UK Crown Dependencies submission to the Balance of Competences Review:
Single Market in Financial Services and the Free Movement of Capital

Executive Summary

The Crown Dependencies have a strong shared interest with the UK in Britain's prosperity and in a healthy UK finance sector. They agree with the overall theme of the call for evidence that a level playing field in the EU single market is an important ingredient in the UK finance sector's success, and emphasise that their own financial centres are also significant assets to the UK economy.

Recent steps at international level and in the EU have the potential to create economic opportunities on all sides by improving the quality and consistency of financial supervision and regulation, and by bringing transparency to the terms of market access across different jurisdictions. However, some of the risks highlighted in the call for evidence are also of concern to the Crown Dependencies, for example any discrimination between the Sterling Zone and the Eurozone. It is also important that feedback is taken on board about how the relatively recent concept of 'equivalence' has worked in practice, to ensure the Crown Dependencies can continue to act as conduits for internationally mobile investment from around the world into the UK.

The Crown Dependencies therefore appreciate this opportunity to share their perspectives on the exercise of EU competence in the area of financial services, in particular identifying how subsidiarity and proportionality can be ensured in any third country elements of EU regulation. Each Directive is necessarily different, but in terms of supporting UK leadership on the overall approach to equivalence, 7 common observations can be made:

1. Impact Assessments should more systematically and explicitly expose any inconsistency between EU standards and international standards that the EU and/or its Member States have committed to, in order at an early stage to foster compatibility with trading partners' laws;
2. EU authorities should where possible use existing assessments of third countries' compliance with international standards by international institutions;
3. Where there have not been assessments by international bodies, the EU should refer to existing peer review processes;
4. Where EU assessments of 'equivalence' are still deemed necessary, in addition to international or peer review assessments, the UK should have lead responsibility for determining equivalence in its dependent territories as the 'Member State of Reference';
5. In the case of delays in EU equivalence decisions, the UK should have the authority to establish or extend transitional measures for access to its own market;
6. For sectors or policy areas where the EU has introduced an agreed approach towards third countries, it should be empowered to challenge Member States that discriminate against third countries on criteria unrelated to the sector or policy area in question;
7. Where policy objectives with a legal base requiring unanimity (such as tax) are affected by a financial services regulation, the relevant elements of the proposal should be subject to the appropriate legislative processes.

Purpose of evidence

The United Kingdom is responsible for the external relations of Jersey, Guernsey and the Isle of Man. All three jurisdictions are part of the Sterling Zone and part of the UK's payment and clearing system. Their financial sectors have been shown to be significant net contributors to the UK economy. They are not members of the EU so are third countries for the purposes of EU financial services legislation.

This evidence is submitted jointly by the Governments of Jersey, Guernsey and the Isle of Man.

Context of the Crown Dependencies

In terms of economic significance, Jersey, Guernsey and the Isle of Man are important trade and investment partners for the UK. Their firms improve access to finance in the UK economy as well as providing supply and demand for high quality services. A large proportion of their investment is sourced from outside the EU. The UK's 2009 Foot Review found that Crown Dependencies banks provided net liquidity of over £300bn to the UK banking sector during the financial crisis, while a 2013 study by Capital Economics concluded that £500bn of the stock of inward investment in the UK came via Jersey. At a time when the UK is making a strong case for openness to the global economy, particularly to regions of strong economic growth, and to increasing inward investment, maintaining open trading links with the Crown Dependencies is more important than ever.

In terms of supervisory systems, the Crown Dependencies have their own independent regulators and regulatory systems, and have longstanding agreements and systems in place with UK authorities for co-operation in the supervision of the financial sector. More recently the three jurisdictions have concluded a number of agreements with EU authorities, for example for the Alternative Investment Fund Managers Directive, and are taking an increasing profile in international standards bodies. On that basis, they work with European Institutions directly or in collaboration with UK authorities to pursue the twin aims of open markets and effective supervision of cross border firms' activities.

All three Crown Dependencies recognise and support the increasing moves towards consistency of international regulation and supervision, and share the political commitment to preventing future crises, but also wish to emphasise that creating disproportionate barriers to trade and investment between the EU and the rest of the world would prolong current economic challenges.

Policy Issues

Article 63 of the Treaty on the Functioning of the European Union extends the free movement of capital to third countries, but in practice it has been left to Member States to decide how to permit third countries' firms access to their markets. The Crown Dependencies' experience of the 2010 Financial Services Action Plan shows that the EU is increasingly moving into this 'shared competence' space of trade and investment relations with third countries, in particular the criteria for authorisation and supervision of investment services providers and banks. This therefore includes determining trading relations between the UK and its own Dependencies, gradually replacing an existing system of regulatory co-operation between the Financial Conduct Authority, Bank of England, the Jersey and Guernsey Financial Services Commissions (JFSC and GFSC) and the Isle of Man Financial Supervision Commission (IOMFSC).

The Crown Dependencies' experience highlights a number of lessons about this trend and consequently the balance of competencies between the UK and the EU, and their interaction with international bodies. The questions in the call for evidence about third countries show that assessing practical implementation of this is very timely: the first 'co-operation agreements' are already in force; a number of equivalence assessments are currently underway; and the Banking Union programme is leading to both changes in voting systems and a more flexible geographical scope of regulations within the EU and EEA, most notably with differences in where minimum and maximum harmonisation apply as with the Capital Requirements Directive.

Sectorial specialisation and their constitutional position all give the Crown Dependencies a particular and relevant perspective on questions about EU competence in financial services regulation. Their critical interest lies in strong support for UK leadership of a proportionate approach to the treatment of third country regulators and firms where action is taken at the EU level, but particularly in areas of substantial trade with the UK such as banking, fund and asset management, wealth management and insurance, including captive insurance. Without effective UK leadership on relations with third countries, and a clear mandate for the European Commission and the European Supervisory Authorities to pursue an effective and growth-based regulatory agenda, there are risks that EU-level authorisation and supervision of third country firms could be skewed towards less balanced and more protectionist approaches, to the detriment of consumers and economic growth, while strengthening incumbent operators at the expense of smaller and more innovative businesses. This may also concentrate risks within the EU.

<u>Specific observations on EU competence for third country relations</u>

The Call for Evidence asks "How has the EU's approach to Third Country access affected the ability of UK firms and markets to trade internationally?" The Crown Dependencies highlight four themes it will be important to consider in the future balance and exercise of competencies between the EU and its Member States, and seven associated suggestions for the future.

Consistency with international standards

EU implementation of international standards are susceptible to creating barriers to trade and investment where, in the process of their interpretation in the EU, requirements go significantly beyond commitments made in international bodies.

<u>Suggestion 1</u>: Impact Assessments should more systematically and explicitly expose any inconsistency between EU standards and international standards that the EU and/or its Member States have committed to, in order at an early stage to foster compatibility with trading partners' laws;

Effective use of resources and evidence in assessing equivalence

Introducing a requirement that regulation and/or supervision in third countries should be 'equivalent' to that required in the EU is fast becoming a standard requirement for access to the EU single market, even where access to only one member state is sought, in return for a passport across the Union. The EU should mitigate the risk of divergence from international standards with pragmatic cross-references to international standards in its equivalence measures, and through the use of data and evidence from reviews of third countries undertaken by other international institutions.

Consistency of assessments remains important for confidence purposes and to guard against discriminatory treatment, but the European Supervisory Authorities are rightly tasked to focus their limited resources on large systemic risks. Therefore a greater use of existing peer reviews, undertaken under the aegis of international bodies, would be a pragmatic alternative to the EU undertaking its own detailed assessments of all third countries.

A widely accepted lesson from the financial crisis is that supervisors should focus on outcomes and empowered local regulatory judgement, rather than an approach based on the need to mirror a precise form of regulatory system. In this context, where an EU assessment is deemed necessary over and above the relevant international standard, more specific emphasis should be placed on the responsibilities of the Member State as a 'Member State of Reference' for dependent territories. This would of course be the UK in the case of the Crown Dependencies.

<u>Suggestion 2:</u> EU authorities should where possible use existing assessments of third countries' compliance with international standards by international institutions;

<u>Suggestion 3:</u> Where there have not been assessments by international bodies, the EU should refer to existing peer review processes;

<u>Suggestion 4:</u> Where EU assessments of 'equivalence' are still deemed necessary, in addition to international or peer review assessments, the UK should have lead responsibility for determining equivalence in its dependent territories as the 'Member State of Reference';

Maintaining investor confidence

When new EU regulations are implemented in the UK, transitional arrangements for third countries provide important confidence for investors. The UK should retain competence to extend these transitional arrangements for its trading partners where EU-wide political decisions delay assessments. For example, if the EU gives priority to assessments of G20 countries, rather than those with the largest relevant industries or greatest interest in securing equivalence, the UK could give continued access to its own market pending conclusion of the EU-wide processes.

<u>Suggestion 5:</u> In the case of delays in EU equivalence decisions, the UK should have the authority to establish or extend transitional measures for access to its own market;

Transparency and consistency

For cases where discussions on financial supervision affect the relationship with all Member States, for example in the fight against money laundering and terrorist financing, the EU is a valuable intermediary. The publication of criteria for equivalence to the 3rd AML Directive in 2011 was to be welcomed : however it is less clear how those criteria have been used by Member States, and whether all Member States have been held to account for fair and objective application of the criteria, leading to some ambiguity in the value and status of the 'Common Understanding List'

<u>Suggestion 6:</u> For sectors or policy areas where the EU has introduced an agreed approach towards third countries, it should be empowered to challenge Member States that discriminate against third countries on criteria unrelated to the sector or policy area in question;

Increased political attention on the financial services sector is leading to a wider range of factors being considered in setting regulation for the sector. At its best, that can ensure a sensible balance between growth and stability objectives. However, there is also a substantial risk that competence lines may become blurred, if financial regulation is used as a tool to pursue EU objectives on subjects subject to intergovernmental unanimity, such as tax policy or EU enlargement. This can create license for discrimination or the pursuit of more political objectives.

<u>Suggestion 7:</u> Where policy objectives with a legal base requiring unanimity (such as tax) are affected by a financial services regulation, the relevant elements of the proposal should be subject to the appropriate legislative processes.

Case study: The Alternative Investment Fund Managers' Directive

The establishment of this new EU regime for authorising the marketing and management of hedge funds and private equity funds has a direct impact on one of the Crown Dependencies' most significant industries, which is a significant source of employment, particularly in the Channel Islands. Over €500bn of funds are managed and administered in the three jurisdictions . Much of this investment is sourced from outside Europe but is invested into Europe, particularly the UK, and the ability to fundraise in the UK markets is an important part of the business model. The Crown Dependencies already had regimes for supervision and regulation of such funds, which meant adaptation would be easier than in many EU Member States: the Islands would need to update and amend existing legislation and supervisory practices to be deemed equivalent, whereas many others would be required to introduce brand new legislation for unregulated firms.

After the Directive was to come into force in July 2013, there would be two phases of implementation: first, continuation of a private placement regime in Member States, subject to agreeing a co-operation agreement with ESMA, modelled on an IOSCO standard, and complementary agreements with relevant Member States; the second phase would be an equivalence assessment by the EU leading to the ability for firms authorised in the third country to market across the EU with a 'passport'.

The Crown Dependencies believe the outcome in June 2013 of an agreed MOU is an important stage in this process, and valued the time and attention given to the various issues by the UK authorities, European Commission and ESMA. Key points to note were:

- The agreed Directive included important references to third countries needing to meet international standards on tackling money laundering, financing of terrorism and tax evasion (FATF and OECD). This gave clarity on what was expected and provided reassurance that objective standards would be applied.
- The draft co-operation agreement caused initial legal difficulties due to divergences from the model MOUs agreed in the International Organisation of Securities Commissions (IOSCO). These differences – and the need to agree 100 agreements in a short timeframe – meant the work continued right to the July 2013 deadline and had some negative impact on investor certainty.
- The opportunity to feed into public consultations on Level II measures were important to improve understanding on both sides. The benefits of additional direct interactive contact were also very significant, including meetings between Crown Dependency supervisors and ESMA. However, the timetabled consultation between supervisors and with Governments did not always match more informal EU consultations with industry. This had negative impact on business confidence when, for example, early drafts of measures to tackle 'letter box entities' appeared to go much further than those discussed through official channels.
- The provisional agreement between the European Parliament and the Council on the Venture Capital Directive (later overturned) set a subjective and new definition of 'tax havens' that was inconsistent with the Commission's own definition of co-operative jurisdictions, creating concern that standards could be set and changed arbitrarily and that tax policy could be set through the co-decision method rather than unanimity.
- The sheer number of co-operation agreements and the emphasis on central control and consistency, particularly in a high-performing but only recently established body, meant that there were inevitable delays in feedback that created uncertainty for investors;
- The potential economic rewards on all sides of completing agreements are significant, and are on balance fairly proportionate to the significant efforts required. However, while the incentives for implementation, and consequences of non-implementation, were repeatedly

made clear to third countries, this appears to have been less strong for the Member States, some of whom have not yet fulfilled their responsibilities under the Directive

- A harmonised approach to the MOUs and co-operation agreements was a necessary condition for workability: fortunately no Member State has yet used the option of gold-plating the agreement, but allowing such additional requirements creates some uncertainty about effectiveness of future co-operation and about the possibility of genuinely cross-border investment funds, which are particularly important for access to finance and for returns to investors in smaller jurisdictions and countries.