The British Chamber of Commerce for Luxembourg
Association sans but lucratif

Response to *Balance of Competences Review* call for evidence on *Single Market - Financial Services and the Free Movement of Capital*
January 2014

Introduction

The British Chamber of Commerce in Luxembourg, representing leading financial services organizations with a presence in Luxembourg, wish to express their views on certain questions raised in the *Balance of Competences Review* call for evidence on *Single Market - Financial Services and the Free Movement of Capital.*

Luxembourg and the UK have a strong business relationship in the area of financial services as a significant number of UK financial services firms carry out business in or through Luxembourg. Most of the largest UK banks and asset managers have activities in Luxembourg: for example, as at 31 October 2013, there were over 120 UK based promoters with funds in Luxembourg representing assets under management in excess of €230 billion, and some UK banks and insurance undertakings also have activities in Luxembourg. Luxembourg financial services firms also carry out business in the UK.

In the financial services market, Luxembourg generally positions itself as a European and global hub where financial services organizations can set up operations and access UK, EU and international clientele.

Luxembourg offers UK financial services organizations appropriate structures, an EU recognized regulatory framework, experienced multi-lingual service providers and access to international markets and an international clientele. Luxembourg has regulatory and tax regimes which meet international standards and offers financial services organizations appropriate flexibility to conduct business efficiently.

The most significant business relationship is in the area of asset management. UK-based asset managers choose Luxembourg as their domicile of choice for certain of their flagship investment funds and management entities. Such a UK-Luxembourg relationship in asset management generally operates as follows:

- From a competencies perspective, portfolio management is carried out in the UK. The investment fund and management entity are set up and operated in Luxembourg; for example, oversight, risk management, depositary and administration activities are carried out in Luxembourg
- From a business perspective, the Luxembourg-domiciled fund is marketed and distributed to investors in the UK/EU via an EU passport and/or internationally, leveraging Luxembourg's international brand recognition in this market as well as its specific advantages in the area of investment funds

A second significant business relationship is in the area of private equity. UK-based private equity houses may use Luxembourg in either or both of the following ways:

- As their domicile of choice to set up and operate their private equity fund structures and management entities
- To set up and operate structures to hold the underlying assets of the private equity portfolio

A third significant business relationship is in the area of real estate. UK-based real estate managers use Luxembourg as their domicile of choice to set up and operate their international real estate fund structures and management entities and many of the related holding structures.

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A fourth significant business relationship is in the area of banking. UK-based banks carry out one or more of the following business in Luxembourg:

- As service providers to various types of investment funds, for example, offering depositary and administration services
- As private banks offering services to UK and international clientele
- As bankers to companies, especially international companies, that have Luxembourg activities
- As investment bankers and traders in the institutional market

Finally, in the area of insurance, there are a number of different business models including:

- Luxembourg as a hub for international life-insurance
- Specific insurance business set up in Luxembourg such as shipping insurance
- UK insurers offering life and non-life insurance directly in Luxembourg through free provision of services
- Luxembourg insurers with life and non-life insurance business in the UK, either through branches or free provision of services

1. How have EU rules on financial services affected you or your organization?

Common EU rules strengthen the ability of UK and EU financial services firms to build international businesses in financial services, as illustrated in the introduction from a UK-Luxembourg perspective.

A good example is the UCITS Directive, a piece of EU legislation applied across the European Economic Area, which has enabled asset managers and their service providers to build the globally recognized and trusted UCITS brand. The UCITS Directive, as amended, has been mutually beneficial to the UK asset management industry and Luxembourg fund servicing business. UK asset managers have leveraged the UCITS brand to grow their investment management and brokerage businesses, leveraging the Luxembourg platform as the leading global distribution hub, enabling UK managers to access investors in almost all regions of the world, including Europe, Asia and Latin America. The UCITS brand has been such a success that it has allowed Luxembourg to develop as a hub for the international distribution of funds. This success can be measured by the fact that since the UCITS regulation past into national law, Luxembourg has progressed from not being a player in this space to the largest cross-border fund domicile in the world with net assets in excess of €2.5 trillion. This has been of significant importance to UK asset managers as through the use of this EU regulation they have used Luxembourg as a fund domicile but still allowing these asset managers and fund promoters to conduct portfolio management activities from the UK. This business model has led to both jurisdiction creating a competitive advantage in their contribution to the fund value chain and as thus has been mutually beneficial.

Financial services businesses with operations in the UK and Luxembourg are subject in general to three levels of regulation:

- The international regulatory agenda, including G20, which may be implemented by national regulation and/or European Union regulation
- European Union regulation, as transposed into national law (Directives) or directly (Regulations)
- National regulation in countries where they operate, including the UK, Luxembourg and generally countries where they distribute their products

Members are of the view that the regulation in most jurisdictions in which they operate globally is converging; however, global regulation needs to be much better aligned (see next section: *Are they proportionate in their focus and application?*).

UK financial services groups operating internationally have to comply with the highest level of regulation to which they are subject (under the parent group regulator or college of regulators principles in the EU), and therefore adopt this as their standard within their whole organization. The national regulatory specificities require them to adapt their global approaches to each jurisdiction in which they operate. It is also felt that significant regulatory requirements will be driven from the domicile of the group head office, which for the purposes of the report is UK based. Therefore UK as well as Luxembourg regulation is commonly applied by Luxembourg entities for UK head office organizations.

Are they proportionate in their focus and application?

The participating financial services organizations are generally of the view that the overall level of regulation was too high and therefore not proportionate to the objectives in focus or application. Organizations would overall prefer principles-based regulation as opposed to the more rules-based model. However, it is not clear that regulation would be any less onerous if it was determined at individual member state level, rather than at EU level. It is noted that many EU regulations are based on regulations already in place in one or more member states and particularly in the UK, e.g. the Markets in Financial Instruments Directive (MiFID) largely adopted principles already enacted in the UK, the Insurance Mediation Directive (IMD) polarised insurance intermediation as was already the case in the UK, the Retail Distribution Review (RDR) foreshadowed the Packaged Retail Investment Products (PRIPS) etc.

Actors in the industry tend not to distinguish too much the source of regulatory change when expressing concern about increased regulation. So it may be useful to consider the issue in terms of the three main purposes of EU regulation:

- Free movement of capital through the creation of a single market in financial services: it is recognised that extensive harmonisation of regulation is a pre-requisite of this and that the UK is a net beneficiary of the single market in financial services and the free movement of capital (witness the emergence of London as the leading centre for EURO denominated capital transactions).
- Consumer protection: much consumer protection regulation remains at the member state level, where it is sometimes a smoke-screen for straightforward protectionism. Significant compliance cost attaches to complying with member-state specific consumer protection regulation, upheld under “general good” principles.
- Financial stability: this an area where supra-national bodies (G20, IMF etc.) have a big influence. It is widely acknowledged that responses at a national level cannot adequately address global risks. It is less clear whether the EU can add usefully to more global influences in this area, other than where the Eurozone is concerned.

While national regulators may have more flexibility to build principles based regulation, the overall consensus is that principles-based regulation is more challenging to develop. It also requires a different approach to regulation and supervision; today’s multiple political agendas will nevertheless result in a significant amount of rules-based regulation. As an example, it is unlikely that an important jurisdiction could implement regulation substantially different from US and EU regulation on clearing and reporting of derivatives transactions.

While some regulation may be beneficial overall for large financial organizations, for example in the area of improved governance and systems, it does mean additional investment (e.g., in staff, advice, systems), entailing additional costs borne by financial services organizations impacting their competitiveness. The overall level of EU regulation is considered as a barrier for small financial services businesses to enter and conduct business in the marketplace, innovate, boost competitiveness and create added value. This is likely to have a knock on effect on competition, consumer choice, and employment.

Financial services organizations are therefore in favour of greater consultation between regulators at Member State, EU, third country and global levels in order to achieve better alignment between regulatory initiatives.

The proportionality principle is particularly relevant for smaller financial services businesses. In general the proportionality principle is applicable to a relatively small percentage of each EU regulation in the area of financial services, and therefore has limited impact. An issue arises with diverging interpretation and application of the proportionality principle in each Member State. However, the financial sector acknowledges the importance of the proportionality principle in its current application to smaller financial services entities.

Do they respect the principle of subsidiarity?

In general, participants felt that whilst subsidiarity appears to be implemented over the short term, they did not feel that subsidiarity was relevant in practice over the long term. Typically areas of national Member State regulatory competence in financial services transition towards areas of EU competence; in other words, Member State national regulatory initiatives often lead to EU initiatives. As an example, elements of the Retail Distribution Review are being integrated into current EU legislative initiatives, or EU guidelines. This has allowed the EU to use local regulations to drive common EU regulation. Often a local initiative such as the said Retail Distribution Review is led by local legislation, in this case the UK. This has encouraged other jurisdictions, for example the Netherlands and Germany, to implement similar national legislation. Currently, such legislation is also being developed at EU level through MiFID II. This approach is of great benefit to UK asset managers wanting to distribute their products across the EU as instead of having various local rules across many jurisdictions a common EU led initiative allows for easier administration and hence lowers compliance costs through the harmonization of fund distribution rules.

Over the long term, it is, therefore, difficult to identify many areas where Member States will in practice retain competencies in the area of regulation, as opposed to supervision.

Do they go too far or not far enough?

Examples of potential regulatory developments which may go too far are the split of trading activities of banks from other activities of banks, and remuneration rules for banks. Participants suggest more thorough consultation, as discussed in Question 2.

2. How might the UK benefit from more or less EU action? Should more legislation be made at the national or EU level?

Financial services organizations represented feel that the UK and Luxembourg would benefit from a more principles-based EU regulatory approach rather than the current more rules-based model. They favour simpler regulation, e.g. by removal of duplication between national and EU regulation.

Participants are of the view that a longer period of time should be allocated to consultations on regulatory action including more thorough consideration of the key objectives, business implications and risks, and consultation including a wider range of stakeholders. In addition to public consultations, regulators should engage in greater discussions with industry representatives and key players.

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

It was generally felt that global regulation, as implemented in the EU, does improve financial stability. A good example of this is the implementation of Basel III in the EU through the Capital Requirements Directive (IV) package which has, *inter alia*:

- Increased the levels of capital held by European Banks
- Led to improvements in liquidity management
- Led to improvements in risk management and governance

A consequence of the CRD IV, however, has been the restriction on the availability of lending, leading to lower growth and the potential consequence that borrowers seek funding from alternative and often less regulated sources.

Although supervisory authorities are collecting an increasingly large volume of information, participants questioned whether they are able to use the information effectively in order to identify emerging risks in financial markets.

Participants felt that although the higher level of EU regulation can put financial services at a competitive disadvantage, there are also benefits as clients appreciate the level of regulatory protection and therefore may invest in European products and markets in order to benefit from the protection as opposed to less regulated products and markets.

Participants agreed that consumer protection has increased through a number of EU regulatory initiatives such as the UCITS Key Investor Information Document (KIID) and MiFID. Due to the fact that initiatives are aimed across various segments of the financial sector, for example such as Insurance (Solvency II and IMD) and Shadow banking (Money Market fund regulation) this creates a level playing field and thus engenders competition and financial stability.

4. Is the volume and detail of EU rule-making in financial services pitched at the right level?

We refer the reader to the response to Q1 section on *Are they proportionate in their focus and application?*

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 UK firms with activities in Luxembourg overall favour the UK remaining within the European Union, and prefer to focus on how the UK can appropriately and effectively influence the European Regulatory agenda in financial services. The firms believe that the UK could better influence the EU regulatory agenda in financial services if it joined the Eurozone and the Banking Union. The firms are currently neutral as to whether participation in the Eurozone or the Banking Union would affect the volume of the UK business in financial services. However, there was some concern expressed that the UK's position outside these initiatives could disadvantage UK firms – for example initiatives to bar London from remaining a leading centre for EURO denominated transactions, which were considered entirely inappropriate. The EURO, together with the USD, is now a leading international currency and any attempt to circumscribe the geographical scope of transactions in the EURO runs counter to free movement of capital principles and globalisation trends in capital transactions.

A different example is the Financial Transaction Tax (FTT), where participants are of the view that this voluntary enhanced cooperation between certain Member States is neither positive for the UK nor EU financial services in general. The FTT could result in a decrease of financial transactions linked to cooperating states.

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