Balance of Competences Review-Single Market: Financial Services and the Free Movement of Capital

Submission by David W Green

While there have been great strides forward in the creation and then implementation of EU-wide rules for financial regulation, there continues to be room for improvement. Europe needs a manageable set of rules which match the requirements of the final users affected by their consequences and of the financial firms and markets who have to implement them.

The most important issues relates not to the overall Balance of Competences, where the distribution of competences in general serves both the UK and other Member States, but to the processes for the creation of individual pieces of legislation and their subsequent implementation.

In particular there are serious shortcomings in the way that legislative proposals are brought forward. Many of the most problematic pieces of legislation have come about because analysis of what legislation is needed and why, and what side effects need to be avoided, takes place either too late or not at all. Impact assessment and cost benefit analysis needs to be central to the legislative process, not an optional extra. The main features of Better Regulation which now require greater focus are proportionality and targeting; the impact of regulation needs to be proportional to the market failure which is being addressed and regulation needs to be targeted precisely at the relevant market failure to ensure that unintended consequences are minimised.

This submission recommends reforms which, if implemented, would greatly reduce the risk of proposals for ill-conceived or ill-targeted legislation being introduced. Such reform would not only reduce the economic damage which might be done by ill-considered legislation but also reduce the current substantial cost involved in the effort to rework proposals to make them fit for purpose which would otherwise be avoided.

It is recommended that new principles be introduced to guide both the development of legislation and of the detailed rules which flesh out and implement them. These principles should be incorporated formally into the beginning of the process whereby proposals for both legislation and rules under the Single Rule Book are brought forward. These principles are as follows.

In relation to each piece of legislation or rule the proposal must:

Identify the mischief. Without prior understanding of what perceived problem the rule(s) are supposed to address, it is not possible to know what character of rule to adopt or how much detail the rules need to provide.

Identify the market. If a market is local or national, detailed rules at the EU level should focus on requirements which will open those markets to contestation, assuming that competition policy is not a better tool. Otherwise, changing a local market structure without good reason will be a costly exercise without necessarily corresponding benefits for the customers in those markets.

While totally uniform regulation can have benefits, this is not always the case and there need to be tests as to which categories of regulation need to be absolutely uniform and require universal implementation. There are two main areas where uniform implementation everywhere may most obviously cause difficulty; the first relates to potentially excessive cost, the second to undue deterrence of competition.

In relation to *cost*, while there may be benefits for large firms, and perhaps their customers, where uniform regulation across the whole EU permits economies of scale and scope, including for cross-border group supervisors, there are likely to be very large costs for the much larger number of smaller firms (and their customers) who undertake little or no cross border business if they are obliged to change their systems to accommodate the demands of uniformity, but without material regulatory benefit for their customers, who will inevitably have to bear a material portion of those costs.

In relation to *competition*, while uniform regulation can promote competition by bringing a level playing field into being, it can also stifle competition if it inhibits healthy response to the changing needs of users of financial services or if the regulation is ill-conceived and results in customer detriment in some kind of way. This issue applies both to areas where EU legislation has already been decided on and especially so to new areas.

Choose the right policy tool. At one level this involves deciding which tool is best to address the mischief; whether an issue is best addressed by competition policy, by supervisory activity or by enforcement. At another, it means deciding whether there should be ever greater detail in rules about what precisely firms should do or whether the rule might better incorporate a set of considerations against which a firm's decision would be assessed by supervisors and overruled if determined to be excessively risky.

Identify the right kind of rule. Is the best approach one addressed at content, process, outcome or behaviour? Content relates to a specific requirement which must be met, like a capital ratio. Process sets out a set of actions which must be followed over time. Outcome relates to what is to be achieved, perhaps at a certain level of generality. Behaviour specifies or prohibits the way in which an act must be undertaken. There could also be tests relating to how the rule is to be used; is it to be enforced and if so is it suitable for this purpose; is it just a means to an end rather than the outcome itself; what are the risks of the rule generating unwanted changes in behaviour; and so on.

No rule should be more detailed than necessary. This is in part to avoid unrealistic implementation challenge and partly to avoid diversion to rule evasion rather than true risk mitigation.

A process of this kind would greatly reduce the risk of damaging legislation/rules being introduced at all. It would also make it easier to clarify what is really needed for the Single Rulebook to deliver what is required and what not.

There are two other process improvements which would assist.

Post Implementation Review. No new piece of regulation should go un-reviewed. There should be a requirement to examine ex post the actual impact of each piece of legislation on the market – has it achieved its desired result and if not what steps would be necessary to recalibrate it. The manner of the Post Implementation Review should be agreed as part of the rule making process as should the deadline by which it will be reviewed. This builds on and universalises the processes already agreed in some instances, such as the built-in review of the post-Larosiere institutional structures of the ESAs and ESRB.

Assessment of cumulative cost of regulation. When impact assessment and cost benefit exercises are being conducted the individual costs associated with each piece of legislation should be examined alongside the cumulative cost of regulation as it affects a particular sector rather than simply being assessed on a stand-alone basis. This is to address the risk that individual pieces of legislation might appear cost-justified in isolation but not if the overall cumulative impact on the market concerned is taken into consideration.

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