Submission to the Balance of Competences Review: Single Market for Financial Services and the Free Movement of Capital

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

To tackle cross-border financial instability, nation-states face a choice. There is a trilemma in international financial economics – between financial stability, internationalised finance and national sovereignty.[1] It is possible to have two of these options, but not three. Financial stability and cross-border finance means that rules have to be agreed internationally. National rules and global finance creates financial instability. After the crisis, the member-states of the EU, and those of the G20, recognised that international rules were too lax before the crisis, and that national regulatory competition to give financial centres a competitive advantage increased the risks in the global financial system.

The eurozone's member-states will slowly cede national sovereignty over their financial systems in the hope of making the euro more stable, through the construction of a 'banking union'. The G20, through the Basel process, is raising capital and liquidity requirements and imposing controls on banks' leverage. It is raising global minimum standards, to improve stability and make it impossible for a rogue country to undercut others to attract financial activity within its borders.

Britain faces the same trilemma as the others, but more acutely, as it is home to one of the world's largest financial centres. If it were not a member of the EU, it could try to strengthen national sovereignty and improve financial stability by forcing all banks within its jurisdiction to act as full-capitalised subsidiaries, regulated and supervised by the British authorities alone. It could also unilaterally raise the level of prudential regulation above international norms, in order to prevent its banks from taking risks at home or abroad that jeopardise the UK's financial system. The consequence would be a higher cost of capital for firms and households, in exchange for greater regulatory autonomy and financial stability. However, it would reduce the City's competitiveness.

Alternatively, it could engage in regulatory competition to encourage more financial firms to set up in the City – but at the risk of reducing financial stability. And other countries would inevitably say that the City threatened the world's financial system, and seek to reduce the threat by preventing British-based banks from having access to their markets.

Thus, if the City is to remain open to international capital flows – with its banks having access to international interbank markets, its investors buying financial assets in other countries, and its hedge funds providing investment services for international clients – then it must make its rules according to international norms.

In fact, British regulators have shown little desire in recent years to design regulation to give the City a competitive advantage. Before the crisis, the Financial Services Authority was legally required to consider the City's competitiveness. This is no longer the case: Britain has, in many ways, been leading the charge towards stricter prudential regulation. The authorities have forced banks to raise capital and to hold more liquidity; banks are now required to draw up recovery and resolution plans (so-called 'living wills'; and the government has agreed to implement most of the recommendations of the Vickers Commission, which will force banks to ring-fence their retail operations from their trading and investment arms.

By contrast, several EU countries have been slower to force their banks to build capital in the face of stagnating, or shrinking economies. The EU directive that aligns the way in which banks across the EU should be resolved was agreed at the end of 2013, well after British rules had been changed. And the EU is only now implementing the Liikanen report's suggestions for ring-fencing operations – although the timeline for implementation is very similar to Britain's.

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[1] Dirk Schoenmaker, 'The financial trilemma', Economics Letters, 2011.

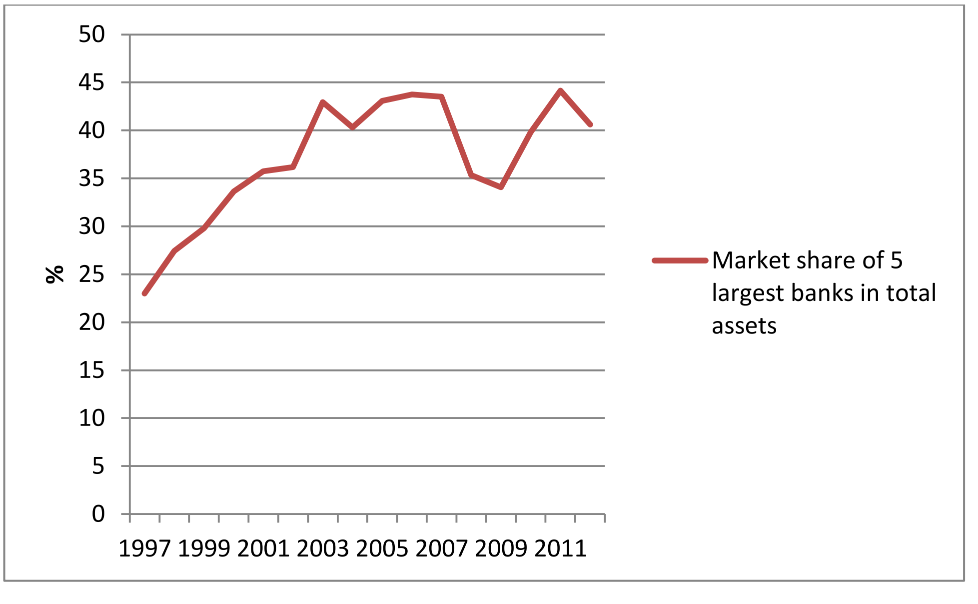
Thus, Britain has moved from erring on the side of competitiveness to implementing more hawkish regulation than many other member-states. EU regulation has lagged behind British initiatives, and in many cases is following the UK's lead.

This is not to say that all recent EU proposals have been welcomed by the City – or the UK government. The draft Alternative Investment Fund Managers Directive (AIFMD), when it was originally proposed by the Commission in 2010, imposed limits on non-EU funds' ability to provide services in the EU. These funds had little to do with the financial crisis, many Britons argued, and the UK government had some (but not all) of the restrictions in the directive eased. The European Central Bank has tried to force clearing houses that guarantee large volumes of euro-denominated trades to relocate to the eurozone. The British government has taken the ECB to the European Court of Justice over the issue, arguing that this violates the free movement provisions governing the single market in the treaty. Finally, the EU has proposed a financial transactions tax – a small tax on financial trading – that would raise a disproportionate amount of money in London.

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

The rationale for the financial single market programme to raise the level of competition, and so drive down prices for consumers. It cannot be described as a success for British retail consumers, who still face a highly concentrated market. The market for mortgages and business loans before the financial crisis came to be dominated by four large lenders: HSBC, Barclays, Lloyds group and Royal Bank of Scotland group. A series of mergers and acquisitions led to a much less diverse banking sector. The market share of the largest banks rose between 1997 and 2007 (see chart 1). Cross-border mergers and acquisitions have been far more prevalent in Central and Eastern than in Western Europe. Since the crisis, the Spanish bank Santander has entered the market by taking over three smaller banks, and Lloyds has been broken into two by the government, after its bail out in 2009 – but the level of concentration in UK retail finance is not much lower in the pre-crisis period (see Chart 1).

Chart 1. Five largest UK banks' market share, 1997-2012.



Source: European Central Bank

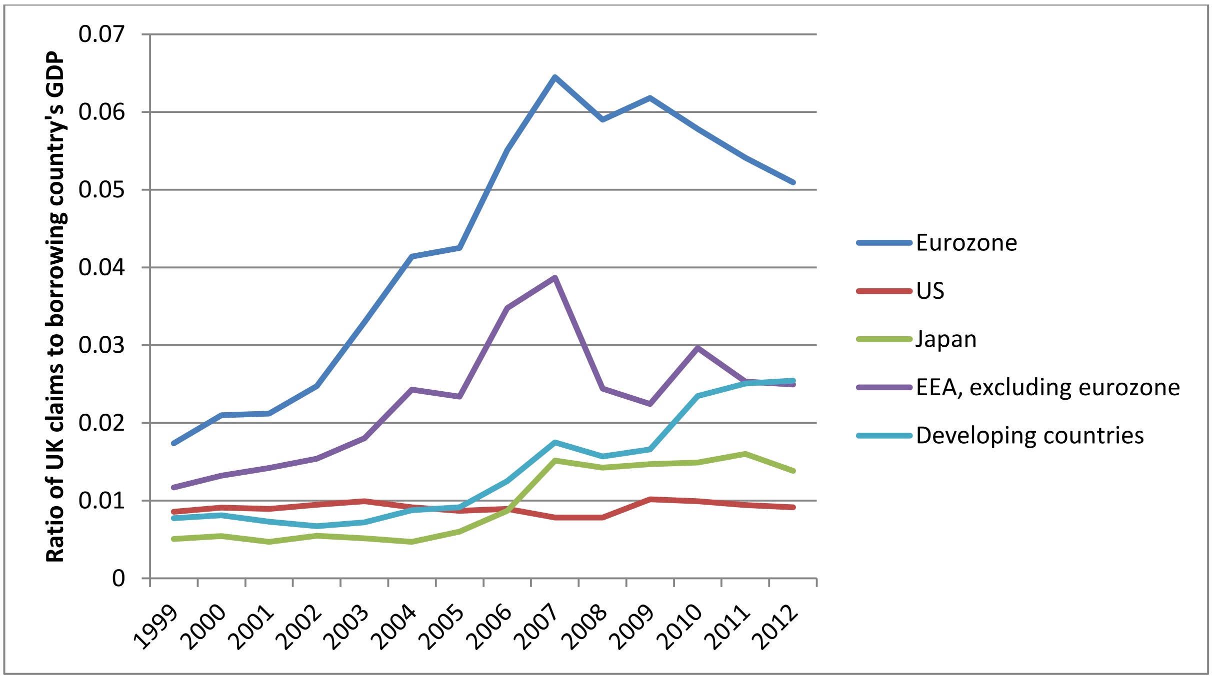
As EU-level attempts to open UK retail financial services to competition from banks elsewhere in the EU have not been successful, it should be clear that boosting competition, for Britain at least, is largely a national competence.

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

The largest impact of the single market on the UK has been on the City of London as an international financial centre. The single market programme – and the reduction in barriers to capital flows across the developed world – led to larger flows of savings looking for investments, and the growth of European bond and equity markets. (The British government and its officials were chief advocates for the programme, and its architects: the advantages of a liberalised European financial system for the City of London were obvious.) UK-based banks own 25 per cent of of all EU banking assets.[2]

The City of London is the largest global financial financial centre in the EU. But it is also an important part of the eurozone's financial system. The single market and the euro have deepened financial integration between Britain and the rest of the EU. Britain integrated faster with the eurozone in the mid-2000s boom than with other markets. Chart 2 shows British banks' lending to the eurozone, the rest of the EU and European Economic Area, the US, Japan and developing countries, as a proportion of their respective GDPs (so controlling for economic growth and providing a more accurate assessment of financial integration). UK-based banks built up heavy exposures to both the eurozone and the rest of the single market, with the scale of flows growing much faster than GDP between 1999 and 2008. Since then, they have been selling EU assets, and switching into faster-growing 'emerging' markets in the developing world.

Chart 3. UK banks' international claims as a proportion of GDP



Source: CER, using Bank of International Settlements and World Bank data

The economic rationale for the single market for capital – and for financial globalisation – is two-fold. First, banks become less risky by lending and raising funds from more diverse sources. If banks lend to many different countries and many different economic sectors, their balance sheets are less exposed to economic shocks. On the liabilities side, if banks develop funding sources from other countries, they are less at risk from sharp withdrawals of deposits, say, by their domestic customers. Second, international capital flows allow savings to flow to where they may be most profitably invested, allowing savings-constrained but potentially fast growing countries more capital to invest.[3]

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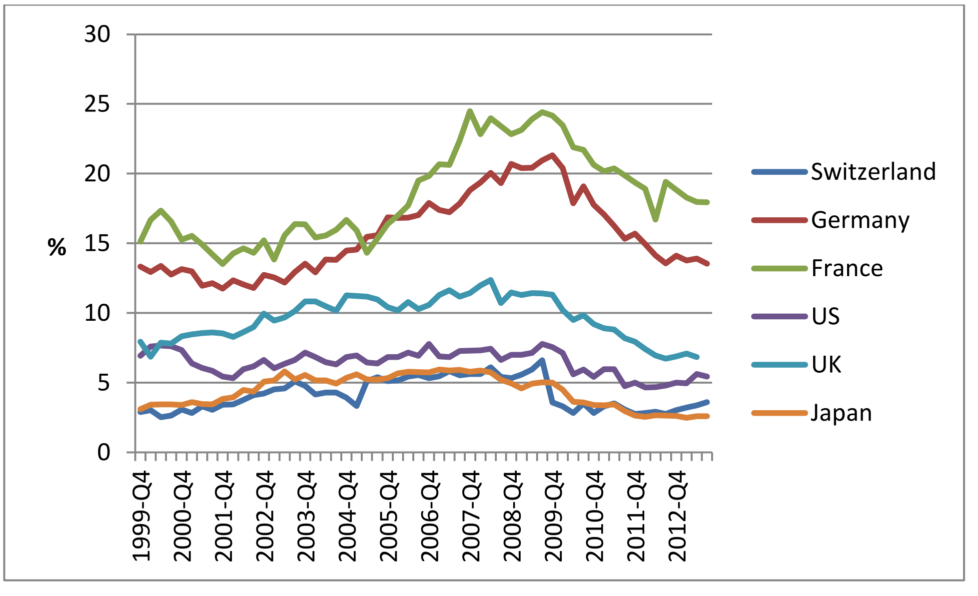
[2] International Monetary Fund, 'Technical note on financial integration and fragmentation in the European Union', March 2013.

[3] See, for example, Dirk Schoenmaker and Wolf Wagner, 'The Impact of Cross-Border Banking on Financial Stability', Tinbergen Institute Discussion Paper, 2011; Claudia Buch et al, 'Cross-border diversification in bank asset portfolios', International Finance, 2009; and Barba Navaretti et al, 'Multinational banking in Europe: Financial stability and regulatory implications', Economic Policy, 2010.

However, the problem British and other European banks have faced is that their diversification has been heavily skewed towards two regions that suffered serious financial shocks; namely, the United States and the eurozone's periphery. On the eve of the financial crisis, European banks were highly exposed to the United States. European banks and other financial institutions had bought many of the American securitised assets – bundled mortgages and other loans to US households and companies – whose risks had been underpriced. And they relied on US money markets to help fund their asset purchases denominated in dollars. In the aftermath of the Lehman Brothers collapse, US money markets froze, and European banks found it difficult to borrow from other sources.[4] Meanwhile, French, German and to a lesser extent, British banks specialised in lending to the eurozone periphery, mainly on wholesale markets, in the period before the crash. The proportion of their balance sheets devoted to assets in the eurozone periphery nearly doubled between 2001 and 2008 (see chart 5).

Chart 5. Banks lending to the eurozone periphery, various nationalities, as a percentage of total lending

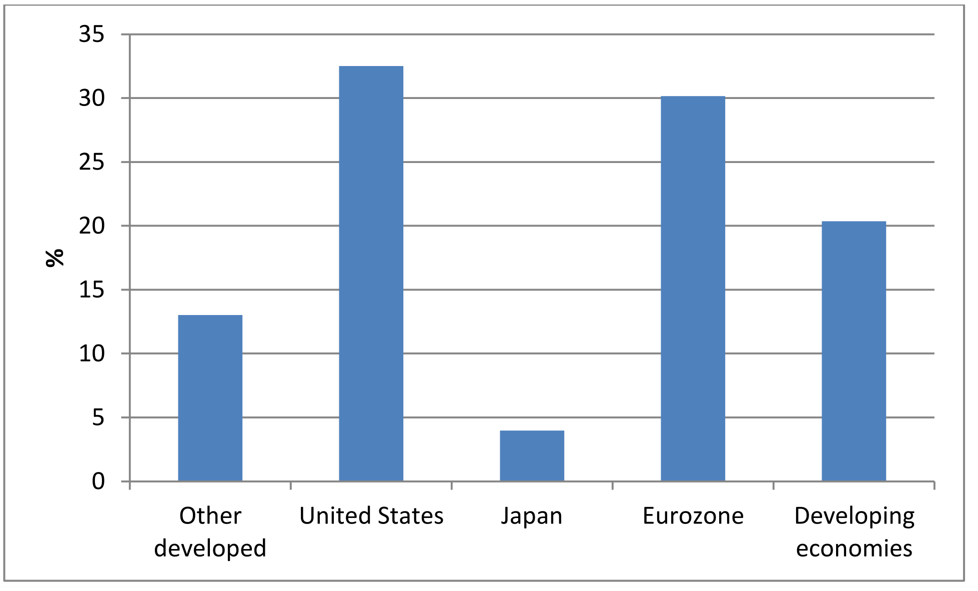


Source: CER, using Bank of International Settlements data

The main destinations for the City's international lending remain the United States and the eurozone, even after the cycle of deleveraging that started in 2008 (see chart 6). The integration of developing economies into the global financial system is something to be welcomed, if the benefits from diversification can be made to outweigh the risks to global financial stability. But the City's largest markets will continue to be the US and the rest of the EU in coming decades.

Chart 6. Proportion of UK international lending, Q3 2013.

[4] Bob Hills and Glenn Hoggarth, 'Cross-border bank credit and global financial stability', Bank of England Quarterly Bulletin, June 2013 and Katrin Forster, Melina Vasardani and Michele Ca' Zorzi, 'Euro area cross-border financial flows and the global financial crisis', European Central Bank, July 2011.



Source: CER, using Bank of International Settlements data

Second, while cross-border capital flows allow savings to flow to the places where they may be most productively invested, foreign capital is more volatile than domestic capital, and in the European context, the single market and the euro can be held accountable for some amplification of the European credit cycle that ended in the financial and eurozone crises. While the developed world's financial system is now so interconnected that a global under-pricing of risk is the cause of the crash, regional financial integration in Europe also played a part. The convergence of interest rates and a large expansion in the provision of cross-border credit – despite a lack of convergence in productivity rates across the Union – caused severe problems in the eurozone periphery when financial conditions tightened in 2008, and capital flooded out. European cross-border capital's volatility was worsened by the fact that much of it was conducted between banks, and to a lesser extent, between banks and large corporations and governments in bond and equity markets. These highly fungible forms of investment are easily taken up in good times and dumped in bad – in other words, they are easy to exchange for other assets on international financial markets, and so capital can dry up quickly. And the high levels of interconnectedness between banks made them more liable to 'contagion': core banks dumped assets in the periphery, so their price fell, and rendered peripheral banks who held similar assets insolvent.

As the City of London is at the core of Europe's financial system, but sits outside the eurozone, some compromise between the UK's single market interests and eurozone financial stability must be found. Financial stability is a regional and global public good, given the highly integrated European – and global – financial system, common rules are needed.

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

Many in Britain and the eurozone agree that a banking union will lead to more regulatory clashes, rendering the City's position unsustainable, and will drive Britain towards the exit. Whether the ECB's move to force euro-denominated clearing to be conducted under its watch heralds a new regulatory assertiveness – and whether its assertiveness would impose substantial costs on the City of London – is uncertain. There are certainly areas in which it is easy to envisage conflict. The resolution of eurozone headquartered bank with large operations in the City of London is one. The ECB and the Bank of England may have opposing interests when it comes to resolution: the ECB will seek control of the bank's assets, even if a part of its balance sheet is under the Bank of England's jurisdiction. Another is the regime for bailing in private creditors upon the failure of a bank. Should the Bank of England apply more favourable conditions than the eurozone, it may encourage banks to shift the location of some of their activities to the UK. On the other hand, the British government has won a 'double majority' voting system in the European Banking Authority, which sets the rules for the EU, so that any measure requires a majority of both eurozone members and those outside. And it has access to the European Court of Justice to determine whether eurozone-inspired regulations violate the principles of the single market.

The British government, for its part, has made clear that it wants the eurozone banking union to be comprehensive, so that it maximises the EU's financial stability – which is, of course, wholly in Britain's national interest, given its position at the core of the EU's financial system. Whether it gets its wish is open to question: the eurozone has struggled to agree upon a banking union that goes beyond centralised supervision and common rules for resolution, and sets up a common backstop for the financial sector. The ECB may end up dominating the regulatory process, making life uncomfortable for Britain.