HM Treasury

ECONOMIC AND MONETARY POLICY

CALL FOR EVIDENCE (MARCH 2014)

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Questions 1-4. Governance and Policymaking Process:

This note addresses HM Treasury's consultation on UK economic and monetary policymaking. My comments will focus on developments as they relate to UK economic and financial policy in respect of some aspects of the Banking Union legislation and the Commission's proposals for an integrated economic policy. The economic governance system provides an adequate allocation of competences between the European Commission and the Council. The Commission has taken on an important role in initiating legislation and policy to achieve 'Genuine Economic and Monetary Union'.[2] The three pillars of 'Genuine Economic and Monetary Union' consist of the first pillar of Banking Union, the second pillar of an integrated budgetary framework, and the third pillar of an integrated economy policy framework. In all three areas, the Commission is playing important role in initiating policy and influencing the content of legislation. For example, its legislative work for the Banking Union has begun to take effect with the creation of the Single Supervisory Mechanism and the Single Resolution Board. Moreover, the Commission's powers to approve technical implementing standards and regulatory standards proposed by the European Supervisory Authorities provide it with significant influence in shaping the development of EU financial regulation. The Commission also initiated and is overseeing the implementation of the Six-pack and Two-pack agreements to promote more budgetary discipline for Member States. These important policy initiatives – along with its longer-term initiative to enhance productivity through competition and labour market reforms – suggest an important realignment in the political influence of the Commission at the expense of the Council.

In addition, the Banking Union proposals mark an important development in the creation of 'an internal market within the internal market', from which the UK has excluded itself from any governance responsibility. The UK government's hope that the internal market principle of free movement will protect British firms and investors from any disadvantage in the operation of the banking union is misplaced. The steady move to macro-prudential

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[2] See European Commission (20 March 2013), 'Towards a Deep and Genuine Economic and Monetary Union: Ex ante coordination of plans for major economic policy reforms', COM (2013) 166FINAL.

supervision and regulation will lead inexorably to regulatory barriers to entry for British financial services firms in the euro area and in other participating Member States in the Banking Union.

The European Parliament – especially the Economic and Monetary Affairs Committee (ECON) - has taken on an important role based on its enhanced powers in the Lisbon Treaty in reviewing and approving legislative proposals by the European Commission and engaging in the ‘trilogue’ with the Council and the Commission in negotiating the final details of proposed legislation. Although complicated at times and in need of additional transparency regarding its decision-making and deliberations, the European Parliament’s role is vital for democratic accountability in influencing the development of European legislation. The European Parliament’s influence will probably grow further following the May 2014 elections, and the Council’s approval of Jean-Claude Juncker as European Commission President speaks volumes as to Parliament’s considerable influence in EU policymaking. The UK government should improve its policy coordination with the ECON committee (and other Parliamentary committees) in order to play a more meaningful role in influencing the development of EU economic and monetary policy.

Regarding the role of national parliaments, the EU Treaty (Treaty for the Effective Functioning of the European Union, the ‘Lisbon Treaty’) empowers national parliaments to scrutinise the European legislative process and to request and take evidence from EU policy makers and representatives of the relevant EU institutions involved in initiating policy and deciding legislation. The role for national parliaments therefore is important; they should utilise their powers of scrutiny more over European legislation and policy and engage EU policy-makers in meaningful dialogues regarding the direction of EU policy. In this regard, the British Parliament’s House of Lords Europe Committee has played an important role in scrutinising proposed EU legislation and considering the impact on the UK.

The current European Union governance structure is appropriate for EU institutions. But the Banking Union legislation – especially the Single Supervisory Mechanism regulations and the Single Resolution Mechanism regulation and inter-governmental agreement creating a resolution fund - will require adjustment of the powers of the Eurogroup so that they – as Finance Ministries representing national governments - can exercise oversight effectively of the ECB and SRM institutions and the member state bodies charged with carrying out related supervisory and resolution functions. However, the Eurogroup Finance Ministers do not have the necessary competences under the EU Treaty to exercise oversight of fiscal and financial policy. An enhanced role for the Eurogroup may require amending the Treaty.

In addition, the recent crisis reveals weaknesses in macro-economic and financial policy coordination that contributed significantly to substantial trade imbalances between states and fiscal deficits at member state level that were exacerbated by a common monetary policy. This would suggest that in the Eurozone macro-economic and monetary policy should be coordinated more directly with fiscal policy at the Eurozone level, for example, by allocating competence to the Eurogroup over certain aspects of fiscal expenditure and taxation that could be utilised to address macro-economic imbalances across the Eurozone.

Questions 5-13 Monetary, fiscal and economic policy

'Genuine Economic and Monetary Union' consists of three pillars: 1) Banking Union, 2) an integrated budgetary framework, and 3) integrated economic policy framework. Through the third pillar, the Commission has made significant progress in recent years in developing the 'Convergence and Competitiveness Instrument' (CCI) which establishes contractual arrangements between Member States and EU institutions for the states to undertake measures to enhance their competitiveness and market structures. Over the medium-term, the Commission's proposes deeper coordination of labour and tax policy. And in the long-term the Commission aims to achieve full fiscal and economic union in the euro area and other participating Member States that could provide 'a means of imposing budgetary and economic decisions on its members, under specific and well-defined circumstances.'[3] The Commission's legal basis for undertaking these initiatives is Article 121 TFEU, which states that 'Member States shall regard their economic policies as a matter of common concern.'[4] Member States in the euro area have already achieved a great deal in terms of greater economic coordination; for instance, the Commission has utilised the 'European Semester' to enhance surveillance of economic, budgetary, and structural policies. Although these initiatives have strengthened the European Monetary Union and made it more robust for facing future financial crises, some observers have criticised this system of economic governance as complex and in need of streamlining.[5] Moreover, the focus of the European Semester has been criticised as being primarily concerned with imposing binding obligations on Member States regarding fiscal consolidation and implementing austerity measures, with less emphasis on the need to achieve economic growth and employment targets.

Although the UK has opted to stay out of the euro and more recently decided not to be involved Banking Union (pillar 1), it could still influence the development of substantive regulations that apply to all EU states pursuant to EU banking legislation (ie., CRD IV). Nevertheless, the UK's refusal to play a role in the governance of the Banking Union and to contribute to the European Stability Mechanism will create tensions between the UK and other Member States that will lead over time to the creation of an 'internal market within the internal market' or in a worst case scenario a UK withdrawal from the European Union with the City of London becoming a large off-shore banking centre. The implications of Banking Union are immense for British economic and financial policy.

The UK already plays a limited role in the integrated budgetary framework (pillar 2) by, among other things, not submitting to binding fiscal targets regarding the 3% deficit and 60% debt rules. The UK has also not embraced, at a policy level, the need to achieve deeper economic coordination (pillar 3). Although more engagement is needed here, it is fair to say that much of the progress in pillar 3 has occurred in the CCI contractual arrangements to ensure Member States abide by fiscal consolidation plans, whilst longer-term objectives in the

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[3] Ibid.

[4] Similarly, article 136 TFEU provides for closer coordination among euro area countries.

[5] See House of Lords, European Union Committee, 'Genuine Economic and Monetary Union' and the implications for the UK', (HL Paper 134) p. 55.

areas of tax and employment/labour regulation appear remote and politically difficult to achieve.

The Stability and Growth Pact (SGP) has been given stronger legal force through the adoption of the Six-pack and Two-pack agreements. The European Commission is playing an instrumental role in conducting surveillance of EU countries to ensure that they do not run unsustainable deficits and control their national debts. The two-pack agreement applies fiscal sustainability requirements to the euro area with binding sanction for countries which miss their targets. Regarding the SGP's impact on the UK, it should be emphasised that the UK has opted out of the sanctions regime and of any legally binding obligation to implement the SGP's main strictures: that national deficits not exceed 3% of GDP, whilst national debts not exceed 60% of GDP. Nevertheless, the UK has reporting requirements to show how it is managing its variable and structural deficits and controlling its national debt over the medium term.

14. EU financial assistance mechanisms:

EU financial assistance mechanisms were crucial during the banking and sovereign debt crisis in keeping the Eurozone together and in imposing strict conditions on EU states which borrowed from these facilities in improving their fiscal positions and stabilising their macro-economic positions. These mechanisms – EU Balance of Payments facility (EUBoP), Macro-Financial Assistance (MFA), the European Financial Stability Mechanism (EFSM), and the European Stability Mechanism (ESM) – were all utilised at different stages of the banking and sovereign debt crisis and they disbursed limited funding to stabilise the EU financial and sovereign debt markets in conjunction with strict oversight and conditionality and additional support from the International Monetary Fund. All four of these funds are examples of how EU states working together can overcome collective problems to prevent financial contagion from causing more serious financial instability problems. For example, the United Kingdom's financial sector was spared serious harm from the collapse of the Irish banking system by the EFSM bailout of Ireland in conjunction with IMF support. Similarly, in 2008 the UK economy's exposure to a near collapse of the Hungarian, Romanian and Latvian economies because of the impact of the global credit crunch was minimised by the use of EUBoP funding for these countries in conjunction with IMF support and strict conditionality programmes. The UK's financial contribution to these 'mechanisms' and its involvement with other EU countries in overseeing the related international adjustment programmes has benefitted the UK economy and financial system greatly by protecting it from a great deal of economic and social damage arising from the banking and sovereign debt crisis.

The MFA provided assistance for Iceland and other third countries which in conjunction with IMF support protected the British economy and financial sector from unnecessary fallout from the crisis. The EUBoP, MFA and EFSM have been good value to the British taxpayer, and the UK's potential liability under these funds is disproportionately small compared to the relative benefit the UK derives in terms of stabilising Europe's financial sector, as demonstrated in the recent crisis. In contrast, the UK is not liable for any exposures under the ESM, and given the stability-enhancing benefits for the British banking sector and economy – for instance, the ESM's support for the two main Cypriot banks in 2012 has directly

benefitted many British account holders and counter-party British financial institutions of Cypriot banks (not to mention the ESM support for Spanish banks that greatly helped Santander and its UK subsidiary) – it raises the question whether Britain should take on a proportionate liability in the ESM fund to help pay for the protection it has received (and probably will receive again) through the fund's disbursements.

Also, regarding the ESM, the newly developed direct bank recapitalisation programme requiring euro area national governments to contribute 10/20% of the total ESM contribution unless justified by exceptional circumstances (as well as injecting capital should the bank not fulfil the 4.5% Tier 1 equity ratio requirement) has been criticised by some[6] as defeating the tool's very purpose of breaking the link between failing banks and sovereigns. Indeed, even Olli Rehn, the EU's economic and monetary affairs commissioner, said that the ESM would merely be "diluting" the link.

15. The European Single Resolution Mechanism

The European Parliament and Council reached final agreement in March 2014 on the Single Resolution Mechanism (SRM) regulation. The SRM will serve as one of the pillars of the Banking Union that would complement the supervisory powers of the ECB in the Single Supervisory Mechanism (SSM). The SRM is designed to put banks experiencing solvency problems and which are supervised by the ECB/SSM into resolution with minimal costs to taxpayers and to the broader economy. The SRM would apply the substantive rules of the proposed RRD to banks that are supervised by the ECB/SSM.[7] The main requirements of the SRM proposal are the following: 1) the ECB would identify and make an assessment of a bank in a SSM/SRM state and whether it was in serious financial difficulties and should be resolved; 2) A Single Resolution Board (SRB) consisting of representatives from the Commission, the ECB, and national authorities where the bank operates would make a recommendation on resolution; 3) the Commission and the Council would have the ultimate authority for triggering a bank resolution and in approving the resolution plan; 4) national resolution authorities would implement the approved resolution plan under the supervision of the Single Resolution Board; and 5) a single Bank Resolution Fund is established by separate inter-governmental agreement under the oversight of the SRB that would be funded by contributions of the banking industry that would lead over time to cross-border mutualisation of financial support by banks across SRM participating states.

The SRM has attracted criticism on a number of grounds, including its complexity of decision-making structure in which the decision to trigger a bank resolution must involve the SRB making a recommendation based on an assessment provided by the ECB which must then be considered and approved by the Commission, and in turn approved by a special majority vote of Council. Moreover, of particular concern, the ECB – as the bank supervisor – has no legal competence to engage in any way in the resolution of a bank its supervises.

[6] Peter Spiegel, „ESM's direct recap plan: Really 'breaking the link'?", FT Blog of 17 June 2013 (available at http://blogs.ft.com/brusselsblog/2013/06/esms-direct-recap-plan-really-breaking-the-link/)

[7] The EU Council of Finance Ministers and European Parliament Committee on Economic and Monetary Affairs are negotiating details of the SRM proposal and the draft RRD and are expected to reach final agreement on both proposals in the autumn 2013.

The ECB can only conduct assessments of banks it supervises and convey these assessments to the SRB, which then considers the ECB's assessments as part of its broader decision to recommend (or not) to the Commission and to Council whether a bank should be taken into resolution. This complex procedure with layers of decision-making authority for different institutional bodies limits significantly the ability of the SRM and SRM Board to act quickly and effectively in putting a bank into resolution. Moreover, the SRB has no central bank representatives from participating states on the governing board or involved in any way in resolution decision-making. Given the fact that central bank liquidity support could be necessary in supporting the restructuring of a large bank – especially in the early years of SRF operations while the fund is small – it is certainly a weakness in the regime that no central bankers are in a position to influence the resolution process. This should be contrasted with the United Kingdom's supervisory and resolution framework where the resolution unit is in the Bank of England and its independence protected by statute.

The complexity and opaqueness of decision-making in the SRM presents a threat to UK financial stability regarding how and whether a large cross-border European bank with operations in the UK could be resolved in an effective manner. By excluding itself from decision-making in both the SSM and SRM, the UK has limited significantly its ability to influence events in a crisis involving a euro area bank and to promote meaningful reforms to the Banking Union regime that would enhance financial stability whilst protecting the City of London's position as a leading financial centre.

16. Failing banks and public finances

While the Recovery and Resolution Directive's (RRD) bail-in tool can shift the burden of a failing bank away from the public finances, some argue[8] that the true debt ratio relevant to a country's solvency is not the public debt to GDP ratio, but rather its total external debt – both public and *private* – to GDP, so that by bailing in the (usually) domestic creditors the shift of the debt burden away from the public sector merely moves it to the private sector, which still burdens the country's total solvency ratio in the broader sense.

Another concern raised by the creation of the SRM's Single Resolution Fund (SRF) is that its funding mechanism based off a levy on bank balance sheets from across the Eurozone, resulting in countries with more solvent banks indirectly subsidising countries with less solvent banks, mutualises debt in a way that may violate article 125 of the EU Treaty. One could argue, however, that this is not a (dreaded) mutualisation of losses in itself, but rather a mutualisation of an otherwise unused buffer in other countries – leaving their public finances *ceteris paribus* untouched.[9]

17. ECB policies linked to sovereign debt transactions?

Beyond the regulatory incentives to hold sovereign bonds, the ECB's cheap 3-year loans at 1% interest (known officially as the Long-term Refinancing Operations – LTRO) adopted in

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[8] Wolfgang Münchau, „The EU will regret terminating a banking union", FT of 30 June 2013 (available at http://www.ft.com/intl/cms/s/0/4d433ec6-de93-11e2-b990-00144feab7de.html)

[9] Speech by Jörg Asmussen (ECB Executive Board Member) at the Atlantic Council, 9 July 2013 (available at http://www.ecb.int/press/key/date/2013/html/sp130709.en.html)

2011 led governments to turn to their banks as *buyers-of-last-resort* who – under the LTRO Programme – used the ECB funding to invest in sovereign bonds (the so-called "Sarkozy Trade"). Even the ECB *itself* can, for the exclusive purpose of fulfilling its monetary policy mandate, purchase sovereign bonds on the secondary market. These policies together heavily reinforced the link between sovereign debt and banks (as governments then rely on banks either buying their bonds with ECB money or selling them to the ECB on the secondary market). The ECB has attempted to sever this link between the banks and euro area sovereigns by approving in July 2014 a new but modified LTRO programme that would require banks whose bonds were purchased by the ECB under this programme to lend in turn to the private sector in order to boost the Eurozone economy or to report why they have not been able to make such loans. The ECB's direct involvement in promoting bank lending to the private sector may conflict with the ECB's new role as a bank supervisor in the SSM. This makes the complete organisational separation between the supervisory and monetary policy arms of the ECB all the more essential as set forth in the SSM Regulation.

18. Mutual influence of banks and sovereign debt, the so-called "doom loop"

The link – or so-called 'doom loop' - between bank balance sheets and sovereign debt arises mainly from EU bank capital regulation, which has traditionally set a 0% risk-weight for EEA/EU member state government bonds issued in domestic currency to regulated financial institutions.[10] In addition, government bonds have been exempted from the 25% large exposure limit that has applied to most other risk-based assets.[11] The Capital Requirements Directive IV – consisting of a Directive (CRD) and a Regulation (CRR) – continues to apply in the CRR both the 0% risk-weighting to sovereign bonds issued by EEA/EU states and the exemption from the 25% large exposure limit for sovereign bonds issued by EEA/EU states. The original Basel III proposal for a Liquidity Coverage Ratio permitted only government bonds to be used as the highest quality liquid assets (Level 1 assets) to fulfil the Basel III Liquidity Coverage Ratio.[12] The revised Basel III and EU CRR, however, widens the scope of assets that can be held to fulfil the Liquidity Coverage Ratio requirement, making such bonds merely one of many other admitted liquid assets.[13] The Basel Committee announced in July 2014 that it will review the risk-weightings for sovereign bonds.

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[10] Annex VI Part 1, Pt. 4 CRD; Art. 114(4) CRR.
[11] Art. 113(3)(a) CRD ; Art. 400(1)(a).
[12] The original Basel III Liquidity Coverage Ratio mainly included in its 'Level 1 high-quality liquid assets' (i.e. assets that, for LCR purposes, could be held without limits or haircuts, as opposed to Level 2 HQLA), "cash, central bank reserves, and certain marketable securities backed by sovereigns and central banks", since such assets "are typically of the highest quality and the most liquid, and there is no limit on the extent to which a bank can hold these assets to meet the LCR." (BIS, *Summary description of the LCR*, January 2013, available at http://www.bis.org/press/p130106a.pdf)
[13] Art. 416(1)(c)(i) CRR

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