HSBC

Douglas J Flint CBE
Group Chairman

Rt. Hon. George Osborne MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

20 January 2014

Dear Chancellor,

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

HSBC welcomes the opportunity to respond to HM Treasury's call for evidence on the Balance of EU competences in financial services and the free movement of capital.

We believe that UK based financial institutions such as HSBC benefit from the EU single market in financial services. This is shown by the UK's large trade surplus in financial services with the rest of the EU and by the scale of the UK financial sector, the biggest in Europe. London in particular has prospered as a financial centre not just as a result of deregulation in the 1980s but also as a result of the extension of the single market. This has allowed a significant concentration of financial groups in the UK. This includes those headquartered outside the EU, which can then branch freely throughout the EU provided that they submit to being regulated under EU and UK rules. This concentration of activity generates significant employment and tax revenues in the UK. Additional foreign competition drives higher productivity and efficiency, creates deeper and more liquid markets, and lowers the cost of capital and credit to UK companies and consumers, increasing the overall competitiveness of the UK economy.

The financial sector's experience of EU rulemaking has been mixed, however. The understandable and significant increase in EU rules in response to the 2008 financial crisis and to create the Banking Union, alongside the creation of the European Supervisory Authorities (ESAs) and increasing use of EU Regulations with direct legal effect, have resulted in a significant increase in EU harmonisation. Many of the measures enjoy broad support, as they are rooted in reforms agreed at international level. But there are concerns over the quality of the legislation produced, often to very compressed timetables. The financial sector and its regulators would benefit from a regulatory "pause" to allow measures to bed down.

HSBC Holdings plc
Level 42, 8 Canada Square, London E14 5HQ
Telephone: +44 20 7991 2889 Facsimile: +44 20 7991 4675
Web: www.hsbc.com

More generally, in the years following the crisis less weight has been given to competitiveness and growth concerns, with a consequent risk that stability concerns are reinforcing "home bias" and unwinding some of the benefits of globalisation. While this was to some extent inevitable following the crisis, the EU Long Term Investment agenda – which HSBC fully supports – offers an important opportunity to rebalance priorities back towards the crucial role of the financial sector in supporting growth and investment in the UK and the wider EU economy.

Given the global nature of wholesale markets in particular, in general greater harmonisation of rules is beneficial in delivering financial stability and proper market conduct, provided that rules are proportionate and necessary, based on evidence. Conversely, the regulatory fragmentation experienced at the global level, as the G20 reforms are implemented, shows the costs and inefficiencies of a non-aligned approach. This has become particularly evident as rules become more prescriptive and have an increasingly material impact on market structure and business models, in some cases leading to conflicts of law or competitiveness challenges. A notable example is the EU remuneration rules, which do not respect the proportionality or subsidiarity principles. Allied to this, the EU's "equivalence framework" for third country rules can sometimes give undue weight to reciprocity concerns, while jurisdictions outside the EU may take an unhelpfully narrow view of equivalence. We believe that the EU should place more emphasis on mutual recognition or "substituted compliance", and consider how global standard setters and trade negotiations can support this process.

At the same time, this increase in harmonisation of rules at the EU level does not so far appear to have changed significantly the predisposition or indeed ability of the British Government to regulate its financial sector in a manner increasingly super-equivalent to much of the rest of Europe. This is notably evident in the gold-plating of the Capital Requirements Directive. Our concern is that there are proportionately diminishing stability benefits as capital levels increase and that, over time, the UK approach could present risks to London's long-term attractiveness as a European base for foreign banks, particularly if the Banking Union is successfully implemented. In this respect, continued UK membership of the EU will be important in ensuring that euro-denominated trades can still be cleared within the UK. The ECB has been clear that, but for existing rules, it would insist on bringing such activity within the Eurozone.

Recent experience also highlights areas of concern with the current legislative process. For example, the complexity and speed involved in adopting new prudential legislation have meant that due process, while generally respected, has not always been followed. Moreover, the current legislative process does not always provide the level of legal certainty needed for proper compliance. Our detailed response attached offers some suggestions as to how the EU legislative process might be improved.

In conclusion, we would reiterate that the UK benefits from the EU single market, including from harmonised financial sector rules, to the extent that these are well-crafted and proportionate. Risks to UK competitiveness stem not only from the potential for badly conceived and executed EU rules but also from the UK's propensity to gold-plate EU rules and to produce distinctive rules of its own with competitive consequences such as the Bank Levy, which adds significantly to the cost of basing a multinational banking group in the UK, and the Vickers ring-fencing proposals. This type of impact is unlikely to be resolved were the UK to leave the EU. Moreover, engagement in Brussels by the UK, with its more pro-market, pro-competition philosophy, is often beneficial. It can help deliver better outcomes for EU consumers and businesses, insofar as the British Government focuses on economic concerns rather than issues of sovereignty. We therefore strongly support the UK's aim of building alliances with like-minded member states and the EU institutions to promote reform from within, thus ensuring that the single market in financial services can continue to deliver economic benefits for the UK. Equally important, the Government may wish to examine when and the extent to which its own approach to regulation may need to evolve to reinforce and strengthen growth and competitiveness.

Yours sincerely

Review of the Balance of Competences
Single Market: Financial Services and the Free Movement of Capital
HSBC Holdings plc Response to HM Treasury Call for Evidence

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?

As a universal bank with a large presence in the UK, HSBC is able to offer banking services to many companies and financial institutions, using London as one of its major wholesale markets hubs – alongside Hong Kong, New York and Paris. To a large extent this reflects London's scale as a global financial centre and its role as the EU's primary centre for risk management and liquidity in financial instruments. While HSBC's main banking operations in Europe are organised through locally incorporated legal entities, we are also able to take advantage of EU passporting rules to branch smaller continental European operations out of our UK subsidiary with a reduced level of bureaucracy.

The overall experience of EU rules has been uneven, however. In the aftermath of the major crisis, the financial sector is undergoing significant and necessary re-regulation to promote greater financial stability and create a Banking Union, in part to ensure the survival of the Euro. While many of the measures are necessary and enjoy broad support, having been agreed at the international level by the G20, implementation creates significant issues. In some cases this is a result of jurisdictional differences which introduce additional complexity or even conflicts of law; in others it is as a result of "gold-plating" of international measures by the EU or of EU measures by the UK. In other words, the principles of proportionality and subsidiarity are not always respected, with non-legislative options rarely if at all explored. Measures are proposed at the EU level when they are not fully justified, because there is a perception either that certain activities contributed to the crisis, or that they could lead to one in the future.

Wholesale financial markets are global, so in general harmonisation of rules at the EU level to support financial stability, drive proper market conduct and deliver other policy objectives is right and proper. The experience of the G20 reforms shows quite starkly the inefficiencies of – and additional cost burdens imposed by – regulatory fragmentation. Provided that the resulting rules are proportionate and necessary, based on evidence, in general more harmonisation is required, not less. This should bring with it a reduction in the UK's tendency to gold-plate EU rules. EU harmonisation is, however, necessary but not enough. Some form of mutual recognition between rules in the EU and other jurisdictions is needed increasingly urgently. This is explored further in the answer to question 5.

Moreover, both prudential and market conduct rules, as they become more prescriptive, are having an increasingly material impact on market structure and thus on individual firms' business models. Examples of this include increased ring-fencing of capital and liquidity and mandated central clearing. Over time, while such measures are likely to reduce diversity in the financial system and so aid regulatory oversight, they may also undermine stability if they lead to increases in correlation risk. It should be noted, however, that these elements are also to be found both in the international reforms and in measures proposed by the British Government.

The creation of the Banking Union is in principle very welcome. But it is leading to a complex and to some extent unintuitive overall framework, with apparent gaps and exclusions. The new framework also risks introducing additional layers of bureaucracy for banking groups headquartered outside the Eurozone but with significant entities (such as HSBC's in France and Malta) inside the Eurozone.

One area where the financial sector would benefit from less action at the EU level is remuneration. Here the EU has significantly distorted the principles agreed by the Financial Stability Board through the Capital Requirements Directive, to be supplemented by detailed rules drawn up by the European Banking Authority (EBA). These legislative changes, which we recognise are not supported by either the British Government or the Prudential Regulation Authority (PRA), will impact the entire HSBC Group on a global basis, while they will impact only the European operations of banking groups headquartered outside Europe. As with other international banks based in Europe, this could have a damaging impact on our competitive position in many of our key markets outside Europe. In this respect the British Government's legal challenge may, if successful, establish a helpful precedent. It is, moreover, more difficult for the EU to address issues of extraterritorial application of rules from outside Europe (for example, from the US) when EU rules themselves have explicitly intended extraterritorial impact, as with remuneration.

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?

The UK is a key beneficiary of the EU single market as shown by the UK's £15.2bn trade surplus in financial services with the rest of the EU[1]. This has more than doubled over the last decade and is roughly the same size as the US's trade surplus in financial services with the rest of the world. The UK has also benefited from the many jobs and huge tax revenues that the sector supports. The EU is the biggest single market for UK financial services. The UK's financial sector is the largest in Europe and it has prospered as a result of UK membership of the EU. Its size is linked to London's role as a global financial centre and, in particular, as an entrepôt to the single market for non-European banks and other financial institutions, many of which choose to branch their continental European operations out of a subsidiary established in the UK.

In the last decade there has been a significant increase in legislative activity at the EU level in response to the financial crisis, to extend the single market and to build the Banking Union. Three European Supervisory Authorities have been created further to harmonise rules at "Level 2" and to harmonise supervisory practices; and the Banking Union will indirectly impact the UK in terms of supervisory dynamics and potentially, in future, the balance of power when rules are drawn up. The European financial sector and its economy would however benefit from a regulatory "pause" to allow proper implementation and bedding down of measures already agreed.

1 According to TheCityUK, *UK and the EU: A Mutually Beneficial Relationship*, December 2013.

Any assessment of the balance of power between the EU and national levels must, however, look beyond the face of the legislation and consider how EU and national powers and prerogatives are being used, and their economic impact. While it is often argued that the increasing use of Regulations (as opposed to Directives) at EU level will result in a more level playing field in the single market, this is not intrinsically the case. While Regulations do not require implementation in national law, they may still be interpreted differently by supervisors. The existence in certain cases of parallel Directives (notably the Capital Requirements Regulation and Directive) and, indeed, Pillar 2 supervisory measures, produces additional complexity.

In essence, an increasing level of EU activity and harmonisation does not appear so far to have significantly reduced the UK's powers to regulate and supervise its financial sector. Increasingly the UK regulatory framework is in practice operating in a manner which is super-equivalent to the rest of Europe, affecting the competitiveness of UK headquartered banks, especially in providing wholesale banking services within the single market. In particular, the cumulative impact of the various policy options that the PRA has chosen to exercise in implementing the Capital Requirements Directive will likely raise the capital funding costs for UK banks substantially; and it remains to be seen whether measures proposed at EU level will be compatible with the UK approach to mandating bank structures – though Commissioner Barnier has said that he does not wish to prevent the UK from going ahead with implementing the recommendations of the Independent Commission on Banking ("Vickers").

Vickers is also an example where the UK could do better at upstream engagement with the EU institutions and other EU member states to avoid regulatory "front running" on issues that will later become the subject of proposals at the EU level. In the case of bank structural reform, the patchwork of national measures not just in the UK but in France, Germany, Belgium, etc, as well as extra-territorial US rules, has made inevitable a consistent EU proposal to defend the single market.

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

The sheer size of the EU single market, the largest in the world, is a major factor in the success of the UK's financial sector, attracting significant foreign direct investment to the UK and additional foreign competition[2]. This drives higher productivity and efficiency alongside deeper and more liquid markets, ultimately delivering more choice while lowering the cost of capital and credit to UK companies and consumers. Alongside the single market in financial services, the UK financial sector also benefits from the wider talent pool available as a result of the free movement of labour within the EU. Taken together, all these factors make the UK more globally competitive.

[2] According to TheCityUK, *Key Facts about UK Financial and Professional Services*, January 2013, foreign companies invested £40bn in the UK financial services sector between 2008 and 2011.

In recent years, competitiveness and growth concerns have been de-emphasised in the EU policy agenda while stability concerns have occupied centre stage, manifesting themselves in a myriad of measures addressing capital, liquidity, leverage, bank structures, recovery & resolution, market conduct and structure, margining, clearing, etc. Policymakers will always have to balance conflicting objectives. But the end of the terms of the current European Commission and Parliament provide a natural point at which to reflect on the significant progress that has been made in advancing regulatory change to reduce risk in the financial system and begin to focus more squarely on how best to re-establish growth and competitiveness in the European economy. This will rely in part on ensuring that the financial sector rules still to be implemented do not have unintended consequences that reinforce home bias and unwind some of the benefits of globalisation. A central consideration should be ensuring that the prudential frameworks for banks and insurers support growth and investment in the UK and wider EU economy. Market regulation should not result in fragmentation of providers, market structures or customer groups. The Long Term Investment agenda promoted by the European Commission in its 2013 Green Paper is central to achieving this shift in priorities.

In terms of consumer protection, it became clear in the aftermath of the crisis that, once some EU member states had decided to increase the level of protection offered by deposit insurance schemes significantly, harmonisation at a higher level throughout the EU then became crucial. This is another area where EU level action has been beneficial.

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 EU policy response to the financial crisis has resulted in a large volume of legislation decided in a short timescale, in large part owing to the need to meet political undertakings by the G20. Implementation deadlines have also been compressed. While the reasons for this are understood and accepted, the quality of legislation has nevertheless suffered. It is to be hoped that, with the most important post-crisis measures now agreed, quality might once again take precedence over speed.

Recent experience also highlights areas of concern with the current process. For example, the current legislative system produces outcomes that do not always provide enough legal certainty. Level 1 negotiations may produce text that does not give enough direction for the European Supervisory Authorities (ESAs). This results in mismatches between Level 1 agreements and Level 2 outcomes; and the Level 1 text may also contain technical errors acknowledged by all parties but which cannot be changed easily. There may also be questions over whether an ESA has, in drafting Level 2 rules, exceeded its mandate or fundamentally extrapolated from the Level 1 text in a manner that could not have been anticipated from the original legislation. This applies particularly to the EBA ITS in areas such as 'Own Funds under Articles 33(2), 69 a(6) and 79(3) of the draft Capital Requirements Regulation (CRR) Part Three' where the extent of capital deduction for direct, indirect and synthetic financial sector holdings was far beyond what could have been anticipated by a reading of the Level 1 text. Moreover, the technical standards which provide the detail necessary for compliance may not be finalised by the time they are due to come into force in accordance with dates set in the Level 1 text. This is the case with about 100 EBA Technical Standards now delayed for finalisation in 2014, beyond the CRD IV implementation date.

In HSBC's response to the recent European Commission consultation on the Review of the European System of Financial Supervision, we recommended that the Commission and co-legislators provide more guidance in legislative proposals about the specific objectives of the Level 1 legislation to help interpretation and rule writing. A clear process could be set out for a review of instances where it is believed that an ESA has exceeded its mandate or deviated from the relevant Level 1 text. We also suggested looking at empowering the ESAs to amend technical errors in the Level 1 text or relevant technical standards. We also proposed that the ESAs grant periods of temporary relief in cases where not enough information had been made public to enable parties to know what the law was and to comply with it, subject to appropriate oversight by the co-legislators.

A consequence of ambiguous regulation and late implementation (as with the CRR) is that banks often have had insufficient time to consider and clarify the final legislation and importantly, no regulatory body with which to engage in this task. This is in part due to the increasing trend in EU financial services legislation towards directly applicable Regulations instead of Directives.

Since a Regulation does not require transposition by the member states, it is important that its text is clear, well-structured and unambiguous both as to Level 1 obligations as well as on matters delegated to technical standards. Where this has not been the case, the use of a Regulation to implement rules should not absolve national or EU regulators from a responsibility to clarify legislation as necessary and appropriate. In the case of the CRR, neither the PRA nor the EBA has been willing to engage with banks on such points. While a Frequently Asked Questions (FAQ) process has been established by the EBA to address questions of interpretation, responses can take many months. Additionally, uncertainty about the status of these FAQs has been raised following statements by the PRA[3] that these had no legal effect. This risks disparate interpretation between banks, reducing the effect of harmonised legislation and potentially leading to increased compliance risk.

As noted above, however, despite increasing harmonisation and use of Regulations, gold-plating of EU rules remains a problem in the UK, notably with implementation of the Capital Requirements Regulation and Directive. In this respect, and leaving aside the need for greater textual clarity within Regulations, the issue is primarily a policy choice of minimum vs. maximum harmonisation rather than the choice of legal instrument.

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

Given the extent to which financial markets are interconnected, regulators must increasingly cooperate with their international counterparts to ensure that rules are internationally compatible and practicable. While the G20 has played an increasingly important role in shaping regulation, implementation across the G20 has been uneven. In some cases it has given rise to extra-territorial application and potential conflicts of laws, both of which can lead to sharp increases in compliance risk and in the cost of doing business.

3 See the PRA's CP 5/13, *Strengthening capital standards: implementing CRD IV*, paragraph 1.17.

In the past, the EU has sought to reduce regulatory burdens through harmonisation or mutual recognition. Often this has happened through regulatory dialogue such as that between the European Commission and US regulators, where the EU can carry more weight than individual member states. By way of example, the mutual recognition of accounting standards delivered through this dialogue directly benefits HSBC, which is listed on five stock exchanges including New York. Since 2007 we have been able to produce a single set of accounts under International Financial Reporting Standards, avoiding the additional burden of reporting also to US accounting standards.

More recently, however, partly in response to unhelpful (if unintended) extra-territoriality in the application of US rules such as the Dodd-Frank Act, the EU has opted to introduce "equivalence" requirements. Where these have been used, predominantly in measures governing wholesale market conduct (such as the Markets in Financial Instruments Directive, the European Market Infrastructure Regulation and the Credit Rating Agencies Regulation), negotiations have proceeded less smoothly.

We are concerned that the EU equivalence framework can sometimes give undue weight to reciprocity concerns. Equally, we believe that jurisdictions outside the EU may take an overly narrow view of equivalence. In our view this should mean equivalent, but not necessarily identical, regulatory and supervisory outcomes.

We believe that the EU should place more emphasis on mutual recognition or "substituted compliance". It should consider whether there is a role for global standard setters, such as the International Organisation of Securities Commissions (IOSCO), in achieving this. In doing so, they could build on the type of peer review process established under the auspices of the Basel Committee and perhaps draw inspiration from the World Trade Organisation's (WTO) dispute settlement process. As an EU member, the UK is also able to benefit from the EU's strong negotiating leverage on Free Trade Agreements (FTAs). We recognise the efforts that the British Government and others are making to use such tools as an additional means of driving regulatory convergence.

We would also note that EU institutions often deal with powerful independent regulators, such as in the US. The ESAs should be capable of playing a full role in those discussions. The current debate on extraterritoriality is highlighting the differences between these jurisdictions in terms of their institutions and their legislative process. Accordingly, we believe that the ESAs should be equipped with enough powers and resources to act with operational independence and to negotiate with their international counterparts effectively, subject to oversight by the co-legislators.

We welcome recent efforts made by the European Commission to advance wider engagement with, and recognise the capabilities of, regulators outside the transatlantic markets, in particular in emerging markets – the future significant trading partners of EU institutions. More priority should be given in the legislative process to embracing these partners, notably China.

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

The European market for retail banking services is largely national. This reflects societal, language, taxation, political and legal differences between member states. Demand for cross-border provision of retail financial services is limited. The proposed EU rules on cross-border bank account switching are likely to impose higher costs for limited benefit. This is particularly the case for consumers living outside the Eurozone, given the additional currency risk. Indeed, problems resulting from retail consumers in some member states taking out mortgages denominated in currencies other than their own have led to new EU rules prescribing higher risk weightings for such loans. Moreover, the potential for mass account switching between EU member states inside the Banking Union could itself become a new source of instability.

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 creation of the ESAs and European Systemic Risk Board (ESRB) at the heart of the European System of Financial Supervision (ESFS) acknowledges the extent to which financial markets have become interconnected and the existence of systemic risk at the European level. The ESAs represent a significant step towards further deepening of the single market in financial services and improved supervisory coordination.

Nevertheless, the ESFS is a relatively new development and, as set out in more detail in our response to question 4 above, we believe that action needs to be taken in three key areas:

(i) to ensure legal certainty, a key principle of EU law;

(ii) to provide adequate time at all levels of the legislative process so as to produce high quality reform, with all legislation drafted via a consultative process grounded in a sound impact assessment; and

(iii) to clarify institutional relations, both within the EU and internationally, as well as the remits of the different institutions within the EU. The ESAs need to be empowered so that they can fulfil their mandates, while ensuring proper accountability and delivering an appropriate distribution of power between the EU institutions. The ability of the ESAs to deal with their international counterparts should also be assessed – and adjustments to the powers of these institutions and the processes by which they operate considered – to ensure that the EU negotiates effectively at the international level (see also answer to question 5 above).

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?

The UK's active participation in the EU is a significant factor in delivering EU legislative outcomes that benefit or at least do not damage the vibrancy of the UK's financial sector. Moreover, during its G20 Presidency, the UK played a leading role in shaping the post-crisis consensus, and no doubt membership of each of the G20 and the EU reinforces the UK's influence in the other.

Recognising the importance of financial services to the UK and its relative expertise in this area, the UK is rarely outvoted on EU financial services rules, despite them being subject to qualified majority voting in the Council. More recently however, we have seen examples of the UK being outvoted, notably on the Capital Requirements Directive, alongside the apparent demise of the so-called Luxembourg Compromise whereby, by convention, EU Member States would not be outvoted on issues of national importance.

Engagement by the UK, with its more pro-market, pro-competition philosophy, to shape and determine EU positions is hugely beneficial. It can help deliver better outcomes for consumers and businesses. Put simply, the UK is good for the EU, and this appears to be recognised by some continental European politicians. In recent years, however, the UK has taken a rather different approach, with considerably less emphasis on competitiveness, on minimising EU regulation or on optimising its efficiency. This has resulted in a different policy dynamic, with markedly fewer advocates of proportionate rules. Moreover, the UK has increasingly placed its primary emphasis in EU negotiations on sovereignty concerns rather than economic concerns.

The UK currently has a number of highly skilled and effective Members of the European Parliament, who punch well above their weight in terms of their contribution to the legislative process. It is crucial that UK MEPs continue to play an active role in the process. Moreover, the UK is under-represented in the permanent staff of the EU institutions and the lack of an adequate pipeline of candidates means that the percentage of UK nationals is falling. The key to remedying this lies partly in Whitehall Departments placing a higher value on – and devoting greater resource to – EU-related skills and expertise.

EU regulation is far from perfect, but, from within the EU, the British Government retains the ability to seek improvements to its rules; and while it is sometimes assumed that adopting UK rules to replace those from the EU would be better and less burdensome, this is far from clear. Moreover, given both the G20 international agenda underpinning many EU financial services rules and the propensity of the UK to place additional burdens on top of (ie. gold-plate) EU rules, the contention is not well evidenced. UK-only regulation would not necessarily be better for the UK than EU regulation, with all its imperfections.

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?

In general, the level of transparency in the legislative process tends to be strongest in the European Parliament. The "trilogue" process where final compromises are struck, often very quickly, remains a black box, however. And while the UK has well developed mechanisms for Parliamentary scrutiny of the positions that the British Government takes with regard to EU decision-making, it is not clear that all aspects of EU policymaking are receiving a proper degree of democratic scrutiny at all levels, particularly given the unprecedented level of EU rulemaking in the post-crisis period.

The quality of impact assessments has suffered in recent years, notably in the case of the proposed Financial Transactions Tax; and it often seems that not enough weight is given to responses by external stakeholders to public consultations – but that is not just a feature of EU processes. On the other hand, the European Parliament, which has acquired significant additional power through successive changes to the EU treaties, currently undertakes more dynamic and effective discussions with external stakeholders.

It is sometimes claimed that impact assessments cannot be published in advance of a legislative proposal by the European Commission and that only the Commission can produce such assessments to avoid cutting across its right of initiative. This is not self-evident, however, since the right of initiative is administrative and not absolute. Should there be legal obstacles to producing independent impact assessments as part of a process to determine *whether* to legislate, it would seem worth exploring how these could be removed.

In general, the later stages of the EU policymaking process, where substantive changes may be made to draft rules, do not lend themselves to proper impact assessment. It might be possible to do more to understand costs and benefits in the later stages if timelines were adjusted.

Due process is generally respected, though attempts are occasionally made to sidestep full democratic oversight. This is a particular risk when a high volume of extremely complex technical legislation is being negotiated. In the final stages of negotiation of the Capital Requirements Regulation, an attempt was made to introduce substantive new changes to rules on leverage that had not yet been agreed even at the international level, without proper scrutiny by the co-legislators. Once alerted, the co-legislators prevented inclusion of these changes pending further developments at the international level. The rules were subsequently amended substantively in the Basel Committee.

The development of the Level 2 rules to underpin the European Market Infrastructure Regulation (EMIR) highlighted a relatively new process that could be improved in a number of ways. The original intention, to allow greater flexibility on reporting of trades for smaller non-financial corporates, was not reflected in the draft Regulatory Technical Standard (RTS) produced by the European Securities Markets Authority (ESMA). The views of the European Parliament, having signalled serious concerns with the text, were not given enough weight by the European Commission. The timetable and schedule of the Parliament's committee meetings left little time in which to react formally, illustrating that even due process itself, including deadlines set in legislation, may not always fully reflect the importance of democratic accountability.

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?

To a large extent this is a false dilemma. The free movement of capital is central to the single market; and the removal of capital controls – the UK being among the first to do so – is today a requirement under the EU Treaty. Where temporary capital controls have been reintroduced, for example in Cyprus, the debate is over how quickly these can be lifted.

Before the financial crisis, a key aim of EU legislative action was to underpin the single market in financial services. Since the financial crisis, however, banks have been subject to a range of national regulatory actions within Europe which have led to "home bias" becoming a persistent problem, fragmenting the single market. Supervisory actions have increased the ring-fencing of capital and liquidity within the EU, so constraining banks' cross-border activities to support economic output and growth and reducing competition. The actions of the Irish authorities during the crisis, to underwrite all deposits, introduced significant distortions and forced other countries to react in order to prevent deposit flight.

As mentioned above, many of the obstacles to capital flows are due to the existence of national discretions in EU rules and in prudential supervisory practices, which remain part of the EU regulatory framework despite the drive towards greater harmonisation through the Capital Requirements Regulation (CRR). The final rules in the CRR also deliver significant flexibility for the UK and other member states to operate a national macro-prudential policy.

So if anything, it might be argued that restrictions on Member States taking measures to limit cross-border capital flows have not been effective or stringent enough. There remain risks to the stability of peripheral EU member states, for example, with knock-on effects on the stability of the region as a whole, from unilateral policy initiatives from larger member states including the UK.

EU member states have generally reserved the right to manage their own tax affairs by requiring unanimous agreement to any EU initiated tax changes. As the dynamics of tax systems are often different from those of regulatory frameworks, it could in general be argued that a blend of national measures, with robust double taxation relief, is a reasonable price to pay to maintain competitive tax systems. In any case, national measures that threaten the free movement of goods, services, persons or capital within the single market can already be challenged under the EU Treaty.

However, some national measures to achieve tax objectives may undermine the benefits of the EU single market. The UK Bank Levy, for example, which has significant extraterritorial reach, represents a significant additional cost of basing a multinational banking group in the UK. A higher proportion of HSBC's payment of the levy relates to activities (including deposit taking) outside than within the UK. And a study[4] suggests that stamp duty levied at 0.5% on UK equities could reduce pension funds at retirement by 0.7-3.5%; raise the cost of equity capital by up to 12% in the UK; and that its abolition could result in a permanent increase in GDP of 0.24-0.78%.

---

4 Oxera (2007), *Stamp duty: its impact and the benefits of its abolition.*

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?

The policy response to the Eurozone crisis is likely to have a profound impact on how the EU operates in the future. Eventually, the creation of the Banking Union is bound to increase economic and financial policy integration in the Eurozone.

While it is right for the UK to remain outside the Banking Union given that it is not part of the Eurozone, and that ultimate resolution authority in the UK remains with the Bank of England and HM Treasury, the Government will need to consider the risks this presents to London's long-term attractiveness as a European base for foreign banks. If the Banking Union is successfully implemented, London is in the longer term likely to see some reduction of its entrepôt role given the larger pool of capital supporting the Eurozone financial system.

The UK will therefore need to remain an active participant in the EU to ensure adequate safeguards for access to the single market in financial services across the whole of the EU as the Banking Union develops. This goes beyond concerns about national sovereignty.

An existing concern is that the technical rules developed by the EBA could be dominated by the views of the ECB. But a more significant economic concern is the ECB "location policy", which seeks to require that central clearing of most euro-denominated trades take place inside the Eurozone. Currently the EMIR Regulation includes a non-discrimination statement that disallows the ECB location proposals. But an EU with an effective Eurozone majority (as will be the case by the end of 2014) might lead to pressure to rewrite the rules. This would almost certainly happen if the UK were to leave the EU. Many banks will wish to clear their derivatives trades with a single central counterparty (in the case of UK-based banks this will almost always be in London) since this creates less legal risk, as only one insolvency regime applies. Mandatory clearing of Euro-denominated contracts with a local central counterparty could fragment the clearing market; make it more expensive (as there would be less competition); and break netting arrangements, which could increase systemic risk.

A further concern is the Enhanced Cooperation procedures under the EU Treaty, whereby nine or more member states can agree measures to integrate further. The EU Treaty includes a proviso that such cooperation must not undermine the single market, constitute a barrier to trade or distort competition between member states. The proposed Financial Transactions Tax would seem to breach this provision. The single market would be more likely to suffer further such attacks, were the UK no longer part of the EU.

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

As noted above in our response to Question 8, UK engagement is beneficial and valued by continental politicians as it can help to deliver better outcomes for consumers and businesses, provided the British Government focuses on economic concerns as well as issues of sovereignty. The overall positive response to the EU Long Term Investment agenda shows that the UK is not alone in wishing to deliver increased growth and competitiveness in Europe. Indeed, as the Prime Minister recognised in his 2013 speech on the UK's relationship with the EU, the UK is best able to promote reform by continuing to work inside the EU, with like-minded member states and the EU institutions. This is likely to be the best route towards ensuring that the single market continues to deliver major economic benefits for the UK and the rest of the EU.