Review of the Balance of Competences

AFB's response to HM Treasury's paper: Single Market: Financial Services and the Free Movement of Capital – call for evidence.

Introduction

The Association of Foreign Banks (AFB) welcomes the opportunity to respond to this call for evidence.

The AFB represents about 180 foreign banks providing financial services throughout the UK, but mainly in London, through branches, subsidiaries and representative offices. The AFB provides a forum for the sharing of information on industry issues for the mutual benefit of foreign banks operating in and out of the UK and makes representations to industry, government, regulatory bodies and other financial services organisations to ensure the attainment of good international practice.

The foreign banks concerned engage in a wide range of banking and investment business activity in the UK primarily in the wholesale banking markets. They make a significant contribution to London's standing as a major global financial centre and to the depth and breadth of the European Financial Markets facilitating trade across the Community. Member banks and their affiliated organisations range from the largest with several thousand staff to the smallest with ten or less staff.

The AFB believes that the UK's interests, with regard to financial services, are best served by continuing to be an inner member of Europe and by helping to develop its regulatory framework. However, we do believe that the processes within Europe should be revised to better reflect the status of the City of London as being the major European centre of financial excellence. We detail below our answers to the specific questions raised.

1. How have EU rules on financial services affected you or your organisation? Are they proportionate in their focus and application? Do they respect the principle of subsidiarity? Do they go too far or not far enough?

The foreign banking community has established a large presence in the UK for several reasons. These are not homogeneous and do not carry the same weight in all organisations. These reasons include:

- To service their customers based in Europe
- To facilitate trade finance with their domestic customers
- To access the worlds principal financial markets based in London
- To gain expertise in financial services in Europe
- To make profits in both the UK and Europe
- To take advantage of the European time zone
- To provide a location for regional headquarters covering Europe and, in many cases, the Middle East and Africa.

Foreign banking business is conducted through locally incorporated companies and branches of the parent organisation. Reliance is placed on common business standards and passporting rights throughout Europe. The foreign banks view a single point of entry into Europe and a single rule book as advantageous to carrying out business consistently for the benefit of customers throughout Europe.

There have, however, been several cases where the "in principle" benefits of this passport and single rule book have not been met. For example, the UK, with its large banking community and financial services sector, has previously introduced legislation in advance of other European countries and/or "gold plated" European standards. Europe does not recognise that there are "first movers" where subsidiarity has been practiced in the absence of European Legislation. For example, there are situations where UK regulators already have tried and tested procedures, yet these are then frequently replicated by similar, but not identical, European ones. The introduction of these European rules requires significant system changes to banks operating within the UK and adds little to UK consumer protection. Specific examples include stress testing for banks, differing capital and liquidity requirements, different reporting requirements such as the FINREP and COREP and caps on bankers' bonuses and remuneration. The foreign banks' preference would be for such requirements to be specified once and implemented consistently throughout the EU. This would ensure a faster implementation in Europe.

There are also situations where the UK has practiced subsidiarity in a manner which has hindered the development of the UK and London as Europe's leading financial centre. For instance, there are differing work permit requirements for third country nationals depending on whether the country is a Schengen country. The UK is not a Schengen country and passporting third country national staff into the UK has been cumbersome for banks.

Nonetheless, although foreign banks welcome pan European initiatives, they believe greater reliance should be placed on the prior experience of those countries which have centres of excellence, such as the UK, from which Europe can draw expertise.

Furthermore, the EU is more influential on the world stage than the UK is acting independently. Thus when international treaties are negotiated the UK is currently able to influence the creation of treaties and protocols which benefit not only the EU, but the UK too. If the UK decides to leave the EU, however, it could be forced to comply with these treaties and protocols negotiated between the bigger power blocks, but would have had no say in the creation of these. This could potentially have a negative impact on the UK.

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.

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?

For the reasons given above, and assuming that the measures promulgated build sensibly on the best practices which are already present, the foreign banks' preference is for more legislation to be passed at an EU level, with less differentiation between requirements at a national level. It is important, however, that the legislation must be introduced more quickly than has been the case in the past, and with a more transparent process for developing the legislation.

We believe that the UK is in the position to take advantage of its financial status and other infrastructure to access Europe, provided that its regulatory framework is consistent with the European countries and there is open access to them. English is the international language, and the City has a critical mass in financial services, far surpassing all other European countries. However, if

inappropriate local legislation is introduced in the UK, this will introduce regulatory arbitrage and drive business to other locations. This has recently occurred as some Chinese Banks have located their European Head Offices in Luxembourg, where they have been able to establish branches. This was due to perceived UK requirements for most banks from third countries to subsidiarise. This has had knock on effects on the amount of capital flowing into the UK and on the offshore Renminbi market due to the relatively low levels of capital in the locally incorporated subsidiaries of these banks. The Chancellor's comments in Beijing last October have helped in this regard.

Another example in the making is the probable impact of the Financial Transaction Tax in Europe. The consequences of where business will be booked are unclear, due to the differential application of the tax throughout Europe. What is clear is that that the volume of business in those countries implementing the tax will be reduced.

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

Being a member of the EU has helped the City of London and the UK economy considerably over the last few decades. We estimate that most of our non EU headquartered banks have used London as a base for carrying out European business and have employed staff, paid VAT and corporation tax, and contributed directly and indirectly to the UK economy. We believe that in the long term, European rules on capital and resolution of banks will be beneficial for financial stability, growth, competitiveness and consumer protection, provided that these are competitive on a worldwide basis, so as not to introduce opportunities for regulatory arbitrage. Thus, ensuring that all European banks are appropriately capitalised and have adequate liquid assets will give greater confidence to business and ensure the above objectives are met. However, in the short term, new rules must be tempered with a realisation that it may be hard to meet them with shortages of capital and liquidity.

***4. 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*?**

The AFB has issues with the process of the rule making but generally not with the directives or regulations themselves or their volume. The AFB can see merit in the outcome of having regulations applied across the whole of the European Union, creating a level playing field for both consumers and firms. Responsibility for this is devolved between the Parliament, Council and Commission with various authorities advising the Commission and producing secondary level legislation. The pathway to developing and authorising legislation is well documented. However, the actual process of issuing non-papers and grey papers is non-transparent and has resulted in the establishment of large numbers of consultancies resident in Brussels to meet the demands of businesses for information on the processes and likely outcomes.

In the ABF's view, the time taken to develop legislation in the EU is often too long and prevents the EU from being a "first mover". For example, one can compare the US response to the financial crisis and the introduction of Dodd Frank with the European introduction of MiFID/MiFIR. Dodd Frank was introduced more quickly with significant differences to the European legislation. This is also an example of a situation where closer co-ordination between the US and EU would have been beneficial and would have resulted in further harmonisation of regulation on an international level.

The remoteness of the European legislative bodies from the impacted institutions is also an issue. By the time changes to legislation are identified by impacted institutions, the legislative proposals are at an advanced stage, and the debate has been conducted by the sponsors of the legislation without sufficient input from the financial services industry. For example, the European Commission proposals for Third Country Access in the MiFID legislation were considered inappropriate by the financial services industry, which has resulted in the institutions concerned having to contact several member state MEPS and Council ministers to try and seek a compromise. There was no formal

process for early consultation on the drafting of the texts on this matter and no adequate process for all interested parties to make representations on the various amendments to the initial Commission proposals. There are no official focal points within ESMA where informal questions and issues can be directed.

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

There was no freedom to provide financial services across Europe until MiFID 1 gave some limited authorisation to carry out some investment business. The exempt persons regime also enables third country firm staff to meet and transact some investment business with European institutions and customers, provided that they are accompanied by a UK approved person. In our experience, this regime has not been widely used. With regard to banking (deposit taking), there has been no passport for branches of non EU banks, established in one European nation, to provide cross border deposit taking business. Thus, UK firms may be prevented from taking advantage of third country firms established in other European Nations. There has also been recent comment that the EU EMIR requirements may be too restrictive on European firms wanting to conduct investment business on overseas investment exchanges, when compared with third country requirements for these exchanges.

In general, there has been a fear that the EU would adopt a strict view on requiring equivalence and reciprocity in the home countries of third-country banks regarding e.g. access to the EU under MiFID/MiFIR and that this would have negative consequences on third country firms wishing to establish places of business and carry out investment business in the UK. There is a danger that an overly strict licencing regime by the EU would drive business away from London and the EU. The proposed criteria have however been subject to debate during the recent MiFID trialogue and the AFB hopes that a consensus can be reached on requiring broad (rather than strict) equivalence of regulatory outcomes in the home countries outside the EU, and that national permissions to transact business may be retained. If such a compromise can be reached, the AFB believes that the UK firms and markets will continue to thrive on international business. Nonetheless, 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.

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

We believe that for investment business, banking and the market infrastructure, there has been enough new EU level regulation which needs to settle down before a reasonable judgement can be made. We believe that consumers would benefit if there was a more standardised European approach to insolvency law. This would facilitate cross border resolution more easily.

7. 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 European Supervisory authorities are more remote from the major participants in the markets and the national authorities sometimes focus on their own national interests. The European Commission, which proposes legislation, has little direct contact with market participants and this is one of the causes of the slow process of developing European regulation and for the occasional divergence of politically motivated decision-making from the realms of what is appropriate and practicable in the financial markets. We are, however, not convinced that repatriating supervisory powers and responsibilities would be advisable as this would work against achieving pan European solutions. The AFB favours increased efforts to resolve national political differences and empowering the European Supervisory Authorities to have greater market participant involvement and the power to issue their own rules and guidelines without Commission involvement. This requires political consensus but

would improve transparency and speed up the process of introducing appropriate pan European regulation.

8. 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?

Considering the size and scale of the UK's financial services, we believe that the UK should indeed have more direct influence on EU Legislation in financial services. However, from a broad point of view, we believe that the regulation coming out of Europe has broad equivalence to what the UK has already developed (with certain exceptions for example, rules on short equity positions).

9. 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?

We believe that the EU policy making process on financial services legislation is inefficient. Although all parties involved in the process maintain documentary libraries on their websites, navigating through these is extremely complicated and it is almost impossible for non-specialists to locate planned legislation, determine what stage it is at, what is currently proposed and who has responsibility for it. There is a plethora of non-papers and grey papers issued to favoured parties who are not accountable. Individuals at the European institutions directly responsible for development of the regulations are frequently not named, so dialogue with them is not easy.

The democratic process with approval by the Council and Parliament is transparent, albeit a long way from the main centres of the financial services.

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?

We believe that there have been few restrictions on capital inflows and outflows of the UK economy placed on third country member banks as a result of European Regulation. However, due to the right of EU banks to establish branches and conduct banking and investment business in the UK, the UK has lost some control over these banks and related influence over capital flows initiated by them. However, the UK has been able to maintain control over the branches of UK Banks in Europe and has been able to maintain influence over these.

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?

With regard to Financial Services, the UK's non-membership of the euro area has had little impact so far, as London has been able to maintain access to the Euro currency and facilitate Euro business. If settlement and processes are restricted to Euro area headquartered banks then this could have a significant impact on the location of Euro transactions and restrict business.

The Banking Union will give more certainty to resolution and support for Banks subject to the regulation by the European Central Bank. This will have some benefits in terms of consumer protection and additional advantages may develop over time. However, the double majority voting requirements for new legislation is a cumbersome method of ensuring that no unfair competitive advantages are given to these banks.

12. Do you have any further comments about issues in addition to those mentioned above?

Changes to the relationship between the EU and the UK that impact the ability of foreign banks to do business in Europe may be detrimental to the UK's interests if cross border business into Europe is restricted. However, the AFB does believe that changes to the European processes, with regard to financial services, should be negotiated to make them more responsive to the needs of the financial services industry and to give the UK greater influence on these processes.

ASSOCIATION OF FOREIGN BANKS.
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