Some notes on the balance of competences section on financial services and the free movement of capital

Business for Britain

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This brief note is intended to provide some further thoughts on the questions as outlined in the Call for Evidence in the balance of competences section on financial services and the free movement of capital.

1) 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?

- The UK would benefit from less EU action in the financial services area. According to a study by JWG the EU-wide financial services industry will spend €33.3bn on complying with new regulatory demands between 2012 and 2015, with the City particularly badly hit. [1] Financial services regulation that seeks to regulate industries that are particular to the City of London is especially pernicious. 80% of hedge funds are managed in London, and the majority of the forex and international commodity market is concentrated in the UK. According to the Regulatory Policy Committee, the Alternative Investment Fund Managers Directive (AIFMD) will cost the City up to £1.24bn each year.[2] It has also been estimated that the EU's Financial Transaction Tax (FTT) could increase transaction costs by up to 1790%.[3]

- EU action has recently targeted the UK's leading financial industries. The ECB's efforts to move clearing houses handling sizeable numbers of Euro-denominated businesses into the Eurozone (a proposal which runs contrary to the principles of the Single Market) is a case in point – as the Chancellor recently noted, it would seriously damage the City of London, forcing businesses to move from the UK to Eurozone countries.[4]

- There is also mounting concern about the role of the European Court of Justice and the non-judicial/political qualifications of the judges appointed from many other EU countries. Financial respondents to Business for Britain interviews described the Court's judgements as seemingly "random" and "political". There was particular discontent over the failure of the UK to limit the EU's power to ban certain financial practices – in particular short selling. Short selling is a means of hedging against falling markets, a basic tool in portfolio management, and would be badly hit by EU regulation in this area.[5]

[1] http://ec.europa.eu/internal_market/consultations/2012/shadow/individual-others/jwg_en.pdf
[2] http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Impact-of-FTT-on-corporate-and-sovereign-debt-Final-PDF.pdf
[3] http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/archive/2012/Oliver_Wyman_Impact_of_the_Financial_Transaction_Tax_on_FX_markets_FINAL.PDF
[4] https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe
[5] http://www.bbc.co.uk/news/business-25845291

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

- The FTT looks set to set to cause large problems for financial firms across the EU, even for member states like the UK which are not involved but will be affected because so many City based transactions involve participants in countries where the FTT might apply and the City-based intermediary involved may have to collect the tax. According to the House of Lords European Union Committee, it is likely that the FTT will drive transactions off-shore. The Swedish experience provides a good case study, whereby a similar transactions tax in the 1980s resulted in something like 80% of business going offshore (to London in particular). The Swedish tax was repealed within a few years. In a recent report by the City of London Corporation and TheCityUK it was argued that the total cost of the FTT to UK government debt would be £3.95bn.[6]

- There is mounting evidence that these laws have already prompted many businesses to leave the UK. In a recent survey by Deloitte on the Alternative Investment Fund Managers Directive (AIFMD), the vast majority of UK-based respondents said that they consider the AIFMD directive a threat to their businesses. 68% of respondents surveyed said that the AIFMD will lead to fewer non-EU managers operating within the EU.[7] Concerns have been raised that, as a result, companies which use hedging facilities may be indirectly affected by this directive.

- Leading foreign banks have warned the Prudential Regulation Authority (PRA) that a European bonus cap could lead to an exodus of senior managers.[8] In interviews financial managers warned Business for Britain that, taken together, these measures would make London less competitive against other financial centres such as Frankfurt and Paris.

- "***The likely effect of many of Brussels' current proposals will be to damage the UK's prospects for growth.*** *Nowhere is this more acutely the case than for professional and financial services, which are being bombarded with unwarranted regulation*."

  John Cridland, CBI Director-General, 14th October 2011

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

- European laws have become increasingly specific. AIFMD for example requires private equity funds to appoint independent valuers and independent custodians – even if the firm has people who understand the value of the business.[9] The requirement for Alternative Investment Funds (AFIs) to have a single depository which will make good any loses to investor assets has also created uncertainty among AFIs about the capital requirements.[10]

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[6] http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Impact-of-FTT-on-corporate-and-sovereign-debt-Final-PDF.pdf
[7] http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_AIFMD%20Survey_090412.pdf
[8] http://news.sky.com/story/1148519/foreign-banks-warn-over-bonus-cap-exodus
[9] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF
[10] http://www.risk.net/risk-magazine/feature/2293304/depositories-ponder-size-of-capital-requirements-for-aifmd-liability

- There is a disconcerting lack of key detail. The CRD IV proposals for a leverage ratio (defined as Tier 1 capital divided by non-risk weighted assets) does not specify the level that the ratio will be set. The EBA is looking into the level over the coming two years, with the European Commission seeking a binding measure by 2018; however the lack of detail is frustrating to many financial firms.[11]

- There have been concerns raised that EU legislation is preventing the UK from introducing the government's bank and regulatory reform policy as proposed by the Vickers Commission.[12]

- "*The proposed Financial Transaction Tax (FTT), also known as the Tobin tax, would be a disaster for the City, even if Britain remained outside the regime.* ***For my industry, it threatens to impose a huge cost on financial transactions – initial reports suggested that transaction costs could increase 18-fold.*** *Although some financial products have received exemptions from the European Commission, senior politicians in Europe are now calling for the FTT to apply to derivatives and other products -this would seriously hurt an industry in which Britain leads the world. And this is only the tip of the iceberg of anti-competitive measures that Brussels is aiming at our financial services industry and the City*."

  Peter Cruddas, CEO CMC Markets, 11 January 2014

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

- There is concern that AIFMD prevents investors from investing outside the EU and vice versa. Under the directive, an EU AIFM may manage a non-EU AIFM if there are co-operation arrangements in place between the home regulator and the regulator for the non-EU AIF. It also requires non-EU AIMFs to comply with "equivalent" third country rules.[13] Such requirements and dependence on cross-government cooperation could harm relationship between EU AIFMD and non-EU AIFMD.

- The EU has a disturbing tendency to 'go it alone' and to not comply with international standards. For example the Capital Requirements Directive (CRD) was drafted separately to the capital requirements determined by the Basel Committee (differences between the two include CRD IV having additional capital buffers, and different remuneration and transparency requirements). Time will tell if these differences mean that large banks end up having to adopt one set of rules for capital requirements for European operations, and another in other countries.[14]

- The EU has been very hostile to proposals for a deeper relationship between the EU and China.[15] Despite the laudable aims of the EU-China 2020 strategic agenda and welcome proposals for a new investment relationship; a much clearer sign that the EU will seek a

[11] http://www.cfainstitute.org/ethics/Documents/CRD_IV_issue_brief_final.pdf
[12] http://www.cityam.com/news-and-analysis/king-eu-could-veto-vickers
[13] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF
[14] http://www.cfainstitute.org/ethics/Documents/CRD_IV_issue_brief_final.pdf
[15] http://www.euractiv.com/uk-europe/cameron-irritates-brussels-pushi-news-532092

comprehensive trading deal and greater financial access between the EU and China is urgently required.

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

- Recent European directives have imposed large costs on European retail financial services – it seems certain that the costs of these regulations will be passed onto the consumers.

- McKinsey have warned that the Directive on Credit Agreements relating to residential property, Market in Financial Instruments Directive and Single Euro Payments Area will reduce margins for European retail banks.[16]

- Fixed rate interest rates are secured by mortgage providers hedging against changes in interest rates. Changes introduced by the AIFMD undermines this and may increase problems facing providers who offer fixed rate mortgages - fixed interest rates may increase as a result.

- "*The essence is: Europe is trying to say what is required to make life better for the consumer in terms of better and best protection, but what seems to be happening is that Europe is pushing directives, not regulations, so things are being imposed on a UK retail sector that is far more advanced than on the continent.* ***There are about 4 million UK consumers who save, invest or are involved in the UK retail financial sector, and I would imagine that the message they are constantly bombarded with is that they are being hit by further regulations from Europe****. From the European side, there is the need to differentiate across the retail consumer sectors*."

  Dr Gerard Lyons, Chief Economic Adviser to the Mayor of London, 27 November 2013

- **56% of financial services professionals think that, on balance, the costs of EU financial regulation currently outweigh the benefits of the Single Market to the City**, while 31% disagree. Over the next five years, 62% expect the costs of EU regulation to outweigh the benefits of the Single Market, while only 24% disagree.

  ComRes/Open Europe poll of 500 financial services professionals (manager level and above) in London. Conducted November 2011.

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

- The concern is that European regulators can override what the national regulator decides. This has been criticised by the House of Lords European Union Committee, who have

[16] http://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/Risk/PDFs/Day_of_reckoning_for_European_retail_banking_July_2012.ashx

warned that: “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.” The report also noted that “There are, however, a number of situations in which ESAs could overrule national supervisors.”[17]

- It is pleasing that the UK has managed to convince the European Commission not to shift direct supervision of benchmarks to Esma.

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

- The UK’s influence over European financial law has been seen to be very poor over the last few years. It has failed to prevent the introduction of measures that it has opposed such as the FTT and the bonus cap (subject to ECJ judgements). It is hard to see how these measures would have been introduced had the UK been solely responsible, considering the opposition to these proposals from both the Labour and Conservatives.[18]

- The UK has secured some protection in the European Banking Authority (EBA) via the double majority lock, however this is still subject to three problems: i) It requires the UK to secure a majority of other non-Eurozone countries, so cannot be considered a competently secure lock and ii) This is not enshrined in the Treaties. It is possible as non-Eurozone countries join the Single Currency there may be new efforts to end this voting system and iii) It does nothing to protect the UK from financial measures introduced from the Council of the European Union where traditional QMV applies.

- **69% of financial services professionals say that they would support the UK having a veto on future EU financial regulation** and other financial measures, even if it risked reducing their firm’s market access to one or more EU countries.
  ComRes/Open Europe poll of 500 financial services professionals (manager level and above) in London. Conducted November 2011.

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

- David Cameron is right to note “It is national parliaments, which are, and will remain, the true source of real democratic legitimacy and accountability in the EU”. This principle should apply in the formation of European regulation – ministers at the Council, supported by the Government and House of Commons should be seen as democratic representatives.[19]

[17] http://www.publications.parliament.uk/pa/ld201012/ldselect/ldeucom/181/18104.htm
[18] https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe and http://www.edballs.co.uk/blog/?p=2419
[19] https://www.gov.uk/government/speeches/eu-speech-at-bloomberg

- The lack of a UK veto is very disconcerting for many financial services firms who fear the EU does not understand their industry. The UK's financial industry is one of the largest in the world (it has the largest financial derivative market in the world) accounting for 11.2% of the Exchequers total tax receipts in 2010, yet it has no national veto over European directives. This lack of influence for democratically appointed British Ministers to block financial measures which are deemed to be against the British national interest should be rectified.

- Double majority voting has been a welcome change, but is not enough by itself to secure British influence. It must be, at the very least, expanded so that it can consider financial legislation determined in the Council of the European Union, and is enshrined in the Treaties.

9) 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?

It is possible to argue that banking union is the only possible course for the Eurozone, however this provides both opportunities and challenges:

- Banking Union will almost certainly require some form of Treaty change. This is an opportunity that should be grasped to make the changes suggested above – securing and expanding the double majority vote and looking at increasing the veto-power of the UK over financial regulation, either via a return of unanimity in the Council of the European Union or via the introduction of a Red Card system. A plurality (32%) of financial managers in a recent Business for Britain/YouGov poll said that they want to see Treaty change and a return of powers to the member states.[20]

- It is important that any changes that are introduced allow retrospective evaluation of existing financial laws – in particular FFT and the bonus cap.

- The FTT has shown the limitations of "enhanced cooperation" and the ability of measures that are meant to only apply in some member states yet affect those who have explicitly stated their opposition to said measure. This will need to be reviewed, and there must be diligence against any other attempts to use enhanced cooperation in the construction of a banking union.

- It is important that all member states retain their veto of any extensions of Brussels' financial supervisory powers.

- "*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… We would still be the world's sixth-largest economy. Countries such as South Korea and Canada do perfectly without huge trading blocs****. Similarly, many of the world's biggest financial centres — such as*

[20] http://cdn.yougov.com/cumulus_uploads/document/e8grrr4xt3/YG-Archive-Business-For-Britain-Results-120913-B2B-sample.pdf

Switzerland, Singapore and Hong Kong — do not have huge domestic economies behind them."

Michael Spencer, CEO ICAP, 22 August 2013

- "*They [member states] do not appreciate or even know or want to consider this huge role that the City plays for the UK and the world. In some countries' cases, I do not think it is conscious. It is certainly not a Brussels view but, of course, one of their own dilemmas is they are frequently influenced not by what they think but by what noisy voices inside the Council of Europe think.* ***There may well be some of those that see it as quite a good thing to knock us down to size, so through that the EU is influenced, but not consciously***."

  Jim O'Neill, Visiting Research Fellow at BRUEGEL, 27 November 2013