poll – *UK Treasury is Right Over ECB lawsuit* (28 September 2011). Available at: www.risk.net/risk-magazine/news/2112350/risknet-poll-uk-treasury-ecb-lawsuit, accessed on 30 June 2014.

The European System of Financial Supervision

3.114 Following the financial crisis, it was argued that the quality of supervision across the EU needed to be improved, and that this would be best achieved by giving the European level powers over national supervisors. As a result, three EU supervisory committees were transformed into EU agencies, under the collective name of the European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). Along with the European Systemic Risk Board (ESRB), the ESAs were given an enhanced role that focused on the management of the European supervisory system as a whole.[143]

3.115 Overall, evidence was broadly positive about the ESAs and the ESRB and specifically considered the introduction of the ESAs to be a necessary step to improve supervision and confidence.[144] For instance, evidence from Standard Life emphasised the positive role that supervisors at the EU-level can play:

> The ESAs provide an excellent forum for sharing information, developing a single rulebook and harmonising application of directives. Because they are empowered to look across different countries, they are better positioned to be able to examine issues that may arise [...] They play a central role in ensuring that the wide range of regulation that has come from the EU in the last five years is applied accurately and consistently.
>
> (Standard Life)

3.116 However, almost all stakeholders emphasised that, having only been operational since 2011, it was relatively early to judge their success or their impact on the UK's national interest.[145] A small minority of views, however, considered the ESAs to be a less welcome addition to the EU financial services landscape – for instance, the WMBA considered their start to be 'inauspicious'.

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[143] The overarching objective of the ESAs is to improve the functioning of the Single Market by ensuring appropriate, efficient and harmonised European regulation and supervision, while the role of the ESRB is to undertake EU-wide macro-prudential analysis, issue risk warnings and make recommendations. The ESRB does not have binding powers over Member States, and derives its authority from the fact that it comprises the President of the ECB and the central bank governors and the lead supervisors of the 28 Member States.

[144] See: AFME, *submission of evidence*, p3; AIG, *submission of evidence*, p5; AILO, *submission of evidence*, p2; BATS Chi-X, *submission of evidence*, p3; BBA, *submission of evidence*, p13; Sharon Bowles MEP, *submission of evidence*, p8; CBI, *submission of evidence*, p14; IUA, *submission of evidence*, p2; Lloyd's of London, *submission of evidence*, p7; RBS, *submission of evidence*, p4; RSA, *submission of evidence*, p8; and Standard Life, *submission of evidence*, p6.

[145] See: ABI, *submission of evidence*, p3; AFME, *submission of evidence*, p3; BVCA, *submission of evidence*, p13; CLLS, *submission of evidence*, p18; FCA PP, *submission of evidence*, p8; HSBC, *submission of evidence*, p7; IRSG, *submission of evidence*, p15; Law Societies, p6; RSA, *submission of evidence*, p8; an unattributed member of the public, *submission of evidence*, p2; and WMBA, *submission of evidence*, p3.

3.117 Some stakeholders noted that the ESAs have, perhaps unsurprisingly given the volume of legislation that has been developed since their establishment, been focused on the drafting of rules rather than other activities, which may have come at the expense of other objectives such as convergence of supervisory practices, mediation, participation in supervisory colleges, and addressing breaches of EU law.[146]

3.118 There was strong support for the ESAs to focus on their collective role as a system manager to raise the standards of supervision across the EU and identify EU-wide risks, with some stakeholders highlighting the importance of the ESAs in helping to raise and enforce consistent standards in regulation and supervision, while others cautioned against the ESAs duplicating the activities of national day-to-day supervisors.[147]

> Our greatest concern about the powers granted to the ESAs has always been that they might have the power to apply a decision directly to an individual institution if they feel that a national supervisor is failing to implement an EU decision. We are pleased to note that the principle that day to day supervision of financial institutions should remain at a national level has now been firmly established. This principle should be reflected in any new legislation proposed at an EU level. There are, however, a number of situations in which ESAs could overrule national supervisors.
>
> (House of Lords European Union Committee)

3.119 In terms of the role of the ESAs in the rule-making process, there was concern that the detailed Level 2 rule-making should not go beyond or reopen the higher, more political Level 1 agreements,[148] although some evidence noted the tension between the amount of detail and specificity that takes place at Level 1 and Level 2.[149] There were also calls for the ESAs to have sufficient time to consult on and draft Level 2 texts, and not to be inappropriately rushed due to international or EU-level deadlines.[150] Some respondents also emphasised the importance of the Commission setting out more transparently the reasons for any deviation from ESA advice.[151] Some of these issues are considered further in Chapter Four.

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[146] See: AFME, *submission of evidence*, p5; and Baillie Gifford, *submission of evidence*, p3.

[147] See: Bank of America Merrill Lynch, *submission of evidence*, p4; the Law Societies, *submission of evidence*, pp2-3; Barclays, *submission of evidence*, p8; BATS Chi-X, *submission of evidence*, p4; BSA, *submission of evidence*, p4; BVCA, *submission of evidence*, p13; FCA PP, *submission of evidence*, p9; IMA, *submission of evidence*, p6; IUA, *submission of evidence*, p2; and RSA, *submission of evidence*, p9.

[148] For instance, CLLS, *submission of evidence*, p19; HSBC, *submission of evidence*, pp.7-8; and JP Morgan, *submission of evidence*, p4.

[149] Sharon Bowles MEP, *submission of evidence*, p12.

[150] See: AFME, *submission of evidence*, pp4,6; BVCA, *submission of evidence*, p14; FBCC, *submission of evidence*, p5; IMA, *submission of evidence*, p5; JP Morgan, *submission of evidence*, p4; and RBS, *submission of evidence*, p4.

[151] See: BVCA, *submission of evidence*, p14; and JP Morgan, *submission of evidence*, p4.

3.120 There were broadly positive views on the provision of guidance and public statements from the ESAs, which can help to clarify rules for national supervisors and firms.[152] However, a couple of respondents noted the excessive or unnecessary use of guidance, notably by EIOPA.[153] There was also some concern over the use of Q&As, in particular when these do not provide greater clarity with regard to rules, as well as the time it takes, in some instances, for ESAs to respond to questions.[154] Evidence from the ICAEW also noted, in relation to public statements by ESMA on shareholder cooperation, that ESAs can be slow in reacting to market developments.[155]

3.121 Many pieces of evidence referred to the resourcing, governance and accountability of the ESAs, with a large proportion of those reflecting on the need for the ESAs to have more resources and in some cases, greater expertise or authority in order to adequately carry out their functions.[156] There were also some calls, notably from the Association for Financial Markets in Europe (AFME), for the ESAs to have greater independence from either or both EU institutions and Member States.[157]

3.122 A number of respondents drew attention to the remoteness of the ESAs and the need for strong accountability, which was considered especially pertinent in light of their increasingly important role.[158] The Financial Services Practitioner Panel commented that 'rule-making at the ESA level is less accountable' and argued that when 'detailed rules are created, there needs to be adequate stakeholder engagement and consultation to ensure effective rules'. There was also concern about the divisions, gaps and overlaps between different ESAs and the extent to which respective ESAs have the relevant skills.[159]

[152] See: AILO, *submission of evidence*, p2; BIBA, *submission of evidence*, p5; IUA, *submission of evidence*, p2; and Standard Life, *submission of evidence*, p7.

[153] See: AIG, *submission of evidence*, p5; and RSA, *submission of evidence*, p9).

[154] FCA PP, *submission of evidence*, p9.

[155] ICAEW, *submission of evidence*, p5.

[156] See: ACT, *submission of evidence*, p5; AFME, *submission of evidence*, pp4,5; Baillie Gifford, *submission of evidence*, p3; BATS Chi-X, *submission of evidence*, p4; BVCA, *submission of evidence*, pp13-14; CBI, *submission of evidence*, p15; CLLS, *submission of evidence*, p19; Sharon Bowles MEP, *submission of evidence*, p12; GSK, *submission of evidence*, p3; IRSG, *submission of evidence*, p15; JP Morgan, *submission of evidence*, p4; RBS, *submission of evidence*, p4; and Standard Life, *submission of evidence*, p7.

[157] See: AFME, *submission of evidence*, pp4,5; AFB, *submission of evidence*, p4; FBCC, *submission of evidence*, p4; and Lloyd's of London, *submission of evidence*, p7.

[158] See: BVCA, *submission of evidence*, pp13-14; AFB, *submission of evidence*, p4; CBI, *submission of evidence*, p15; CLLS, *submission of evidence*, p19; FCA PP, *submission of evidence*, p9; HSBC, *submission of evidence*, p7; Lloyd's of London, *submission of evidence*, p7; and WMA, *submission of evidence*, p10.

[159] Baillie Gifford, *submission of evidence*, p3.

The Short Selling Regulation and UK challenge

The Short Selling Regulation and the related UK legal challenge provides a test case on the scope of powers that it is possible to give EU agencies.

Article 28 of the Short Selling Regulation confers powers on ESMA to restrict or ban short selling in emergency situations. In May 2012, the UK launched a challenge to the ECJ, contending that the powers conferred on ESMA were unlawful. The UK considered that the powers were in contravention of the principle in the case of *Meroni,* a piece of case law which established that an EU agency cannot be given a discretionary power that may make possible the execution of economic policy, because of the broad nature of the powers with few limits on ESMA's discretion in deciding when or how to exercise its powers. The UK also queried whether Article 28 was compatible with the legal base of Article 114 of the TFEU, under which the Regulation was enacted, as Article 114 is focussed on the harmonisation of Member State laws.

The Advocate General's Opinion (AGO) was published in September 2013 and supported the UK in recommending Article 28 be annulled, on the grounds that the legal base (Article 114 TFEU) was not appropriate, as powers conferred to ESMA enable national decision-making to be replaced by the EU-level, and were thus not harmonising powers. Separately, the AGO rejected the UK's challenge that Article 28 is not compliant with the *Meroni* principle.

In January 2014, the UK's legal challenge was dismissed on all grounds. The ECJ found that in an emergency situation any measures taken by ESMA would be harmonising in the interests of protecting financial stability, and so Article 114 TFEU was an appropriate legal base. The ECJ also held that the existence of some delineated criteria on ESMA's use of Article 28 is enough to show that the powers are not discretionary, so Article 28 does not breach the *Meroni* principle.

The Bar Council in its response described the Court's reasoning on the *Meroni* principle as 'very troubling'. It argued that the Court 'while purporting to adhere to *Meroni*, has applied it in such a way as to deprive it of any real effect' and concluded that, 'It is difficult to understand the Court's decision on any basis other than pure expediency'.

The UK Government has consistently stated that it wants tough financial regulation that works, but that any powers conferred on EU agencies must be consistent with the EU Treaties and ensure legal certainty. The ECJ's judgment in this case sets a high bar for successfully challenging the discretionary nature of powers which can properly be delegated to an EU agency following *Meroni,* and has implications for the role of agencies in the EU.

3.123 Looking ahead, there was some unease about the general direction of travel in terms of the increasing powers of the ESAs (see box on the Short Selling Regulation) and the degree of accountability.[160]

> We are certainly concerned that the direction of travel at the EU level is evidently for ever greater transfer of rule-making and supervisory decision-making away from national regulators to bodies which at present are insufficiently accountable to and challengeable by the constituencies which they supervise.
>
> (CLLS)

[160] AIG, *submission of evidence,* p5, on EIOPA.

D. Impact of the Crisis on the EU's Approach to Rule-Making

3.124 The previous section highlighted the need, following the financial crisis, for greater integration in the euro area to support stability in the banking sector and for higher standards of regulation and supervision across the EU. The financial crisis also had a significant impact on the EU's approach to rule-making. There was a shift from a focus before the crisis on more open and competitive markets to a post-crisis emphasis on financial stability, and there was a large and rapid increase in the amount of new legislative proposals. As a result, the EU's recent approach to financial services rule-making raises a number of fundamental questions about the suitability of the current policy-making framework to deliver the new financial stability objective and the quality of the resulting regulation.

3.125 There was broad consensus among stakeholders about the need for EU-level rules to underpin the single market in financial services, notwithstanding some differences in views across market participants. There was also recognition of the link between the need for compromise in harmonising rules in return for the ability to passport across the 28 Member States – this is, in effect, the fundamental tension between the harmonisation of rules and UK sovereignty. Even though the international nature of the UK's financial sector and the importance of access to markets suggests that harmonisation should be in the UK's interest, greater harmonisation of rules necessarily results in the loss of sovereignty which is important to the UK.

3.126 There are, however, key questions as to whether the current approach to EU-level rules is in the UK's national interest. Evidence from stakeholders raised a number of significant concerns, most notably on the recent pace, volume and focus of EU legislation, the failure to differentiate between financial services sub-sectors, the lack of proportionality, and insufficient recognition of the subsidiarity principle.

The Approach to EU Regulation Since the Crisis

3.127 EU regulation can take a number of forms, both with regard to the way in which it is delivered and the approach it takes to harmonisation. But a significant overarching feature of EU financial services regulation since the financial crisis has been its sheer quantity. Over the last ten years, there has been a roughly ten-fold increase[161] in the volume of EU law on financial services as international standards have become more detailed and national rules have been replaced by EU-level rules, many of which are additional to rules that legislate and implement global commitments.

3.128 There was near-universal agreement among respondents that the volume of legislation in the last five years needed to be a strictly temporary phenomenon and that legislative reforms should now be given time to bed down. An insurance roundtable discussion noted that the 'current volume and speed of developing regulation is unsustainable'. Evidence from the Wealth Management Association (WMA) also emphasised that the pace of change is a problem in itself: 'The constant flow of excess new legislation can make it difficult to implement existing material in the pipeline before more legislation introduces more change'.

[161] HMT analysis.

3.129 There were numerous calls for a period of reflection and evaluation, and for the Commission to conduct a comprehensive assessment of existing legislation before bringing forward further legislative proposals. Evidence from HSBC noted that:

> The end of the terms of the current European Commission and Parliament provide a natural point at which to reflect on the significant progress that has been made in advancing regulatory change to reduce risk in the financial system and begin to focus more squarely on how best to re-establish growth and competitiveness in the European economy.
>
> (HSBC)

3.130 In addition, while there was general acceptance of the need to take robust action to address the problems revealed by the crisis and recognition of the role this has played in driving new legislation, stakeholders also considered it important to achieve the right balance between ensuring financial stability on the one hand, and the need to support growth and promote competitiveness on the other.[162]

Differentiating Between Sectors

3.131 The weight and impact of rules also need to be considered in the context of a financial services industry which is composed of different sectors and participants addressing different needs and customers. Appendix I sets out in more detail some of the key differences between the various financial services sectors, such as banking, building societies, insurance, fund management, pensions and market infrastructure, as well as related professional services.

3.132 A particularly important distinction is to be drawn between wholesale and retail markets. Wholesale financial markets generally concern transactions between larger entities such as financial institutions, investment firms, public sector organisations and large companies, and are integrated on a global basis. Operating across multiple jurisdictions, these financial institutions and firms are subject to prudential regulation that is often formulated by global SSBs before being given legal force at EU or national level.

3.133 In contrast, retail markets provide services to individuals and small businesses. These markets exhibit relatively little cross-border activity, and have distinct national characteristics reflecting differences in culture and local requirements in areas such as taxation and national market structures. In its response, RSA explained why insurers tend not to provide cross-border insurance services remotely. This is because of the significant variations in regulatory, legal and taxation requirements. These make it difficult to ensure that a customer is fully compliant across jurisdictions, for example in areas covered by compulsory insurance (400 in Spain, 120 in France and four in the UK), or has access to national insurance pools, for example, for losses resulting from terrorist attacks. RSA stated that practical issues such as claims handling, the language of customers, and the differences in compensation awards resulting from differences in national tort law and court rulings 'are the main factors that lead insurers such as RSA to offer services cross-border via branches rather than on the basis of freedom of services provision'.[163]

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[162] CBI, *submission of evidence*, p4.

[163] RSA, *submission of evidence*, pp2, 8.

3.134 A further example of the potential differences between retail markets in Member States was provided by the BBA, which drew attention to the differences in consumer credit, as shown in the table below.[164]

	France	Germany	UK
Credit cards per head	0.2	0.3	1.2
Savings rate	15.8%	10.6%	5.4%
Consumer credit market size (€bn)	140	250	300

3.135 It can be argued, therefore, that wholesale financial markets, where market access is crucial, stand to benefit from harmonised rules in a way that does not necessarily translate to retail markets. Several respondents felt that this points to a broad division as to how EU rules on financial services should be developed and applied. For example, in its evidence, the IRSG noted that:

> In principle, EU-wide regulations should focus on markets which are larger, have more players and economies of scale. In practice, the focus should be on those products or services that are most easily tradable across national borders.
>
> (IRSG)

3.136 More broadly, the Financial Conduct Authority's Smaller Business Practitioner Panel commented that, 'European-wide rules may also be less appropriate if the maturity of markets differs substantially, as is often the case'. It cited the example of very different life assurance markets across the EU and concluded that, 'Single solutions to tackle the issues might not work for immature markets, and may be burdensome for markets which have tackled the problem with other solutions'.

3.137 RSA identified a number of issues for insurers and consumers when considering what kind of greater market integration is feasible. These include: 'know your customer'; language; culture (including expectations of the local policy-holder); the form and prevalence of fraud (particularly in the case of motor insurance); the tax and supervisory environments; the cost of setting up effective claims management (for example, in property insurance, an insurer will need to build up relationships with builders, roofers, plumbers, electricians etc); and understanding the true risk proposed for cover and the amount of cover needed (for example, the same insured event might lead to a €5m liability claim in one country and just €100,000 in another, due to differences in domestic economies and litigation costs and awards).[165]

3.138 The National Association of Pension Funds (NAPF) pointed out that pensions are a predominantly national market, not a cross-border one with only 82 cross-border pension schemes in the EU, of which 39 are between the UK and Ireland. Furthermore, around 61% of defined benefit schemes in the EU as a whole are in the UK and 24% in the Netherlands. NAPF commented that, 'It seems wholly inappropriate that the 20 plus Member States with less than 1% of defined benefit liabilities should, collectively, have a greater say in relation to supervision and funding requirements for those liabilities than the UK and Netherlands; even Germany and Ireland have only 4% and 2% respectively'.

[164] Cited in BBA, *Beyond Boundaries: How to Drive Regulatory Coherence* (2013).

[165] RSA, *submission of evidence*, p8.

Consumers and Consumer Protection

3.139 Reflecting the basic difference between wholesale and retail markets, the EU's Financial Services Action Plan sets out a strategic objective for creating a single wholesale market in contrast to the goal for 'open and secure' retail financial markets. Reasons for the local nature of retail markets may include consumer confidence, including the extent to which consumers are willing to establish relationships with firms abroad and uncertainty about the degree to which they will be adequately protected if they do, and barriers represented by factors such as language which are not amenable to legislative intervention. This implies that Single Market measures should focus on making domestic markets more contestable and open to new entrants from other Member States or from those using new technologies or business processes, rather than seeking to harmonise the rules of a large number of local markets with different market structures, presenting somewhat different risks.

3.140 EU measures relating to consumers of financial services have addressed matters such as information disclosure and conduct of business requirements for those providing the services. Some provisions are essentially maximum harmonising and some have been minimum harmonising, allowing Member States to go further – for example, on investor protection grounds – if they see the need. But progress in creating a single market for financial services which delivers its full potential for consumers in terms of competitive products, being bought and sold on a cross-border basis, has been slow. Notwithstanding the recent PRIPs and IMD II initiatives, this is, arguably, an area that merits further consideration.

> Cross border retail activity is a potential area of growth, and as a major provider of financial services it would seem relevant to the UK to encourage this business which is more likely to flourish when there are common rules building confidence.
>
> (Sharon Bowles MEP)

3.141 Another view was that the inherently national nature of retail markets meant that consumer measures fell more naturally to the national level,[166] with common approaches across the EU for retail action difficult other than at high levels of principle.[167]

3.142 The Northern Ireland Consumer Council was among those that drew attention to the risk that maximum harmonising legislation could impose thresholds which represent lower standards for some Member States.[168] Others commented that national standards of consumer protection may be threatened by the ability of firms from jurisdictions with lower standards to passport their services.[169] The Financial Services Consumer Panel saw this as one area where there is scope to raise protection at the EU level, commenting that, 'it is imperative that companies are not able to offer services by passporting in from abroad, when they may not meet the standards of disclosure, training and professionalism required of UK advisers'.

[166] Barclays, *submission of evidence*, p5.

[167] WMA, *submission of evidence*, p9.

[168] Northern Ireland Consumer Council, *submission of evidence*, p1.

[169] BIBA, *submission of evidence*, p5.

3.143 A further dimension highlighted in evidence is the impact of digital commerce.[170] Here, the national nature of retail financial services is less clear, and there may be a shift towards a European market in which consumers may not always be aware of the nationality or location of the company with which they are dealing, which may point to a need for EU-level legislation.

Subsidiarity and Proportionality

3.144 The use of EU competences is governed by the principles of subsidiarity and proportionality.[171] These principles establish important parameters so that the EU does not take action, except for areas where it has exclusive competence, unless it is more effective than action taken at national level, and does not go beyond what is necessary to achieve the objectives of the Treaties. They can therefore be seen to represent a fundamental constraint on the EU in the exercise of its competences. The Fourteenth Report of the House of Lords European Union Select Committee, Session 2004-05,[172] stated that, 'The reason for introducing the principle of subsidiarity into the EU lawmaking process was to create a brake on the exercise of lawmaking powers at the Community level, in the interests of decision-making at national and sub-national level'.[173] The application of these principles to EU lawmaking in financial services attracted much comment from respondents. In many cases, they were felt to be key in determining the success or otherwise of legislative interventions.

3.145 The UCITS Directive was cited as an example of well-designed legislation which delivered clear benefits.[174] This Directive is the main European framework covering collective investment schemes that are suitable for retail investors, and was generally well-regarded for giving consumers access to high-quality, consistent investments and for being regulated to a high standard. As a result, UCITS can therefore be seen as a successful example of EU legislation that adheres to the principles of subsidiarity and proportionality notably by creating a global brand at an international level that would have been far more difficult, if not impossible, at a national level and is pro-trade and pro-competition.

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[170] Barclays, *submission of evidence,* p7.

[171] HMG, *Review of the Balance of Competences between the UK and the EU: Subsidiarity and Proportionality*, published in Semester Four. This will consider the principles of subsidiarity and proportionality and their application.

[172] House of Lords European Union Committee, *Strengthening National Parliamentary Scrutiny of the EU – the Constitution's Subsidiarity Early Warning Mechanism (HL 2004-05, 101).*

[173] To help enforce observance of the principles, the Protocol on the application of the principles of subsidiarity and proportionality includes monitoring arrangements, notably a requirement that any draft legislative act should contain a detailed statement making it possible to appraise compliance with the principles. Protocol (No.2) under the Treaty of Lisbon established a watchdog role for national parliaments with regard to subsidiarity, with a right to object early in the process when legislation is drafted if a proposal is felt not to comply with the principle.

[174] See: IMA, *submission of evidence*, p7; Standard Life, *submission of evidence*, p4; and Fresh Start, *submission of evidence*, p17.

The UCITS framework in particular has established a pan-European fund product set and an accepted brand that has also served as a springboard for fund exports internationally, from Asia to the Americas.

(IMA)

3.146 However, the EU's observance of the principles of subsidiarity and proportionality in the field of financial services legislation also attracted criticism. A general concern was voiced by the CLLS with respect to the need to look beyond individual pieces of legislation in order to gauge the full impact: 'there has been little or no attempt to assess the cumulative impact of the full range of European legislative initiatives on the entities that are subject to them. This makes any true assessment of proportionality very difficult'.

3.147 The General Council of the Bar of England and Wales (the 'Bar Council') commented that, 'EU legislation since the 2008 crisis has tended increasingly to encroach on Member States' competences, and towards prescriptive, centralised decision making. This gives rise to cause for significant concerns about subsidiarity and the balance of competences, as well as legal basis and institutional balance'. It cited as examples of this the powers of the ESAs to take decisions binding on national competent authorities, in particular the power of ESMA 'to prohibit, impose conditions on, or require disclosure of, short positions' held on UK markets as part of the Short Selling Regulation. 'Such intervention,' it argued, 'is hard to square with the principle of subsidiarity, and arguably also the principle of proportionality, and the accepted balance of powers between the EU and Member States, as well as between the EU institutions themselves'.

3.148 The EU's use of Single Market competences was also questioned in evidence from NAPF:

Pensions policy is a matter for Member States under the principle of subsidiarity, but the EU has used the Single Market competence to develop a series of interventions in the pensions area.

(NAPF)

3.149 Many respondents considered that EU policy-making also failed to consider the principle of proportionality adequately and highlighted individual pieces of legislation considered unnecessary or disproportionate in their impact.[175] The Alternative Investment Fund Managers Directive (AIFMD) was specifically cited by several respondents as an example of legislation which is disproportionate in its impact and coverage, and without clear cross-border benefits that might have justified its introduction on subsidiarity grounds (see box).[176]

[175] See: ACT, *submission of evidence*, p3; BPF, *submission of evidence*, p2; BCCL, *submission of evidence*, p5; BIBA, *submission of evidence*, p4; WMA, *submission of evidence*, p2; BVCA, *submission of evidence*, p5; and CLLS, *submission of evidence*, p13.

[176] See: CLLS, *submission of evidence*, p3; BVCA, *submission of evidence*, p6; and Lord Flight, *submission of evidence*, p1.

Alternative Investment Fund Managers Directive (AIFMD)

In 2009 the Commission proposed the AIFMD as a response to the financial crisis, describing it as the first attempt anywhere to create a comprehensive framework for the regulation and supervision of the alternative fund industry. It was published without pre-consultation or discussion with expert groups. Although the AIFMD, as finally adopted, was an improvement over the original proposal, it was viewed by a number of respondents as exhibiting significant shortcomings as regards the scope, proportionality and quality of legislation.

The Directive's requirements apply to all funds that are not UCITS, including private equity, investment trusts and real estate funds. Standard Life commented that it created, 'a regulatory environment that covers many product types in which no issues of consumer detriment occurred', adding that, 'It is not obvious that the additional requirements will bring improved customer protection to investors in investment trusts'. Respondents also criticised the proportionality of the proposal. The CLLS commented that, while the de Larosière report found that the hedge fund industry did not cause the financial crisis, the Directive imposed a costly regulatory structure that would be proportionate only if it had. The BVCA commented that, 'Efforts which would otherwise be focused on raising funds and investing those funds in the real economy are instead being diverted to satisfy administrative arrangements which will offer little (if any) increase in investor protection'. It added that, 'Many of the Directive's requirements are not only unduly onerous when applied to firms pursuing PE/VC [private equity/venture capital] strategies (as opposed to other strategies) but are impossible to reconcile with the way in which such firms conduct business'.

The CLLS expressed concerns that a rushed process in putting together and negotiating the Directive resulted in poorly drafted legislation with certain key concepts left undefined. It noted that a survey of asset managers published by Deloitte in June 2012 found that 72% of respondents viewed the AIFMD as a threat to their business and 68% suggested that the AIFMD would reduce the competitiveness of the funds industry in Europe and lead to fewer non-EU managers operating there, putting at risk more than 100,000 jobs at a cost to the economy of some €21.5bn.

Problems with the AIFMD's broad approach have also been recognised in other Member States. In an interview with Dutch financial newspaper *Het Financieele Dagblad,* a senior official in the Dutch Financial Supervisory Authority commented that firms in the Netherlands are struggling to implement AIFMD, mostly because it applies a single set of rules onto a very diverse set of fund managers.

3.150 Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry, is intended to establish a revised set of EU-wide capital requirements and risk management standards with the aim of increasing protection for policy-holders. Though supporting its broad aims, respondents raised concerns about the challenge presented by the process of developing and agreeing the new regime, and the outcome in terms of subsidiarity and proportionality.[177]

3.151 EMIR was also widely criticised for requiring all businesses to report all derivative trades to a trade repository, and for not providing a threshold or an exemption for intra-group derivatives. Evidence from the Association of Corporate Treasurers (ACT) pointed out that, 'Virtually all derivatives done by non-financial companies are likely to be non-systemically important so the entire non-financial corporate reporting infrastructure and burden is pointless'. However, the Commission and others have argued that it is necessary to understand the activity of all firms, including individual firms that are not systemic, in order

[177] See: Legal & General, *submission of evidence*, p2; and the Equity Release Council, *submission of evidence*, p2.

to gain a picture of the entire market and that the purpose of the reporting obligation is to support this approach.

3.152 BIBA listed around 20 areas of EU rule-making that impact on its members, and added that, 'This is a staggering volume of new regulation to put on a sector over the course of a few years. We therefore strongly feel that the right level has NOT been achieved'. In addition, the WMA cited a report published by KPMG that 'wealth management firms spend between 10%-20% of their turnover on regulation', and that for some firms this represents 'up to 50% of profits'.

3.153 The EU's proposed Regulation on Indices Used as Benchmarks has also given rise to concerns. The Regulation is based on, but goes beyond, the principles for financial benchmarks agreed by IOSCO. It would apply to all benchmarks used in financial instruments or contracts, or used to measure the performance of an investment fund, regardless of size or impact. In a reasoned opinion issued in December 2013, the House of Commons European Scrutiny Committee set out its view that the proposal does not comply with the principle of subsidiarity, on the basis of the varied nature of the benchmarks covered, the burden that would be imposed, and the scope for effective national-level benchmark reform.[178]

The Form of EU Legislation

3.154 The form taken by EU legislation, most significantly in terms of directly applicable Regulations or Directives that need to be transposed into domestic law, also has an impact on how market sectors are regulated. The issue of the most appropriate legislative instrument attracted a spectrum of views from respondents. A recurring theme is that there are advantages and disadvantages to both, depending on the circumstances, and that a balance needs to be struck between greater, more effective harmonisation and the need for flexibility, for example to reflect local market conditions and characteristics.

> We believe that there should not be a preference for one form of legislative instrument over another, and at all times the best instrument should be used.
>
> (Barclays)

3.155 Respondents active in wholesale financial markets generally favoured the use of Regulations, for their benefits in establishing a level-playing field and consistency. Directives were, however, seen as more appropriate for retail financial markets. The potential benefits of either approach are dependent on additional considerations, such as clear policy development by the EU and effective transposition by Member States. For example, the CLLS warned that 'Regulations can also result in unintended national disparities, for example, where key concepts are not adequately defined'.

3.156 APFA, while favouring the use of Directives for their flexibility, also expressed reservations that an approach to implementation of Directives that relied on 'copy-out' could negate their advantages:[179] 'whilst firms do not want gold-plating (which we would define as substantive requirements beyond what the directive requires), they do want clarity as to what is required and for the regulator to exercise more discretion when implementing directives so as to ensure the rules provide certainty'.

[178] Further details available at: www.parliament.uk/documents/commons-committees/european-scrutiny/RO%20-%20Benchmarks.pdf.

[179] 'Copy-out', as the name suggests, is where the implementing legislation adopts the exact same wording as that of the Directive or where it cross-refers to the relevant Directive provision, rather than adjusting to accommodate local characterisitics while still achieving the intended outcome.

3.157 A further dimension, usually used in connection with Directives, is the use of minimum or maximum harmonisation. Respondents again generally felt that context was key to determining which approach should be favoured, with the nature of the activities being regulated and the degree to which harmonisation was the aim being essential considerations.

Fundamentally, any assessment of the use of minimum and maximum harmonisation must focus on the underlying objective of the measure in question. Maximum harmonisation is justified where markets and consumers are cross-border and when differential rules would give rise to undesirable externalities. Minimum harmonisation is appropriate when supervisory judgement is required in the application of rules.

(BBA)

3.158 Maximum harmonisation, by preventing additional measures across different Member States, was in principle seen as a useful tool to guarantee a level-playing field and fair access.

The pressure to achieve the economic efficiencies of the Single Market also points to the use of maximum harmonisation measures so that a financial services firm in say London is not impeded in its activities in say France by local measures that are, in truth, intended to make it difficult for the foreign entrant.

(Graham Bishop)

3.159 Some respondents thought that effective enforcement was another important consideration with regard to harmonisation.[180] In practice, the benefits of EU-level rules are undermined without action to ensure that breaches of EU obligations, such as late implementation, are reviewed and addressed on a consistent basis across the EU.

[180] See: CLLS, *submission of evidence*, p11; and BBA, *submission of evidence*, p6.

Chapter 4: EU Policy-Making Process

4.1 This chapter considers evidence on the quality of policy-making, the legislative process and the controls of these processes in the area of financial services. In short, it covers the question of how effectively the EU exercises its current competences. The evidence sets out that, while there may be broad, if not universal, support for the balance of competences as intended in the EU Treaties, there are widespread concerns regarding the quality of EU-level rules and the policy-making process.

4.2 The financial crisis exposed a large hole in the rules that govern financial institutions, especially banks. In the wake of the crisis, the Financial Stability Board (FSB) agreed to a regulatory agenda of 67 recommendations in 2008, to be taken forward by the sectoral international standard setters. These were then given stronger political direction at the G20 Pittsburgh summit in September 2009 (see paragraph 1.12).

4.3 These standards then fell to local jurisdictions to apply. Within Europe they were implemented at the EU level. The resulting volume of legislative initiatives was such that the Commission estimated that around 40% of all its legislative activity in 2010-2011 was focused on financial services.[1] It is therefore only to be expected that the better regulation standards adopted by the Commission would be stretched in view of the volume of legislation proposed during this period.

4.4 In terms of reactions to the quality of the EU policy-making process, views from stakeholders were mixed. Evidence from the International Underwriting Association (IUA) noted that, 'overall we find EU processes to be effective and accountable', and the joint response from the Law Societies observed that, 'as a general rule the EU policy-making process on financial services legislation is satisfactory'.

[1] See, J. Welch, and P. Parker, 'European Financial Services', in G. Walker, R. Purves and M. Blair QC (eds), *Financial Services Law*, 3rd ed. (2014), p94 footnote 46.

4.5 However, most respondents felt that there were significant short-comings in the policy-making process. A minority felt that this was due mainly to the volume of legislation that the EU has needed to adopt following the financial crisis. On the other hand, a large majority of respondents took a different view.[2] For example, the CLLS stated that its 'overall conclusion is that the legislative process at the EU level is flawed, and the problem is not whether the level of detail in EU rules is consistently too great or too general, too restrictive or too liberal, but that it is not properly informed by agreed policy considerations that have been the subject of effective consultation'.

4.6 Moving beyond generalised assessments, almost all industry respondents have detailed and targeted criticisms to make, covering:

- The quality of the Commission's impact assessments, consultations, and policy-making and policy proposals;
- The transparency, evaluation and quality of changes made to Commission proposals by the Council and Parliament and the way in which common texts are then agreed in trilogue discussions; and
- The quality of subordinate legislation.

4.7 The rest of this chapter looks first at policy-making in the Commission and then at the legislative process both for Directives and Regulations and for subordinate legislation, including Level 2 delegated acts, implementing acts and Binding Technical Standards (BTS). It concludes with detailed consideration of some options to improve the policy process.

Commission Policy-Making

Policy Expertise

4.8 Respondents had few criticisms to make where the Commission had consulted properly or faithfully transposed international standards. The Wealth Management Association (WMA), for example, praised the Commission for taking 'steps to ensure that its staff has sufficient expertise in specific areas to draft relevant consultation documents and legislative proposals'. There was, however, pointed criticism where proper consultation had been lacking or international standards had not been followed, and in these areas the quality of Commission policy expertise was then called into question. The AIFMD and FTT were two frequently cited examples (for details see boxes in Chapter Three).

2 See: CBI, *submission of evidence*, pp5-6; CLLS, *submission of evidence*, p13; Baillie Gifford, *submission of evidence*, p3; WMA, *submission of evidence*, pp5-6; and RSA, *submission of evidence*, p3.

4.9 Criticism of Commission expertise was not confined however to the AIFMD or the FTT. NAPF stated that, 'A key concern is that too much EU policy is developed as an internal exercise within the EU institutions, rather than in collaboration with practitioners and experts in the field'. The Wholesale Markets Brokers' Association (WMBA) similarly commented that, 'Lower level staffers and secondees tend to listen to industry, often as a consequence of unfamiliarity with the content; but all expert input tends to be ignored at a more senior level because of what would appear to be a much stronger political culture within these bodies'.

4.10 Many Directives and Regulations delegate subordinate legislative authority (Level 2) to the Commission, and the quality of the Commission's policy and decision-making in this area was also criticised. For example, the CLLS noted that the Commission rejected ESMA's technical advice to delay the EMIR reporting date for exchange traded derivatives in the 'interests of achieving a political goal'.[3]

Impact Assessments

4.11 Many respondents considered the Commission's impact assessments to have been inadequate, concentrating on the benefits assumed to arise rather than critically assessing whether or not they were likely to do so.[4] The impact assessments were also criticised because they failed to reflect the costs imposed on the industry and the incentive effects, i.e. the ways in which the new rules might change the behaviour of market participants.

4.12 For example, the CBI stated that, 'too many rules are being put forward with unconvincing evidence of the overall benefits or with weak assumptions and a weak evidence base'; and BATS Chi-X noted that, 'little or no research or empirical data was gathered prior to draft legislation being published (including) proposals to regulate high frequency trading, to limit dark book trading through waiver caps and to introduce a European financial transactions tax'. The Payments Council considered that, 'all new legislation needs to be impact-assessed, not only against the current (unregulated) environment but also against other current and proposed legislative instruments'.

4.13 A number of respondents also referred to the introduction of the remuneration cap provisions in the late stages of the CRD IV/CRR negotiations as a further example of a case in which new measures have been introduced without appropriate analysis (see box below).

3 The CLLS also noted that the Commission delegated legislation (Regulation 231/2013) for AIFMD adopted rules which ignored the recommendations of Europe's regulators in ESMA, which had been informed by proper consultation with the industry.

4 See: CBI, *submission of evidence*, p15; CLLS, *submission of evidence*, p22; BATS Chi-X, *submission of evidence*, pp1-2; FCA Practitioner Panel, *submission of evidence*, p10; BIBA, *submission of evidence*, p6; RSA, *submission of evidence*, p10; IMA, *submission of evidence*, p6; and NAPF, *submission of evidence*, p19.

4.14 In some instances, the Commission has produced proposals based on impact assessments which have been considered inadequate by the Commission's own Impact Assessment Board. The most recent example of this is the draft revision to the Directive on Institutions for Occupational Retirement Provision (IORP), where the accompanying impact assessment twice received a 'Negative' opinion from the Board. The Impact Assessment Board performs an important role, helping to ensure that Commission impact assessments are of high quality so that the evidence base for proposals can be relied upon. The opinions of the Board should be carefully considered with reservations about impact assessments properly and transparently addressed before proposals are made. Producing proposals without a robust impact assessment risks undermining confidence in the ability of EU institutions to develop effective, proportionate, evidence-based legislation.

Capital Requirements Directive (CRD) IV Bonus Cap

One of the amendments adopted by the European Parliament to the Commission's proposal for the Capital Requirements Directive (CRD) IV was to cap bonus payments to bankers at one times salary or twice times salary with shareholders' approval. This amendment was subsequently agreed at Trilogues despite UK opposition and now forms part of CRD IV.

The UK is challenging before the ECJ the lawfulness of the bonus cap ratio provisions in Article 94 of CRD IV and other related remuneration disclosure provisions in the Capital Requirements Regulation (CRR).

The UK's position is that the relevant provisions lack an evidence base and were not supported by the Commission's impact assessment. The resulting regime, in the view of the UK, is not fit for purpose and will not improve stability across the banking system, and will lead to an increase in fixed salaries which would run directly counter to the objectives of the legislation. The UK is also challenging the provisions on Treaty base (in particular, breach of the restriction in Article 114(2) TFEU on provisions concerning the rights and interests of employed persons) and other grounds.

Furthermore, as some respondents noted in the Call for Evidence, the introduction of the provisions without following better regulation standards constitutes serious deficiencies in the EU's legislative process – a matter that is particularly serious in this case due to the potential impact on the competitiveness of the EU. For instance, evidence from the CLLS notes that, 'The CRD IV remuneration provisions are another example of where inadequate policy formulation and consultation has resulted in highly prescriptive rules that deny national authorities the ability to tackle misaligned incentives in a way which meets their market conditions'.[1]

It is notable that, when asked by the press whether there was evidence of a link between the size of bonuses and the risk of bank failure, one of the MEPs proposing the amendment replied, 'There is no evidence. But the banks do not have evidence that the way they do things today works either'.[2]

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1 In addition, see evidence from the BBA (p. 14) and the Bar Council (p. 8).

2 Article by William Wright, *(Deliberately) missing the point on bonus cap*, Financial News, 14 March 2013.

Consultations

4.15 Evidence on the quality of Commission consultations was mixed. The BBA considered the consultation stage to be transparent and provide a good opportunity for interested parties to engage with policy-makers.[5] The Financial Services Consumer Panel praised the Commission for having 'undertaken significant positive reforms with regard to consumer representation [...] and has also created its own consumer and civil society advisory group by setting up the FSUG [Financial Services User Group][6] and provided the group with significant financial resources', but also noted that there is 'a lack of transparency within the European institutions and during the policy making process [...] Currently the Commission is not required to respond formally to opinions from its FSUG consultative group'.

4.16 However, a number of respondents criticised the Commission for approaching consultations with a closed mind and for providing insufficient time for responses or to consider responses.[7] For example, the CLLS stated that, 'trade associations and other respondents often find that they have to commission their own detailed cost/benefit reports as part of their responses to consultations; but this is often too late to influence conclusions'. The Investment and Life Assurance Group (ILAG) commented that, 'As a medium sized trade body with limited resources we find it very difficult to get our voice heard'. BIBA commented that the open hearings it has attended have left it 'with the strong impression that these are simply a box ticking exercise where little if any of the hearings take into account the points raised in evidence'.

4.17 A number of pieces of evidence also commented on the poor timing allowed for consultation.[8] The ICAEW cited EMIR, the Short Selling Regulation and the review of the Market Abuse Directive as examples, 'all of which had consultation periods of less than one month' – see Figure Eleven for duration of key consultations undertaken by the Commission on financial services legislation since the crisis.

4.18 The joint response of the Law Societies commented that the first consultation over the AIFMD 'was open over a Christmas holiday and truncated. It would have been preferable if the initial consultation would have been longer and better researched'. ILAG pointed out that, 'consideration of the day to day practicalities of change can also be vitally important in framing new legislative proposals. The current consultation process does not allow sufficient time for these views to be properly expressed and considered. What is often missed through this approach is the Practitioner and Consumer view, both of which can add real value and, in our experience, avoid much wasted debate'.

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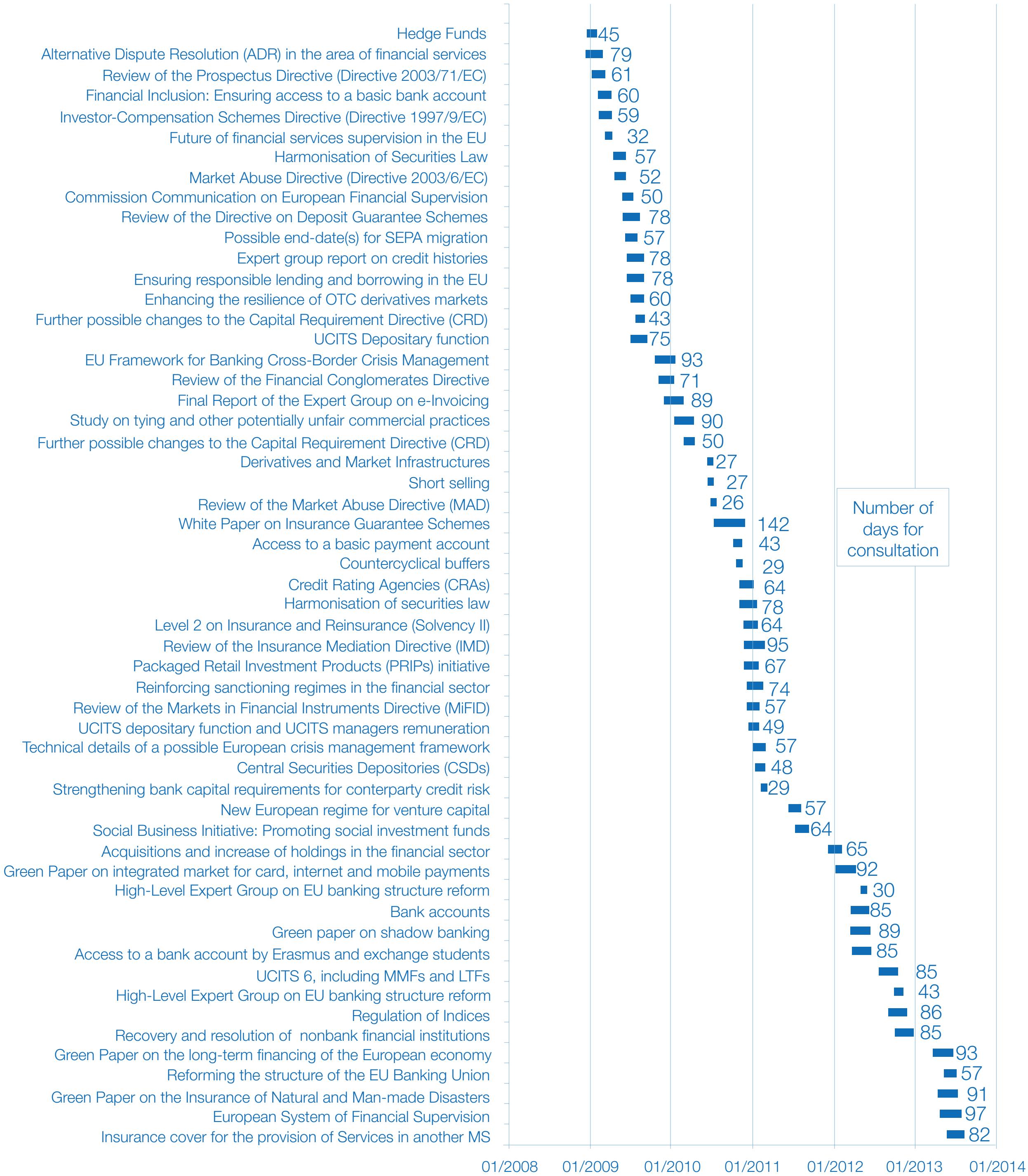
5 BBA, *submission of evidence*, p14.

6 For further information, see: www.ec.europa.eu/internal_market/finservices-retail/fsug/index_en.htm, accessed June 2014.

7 See: CLLS, *submission of evidence*, p22; AFB, *submission of evidence*, p5; CBI, *submission of evidence*, p17; ILAG, *submission of evidence*, p4; WMA, *submission of evidence*, p13; RSA, *submission of evidence*, p10; BIBA, *submission of evidence*, p6.

8 See: ICAEW, *submission of evidence*, p5; NAPF, *submission of evidence*, p18; FCA PP. *submission of evidence*, pp9-10; and the Law Societies, *submission of evidence*, p7.

Figure Eleven: Key Consultations Undertaken by European Commission on EU Financial Services Legislation, 2009-13



Source: European Commission

Implications for Policy-Making

4.19 Policy-making is a challenging task and requires a combination of technical knowledge, open consultation, impact assessments informed by an economic analysis of markets, and high quality legal input to ensure that the proposed rules are clear and unambiguous and have the correct Treaty base. Where these conditions are not met, the resulting policy, and the rules that give effect to that policy, is likely to have a detrimental impact on markets. Evidence highlighted a number of policy failures and issues with legal drafting.

Diversity of Market Structures and Subsidiarity, and the Lack of Proportionality

4.20 A particular criticism was that EU policy can fail to recognise and accommodate market structures in some Member States that are different from those in others.[9] A failure to recognise that different market structures create different risks indicates that the principle of subsidiarity may not be being properly applied, and will lead to rules being applied to address a risk which does not arise or is not necessarily better dealt with at the EU, compared to the national, level.

4.21 Given criticism of the Commission's impact assessments, it is perhaps unsurprising that there is also criticism of the proportionality of the resulting proposals. Impact assessments are designed to help policy-makers assess the proportionality of their proposals for example by assessing the costs that will be imposed on existing firms, the incentives which the proposed rules will create, and the changes in market behaviour that may result. Therefore, inadequate impact assessments are likely to result in proposals whose costs and benefits have not been rigorously analysed and therefore may not be proportionate. See paragraphs 3.144-3.153 in the previous chapter for a more detailed discussion of the evidence on each of these issues.

One Size Fits All, Despite Different Risk Profiles

4.22 A common set of EU-wide rules also needs to be calibrated to the risks which institutions of different types face. Particular criticism was directed at the application of prudential requirements designed for banks and investment banks to smaller investment firms, such as stock-brokers and fund managers.[10]

4.23 The BSA stated that the way the EU has implemented international accords 'such as Basel 2 and 3 (intended for major internationally active banks) as Single Market measures has necessitated their application to all EU credit institutions down to the smallest domestic savings bank. This has imposed disproportionate, and unnecessary, burdens on small firms'.[11] It cites as an example, 'the imposition of harmonised regulatory reporting, known as COREP [...] which has imposed a colossal burden and very substantial costs, as confirmed by the PRA's own estimates, which give alternative costs for building societies only on two different methodologies, of £189m and £278m, but to no apparent benefit.[12] PRA does not intend to make much use of CoRep outputs, but instead will impose its own entirely separate prudential reporting regime'. Evidence from the British Private Equity & Venture Capital Association (BVCA) criticised the EU's FinRep/CoRep regime for similar reasons.[13]

4.24 NAPF criticised EU policy-making for seeking 'to apply to pension schemes the same solutions [that] have been developed for hedge funds, banks and insurance companies, even though the risks posed by pension schemes are quite different'. NAPF criticised

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9 See: Bar Council, *submission of evidence*, pp2-3; FCA SBPP, *submission of evidence*, p4; BIBA, *submission of evidence*, pp2-3; Barclays, *submission of evidence*, p3; NAPF, *submission of evidence*, pp11-12; FCA PP, *submission of evidence*, pp6-7; Lloyds, *submission of evidence*, pp3-4; RSA, *submission of evidence*, p3; WMA, *submission of evidence*, pp4, 6; and BSA, *submission of evidence*, p3.

10 See: CLLS, *submission of evidence*, p4; BSA, *submission of evidence*, p2; LME, *submission of evidence*, p2; WMA, *submission of evidence*, pp3, 9; BVCA, *submission of evidence*, pp3-8; Lloyds, *submission of evidence*, p5; NAPF, *submission of evidence*, pp11, 13-14; and Equity Release Council, *submission of evidence*, p4.

11 In addition, see WMA, *submission of evidence*, p3.

12 CoRep is the common regulatory reporting framework for reporting risk and covers capital adequacy, credit risk, market risk, operational risk, group solvency, losses from the property book, securitisations and large exposures. FinRep is the EU's harmonised regime for the reporting of financial information to the regulator. Both FinRep and CoRep are provided for by the CRD.

13 BVCA, *submission of evidence*, p5.

EIOPA, in particular, for seeking to apply a new approach to pension scheme valuation, 'the holistic balance sheet', which would have the effect of increasing the deficit on UK defined benefits by 50% or £150bn. Such a policy, if adopted, would, it argues, 'significantly increase funding requirements for DB [defined benefit] schemes, leading to more scheme closures and sponsor bankruptcies; and undermine economic growth'. It also cited research undertaken by Oxford Economics, which estimated that by the mid-2020s the effect of applying a capital regime for insurers to pension funds would result in GDP being 2.5% lower than it would otherwise have been, business investment being 5.2% lower and employment being 0.5% lower, that is 180,000 jobs that would not have been created.

4.25 The London Metal Exchange (LME) stated that it is important that, 'the virtues of greater harmonisation and moves towards regional supervision [...] are carefully balanced against the specificities of individual markets to ensure that any unintended consequences of such moves do not create even greater risks to the system than the ones they are seeking to mitigate'. It cited, as an example, the failure to recognise such specificities during the MiFID II trilogue discussions on position limits, which 'having set out with the well-intentioned objective of establishing limits on agricultural food prices, are now putting in place a universal position limit regime encompassing all commodities, without enough consideration of the LME's own existing position management controls tailored to the specificities of our market. Put simply, a one-size-fits-all approach to European policy such as this is not appropriate'.

Lack of Clarity About the Purpose, Detail and Outcome of Rules

4.26 Respondents also criticised the failure of policy-makers to identify with sufficient precision the purpose of the rule, for example whether it was to address a problem, open a market, protect consumers or safeguard financial stability, or to ensure that the rule was adapted to that purpose.

4.27 A lack of clarity about the purpose of a rule and an absence of clear focus on the target can lead to perverse outcomes. The BBA cited the recast Insurance Mediation Directive as 'a good example of the unintended consequences that can affect some European legislation'.[14]

4.28 Standard Life commented of CRD IV and Solvency II that, 'In both cases we strongly agree with the principle of the intended purpose of these prudential regulations. However, we feel that lengthy rule books that run into the thousands of pages and are at an extremely granular level of technical detail may not be helpful and may even constrain market access to new entrants... a more proportionate approach to both the volume and level of detail in these regulations is likely to result in better regulation and a safer industry'. It is worth noting that prudential requirements can require a detailed calculation of capital adequacy, an approach which is often supported by industry in providing for greater sophistication and risk sensitivity. However, the BSA also drew attention to the risks resulting from over-detailed rules.[15]

Failure to Consider the Cost of Short Implementation Deadlines

4.29 The time firms are given to adapt their systems to new rules has a considerable impact on the cost. Firms spend considerable amounts of money upgrading computer systems,

[14] In addition, RBS, *submission of evidence*, p4.

[15] BSA, *submission of evidence*, pp3-4.

changing their marketing material, and amending the terms and conditions of their customer agreements. As a result, the cost of new regulatory requirements in these and other areas will be lowered when they can be planned in advance and will, conversely, be significantly increased where implementing deadlines are short.

4.30 Evidence from respondents was critical of the failure of EU policy-makers to consider the costs both of short implementing deadlines and of changing proposed rules late in the day.[16] The CLLS cited CRD IV as an example of a lack of proper focus by the EU on implementation. The original implementation deadline for CRD IV was 1 January 2013. At that date, the legislation had not been agreed, but no alternative date was provided. The text was then adopted on 16 April 2013 but, without knowing when it would appear in the Official Journal, the industry could not know when the implementation date was – an uncertainty that increased when both the Parliament and the Council published texts in mid-June correcting errors in the original adopted versions of the texts. The CRD IV package was finally published on 27 June 2013 for implementation by 31 December 2013. If it had been published after 1 July, the industry would have had 12 months to prepare not six. EU law is also the trigger for national consultations. The result of the six-month deadline was that the FCA needed to issue three consultations for investment firms subject to the CRD as soon as possible, with the first issued within a month of publication of the CRD IV text. This timeframe meant that the FCA's final rules were published on 13 December 2013, two weeks before the deadline for implementation.

Lack of Sequencing and Coherence

4.31 The overall coherence of EU policy- and law-making was also raised in evidence with the criticism that EU financial services policy is often made in sectoral silos with, for example, different units of the Commission services responsible for mutual funds, insurance products, securities, and retail issues. This can result in products with similar risk profiles and similar target markets being subject to different regulatory requirements.

4.32 Standard Life commented that, 'the instances of conflict and ambiguity are increasing' between EU legislation with overlapping provisions, such as MiFID, PRIPs, and IMD II. It further warned that, 'Lack of synchronisation in EU legislation can result when lead pieces of legislation are under development whilst a related regulation has already been completed, as with the case of MiFID II, and EMIR ... there should be a heavy focus on ensuring that legislation is not drafted in silos, that is to say, the contents of the legislation need to be consistent'.

[16] See: CLLS, *submission of evidence*, pp23-26; and Barclays, *submission of evidence*, p9.

Lack of Precision and Clarity in the Legal Texts

4.33 It is important that EU law is clear, unambiguous and legally certain. The Bar Council was particularly concerned that Article 114 TFEU (a Single Market Treaty base) has been used to achieve objectives which are only obliquely in the interests of removing impediments to the exercise of the four freedoms. It considered that, 'EU institutions prefer to push at the boundaries of what is legally permissible under the EU Treaties rather than contemplating such a possibility [Treaty change]. As noted above, this is of concern both on constitutional grounds and because it has an impact on the substantive quality and legal certainty of the legislation'.

4.34 In this regard, the Bar Council considered it 'regrettable' that the ECJ did not follow the reasoning of the Advocate General with regard to the UK legal challenge related to the Short Selling Regulation, and considered that the power conferred on ESMA to take measures to ban short selling 'cannot readily be seen as Article 114 harmonisation measures. In substance, they are a form of direct regulation by an EU agency of individual citizens in Member States'.[17]

4.35 The textual clarity of the content of the Directives and Regulations adopted by the EU was also raised as a concern in evidence:

> The Commission's original proposal is not drafted by lawyers, the Commission Legal Service only has a right of review ... By the time the text that is eventually adopted has been amended in Council, in Parliament and in trialogues, the quality of the drafting has deteriorated further. The jurist linguist stage occurs too late in the day (after political agreement) to make any significant difference and is rarely attended by legal draftsmen. The process also remains highly political.
>
> (Bar Council)

4.36 Respondents singled out further examples of poor drafting. These included the passporting provisions of AIFMD, where lack of clarity in the text created different views among national regulators about whether a passport was available for discretionary portfolio management.[18] A further example of ambiguity in the AIFMD is the definition of what constitutes marketing. The wording in the Directive is imprecise and the UK authorities consider that it excludes pre-marketing activity and so will not issue a passport notification for this activity. Both the BVCA and the City of London Law Society Regulatory Law Committee (CLLS) stated that other Member States will not allow pre-marketing material to be circulated without a passport notification. The result is that firms are exposed to legal risk.

Inadequate Legislative Delegations for Level 2 Measures

4.37 Many Directives and Regulations provide for the Commission to adopt subordinate legislation (Level 2). These legislative delegations should be precisely drawn in order to avoid ambiguity and ensure subordinate legislation is confined to the scope of the empowering legislation.

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[17] The definition of market making in the Short Selling Regulation is also cited as an example of poor drafting. The CLLS reports that France, Germany and the UK on the one hand, and Italy and other Member States on the other 'are divided as to whether it can be used for hedging activities in OTC derivatives'. See box in Chapter Three on the Short Selling Regulation and the related UK legal challenge for more details.

[18] This will now be resolved through a measure in MiFID II – Member States will be required to apply this measure from mid-2015.

4.38 The quality of the legislative delegations was subject to some focused criticism. HSBC noted that loose EU legislation resulted in 'mismatches between Level 1 agreements and Level 2 outcomes: and the Level 1 text may also contain technical errors acknowledged by all parties but which cannot be changed easily. There may also be questions over whether an ESA has, in drafting Level 2 rules, exceeded its mandate or fundamentally extrapolated from the Level 1 text in a manner that could not have been anticipated from the orginal legislation'.[19] Evidence from the Association for Financial Markets in Europe (AFME) also highlighted issues in the AIFMD legislative delegation regarding outsourcing, the Short Selling Regulation and the scope of the exemption for market making and primary market operations for the purposes of the ESMA Level 3 Guidelines.[20]

The Legislative Process

4.39 After the Commission has adopted a legislative proposal, both the Council and the Parliament consider it and make amendments. Evidence also focused on this part of the process. While the industry is critical of the process as a whole, there was wide variation in views of the quality, transparency and accessibility of the Commission, Council and Parliament. There was, however, considerable criticism of the trilogue process under which the Commission, Council and Parliament negotiate on their different texts to achieve an agreed position.

4.40 Generally, the legislative process was considered difficult to follow. Evidence from the BVCA noted the following contributory factors: revised versions of legislation are not always well publicised; the revised texts do not always indicate what amendments have been made; and timelines are irregular with long periods where nothing much seems to happen, punctuated by sudden revisions and then the adoption of a text.[21] As an example of the last factor, the BVCA noted that the Parliament published a revised version of the PRIPs Regulation on 6 November and voted on it two weeks later. The box above on the bonus cap ratio highlights the consequences that result from a failure to follow the standards of law-making with which EU institutions have themselves agreed to comply.[22]

Quality of Legislative Amendments

4.41 Evidence from respondents considered that where flaws in legislation were corrected it was often because of technical input by the industry and that a good policy proposal would have captured these issues first. Where the proposal was made worse, this was frequently because substantial and wide-ranging changes were proposed by the Council or the Parliament without consultation or cost-benefit analysis.

4.42 The Financial Conduct Authority's Practitioner Panel commented that, 'Where domestically the FCA or HM Treasury would be required to re-consult if proposals change in this way, the EU process does not appear to require, in practice, that further consultations or impact assessments are conducted'. It cited the example of Solvency II as one where 'the legislative process has been highly inefficient and lengthy [...] with the result that the directive now fails to align with new developments in the market and in regulation'.

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19 As an example, HSBC highlighted the EBA's BTS on own funds 'where the extent of capital dedication for direct, indirect and synthetic financial sector holdings was far beyond what could have been anticipated by a reading of the Level 1 text'.

20 AFME, *submission of evidence*, p11. See also the criticisms made by the CLLS (p6) as regards the delegation to Level 2 of the definition of open-ended and leveraged funds in the AIFMD, and the 'unexpected interpretation' that resulted: 'Even worse, these flawed concepts will now be used in future legislation'.

21 BVCA, *submission of evidence*, pp17-18.

22 See the Inter-institutional Agreement between the European Parliament, Council and Commission on better law-making (2003/C 321/01).

4.43 The European Parliament was criticised by some stakeholders.[23] Evidence from the Building Societies Association cited the Mortgage Credit Directive as an example of a proposal where the Parliament's rapporteur had attempted to introduce major new measures that 'were not supported by any impact or cost benefit analysis, and appeared largely designed to address shortcomings in the Rapporteur's home state or in another state, rather than genuine EU-wide issues'.

4.44 Evidence from the WMA noted that the Council generally delivered 'reasoned and well-thought through texts', but that:

> The European Parliament rarely undertakes evidence gathering in the way that the Commission does, nor does it as a corporate body seek impartial external advice and it certainly does not do impact assessments or cost-benefit analyses. There is, however, plenty of evidence of individual rapporteurs seeking advice that suits their particular political persuasion. This results in Parliamentary responses to Commission legislative proposals that are often lacking in focus, whimsical in reflecting the pet ideas of the rapporteur (or other provider of amendments) that are often only partially relevant, and broad catchalls embracing numbers of issues beyond those in the initial focus of the proposals. This creates excess volume, lack of relevant detail, and poor quality legislation that is often misguided or off-target.
>
> (WMA)

4.45 However, Sharon Bowles MEP, chair of the Parliament's Economic and Monetary Affairs Committee (ECON), defended the transparency and democratic process of the Parliament, setting out that, 'All the amendments are published and there is no compromising done by a tabling office prior to publication. Then all the amendments are discussed in open committee and only at this stage are compromises negotiated and compiled by the MEPs leading on the work, usually with further public discussions and sometimes more hearings, followed by votes on compromises and every amendment'.

4.46 Evidence from Bank of America Merrill Lynch stated that where there is a substantive change to the legislation by either the Parliament or Council, 'the impact on business and society of the altered legislation is not properly assessed at the most appropriate point. We therefore believe that the decision making process would benefit from a more transparent approach and an independent assessment of any additional proposed changes that arise during the decision making process'.

Transparency and Accountability

4.47 Although there were concerns about transparency in many EU institutions, it is notable that despite concerns above regarding the quality of its amendments, the Parliament was considered to be more open and transparent.

4.48 HSBC noted that transparency 'tends to be strongest in the European Parliament' and that it 'currently undertakes more dynamic and effective discussion with external stakeholders'. Bank of America Merrill Lynch described the legislative process as a whole as 'very complex', but considered that the Commission is 'the most transparent institution', followed by the Parliament 'mostly transparent'; whereas it considered that in the Council 'the decision making process is at best opaque and appears to be the least efficient and accountable one'.

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[23] BSA, *submission of evidence*, p5; RSA, *submission of evidence*, p3; and WMA, *submission of evidence*, pp6-7.

4.49 Evidence from Sharon Bowles MEP also argued that, 'in general it is easier for an interested member of the public, NGO or industry from all sides to get an amendment tabled in the EU via the EP [European Parliament] than it is to get an amendment tabled to legislation in the UK Parliament'.

Trilogues

4.50 The trilogue process was widely criticised for being opaque and involving political horse trading, unrelated to the technical issues in play. HSBC described it as 'a black box' while evidence from Barclays stated that:

> It is often the case that substantial change occurs to legislative texts during the trilogue period (such as CRD IV) meaning assumptions as to the ways elements are likely to turn out will not always be right and there will need to be changes to systems to be fully compliant ... the trilogue process [assumes] crucial importance in the legislative process. This centralises power in the hands of a smaller number of policymakers and politicians and is of questionable benefit in terms of speed or democratic accountability.
>
> (Barclays)

4.51 Sharon Bowles MEP noted that, 'There is as yet no formal agreement as to allowing routine publication on websites of the 'trialogue' tables but discussions about that have taken place'.

4.52 Issues also arise when substantive changes are subsequently made to the text agreed in trilogues through the technical process. Moody's raised this concern with regard to the Credit Rating Agency (CRA) III Regulation. The main text imposes an obligation on shareholders not to have a holding of more than 5% in more than one CRA. After the trilogues had concluded, a substantive addition was made to annex 3 section I (new Article 22a) of the Regulation. This addition states that if a shareholder does have a shareholding of 5% in more than one CRA, the agencies are also in breach of EU law.

The Contribution of the ESAs

4.53 While the ESAs were praised for their efforts to consult, especially given short legislative timetables, they were criticised for sometimes failing to respect the scope limits set in the underlying Level 1 text. The BVCA commented that, 'ESMA is required to consult within timelines which it does not set. It is often subject to unrealistically short timeframes set by the Commission which leave little opportunity for ESMA to conduct a proper and meaningful consultation process or for it to analyse the large numbers of detailed responses which it receives from stakeholders'.

Improving the Policy Process

4.54 The process of policy- and rule-making prompted criticism from most respondents. It seems likely that flaws in legislation are partly a result of the volume of legislation adopted in response to the financial crisis, and the associated failure to consult adequately and undertake high quality impact assessments.

4.55 The potential impact of these failures, and therefore the urgency of addressing them, has increased in importance as the objectives of EU policy-making have expanded over the last ten years from removing obstacles to the Single Market to ensuring financial stability and protecting consumers.

4.56 Whereas a failure to remove an obstacle to the Single Market will defer the benefits of more open markets, the impact will be much greater from a policy failure that results in risks to consumer protection, or which prevents a Member State from safeguarding its financial stability or maintaining the safety and soundness of banks, or which does not support a proportionate regulatory regime. Policy failures in these areas may have significant impacts on consumers, the control of risk, the contestabilty of markets, national tax-payers and, ultimately, on economic growth.

4.57 The extension of EU policy-making to financial stability and consumer protection also increases the likelihood of policy failures: first, because the Commission's core policy competence lies in the area of the Single Market; second, because the policy and legislative process has not been designed to capture and incorporate the high level of expertise, modelling, empirical analysis and market-testing required for policy- and law-making focused on consumer protection and financial stability across the EU 28; and, third, because international regulatory standards and the EU's consumer protection Treaty base both operate on a minimum harmonisation basis. By contrast, the Commission's ambition for the EU's single rulebook for financial services is that it applies on a maximum harmonisation basis, wherever possible.

4.58 For these reasons re-engineering the policy and legislative process is of high importance, and respondents made a number of suggestions in this area to avoid the risks of poor quality rule-making.[24] These covered standards of policy-making, the policy process, legal drafting, quality assurance, accountability, the legislative process and subordinate legislation, including Level 2 and BTS (delegated and implementing acts that are drafted by the ESAs for the Commission then to adopt).

Enhancing the Standards Against Which Policy is Assessed

4.59 The Commission has set itself standards of good regulation that include a requirement to consult and undertake impact assessment, which could be amended and made more focused to address the failures identified in this report, including through:

- The development of cumulative impact assessments, to address the risk that the overall burden of rules is not taken into account;[25]
- The rigorous evaluation of existing requirements to determine whether their expected benefits have been realised, prior to the publication of any new proposals, as proposed by the Business Taskforce; in this regard, it is particularly important to identify why the expected benefits have not been realised;[26]
- The application of a competitiveness test for the relevant economic market, in line with the recommendations of the Business Taskforce; and

[24] These suggestions were also discussed at a round table convened at HM Treasury in March 2014 to explore options for change.

[25] Such assessments have been undertaken for the aluminium and steel sectors, see respectively: www.ec.europa.eu/enterprise/sectors/metals-minerals/files/steel-cum-cost-imp_en.pdf www.ec.europa.eu/enterprise/sectors/metals-minerals/files/final-report-aluminium_en.pdf.

[26] See the 'Compete' principles in *'Cut EU Red Tape': A Report From the Business Taskforce* (2013), pp12-13.

- The revision by the Commission of its Impact Assessment Guidelines to strengthen core policy principles. These might include some sector specific material, such as methodological approaches to identifying the correct baseline definition, or estimating macro-economic benefits of new regulations, or predicting how business models respond to regulation. Such material could then be used to guide and help hold to account Commission policy-making.[27]

Enhancing Process Disciplines to Ensure Stakeholders Contribute Constructively

4.60 Respondents considered that the two guiding principles should be openness and transparency. The principle of openness implies: that the Commission would consult on the nature of the problem, and on the high-level options and design considerations for addressing it; and that it would publish its more detailed impact assessment in draft, so that stakeholders are in a position to correct mistakes of fact and analysis. A precondition for effective consultation is providing enough time for stakeholders to obtain empirical data to inform the policy process, as it may take several years to complete complex pieces of research. It is important that stakeholders have advanced knowledge of planned future initiatives. A second precondition is the discipline of consulting on significant new elements of a policy. A consultation on one set of propositions with a proposal that includes substantially different elements brings the process into disrepute.

Improving the Quality of Legal Drafting

4.61 Consideration could be given to publishing legislative texts in draft for comment and creating an Office of European Draftsmen, whose members would be charged with drafting legal texts. Two immediate benefits would result: first, policy-makers would need to provide precise instructions which should aid clarity over the purpose of a legislative proposal; second, the legal quality of the text should improve, an outcome that would be particularly beneficial where EU law takes the form of directly applicable Regulations.

Enhancing Quality Assurance Procedures to Achieve Standards in Practice

4.62 At present, the Commission's Impact Assessment Board needs to approve proposals before they can go to inter-service consultation. It would be worth considering the advantages and disadvantages of opening up the Commission's Impact Assessment Board and extending its scope so that stakeholders could see and comment on the Commission's Impact Assessment Board to external experts, and widening the evidence base available to it by permitting stakeholders to see and comment on the Commission's proposal and provide their own data and analysis to the Board.

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[27] In his evidence, David Green proposed that the policy principles include the following: (i) identification of the problem; (ii) identification of the market; (iii) selection of the right policy tool to address the problem; (iv) articulation of clear objectives for the proposed measure; (v) the identification of the right kind of rule; and (vi) the adoption of the principle that no rule should be more detailed than necessary. Identifying the right kind of rule might involve determining, for example whether the problem is best addressed by a rule that specifies the content (for example, a capital ratio), a process (for example, a model approval by supervisors), an outcome (for example, conflicts of interest must be properly managed), or a behaviour (for example, market manipulation).

Enhancing Accountability Processes so Breaches of Standards are Sanctioned

4.63 Accountability might be enhanced if the Court of Auditors regularly reviewed compliance with the better regulation guidelines, and monitored the extent to which the Commission follows its recommendations. It is notable that its 2010 special report on impact assessments included recommendations which have been repeated by respondents to this Review, including consulting on impact assessments and updating them during the legislative process.[28] In addition, the EU might consider changes to the rules of judicial review, including standing, so that the ECJ could play a full role in incentivising compliance with policy standards and processes, and ensuring that a strict reading of Treaty bases prevail (these reforms might require Treaty change).

Increasing the Transparency and Accountability of the Legislative Process

4.64 It is important that better regulation standards are maintained throughout the legislative process. If there were an Office of European Draftsmen, it could be made responsible for drafting amendments proposed in the Council or Parliament. Consideration could also be given to the Council and Parliament agreeing that substantive new provisions would require consultation and impact assessment. Indeed, the inter-institutional agreement on better law-making envisages that there will be an impact assessment before 'the adoption of any substantive amendment' at first reading or conciliation.[29] Complying with this agreement and extending it to all stages of the legislative process would help address the risk of new proposals emerging at the trilogue stage or later, a practice that undermines all better regulation standards. Greater willingness to go to second readings might also help in this area. It could be worth considering whether a failure to comply with these standards should be made reviewable by the courts with the remedy being the striking down of provisions that were deemed non-compliant.

Applying Standards of Better Regulation to the Commission's Level 2 Rule-Making

4.65 Respondents highlighted the failings of the Commission's Level 2 rule-making. The application of better regulation procedures should help address these failures, and this would imply imposing a duty on the Commission to consult and undertake impact assessments for Level 2. A requirement to consult on the proposed legal text, to ensure legal clarity, might also improve standards, and consideration could be given to requiring them to be submitted to the Impact Assessment Board for approval and comment by stakeholders. A further process control would be voting controls. At present, the Treaty requires the Council to assemble a qualified blocking majority to set aside a Commission Delegated Act. When the Treaty is next revised, it might be worth reviewing this provision.

4.66 As regards BTSs, consideration might be given to requiring the the ESAs to publish the draft text for comment by stakeholders, thereby enhancing its legal quality. Where the Commission proposes to amend BTSs, consideration might be given to requiring it to undertake its own draft cost-benefit analysis and consult on it, where it chooses to amend materially a provision or introduce a new one. Furthermore, where it amends the text on point of law grounds, it would be worth considering whether it should have to publish the supporting legal advice.

[28] See: European Court of Auditors, *Impact Assessments in the EU Institutions: Do they support decision-making?*, Special Report No. 3 (2010).

[29] Article 30 of 2003/C 321/01.

4.67 In summary, evidence from stakeholders raised a range of concerns and issues regarding weaknesses in the existing EU policy-making framework and processes. There was a broad consensus that the current legislative framework has not been adequate for the type, volume or pace of legislation experienced in the last five years. Evidence strongly suggested that the quality of consultations, impact assessments and drafting of detailed rules by the EU has not been sufficiently high, and that technical competence on financial services issues within EU institutions should be developed and strengthened.

Chapter 5: Options and Challenges

5.1 This chapter considers some of the challenges and opportunities related to EU competences on financial services and the Free Movement of Capital that may impact upon the national interest in the future, and sets out some of the potential options that have emerged in the review.

5.2 As highlighted in previous chapters, financial services and the Free Movement of Capital are affected by a high degree of international and domestic interaction. Consideration of the EU and its policy-making in isolation would overlook essential aspects of the broader framework within which it operates. This chapter therefore considers the issues for the balance of competences, and its exercise, through four dimensions:

- The global dimension;
- The EU dimension;
- The euro area dimension; and
- The national dimension.

5.3 Each dimension has its own core area of competence which needs to be respected by the others for reasons of effectiveness, legitimacy and, where appropriate, democratic accountability. In an interdependent world, there also needs to be assurance that the competence is being properly exercised at all levels.

The Global Dimension

5.4 Financial services are increasingly global, in terms of both the framework for regulatory standards and the nature of markets. The EU has a key role in the international organisations that develop the international framework, and also has competence in trade negotiations and the approach to Third Country regimes. The manner in which the EU acts and exercises its competences in these areas is of key importance to the UK, given the highly international nature of its financial services sector.

5.5 The EU is influential in the international organisations that are responsible for setting standards for financial stability and the safety and soundness of banks, insurers and other financial institutions. The Commission and ESAs are active participants and a number of Member States, such as the UK, are also members in their own right. Therefore, it should not be problematic for the EU to implement these standards faithfully and consistently.

5.6 However, in reality, implementation at the EU-level is not always faithful or consistent, although this is not a failure that is necessarily specific to the EU. Respondents highlighted the consequences of such failures, which include: regulatory incoherence; conflicting requirements imposed on firms; the fragmentation of markets; the increased difficulty of assessing risk on a consistent basis; the assertion of extra-territorial jurisdiction; the erection or maintenance of barriers to trade; opportunities for arbitrage; and damage to the credibility and authority of international organisations and their output.

5.7 The EU should, therefore, consider how to improve its engagement with international bodies and other jurisdictions to help shape and strengthen the international framework, including to ensure that standards are appropriate and followed more consistently in EU legislation. Steps could also be taken to help ensure all jurisdictions comply with international standards. The EU should consider how to reduce the incidence of regulatory conflicts or inconsistency with other jurisdictions in order to mitigate the scope for fragmentation and extraterritorial approaches. In this regard, the trade agreement being negotiated between the EU and the US – the Transatlantic Trade and Investment Partnership (TTIP) – provides a key opportunity to improve regulatory cooperation between the EU and the US, in line with the Commission's existing approach which the UK Government strongly supports. The EU should also support action to ensure that international standard-setters have the capacity and capability to identify risks and instigate standards to mitigate them.

5.8 The increasing size and number of large and liquid markets will offer the world economy significant potential benefits. The importance of supporting the framework of global standards is likely to increase over time as emerging markets account for an ever-larger proportion of financial assets. According to HSBC's research paper, *The World in 2050*, 17 of the top 30 economies in the world in 2050 could be emerging countries. Their growth will be driven by financial markets, and both equity and bond markets may be more important in meeting finance needs than banks. Among Brazil, Russia, India, China and South Africa – the 'BRICS' countries – securities markets already provide 60% of total financing and their equity markets are around six times larger than they were in 2002.

5.9 To support the UK's national interest, there should be good access between the EU's wholesale markets and other global markets. Obstacles and barriers to trade in financial services should be removed. An appropriate EU regime should be developed for Third Countries which values and supports access to global markets, including through greater use of substituted compliance or mutual recognition. EU trade negotiations should also be sufficiently ambitious in terms of financial services, including increased market access and improved regulatory cooperation. The TTIP sets an ambitious benchmark and, in terms of financial services, future trade negotiations between the EU and other countries should seek to be as ambitious as possible.

5.10 The removal of unnecessary obstacles to the Free Movement of Capital, where there are no sound public policy justifications, would complement the removal of barriers to trade in financial services. More generally, even greater freedom of movement for capital could support the economic benefits of open, well-regulated capital markets that are documented in the literature review.

The EU Dimension

5.11 Before the financial crisis, the EU's core objective in financial services was to harmonise rules in order to remove national regulatory barriers, thereby opening markets, which in turn would support greater efficiency and competition. Recent years have seen a shift to a focus that has prioritised financial stability and the safety and soundness of banks and consumer protection. This has manifested itself in a large number of new rules that have rewritten almost all areas of financial services regulation.

5.12 However, there are significant challenges in the ambition of creating a single rulebook that uses the Single Market Treaty base and removes national obstacles to the Single Market, while being proportionate, protecting consumers and maintaining financial stability. Policy failures in these areas are likely to have a significant impact on the welfare of individuals and the health of economies, and therefore raise the question of whether the policy and legislative framework is sufficiently adapted to minimise the risk of failure.

5.13 The vast majority of respondents from industry supported the extension of EU-level rules to create a full single rulebook, though many recognised that a high level of subsidiarity is appropriate for consumer markets. For wholesale market firms, in particular, a single rulebook was considered important to constitute a genuine Single Market in the EU. For these firms, the Single Market and the Free Movement of Capital are key, and a number of respondents emphasised the importance of the Single Market to their decisions to locate in the UK.[1]

5.14 Respondents noted that the Single Market is underpinned by rules, and that the type and content of these rules profoundly affect the kind of Single Market that is created, including its international competitiveness, openness to innovation and new entrants, and the level of proportionate regulation. Furthermore, because the creation of a single EU rulebook for firms involves replacing national rules with EU ones, it is critically important that EU standards of policy- and law-making match the best in Member States. Poor quality rules will both damage the economies of Europe, for example, by being disproportionate or failing to address market and regulatory failures, or will diminish support for the EU from its peoples, especially from those who see rules being adopted by the EU that would not have passed scrutiny domestically. In this regard, respondents identified a number of areas for consideration, including those set out below.

Complete the Financial Sector Repair Reforms

5.15 Many respondents commented on the considerable volume of financial regulation that has emerged from the EU in the past few years, and argued that there should be a strong focus on completing the reforms, including at Level 2. The EU should consider how to ensure that the overall framework that emerges from the individual pieces of legislation is effective and delivers the desired outcomes. This will necessitate implementing and enforcing rules effectively across Member States before bringing forward any further legislation. Consideration could be given to peer reviews to ensure that rules are implemented consistently across all Member States to ensure a fair and effective regulatory environment.

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1 See the comments of Lord Mandelson in the Evening Standard on 22 April 2014, where he argued that: 'Outside the EU, we would no longer enjoy unfettered access to Europe's financial markets, and much of the City's trade and clients would relocate to continental financial centres because, under current European legislation, you have to be located inside the EU to conduct many financial activities within its borders'.

A Comprehensive Assessment of the Single Market in Financial Services

5.16 The perception that financial services rules impose disproportionate costs led some stakeholders to argue that a comprehensive assessment should be undertaken, covering all EU financial services rules that are in force, including their cumulative impact, coherence and effectiveness, alongside an economic market review designed to identify the extent of any barriers to entry or to the expansion of firms.[2] Others considered that the regulatory regime had become so dense and intractable that it was now too complex to evaluate.

Better Identification of Market Failures

5.17 Market and regulatory failures, including regulatory barriers to entry and the operation of any detrimental market forces, need to be better identified. This will help to clarify the objectives of rules, which is both beneficial for the design and implementation phases, and help to ensure that risks of poor focus are minimised. For example, promoting greater competition in an area where there are significant externalities relating to risk-taking by banks may not result in desired outcomes.

Greater Consideration of Subsidiarity and Proportionality

5.18 One of the major themes that emerged from evidence was that inadequate consideration has been given to the principles of proportionality and subsidiarity. Respondents stressed the importance of ensuring that rules are targeted at the relevant economic markets, so that the characteristics and risks of different financial markets, for example, between wholesale and retail, banking and fund management, insurance and pension funds, or intermediaries and end users, are properly reflected in the rules.

Improving the Quality of the Policy-Making Process

5.19 There were strong views in the evidence that there are significant weaknesses within the EU policy-making process, notably that the quality of consultations, impact assessments and drafting of detailed rules are not sufficiently high. Chapter Four considered these issues in further detail, including possible options to improve the process.

Providing for Strong Oversight

5.20 The ESAs have a key role to play in developing a Single Market that is internationally open and competitive and in raising standards of supervision across the EU 28. To achieve this, the ESAs need:

- An accountability structure that ensures they act in the wider EU interest and are operationally independent of other EU institutions;
- To ensure that a collaborative relationship is fostered with national supervisors, one based on partnership and respect for the different roles and responsibilities of the EU and national levels; and
- To develop cutting-edge skills in the areas of audit, performance indicators, the economic analysis of markets, policy analysis and legal drafting.

5.21 Some additional staff may be necessary, but it is more important that staff are recruited with the right skills and experience (in particular a strong mix within the organisations of people with skills in the areas of regulation, economics, risk, audit and law) and the right framework of accountability and review.

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2 The Commission recently published a wide-ranging assessment of the financial services proposals it has adopted. See: Commission Staff Working Document, *Economic Review of the Financial Regulation Agenda*, SWD(2014) 158 final, 2014. This document accompanied the Commission's Communication, *A Reformed Financial Sector for Europe*, COM(2014) 279 final, 2014.

Improving UK Engagement and Contribution to the EU

5.22 Respondents also considered that effective UK engagement in policy- and law-making is critical given the importance of the sector to the UK. They called for the quality and focus of the UK's contribution to the EU process to be enhanced, and suggested that this could be achieved through: more national experts being employed by or seconded to the Commission and ESAs; the high-quality of MEPs that are engaged in supporting the national interest; encouraging officials to develop greater language skills; stronger efforts to establish alliances with other Member States (both euro area 'ins' and 'outs'); better coordination between UK authorities; and earlier policy engagement with the Commission at the pre-proposal stage.

Ensuring Adherence to the Treaties

5.23 One notable feature of the UK's relationship with the EU on financial services in recent years has been the number of legal challenges that the UK has launched regarding EU measures relating to financial services.[3] The UK does not take lightly the decision to challenge EU acts. Although each challenge must be considered individually and on its own merits, these challenges have commonly raised questions about the proportionality of the measure and its legal base. It is notable that from the start of the financial crisis the Commission has been very active in presenting proposals in the field of financial services. Arguably, the proposals have been more ambitious in terms of timeframes, scale and effect than in any other area. As a result, difficult legal and policy issues have arisen.

5.24 Evidence to this report demonstrates that the UK's approach to the legal challenges is supported by a number of stakeholders. For instance, evidence from the BBA highlighted 'the importance of establishing an appropriate legal base and the need for legislation to be legally sound, based on a clear and accepted understanding of the Treaty parameters'.[4] The UK is not the only Member State that has expressed concerns regarding the approach to and use of the EU Treaties by EU institutions with regard to financial services legislation. On this basis, it is important that the UK authorities continue to scrutinise the Treaty base of all financial services legislation. When there are concerns that legislative proposals may not have a sound Treaty basis, the UK should consider whether it is necessary and appropriate in the circumstances to take legal action.

The Euro Area Dimension

5.25 The establishment of the banking union was triggered by the need to sever the link between weak sovereigns and weak banks and, thereby, help to resolve the euro area crisis. One of the effects of this development has been the creation of an additional dimension in the regulatory framework for the Member States. Although the UK has made clear that it will not participate in the banking union, it is already evident that euro area measures have the potential to impact on Member States that have chosen not to participate, as has been seen, for instance, during the negotiations on the Single Supervisory Mechanism and the Single Resolution Mechanism. The forthcoming *Review of the Balance of Competences between the UK and the EU: Economic and Monetary Policy* report considers further the implications for the UK of closer integration of the euro area.

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[3] Each UK legal challenge in the area of financial services legislation has been considered separately in individual boxes in Chapters Three and Four in this report.

[4] In addition, see Bar Council, *submission of evidence*, p13, which noted that where EU institutions push at the boundaries of the Treaty, not only does this create concerns on constitutional grounds, but also has 'an impact on the substantive quality and legal certainty of the legislation'.

5.26 Although respondents generally welcomed the establishment of the banking union as a necessary step to help restore financial stability across the euro area, noting that the benefits of financial stability in the euro area are felt across the whole EU as well as the rest of the world, there were significant concerns that the advent of the banking union could have an unfair or damaging effect on Member States outside the euro area.

5.27 Risks to non-euro Member States fall broadly into two categories: first, that there is a failure to achieve the fiscal, economic and financial integration that is needed to place the single currency on a secure long-term basis; and second, that the measures that do secure closer integration among euro area Member States fail to respect the rights and interests of non-euro area Member States.

5.28 Failure to enshrine financial stability in the euro area could create risks that the currency union becomes deflationary and unstable and that these effects are exported to neighbouring countries. Such failure could arise from: design failures, for example, failing to provide for any further collective action that may be needed in the areas of greater fiscal or economic integration; operational failures, for example, a failure to deliver sufficient quality of supervision of euro area banks; or scope failures, for example, risks to banks from conduct failures like mass misselling or losses in banks' insurance subsidiaries which fall outside ECB supervision.

5.29 The risks to non-euro area Member States of greater integration that fails to respect the rights and interests of non-euro area Member States include: greater convergence of political and economic interests among euro area Member States that results in EU-wide regulation that is appropriate for the euro area but is not suitable for all Member States; the practice of caucusing and the development of a common euro area position on financial services issues which are at odds with a single market that is open internationally, dynamic, innovative and globally competitive; the fragmentation of the Single Market with barriers erected between its euro area and non-euro area constituents; the undermining of economic benefits associated with liberalised capital markets; and the marginalisation of non-euro area interests.

5.30 Respondents encouraged the UK, other Member States and EU institutions to take steps through the design of processes and policies to ensure that these risks do not arise. There were, however, also concerns which suggested that Treaty change should not be ruled out as this could be necessary to secure long-term safeguards for non-banking union Member States. The use of inter-governmental agreements has also highlighted that, in some instances, it may be easier for relevant Member States to agree measures outside the Treaty framework, subject to their compatibility with the EU Treaties and agreement from all Member States to any new tasks conferred on the EU Institutions. Evidence from some respondents, for instance the Rt Hon John Redwood MP, argued that the integration of the euro area and banking union called for the UK to repatriate banking regulation to the UK and establish a system of cooperation and information-sharing with the ECB and EU regulators, as is the case with US regulators.

5.31 Issues raised in evidence suggest that there are a number of areas where further specific consideration could be given, as set out below.

Ensuring the EU Manages a Europe of Variable Geometry

5.32 The creation of the banking union underlines the fact that the EU has become so large and diverse that 'variable geometry' is necessary.[5] While the ultimate impact of the banking union is hard to predict at this stage, it is likely to pose a number of challenges to the UK's interest in maintaining a central role of influence in an internationally competitive financial market in the EU, especially as it is possible that over time there will be a divergence of policy interests between participating and non-participating members.[6] EU institutions should, therefore, consider how to ensure that the increasingly diverse nature of Member States, including their different legal requirements in relation to the euro, are fully respected by EU processes, systems, policies and rules.

Ensuring Safeguards for Non-Euro Area Member States

5.33 There is no discernible evidence to date that euro area Member States are collectively caucusing on Single Market rules. However, if the interests of these Member States do start to converge, then it is likely that they will coordinate their positions on certain issues. While there was recognition by stakeholders of the safeguards secured to date (see paragraph 1.17 for more details), there were strong calls in the evidence for the Commission, Parliament and the EBA to defend the integrity of the Single Market, and for the UK to work with other non-euro area Member States to safeguard their collective interests.

Strengthening the Role of Single Market Institutions and Agencies

5.34 In order to ensure the needs of the banking union and the Single Market are recognised and protected, consideration should be given to how Single Market institutions, such as the EBA, can be strengthened, made sufficiently independent from other EU institutions, and given a clear mandate. For example, the banking union's binding supervisory manual will necessarily be significantly different and more detailed than the EBA's non-binding supervisory handbook. It will also be important to settle the respective roles of the ESAs as responsible for system management and of national supervisory authorities as responsible for day to day supervision.[7] Only on this basis, will the European System of Financial Supervision provide the organisational basis for applying the lessons of the financial crisis.

Preventing Discrimination Against Non-Euro Area Member States

5.35 The risk of discrimination against non-euro area Member States has already crystallised with the ECB location policy that euro-denominated financial instruments should be cleared only by a clearing house physically located in a euro area Member State. This is an example of a policy that would have the effect of creating a single market within the Single Market. Consideration should, therefore, be given to how to prevent such issues from arising again.

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5 'Variable geometry' is defined by the Commission as 'the term used to describe the idea of a method of differentiated integration which acknowledges that there are irreconcilable differences within the integration structure and therefore allows for a permanent separation between a group of Member States and a number of less developed integration units'. For further details see: Europa, *Summaries of EU Legislation* (n.d.). Available at: www.europa.eu/legislation_summaries/glossary/variable_geometry_europe_en.htm, accessed on 10 May 2014.

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

7 For further details on this point see HMT's, *UK response to the Commission Services consultation on the review of the European System of Financial Supervision*, 2013, available at: www.ec.europa.eu/internal_market/consultations/2013/esfs/docs/contributions/public-authorities/hm-treasury-united-kingdom_en.pdf, accessed on 2 June 2014.

The National Dimension

5.36 The role of the Member State within this allocation of roles and responsibilities between the global and EU levels is also important. Member States must comply with the rules adopted by the EU, but they must also contribute to them, both directly by being part of the legislative process, and indirectly, in the case of the UK, through its membership of the international bodies.

5.37 The UK authorities – HM Treasury, the Bank of England, the Prudential Regulatory Authority, the Financial Conduct Authority and the Pensions Regulator – are responsible for providing expertise to inform standard setting at the global level and rule-making at the EU-level. They also need to take steps to ensure that global standards and EU rules give sufficient consideration to characteristics of UK firms and markets and to the national and European interest in an internationally competitive and secure Single Market.

Improving the Application of the Principles of Subsidiarity and Proportionality

5.38 National authorities could consider how they can better demonstrate that financial sector risks are more effectively and efficiently addressed at the national level, for instance through better and more evidence-based analysis. As a result, this could strengthen the UK's ability to shift the focus of potential regulation towards different and better EU-level objectives.

5.39 Consideration could also be given to ways in which the link between the UK and European Parliaments could be strengthened in order to help improve accountability at the EU-level and to address inadequate consideration of subsidiarity and proportionality. As part of this, consideration could be given to the approach to scrutiny of financial services issues by the UK Parliament, including a potential increase in the use of reasoned opinions under the 'yellow card' procedure.[8]

Providing Guidance, and Justifying Gold-Plating and Front-Running

5.40 A common theme in the evidence to this review was concern that the UK authorities did not provide as much flexibility to market participants as authorities did in other Member States. In particular, concerns focused on the potential inadequate provision of guidance as well as the use of front-running and gold-plating, each of which could be detrimental to firms.

5.41 Consideration could, therefore, be given to ways in which the UK authorities could provide more and clearer guidance on EU rules to UK firms, and explain better the rationale, or reduce the negative impact, of front-running policies or gold-plating them. Some respondents noted and welcomed the Insurance Growth Action Plan, which set out that the UK authorities will avoid the use of gold-plating with regard to the implementation of Solvency II.

[8] National parliaments can object via a 'reasoned opinion' if they consider that an EU legislative proposal does not comply with the principle of subsidiarity. In a process known as a 'yellow card', if a sufficient proportion of national parliaments (one-third for proposals in areas including financial services legislation) issue such opinions, the proposal must be reviewed by its originator, for example, the Commission.

Enhancing the Engagement of UK Authorities in EU Policy-Making

5.42 Respondents strongly suggested that the UK authorities should consider ways in which they can engage earlier and more effectively with the EU institutions as well as with other Member States. As noted in paragraph 5.22, this could be achieved through greater UK representation in the Commission and ESAs, steps to support the high-quality and strong engagement of UK MEPs, and better coordination between UK authorities.

Enhancing the Competitiveness of the UK as a Global Centre for Financial Services

5.43 The UK authorities should continue to consider what steps could be taken to enhance the UK's competitiveness and role as an international finance centre. Action is being taken to enhance the UK's competitiveness through the creation of the Financial Services Trade and Investment Board, which recently published an overview of its progress against a range of priorities. For instance, the investment management strategy includes workstreams on tax, regulation and marketing, and the Insurance Growth Action Plan aims to grow the market share of UK insurers in high-growth economies and to attract inward investment. Steps have also been taken to establish the UK as a centre for trading in the Chinese currency renminbi and as a global centre for Islamic finance.

5.44 Further consideration should be given to ways in which the UK can strengthen its links with emerging markets and identify new opportunities to enhance its competitiveness, for instance through developing the UK's capacity to provide back and middle office functions for international financial services firms and identifying and pursuing high-value trade and investment opportunities in the UK financial technology sector.

5.45 In summary, this chapter has set out some of the future options and challenges that the UK may want to consider, in light of issues highlighted in evidence provided by respondents to this report. Key themes include: ensuring the EU single market in financial services is internationally competitive while maintaining financial stability and high standards of consumer protection; improving the EU's approach to financial services legislation and the quality of the policy-making process; protecting the integrity of the euro area and Single Market; ensuring adherence to the EU Treaties; facilitating trade and capital flows both within the EU and between the EU and global markets; ensuring the EU engages effectively with and adheres to international rules; and strengthening the UK's ability to influence global standards and EU rules. The achievement of these outcomes is likely to play a central role in securing the national interest in the area of financial services and the Free Movement of Capital.

Appendix I: Overview of Sectoral Views Submitted to this Report

The financial services industry covers a number of different sectors and markets, with widely differing characteristics in terms of services provided and client requirements. Some threads in the evidence were common to all sectors, such as the need for proportionate, well-evidenced legislative proposals based on robust cost-benefit analysis. But evidence also varied in focus across sectors. Some high-level sectoral views are outlined below. This is not a comprehensive summary, rather, it is intended to illustrate some of the general themes that have emerged. To understand the full range of views of organisations within and across sectors, the complete evidence base of individual responses, published alongside this report, should be consulted.

Banking and Finance[1]

Evidence received from the banking sector was consistent in the importance it attached to access to the Single Market, and the Free Movement of Capital, for UK-based financial institutions. EU access was also a key factor for foreign banks establishing a presence in the UK, along with other considerations such as the cluster effect of being a major financial centre, language, time zone and legal system. The amount and pace of legislative change was a concern, with a need for prioritisation in the future and a re-balancing from stability measures, necessary as they had been, to growth and competitiveness. In wholesale markets, increased harmonisation towards a single rulebook and supervisory culture was generally viewed in a positive light, though there was little appetite for the same in retail markets, given their national characteristics. Evidence also warned against the risks of gold-plating in the implementation at national level of EU legislation.

Building Societies[2]

Providing many similar services to banks, building societies are subject to much of the same EU legislation. However, evidence from this sector pointed to the essentially domestic nature of building societies and the markets they serve. Access to the single market in financial services was consequently less important; indeed, the cost of increased uniformity of rules to promote market access represented a burden with little compensating benefit. Front-running and gold-plating by the UK was also problematic, potentially resulting in additional compliance costs.

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1 AFB, BoA Merrill Lynch, Barclays, BBA, Citigroup, HSBC, JP Morgan, RBS, and Nomura, *submissions of evidence.*

2 BSA, *submission of evidence.*

Insurance[3]

Insurers felt that the Single Market and access to the EU was a significant benefit for the industry, underlining the need for the UK to remain proactively involved in shaping the policy and legislative agenda. Volume and detail of rule-making, for example with regard to Solvency II, was a concern. Although the adoption of Solvency II was generally welcomed, it had been a long and difficult process. Overly prescriptive legislation risked putting EU insurers at a competitive disadvantage, and there was a need to ensure EU legislation was aligned with global developments, so as not to place obstacles in the way of international business. Key differences between the life and non-life markets were not always recognised in legislative proposals.

Fund Management[4]

Recognition of the value of EU rule-making that promotes the Single Market, and global 'brands' more widely, for example with regard to collective investments, was tempered with concerns about the burden of regulation applying to the sector. The application of same or similar requirements between non-comparable sectors in the financial services industry was a concern set out in the evidence. The one-size-fits-all approach created particular difficulty with respect to proportionality, with the risk that requirements or standards set for banks, for example, were applied in unsuitable contexts. The AIFMD was cited by several respondents as an example of EU rule-making that was misconceived in some respects, extending regulation to certain entities in an inappropriate fashion. For some respondents, access to EU markets for investment managers remained difficult and there was a risk that EU legislation could harm wider access to global markets.

Market Infrastructure[5]

One market operator saw open access and passporting rights as a key enabler to conduct pan-European business. EU-level legislation was necessary to promote the single market in financial services. However, while acknowledging that some initiatives were driven by post-crisis international (G20) commitments, it was also noted that the volume and complexity of EU legislation was a factor. Furthermore, its impact could vary between Member States, placing further strain on proportionality, and raising questions about whether the process for legislative approval should reflect and take account of this imbalance of interest. Evidence from another respondent emphasised the need to recognise the specificities of individual markets, and the risks in this regard of a one-size-fits-all approach.

Workplace Pension Providers[6]

Evidence from this sector acknowledged the role the Single Market could play in facilitating access to investment opportunities and services, though did not identify any great demand for measures to promote the cross-border provision of pensions to workers in other Member States. Moreover, the differing characteristics across Member States of the pensions sector argued for a strong national dimension to decision-making. The use of the Single Market competence as the legal basis for the IORP Directive raises questions of subsidiarity as pensions policy is a matter for Member States. The argument used in justification, that harmonisation will help foster more cross-border schemes, ignores the possibility that there is little demand for cross-border schemes.

[3] ABI, AIG, AILO, BIBA, IUA, ILAG, Lloyds of London, RSA and Standard Life, *submissions of evidence.*

[4] BVCA, Lord Flight and IMA, *submissions of evidence.*

[5] BATS Chi-X and LME, *submissions of evidence.*

[6] NAPF, *submission of evidence.*

Professional and support services[7]

Evidence from bodies providing professional services (or organisations representing such bodies) to the financial services industry highlighted concerns about use of appropriate legal bases for EU action, and the legislative process. In the latter context, attention was drawn to the consultation process for new legislation, which was criticised for being in some cases too short, or even non-existent. The difficulty of amending Level 1 legislation was noted, including the 'hard-wiring' of implementation dates, which could lead to impractical deadlines, for example in the development of Level 2 measures by the European Supervisory Authorities. Lack of clarity was a problem in several pieces of EU legislation. One respondent also felt that Member States retained broad scope for discretionary action to obstruct changes in ownership despite EU action in areas such as 'golden share' arrangements, leading to instances of protectionism within and outside the EU.

[7] Bar Council, CLLS, ICAEW, Law Society and Moodys, *submissions of evidence.*

Annex A: Abbreviations

ABI – Association of British Insurers

ACT – Association of Corporate Treasurers

AFB – Association of Foreign Banks

AFME – Association for Financial Markets in Europe

AGO – Advocate General's Opinion

AIFMD – Alternative Investment Fund Management Directive

AILO – Association of International Life Offices

APFA – Association of Professional Financial Advisors

BBA – British Bankers' Association

BCBS – Basel Committee on Banking Supervision

BCCL – British Chamber of Commerce for Luxembourg

BIBA – British Insurance Brokers' Association

BIS – Department for Business, Innovation and Skills

BRICS – Brazil, Russia, India, China and South Africa

BRRD – Bank Recovery and Resolution Directive

BSA – Building Societies Association

BTS – Binding Technical Standard

BVCA – British Private Equity & Venture Capital Association

CBI – Confederation of British Industry

CCD – Consumer Credit Directive

CCP – Central Counterparty

CEPR – Centre for Economic Policy Research

CER – Centre for European Reform

CLLS – City of London Law Society Regulatory Law Committee

CoRep – Common Reporting

CRA – Credit Rating Agency

CRD – Capital Requirements Directive

CRR – Capital Requirements Regulation

CSDR – Central Securities Depositories Regulation

CSMAD – Criminal Sanctions against Market Abuse Directive

CVA – Credit Valuation Adjustment

EBA – European Banking Authority

ECB – European Central Bank

ECJ – Court of Justice of the European Union

ECON – Economic and Monetary Affairs Committee of the European Parliament

EEA – European Economic Area

EIOPA – European Insurance and Occupational Pensions Authority

EMIR – European Market Infrastructure Regulation

EP – European Parliament

ERC – Equity Release Council

ESA – European Supervisory Authority

ESMA – European Securities and Markets Authority

ESRB – European Systemic Risk Board

EU – European Union

EURIBOR – Euro Interbank Offered Rate

FBCC – Franco-British Chamber of Commerce

FCA – Financial Conduct Authority

FCA FSPP – FCA Financial Services Practitioner Panel

FCA SBPP – FCA Smaller Business Practitioner Panel

FDI – Foreign Direct Investment

FinRep – Financial Reporting

FPC – Financial Policy Committee of the Bank of England

FSA – Financial Services Authority

FSB – Financial Stability Board

FSCP – Financial Services Consumer Panel

FSUG – Financial Services User Group

FTA – Free Trade Agreement

FTT – Financial Transaction Tax

G20 – Group of 20 countries

GATS – General Agreement on Trade in Services

GDP – Gross Domestic Product

HMG – HM Government

HMT – HM Treasury

IAIS – International Association of Insurance Supervisors

ICAEW – Institute of Chartered Accountants in England and Wales

ICB – Independent Commission on Banking

ILAG – Investment and Life Assurance Group

IMA – Investment Management Association

IMD – Insurance Mediation Directive

IMF – International Monetary Fund

IORP – Institutions for Occupational Retirement Provision

IOSCO – International Organization for Securities Commissioners

IRSG – International Regulatory Strategy Group

IUA – International Underwriting Association of London

LIBOR – London Interbank Offered Rate

LME – London Metal Exchange

LTF – Long-Term Fund

MAD – Market Abuse Directive

MAR – Market Abuse Regulation

MCD – Mortgage Credit Directive

MEP – Member of European Parliament

MiFID – Markets in Financial Instruments Directive

MiFIR – Markets in Financial Instruments Regulation

MMF – Money Market Fund

MP – Member of UK Parliament

NAO – National Audit Office

NAPF – National Association of Pension Funds

NGO – Non-Governmental Organisation

OECD – Organisation for Economic Co-operation and Development

ONS – Office for National Statistics

OTC – Over The Counter (Derivatives)

PAYE – Pay As You Earn

PE – Private Equity

PRA – Prudential Regulatory Authority

PRIPs – Packaged Retail Investment Products

PSD – Payment Services Directive

RBS – Royal Bank of Scotland Group

RDR – Retail Distribution Review

RSA – Royal Sun Alliance Insurance Group

SEPA – Single Euro Payments Area

SME – Small- and Medium-sized Enterprise

SRB – Single Resolution Board

SRM – Single Resolution Mechanism

SSB – Standard Setting Body

SSM – Single Supervisory Mechanism

TEU – Treaty on the European Union

TFEU – Treaty on the Functioning of the European Union

TTIP – Transatlantic Trade and Investment Partnership

UCITS – Undertakings for Collective Investment in Transferable Securities

UNCTAD – United Nations Conference on Trade and Development

VC – Venture Capital

WMA – Wealth Management Association

WMBA – Wholesale Markets Brokers' Association

WTO – World Trade Organisation

Annex B: List of Evidence Received (including oral evidence)

AIG

All-Party Parliamentary Group on Modern Languages

Association for Financial Markets in Europe

Association of British Insurers

Association of Corporate Treasurers

Association of Foreign Banks

Association of International Life Offices

Association of Professional Financial Advisors

Baillie Gifford

Bank of America Merrill Lynch

Bannerman MEP, David Campbell

Barclays

BATS Chi-X Europe

Bowles MEP, Sharon

British Bankers' Association

British Chamber of Commerce for Luxembourg

British Insurance Brokers' Association

British Private Equity & Venture Capital Association

British Property Federation

British Standards Institution

Building Societies Association

Business for Britain

CBI

Centre for European Reform

Citi

City of London Law Society Regulatory Law Committee

Consumer Council, Northern Ireland

Equity Release Council

European Movement Council (Graham Bishop)

FCA Financial Services Practitioner Panel

FCA Smaller Business Practitioner Panel

Financial Services Consumer Panel

Flight, Lord Howard

Franco-British Chamber of Commerce workshop

Fresh Start

General Council of the Bar of England and Wales

GlaxoSmithKline

Green, David

Horsley, Dr Thomas (Liverpool Law School)

HSBC

Institute of Chartered Accountants in England and Wales

Insurance industry roundtable

International Regulatory Strategy Group

International Underwriting Association of London

Investment and Life Assurance Group

Investment Management Association

JP Morgan

Law Society of England and Wales and Law Society of Scotland

Legal & General

Lloyd's of London

London Metal Exchange

Moody's

National Association of Pension Funds

Nomura

Payments Council

Redwood MP, Rt Hon John

Reed Elsevier

Royal Bank of Scotland Group

RSA Insurance Group

Scottish Government

Smit, Daniel

Standard Life

TheCityUK (addendum to IRSG)

UK Crown Dependencies

Unattributed member of the public

Wealth Management Association

Welsh Government

Wholesale Markets Brokers' Association

This report also drew on relevant pieces of evidence submitted to other reports in the Review of the Balance of Competences:

Civitas (Free Movement of Goods report)

Freedom Association (Trade and Investment report)

TheCityUK (Trade and Investment report)

Any reference to MEPs reflect their status at the time of the Call for Evidence period.

Annex C: Engagement Events

BNY Mellon, Manchester, launch event, 22 October 2013

Attendees:

- BNY Mellon
- Dr Thomas Horsley, Liverpool Law School
- KPMG
- RSA Insurance Group
- Cicero Group
- TheCityUK
- John Ashcroft, pro.manchester/Greater Manchester Chamber of Commerce

City of London Corporation, Old Library Guildhall London, launch event, 24 October 2013

Over 100 attendees in the audience, speakers included:

- City of London Corporation
- RSA Insurance Group
- Gerard Lyons, Mayor of London's Chief Economic Advisor
- Allianz Global Investors
- Open Europe

CSFI, London Capital Club, roundtable, 6 November 2013

Attendees:

- CSFI
- Graham Bishop
- Brunswick Group
- Open Europe
- Citi

- Deloitte
- WMBA
- Zurich Insurance
- PwC
- FCA
- JP Morgan
- ICMA
- Barclays
- Fitch Ratings
- Kreab Gavin Anderson
- Bank of Italy
- AFME
- Bank of Japan
- Lloyds Banking Group
- BBA
- John Bullard
- Huw Jones
- Alexander Merriman
- Embassy of Switzerland
- Genworth Financial
- Christine Brentani
- European Commission
- Standard Life
- Holman Fenwick Willan
- Credit Suisse
- Vanessa Knapp
- BSA
- James Perham-Marchant
- London School of Economics

International Regulatory Strategy Group Experts & Engagement Group, London, roundtable, 7 November 2013

Attendees:

- TheCityUK
- City of London Corporation
- Ernst and Young
- IMA
- Lloyds Banking Group
- Finance and Leasing Association
- Schroders
- BBA
- JP Morgan
- Wealth Management Association
- PwC
- Aviva
- Prudential
- RBS
- KPMG
- Thomson Reuters

UK Permanent Representative's Residence, Brussels, panel discussion, 21 November 2013

Attendees:

- Sharon Bowles, MEP
- EFAMA
- CEPS
- Deutsche Bank
- European Banking Federation
- European Commission
- Open Europe
- FleishmanHillard
- Cicero
- Goldman Sachs
- Afore Consulting

- European Association of Corporate Treasurers
- Santander
- KPMG
- European Parliament
- Barclays
- AmCham EU
- BNP Paribas
- HSBC
- City of London Corporation
- Burson Marsteller
- BBA
- AFME
- Finance Watch
- FTI Consulting
- Citigroup
- Brunswick Group
- KPMG
- Lloyds Banking Group
- Markit
- Kreab Gavin Anderson
- CBI
- EVCA
- Freshfields Bruckhaus Deringer
- SWIFT
- Prudential
- Steptoe
- Standard Chartered
- ISDA
- State Street
- JP Morgan
- EUSIPA
- The ICE

Cicero Group, London, roundtable, 3 December 2013

Attendees:

- Cicero Group
- Chartered Insurance Institute
- CBI
- AFME
- Nomura
- Legal & General

Franco-British Chamber of Commerce, Paris, roundtable, 3 December 2013

Attendees:

- Lloyd's of London
- KPMG
- HSBC
- Barclays
- Franco-British Chamber of Commerce

Frankfurt, roundtable, 4 December 2013

Attendees:

- Association of Foreign Banks
- European Central Bank
- Commerzbank
- DB Research
- DLA Piper
- FMSA Bundesanstalt für Finanzmarktstabilisierung
- Frankfurt Main Finance
- Frankfurt Rhein Main
- Pericap AG
- Royal Bank of Scotland
- BDO AG Wirtschaftsprüfungsgesellschaft
- British Airways
- Cleary Gottlieb Steen & Hamilton LLP
- Deutsche Bank AG
- Standard Chartered

UK Embassy, Rome, presentation and discussion, 5 December 2013

Attendees:

- European Commission
- Ministero dell'Economia
- Bank of Italy
- Embassy of Romania, Rome
- Banca d'Italia
- Embassy of Ireland, Rome
- Embassy of Luxembourg, Rome
- ANIA
- Assosim
- Embassy of France, Rome
- British Council
- Embassy of Hungary, Rome
- UniCredit
- Mandarin Capital Partners
- Dexia Crediop

Citigroup/Invest Northern Ireland, Belfast, roundtable, 6 December 2013

Attendees:

- KPMG
- Ulster Business School
- Citigroup
- A&L Goodbody
- FLSP
- PFPTime
- First Derivatives
- Mercer
- Titanic Quarter Limited
- Belfast Metropolitan College
- Institute of Directors
- NI Chamber of Commerce
- Allstate Northern Ireland

- Herbert Smith Freehills
- Invest NI
- Northern Ireland, Department of Finance and Personnel
- Northern Ireland, Department of Enterprise, Trade and Investment
- Northern Ireland, Department for Employment and Learning

Scottish Financial Enterprise, Edinburgh, roundtable, 9 December 2013

Attendees:

- Scottish Financial Enterprise
- Baillie Gifford
- Royal London Group
- Standard Life
- Aberdeen Asset Management
- John Purvis CBE
- Morgan Stanley
- Shepherd and Wedderburn

British Institute of International and Comparative Law (BIICL), London, conference, 10 December 2013

There were 53 attendees including the following speakers:

- Jane Welch, BIICL
- Guy Morton, Freshfields Bruckhaus Deringer
- Professor Jennifer Payne, University of Oxford
- Deborah Sabalot, Deborah Sabalot Consulting
- Professor Takis Tridimas, King's College London
- Jonathan Overett-Somnier, European Banking Authority
- Professor Kern Alexander, University of Zurich, University of Cambridge
- Alexandria Carr, Mayer Brown
- Professor Niamh Moloney, London School of Economics

Corporate meeting, London, roundtable, 10 December 2013

Attendees:

- Grosvenor
- Energy UK
- BP
- Just Retirement

Aviva, London, roundtable, 11 December 2013

Attendees:

- ABI
- Aviva
- CII
- City of London Corporation
- Clifford Chance
- International Underwriting Association of London
- Legal and General
- Lloyds of London
- LV
- Norton Rose
- Swiss Re
- Prudential
- RSA

HM Treasury, London, better regulation roundtable, 10 March 2014

Attendees:

- British Private Equity and Venture Capital Association
- Wealth Management Association
- Zurich
- Crescendo Advisors Ltd
- Mayer Brown
- Standard Life
- Confederation of British Industry
- Association of Corporate Treasurers
- JP Morgan
- Financial Conduct Authority
- City of London Corporation
- British Bankers' Association

Bilateral meetings:

- FCA Small Business Panel, 4 November 2013
- FCA Consumer Panel, 5 November 2013
- Association of Professional Financial Advisors, 18 November 2013
- European Private Equity and Venture Capital Association, 28 November 2013
- FCA Practitioner’s Panel, 3 December 2013
- National Association of Pension Funds, 9 January 2014
- British Bankers’ Association, 14 January 2014
- Association for Financial Markets in Europe, 15 January 2014
- Association of British Insurers, 15 January 2014
- Paul Morton (Head of Group Tax, Reed Elsevier), 23 January 2014
- Jaguar-Land Rover, 24 January 2014

Annex D: Other Sources

The following list is not exhaustive but sets out some of the main sources drawn upon in preparing the analysis:

Bowles, Sharon, Keynote Speech at the 2nd International Forum on Responsible Banking and Finance at Cass Business School: *Responsible Banking and Finance – The Way Forward 24 June 2013* (2013).

British Standards Institution, *Backing Market Forces: How to Make Voluntary Standards Markets Work for Financial Services Regulation* (2013).

Business Register and Employment Survey (2008).

Cecchini et al, *The European Challenge, 1992: The Benefits of a Single Market* (1988).

Centre for European Reform, *The Consequences of Brexit for the City of London* (2014).

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Annex E: Treaty Bases Most Relevant to Financial Services and the Free Movement of Capital

This Annex sets out the Treaty bases most relevant to financial services and the Free Movement of Capital.

Article 53 TFEU

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

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

Article 63 TFEU

Article 63 TFEU specifies that all restrictions on the movement of capital and on payments between Member States and between Member States and Third Countries shall be prohibited. This is subject to very limited exceptions, mainly for the savings for certain existing restrictions under Article 64 TFEU, and the narrow public policy-related exceptions in Article 65 TFEU.

Article 64 TFEU

Notwithstanding the generality of Article 63 TFEU, Article 64 has the effect of grandfathering – that is, carrying forward – any restrictions on the movement of capital under national or EU law which were in existence on 31 December 1993 applicable to the movement of capital to and from Third Countries involving direct investment, as well as establishment, provision of financial services or the admission of securities to capital markets. The Council has power under Article 64(2) to adopt measures applicable to the movement of capital to and from Third Countries in the same areas, with the proviso (Article 64(3)) that measures involving a 'step backwards' require unanimity and consultation of the European Parliament. Neither of these latter powers has been exercised.

Article 65 TFEU

Again notwithstanding the generality of Article 63, Article 65 TFEU safeguards the powers of Member States, in particular in the areas of taxation and prudential supervision of financial institutions, so long as these powers are exercised in a non-discriminatory and non-restrictive way. Article 65(1)(b) also contains safeguards for measures justified on ground of public policy and security.

Article 66 TFEU

Prior to the Treaty of Maastricht, the EC Treaty contained a number of mechanisms for adopting safeguard measures in respect of capital movements. All these powers have now been swept away, with the exception of what is now Article 66 TFEU. This provides for the Council to take safeguard measures with regard to Third Countries for a maximum of six months 'in exceptional circumstances' and if such measures are 'strictly necessary'. This power has not been exercised.

Article 113 TFEU

Article 113 TFEU confers on the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, a power to adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation.

This power may be used only to the extent that such harmonisation is necessary to ensure the establishment and functioning of the Single Market and to avoid distortion of competition. Article 113 TFEU has been considered in *Review of the Balance of Competences between the United Kingdom and the European Union: Taxation*, but it is noted in the context of this report as the Treaty base for the Commission's proposal for a harmonised Financial Transaction Tax.

Articles 114 and 115 TFEU

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

Article 114 TFEU allows for approximation measures 'which have as their object the establishment and functioning of the Single Market'. The power to legislate in Article 114 has been central to the development of the Single Market, as it permits Directives, Regulations or Decisions to be adopted by a qualified majority (under the ordinary legislative procedure). It is, however, subject to certain express exclusions – for example, it may not be used to adopt fiscal provisions.

Although Article 114 TFEU is undoubtedly broad, there has been controversy about its outer limits. The ECJ has clarified that it is not enough simply to show that there are disparities between national laws. It must also be shown that removing those disparities would improve the functioning of the Single Market. Article 114 TFEU has been relied on as a Treaty basis in a number of areas related to financial services, for example, the Financial Collateral Arrangements Directive, the Regulations establishing the European Supervisory Authorities (ESAs), and the current proposal for a Regulation on central securities depositories and improving securities settlement in the EU.

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

Article 127(6) TFEU

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

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

Article 345 TFEU

The scope of Article 345 TFEU – relating to some of the 'general' exceptions of the Treaty – has been very narrowly circumscribed by the case law of the ECJ. Although the system of property ownership continues to be a matter for each Member State under Article 345 TFEU, the Court has said that that provision does not have the effect of exempting the Member States' systems of property ownership from the fundamental rules of the Treaty.

For example, Member States may choose how to exercise their ownership of public resources but Article 345 does not relieve them of their duty to comply with the rules relating to the Free Movement of Capital. Nor can Member States invoke Article 345 to justify obstacles to investment in privatised undertakings.

Free Movement of Capital, as a fundamental principle of the Treaty, may be restricted only by national rules which are justified by reasons referred to in Article 64(1) TFEU or by overriding requirements of the general interest. Furthermore, in order to be so justified, the national legislation must be suitable for securing the objective which it pursues and must not go beyond what is necessary in order to attain it, so as to accord with the principle of proportionality.

Article 352 TFEU

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

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

Annex F: Key EU Financial Services Legislation

BANKING SECTOR

Regulatory capital

Level 1

- Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Capital Requirements Directive (CRD) IV).
- Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (Capital Requirements Regulation (CRR)).
- Repealed: Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast); Directive 2009/49/EC on the capital adequacy of investment firms and credit institutions.
- The above two Directives were together referred to as 'the Capital Requirements Directive' and had been amended by the following Directives which are also no longer in force having been superseded by CRD IV and CRR: CRD3: Directive 2010/76/EU; and CRD2: Directive 2009/111/EC.

Treaty Base

- CRD IV has as its Treaty base Article 53 TFEU, the CRR has as its Treaty base Article 114 TFEU.

Description

- CRD IV, together with the CRR, contain rules on the authorisation of banks and investment firms, and the prudential supervision of banks and investment firms. They include prudential rules on such matters as capital, liquidity and credit risk, and set the framework for supervision by national competent authorities.

Prudential supervision of financial conglomerates

Level 1

- Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (Directive 2002/87/EC) (FICOD).
- FICOD has been amended by: Directive 2005/1/EC; Directive 2008/25/EC; and Directive 2010/78/EU.

Treaty Base

- Article 47(2) TEC (now Article 53(1) TFEU).

Description

- FICOD sets out the rules for the prudential supervision of financial conglomerates and promotes closer coordination between the supervisory authorities for the individual sectors and the exchange of information between them.

Mortgages

Level 1

- Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property (MCD).

Treaty Base

- Article 114 TFEU.

Description

- The MCD aims to minimise consumer detriment in mortgage markets and increase the harmonisation of mortgage regulation across the EU, by setting out the requirements mortgage lenders and intermediaries must meet when providing or advising on a mortgage for a consumer.

Deposit guarantee schemes

Level 1

- Proposed Directive to amend Directive 2009/14/EC (under negotiation); Directive 2009/14/EC amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay; Directive 94/19/EC on deposit guarantee schemes (DGSD).

Treaty Base

- Article 47(2) TEC (now Article 53(1) TFEU).

Description

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

Reorganisation and winding up of credit institutions

Level 1

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

Treaty Base

- Article 47(2) TEC.

Description

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

Recovery and resolution of credit institutions and investment firms

Level 1

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

Level 2

- Various level 2 measures required to be adopted under the Directive.

Treaty Base

- Article 114 TFEU.

Description

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

Single Supervision Mechanism

Level 1

- Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions ('ECB Regulation').
- Regulation amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No 1024/13 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions ('EBA Amending Regulation').

Treaty Base

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

Description

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

Single Resolution Mechanism

Level 1

- Commission proposal dated 10 July 2013 for a Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending the EBA Regulation (EU) No 1093/2010 ('SRM Regulation'). Political agreement was reached in April 2014. The text is currently being considered by lawyer linguists.

Level 2

- Various level 2 measures envisaged in the proposal.

Treaty Base

- Article 114 TFEU.

Description

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

INSURANCE SECTOR

Occupational retirement schemes

Level 1

- Directive on the activities and supervision of institutions for occupational retirement provision (Directive 2003/41/EC) (IORP). On 27 March 2014 the Commission adopted a proposal for a Directive on the activities and supervision of institutions for occupational retirement provision: 2014/0091 (IORP 2).

Treaty Base

- Article 45(2) EC and Article 95(1) EC; Articles 53, 62 and 114(1) TFEU.

Description

- The general objective is to facilitate the development of occupational retirement savings by: (i) ensuring the soundness of occupational pensions and better protecting scheme members and beneficiaries; (ii) better informing members and beneficiaries; (iii) removing obstacles to cross-border provision so that funds can operate across the Single Market; and (iv) encouraging funds to provide long-term investment to the wider European economy.

Sale of insurance and reinsurance

Level 1

- Commission proposal for a Directive on Insurance Mediation (recast), replacing Directive 2002/92/EC (IMD II), published 3 July 2012.

Treaty Base

- Article 53(1) and 62 TFEU.

Description

- The original IMD established common standards and a registration regime for the sale of insurance and reinsurance across the EU by intermediaries and brokers, covering professional requirements, pre-sale disclosures and consumer protection measures. The proposed IMD II extends the scope of the regime to include direct sales and imposes new requirements intended to increase consumer protection, particularly for insurance investment products.

European Insurance Contract Law

Level 1

- (Working group stage).

Treaty Base

- Article 114 TFEU is expected to be the legal base when a proposal is submitted by the Commission. It is the base for the Common European Sales (of goods) Law proposal, which is analogous to this.

Description

- The Commission has convened a working group of experts to discuss a possible new 'optional' system of European insurance contract law, which parties to the insurance contract could select as the governing law for the contract. This seems likely to lead to a Commission legislative proposal eventually.

Supervision and stability of insurance providers

Level 1

- Solvency II – Directive (EC) No. 2009/138. The provisions of Solvency II start to apply in two stages (April 2015 and January 2016). Consequently, the current substantive law in this area is still set by the pre-Solvency II Directives, which are listed below.
- Pre-Solvency II Directives (currently in force, but due to be repealed when Solvency II applies): 64/225/EEC; 73/239/EEC; 73/240/EEC; 76/580/EEC; 78/473/EEC; 84/641/EEC; 87/344/EEC; 88/357/EEC; 92/49/EEC; 98/78/EC; 2001/17/EC; 2002/83/EC; and 2005/68/EC.

Level 2

- None as yet, although the Commission is currently drafting Delegated Acts, expected for publication in Q3 2014. EIOPA has also begun consulting on Implementing Technical Standards in areas empowered by the Directive.

Treaty Base

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

Description

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

MARKETS

Investment Firms and Trading Venues

Level 1

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

Level 2

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

Treaty Base

- Article 47 TEC (now Art 53 TFEU).

Description

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

Investment Firms and Trading Venues

Level 1

- Markets in Financial Instruments Directive (Directive 2014/65/EU) (MiFID II) Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014) (MiFIR). This legislation has been passed, but in most instances it will not apply until 2016 at the earliest.

Level 2

- Various level 2 measures envisaged in the legislation, but are yet to be made.

Treaty Base

- Article 53 TFEU (MIFID II) and Article 114 TFEU (MIFIR).

Description

- The review of MiFID has led to a new Directive and Regulation to further integrate the regulation of financial markets. MiFID II builds on MiFID obligations for the authorisation of investment firms, conduct of business obligations (investor protection), in addition to continuing the regime for the authorisation and regulation of Regulated Markets and Multilateral Trading Facilities. It continues the right to passport services across the EU. MiFID II will introduce the regulation of a new type of trading venue, the Organised Trading Facility to increase the use of transparent venues for trading. Organised Trading Facilities will differ from other authorised venues in that they may exercise discretion in their operation, though access to them must be available on a non-discriminatory basis. MiFID II will also introduce requirements on trading venues to impose position limits on commodity trades and contains provisions concerning the provision of investment services by third country firms through branches in the EU, though these are not mandatory. In addition, MiFID II will provide for the regulation of providers of financial market data reporting services.

- MiFIR, which will be directly applicable in all Member States when it takes effect, proposes to extend the existing trade transparency rules (currently in MiFID) to cover non-equity markets and the new Organised Trading Facility. MiFIR will implement the G20 agreement to require certain derivatives to be traded on trading venues (which complements the obligation to clear certain derivatives under EMIR (648/2012/EC)). It also provide for rights of access to trading venues, central counter parties and benchmarks to facilitate competition in the market. MiFIR also contains provisions to enable third country firms to be recognised in the EU and receive passporting rights to provide services across the EU to professional clients. Finally, MiFIR will give powers of intervention for the European Securities and Markets Authority to set position limits on commodity trades or intervene to restrict financial activities in emergency situations.

- The MiFID II and MiFIR package of legislation is complementary. The elements which have been placed in MiFIR are to ensure absolute harmonisation of regulation across the EU. Compared to the scope of MiFID, the principle areas where MiFID II and MiFIR will significantly change the balance of competences between EU regulation and that enjoyed at a national level will be the proposed powers of ESMA to intervene in financial markets in an emergency.

Listing/admission of securities

Level 1

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

Treaty Base

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

Description

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

Issuance of securities on regulated markets

Level 1

- Prospectus Directive – (Directive 2003/71/EC, amended in 2010 by Directive 2010/73/EU, Directive 2010/78/EU and Directive 2013/50/EU).

Level 2

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

Treaty Base

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

Description

- The Directive establishes common rules across the EU for the issuance of both equity and non-equity securities on regulated markets, the requirement for a prospectus and the content of that prospectus. In particular, the Directive, together with the Level 2 Regulation adopted pursuant to it, establishes detailed rules regarding the information which is to be provided to potential investors and the way in which it is to be provided. In recognition of the investor-protection function of this measure, less onerous standards are applied when an issue is targeted only at qualified investors. It also introduced the ability for a prospectus once approved in one Member State to be valid across the EU, giving issuers a 'passport' across the EU capital markets. The measures have been fully incorporated into FSMA. Significant amendments were made to the Directive in 2010, and correspondingly to FSMA and FSA rules in 2011 and 2012. These amendments improved and simplified the application of the Directive, and included changes to reduce administrative burdens on issuers whilst maintaining investor protection. In November 2013, a relatively minor amendment was made to the Directive by Directive 2013/50/EU which amends the Trasnparency Directive (see below).

General transparency requirements for listed companies

Level 1

- Transparency Directive – (Directive 2004/109/EC as amended by Directive 2010/73 EU and Directive 2010/78/EU). The Directive has been further amended by Directive 2013/50/EU, which entered into force on 26 November 2013. Member States have two years to implement the amendments.

Level 2

- Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.
- Regulation (EC) No. 1569/2007 establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC.

Treaty Base

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

Description

- The existing Transparency Directive provides for the harmonisation of transparency requirements across the EU by requiring issuers of securities admitted to trading on a regulated market to disclose a minimum level of information to the public. It built on and amended the Admissions Directive (2001/34/EC) (see above). The main requirements of the existing Transparency Directive include:
  - companies to publish periodic financial reports (an annual report, a half yearly report and two interim statements for each half of the financial year);
  - major shareholders to disclose their holdings and entitlements to shares when these cross certain thresholds and the relevant company to disclose this information to the market; and
  - companies to release information useful to investors on a fast and pan-European basis. The Directive also establishes a framework for the central storage of such information.
- The recent amendments to the Transparency Directive made by Directive 2013/50/EU aim to improve the existing regime, and its main provisions include:
  - clarifying the circumstances in which Member States can require the publication of periodic financial information on a more frequent basis than annual financial reports and half-yearly financial reports;
  - amendments to a Member State's ability to impose stricter or additional requirements in connection with notification thresholds, aggregation of holdings of voting rights and exemptions to the notification requirements, broadening the definition of financial instruments subject to notification requirement;

- the process for calculating voting rights in relation to financial instruments with similar economic effect to holding shares and entitlements to acquire shares which provide for cash settlement;
- clarifying the disclosure obligations in relation to payments made to Governments by extractive industries (e.g. as oil, gas and mining) or loggers of primary forests;
- amendments to the definition of home Member State aimed at ensuring all issuers are supervised by a competent authority of a Member State; and
- requiring the development and establishment by January 2018 of a web portal providing an EU level access point to regulated information.

Shareholder rights

Level 1

- Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies. On 9 April the Commission published a proposal for a second Directive (amending Directive 2007/36/EC) as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement: 2014/0121.

Treaty Base

- Article 50(2) (g) and 114 TFEU.

Description

- This Directive has the following specific objectives: (i) to increase the level and quality of engagement of asset owners and asset managers with their investee companies; (ii) to create a better link between pay and performance of company directors; (iii) to enhance transparency and shareholder oversight on related party transactions; (iv) to ensure reliability and quality of advice of proxy advisors; and (v) to facilitate transmission of cross-border information (including voting) across the investment chain in particular through shareholder identification.

Market Abuse

Level 1

- Market Abuse Directive – (Directive 2003/6/EC). A new market abuse package, replacing Directive 2003/6/EC, has recently been adopted by the EU legislature. It consists of a Market Abuse Regulation (Regulation (EU) No 596/2014) (MAR) and a Market Abuse Directive (Directive 2014/57/EU) (MAD). Political agreement was reached on MAR in July 2013 and on MAD in December 2013. The UK Government has stated that it will exercise its right to not opt in to the new Market Abuse Directive.

Level 2

- Directive (EC) No. 2003/124 relating to the definition and public disclosure of inside information, and the definition of market manipulation; Directive (EC) No. 2003/125 relating to the fair presentation of investment recommendations and the disclosure of conflicts of interest; Regulation (EC) No. 2273/2003 relating to exemptions for buy-back programmes and stabilisation of financial instruments; Directive (EC) No. 2004/72 relating to accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions; and Directive (EU) No. 2010/466.

- MAR mandates and envisages the adoption of Level 2 regulations by the Commission on the basis of draft Binding Technical Standards proposed by ESMA.

Treaty Base

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

Description

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

Credit Ratings Agencies Regulation

Level 1

- Regulation (EC) 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies as amended by Regulation 513/2011 and Regulation 462/2013.

Treaty Base

- Article 95 TEC (now Article 114 TFEU).

Description

- The Regulation establishes a common regulatory approach in order to enhance the integrity, transparency, responsibility, good governance and reliability of credit rating activities. In particular, as a result of the amendments made by Regulation 513/2011, the European Secuities and Markets Authority is exclusively responsible for the registration and supervision of Credit Rating Agencies in the European Union.

Short Selling Regulation

Level 1

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

Treaty Base

- Article 114 TFEU.

Description

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

CLEARING AND SETTLEMENT

Clearing

Level 1

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

Level 2

- Commission Delegated Regulation 149/2013 on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty (CCP). Commission Delegated Regulation 152/2013 on capital requirements for CCPs; Commission Delegated Regulation 153/2013 on requirements for CCPs; other RTSs are also in preparation.

Treaty Base

- Article 114 TFEU.

Description

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

Settlement

Level 1

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

Treaty Base

- Article 114 TFEU.

Description

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

ASSET MANAGEMENT

Individual portfolio management

Level 1

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

Treaty Base

- Article 53 TFEU (MIFID II) and Article 114 TFEU (MIFIR).

Description

- Individual portfolio management is an ‘investment service’ under MiFID/MiFIR—see separate summary in ‘Markets’ section.

Collective investment schemes

UCITS IV

Level 1

- Undertakings for Collective Investment in Transferable Securities Directive 2009/65/EC (UCITS IV).

Level 2

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

Treaty Base

- Article 53 TFEU.

Description

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

UCITS V

Level 1

- UCITS V (Commission proposal dated 3 July 2012). Political agreement was reached on the text in late-February 2014 and the text is currently being considered by the lawyer linguists.

Treaty Base

- Article 53 TFEU.

Description

- Amends Directive 2009/65/EC in relation to depositaries, remuneration of fund managers, and sanctions for breaching Directive requirements.

Level 1

- UCITS VI (consultation document published 26 July 2012).

Description

- Questions relate to eligible assets for UCITS fund investment; efficient portfolio management techniques; OTC derivatives; extraordinary liquidity management tools; depositary passporting; money market funds; long term investment funds. Separate proposals have since been published or are expected on the last two topics (see below).

AIFMD

Level 1

- Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD).

Level 2

- Regulation 231/2013 (supplementary provision in reaction to a range of matters).
- Regulation about determination of open or closed-ended nature of funds (yet to be published in the EU's Official Journal).
- Regulation 447/2013 (procedure for opt-in of sub-threshold AIFMs); and Regulation 448/2013 (non-EU AIFMs).

Treaty Base

- Article 53 TFEU.

Description

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

EUVeCa Funds

Level 1

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

Treaty Base

- Article 114 TFEU.

Description

- Lighter-touch harmonised regime for managers of venture capital funds in place of the requirements of AIFMD. Managers who comply will be able to market their EUVeCa funds across the EEA on the basis of a single authorisation.

EUSEFs

Level 1

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

Treaty Base

- Article 114 TFEU.

Description

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

European Long Term Investment Funds

Level 1

- Regulation on European Long Term Investment Funds (Commission proposal dated 1 July 2013; working parties are currently ongoing).

Treaty Base

- Article 114 TFEU.

Description

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

MMFs

Level 1

- Regulation on Money Market Funds adopted 4 September 2013. The European Parliament recently voted to delay further consideration of this file until the new Parliament is convened after the Parliamentary elections in mid-2014.

Treaty Base

- Article 114 TFEU.

Description

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

Packaged retail investment products (PRIPs)

Level 1

- Regulation on key information documents for investment products. The Council's final compromise package was submitted to the European Parliament on 31 March 2014.

Treaty Base

- Article 114 TFEU.

Description

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

PAYMENT SERVICES AND E-MONEY

Payment services

Level 1

- Commission proposal for a Directive on payment services, replacing Directive 2007/64/EC (PSD), published 24 July 2013. Anticipated adoption December 2014.
- Commission proposal for a Regulation on interchange fees for card-based payment transactions ('MIF Regulation'), published 24 July 2013. Anticipated adoption December 2014.

Treaty Base

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

Description

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

E-money

Level 1

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

Treaty Base

- Article 114(1) TFEU.

Description

- The Directive has the same rationale as the PSD: to regulate the provision of e-money services. The Directive establishes an authorisation regime for certain e-money issuers and makes them subject to certain prudential requirements.
- 'Electronic money' is monetary value which is: (a) stored electronically (including magnetically); (b) issued in return for funds; (c) intended as a means of payment; and (d) accepted by third parties. However it does not include: (i) voucher type instruments which may only be used for purchases on the issuer's premises, or for a limited range of purchases under an agreement between the issuer and the seller or service provider; or (ii) value (such as credit on a mobile phone account) used to make purchases through a telecommunication device of goods or services used through a telecommunication device, where the operator is involved in the transaction.

Payment Accounts Directive

Level 1

- Commission proposal for a Directive on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features published on 5 May 2013. Adoption is expected in the second half of 2014.

Treaty Base

- Article 114 TFEU.

Description

- The Directive has three principal elements: (i) making it easier for consumers to compare fees charged in connection with the provision of payment accounts, including a requirement that Member States ensure that consumers have access to at least one website comparing fees charged by payment service providers; (ii) requiring payment service providers to offer consumers a payment account switching service; and (iii) requiring Member States to ensure that payment accounts with basic features are offered to consumers by all credit institutions or by a sufficient number of credit institutions so as to guarantee access for all consumers in that Member State.

REGULATIONS ESTABLISHING THE EUROPEAN SUPERVISORY AUTHORITIES

European Banking Authority (EBA)

Level 1

- Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority).

Treaty Base

- Article 114 TFEU.

Description

- Regulation to establish the European Banking Authority.

European Securities and Markets Authority (ESMA)

Level 1

- Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority).

Treaty Base

- Article 114 TFEU.

Description

- Regulation to establish the European Securities and Markets Authority.

European Insurance and Occupational Pensions Authority (EIOPA)

Level 1

- Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority).

Treaty Base

- Article 114 TFEU.

Description

- Regulation to establish the European Insurance and Occupational Pensions Authority.

European Systemic Risk Board (ESRB)

Level 1

- Regulation (EU) No 1092/2010 on European Union macro-prudential oversight and establishing a European Supervisory Authority (European Systemic Risk Board).
- Council Regulation (EU) No 1096/2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

Treaty Base

- Article 114 TFEU and, for the Regulation conferring specified tasks on the ECB, Article 127(6) TFEU.

Description

- Regulations to establish the European Systemic Risk Board.