HOUSE OF LORDS

EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE

Review of the EU financial regulatory framework

Written and Oral evidence

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**House of Lords EU Economic and Financial Affairs Sub-Committee's inquiry into the EU Financial
Regulatory Framework**

Introduction

In response to the Committee's call for evidence, this letter offers some insight into the current state of the EU financial regulatory framework from the perspective of Aberdeen Asset Management PLC (Aberdeen).

Aberdeen is a global asset manager and a FTSE 100 company headquartered in the UK. We are based in 25 countries around the world of which half are EU Member States. 69 % of our global assets under management (AuM), which reached £331 billion as at 29 August 2014, are domiciled in the EU where we employ 70% of our total workforce of over 3,000. Although the UK domestic market remains by far our biggest single market to raise assets (56% of total AuM), the EU Internal Market excluding the UK constitutes the second biggest trade area to develop our business.

Please visit our website at www.aberdeen-asset.com for more information about the Aberdeen group.

1. Importance of the EU to UK and international markets

As evidenced in the preliminary remarks, the UK as an international financial services centre has benefited from the EU Internal Market and completion of the Internal Market will sustain the UK's long-term economic success. I refer you to the written evidence submitted by our main trade body, the Investment Management Association, for an overview of the importance of the EU to the UK asset management industry.

2. Difficult balance of competences between the EU institutions and supervisory agencies in the operation of the financial regulatory framework

The basic framework for EU financial services legislation is largely consistent with the UK framework, specifically in setting out key principles for conducting business, recognising the expertise in the market and expecting the inclusion of proportionate supervision.

The framework runs on a balance of competences between the Council, European Parliament and European Commission in combination with the European Supervisory Authorities (ESAs) which play an important part in promoting consistency and enforcement in EU legislation by introducing implementing measures known as "level two" [1]of the framework.

The significant programme of regulatory reform which has been applied to EU financial services since the global crisis of 2008 has significantly increased the number of delegated

[1] The EU supervisory and legislative framework is based on a four-level legislative procedure: a legislative act at level one; implementing measures at level two; consultation and guidance by the ESAs at level three and supervision and enforcement at level four.

acts and regulatory technical standards falling under the remit of the ESAs, in particular of the European Securities and Markets Authority (ESMA). There has been a notable shift in the level of expertise required at this level, coupled with increased time pressure for ESMA to provide detailed guidance to the industry and to agree technical standards under the level two process. This demanding timeframe is limiting the amount of input that industry can have in assisting ESMA's work such as providing data and working on calibrations.

A clear example of the uneasy articulation of output from the EU's legislative stakeholders is the Markets in Financial Instruments Directive (MiFID 2). A difficult compromise was achieved between the Council, Commission and Parliament and ESMA was tasked with drafting technical standards and delegated acts. When the first consultation from ESMA was published, the European Parliament rapporteur, Markus Ferber MEP, raised doubts about the interpretation of the legislative text by ESMA. Although these doubts were subsequently alleviated at an ESMA open hearing when the supervisory authority clarified its interpretation, such a discrepancy at the heart of the EU rule-making process is of concern for the industry.

Furthermore, when ESMA's own timeframes and deadlines to the Commission come under pressure this has a knock-on effect on the time available for the industry to respond to increasingly detailed consultation papers, as illustrated clearly by ESMA's 844 page MiFID II Consultation and Discussion Papers issued on 22 May 2014 which gave a little over two months to respond. The Commission however has recognised in its recently published review of the operation of the ESAs that the supervisory agencies require "sufficient time to prepare high-quality draft standards and allow for their public consultation within adequate time-frames"[2].

3. On-going efforts to improve EU legislation

EU rule-making may result in multiplicity of reporting obligations and disclosure requirements. Overlapping or, conversely, misaligned rules have derived from the close succession of substantial EU directives. An example of this is the potential overlap between MiFID 2 and the revision of the Insurance Mediation Directive (IMD 2). While MiFID 2 addresses investment products, IMD 2 sets out the framework for selling insurance products that include an investment element. These can be very similar products in practice but inconsistency between the two directives has the potential for consumer confusion and increased risk of regulatory arbitrage. Another example stems from industry concerns relating to divergences in interpretation at national level on the evolution of the Key Investor Information Document (KIID) as rules continue to evolve under the regulation on packaged retail investment products (Prips) and how those will be coordinated with the sanctions regime of UCITS V. Additionally many third countries (non-European jurisdictions) require KIID like reports but each with their own specifications.

There are grounds to propose that throughout the level one and level two process, time is allocated to conducting rigorous impact assessments as well as a robust cost-benefit analysis. A perceived lack of high-quality cost-benefit analysis was also highlighted in the Commission's report on the operation of the ESAs. This was a welcome finding as regulatory costs are not simply a matter for the industry, indeed a significant proportion of such costs

[2] http://ec.europa.eu/internal_market/finances/docs/committees/140808-esfs-review_en.pdf

will ultimately be borne by end investors. Equal consideration should be paid to the quality of impact assessments and to the impact of aggregated existing regulation. We recognise that substantial regulatory change was necessary following the financial crisis, but we believe that the focus could have been more precisely targeted. Whilst it is recognised that regulatory changes have produced heavy burdens for the financial services industry, we believe the key impact on customer outcomes is less well understood, partly as there will inevitably be a time lag until the additional costs reach investors.

We have noted with interest the creation of new portfolios for the 2014 - 2019 term led by Jean-Claude Juncker, to address some of the concerns expressed by both business and citizens on the functioning of the European executive. We welcome the new position of First Vice-President in charge of “Better Regulation, Inter-Institutional Relations, the Rule of Law and the Charter of Fundamental Rights” which will be dedicated to creating a better regulation agenda to steer and coordinate the Commission's work and remove unnecessary red tape and undue burden for industry. All Commissioners and Vice Presidents will need to convince the First Vice-President that their initiatives do not breach the principles of subsidiarity and proportionality. I would add that legislation dealing with third country access and extraterritoriality needs to be carefully handled to maintain market- openness and avoid market protectionism in the EU.

The creation of these new responsibilities within the Commission is a positive development, albeit one which will come under intense scrutiny as providers of financial services hope for improved coordination between the different policy arms and objectives of the EU financial regulatory framework.

30th September 2014

Professor Kern Alexander, University of Zurich and Professor Lucia Quaglia, University of York- Oral evidence (QQ 26- 44)

Evidence Session No. 2 *Heard in Public* *Questions 26 – 44*

TUESDAY 29 JULY 2014

Members present

Lord Harrison (Chairman)
Lord Balfe
Viscount Brookeborough
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland
Lord Vallance of Tummel

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Examination of Witnesses

Professor Lucia Quaglia, Professor of Political Science, University of York, and **Professor Kern Alexander**, Chair for Law and Finance, University of Zurich.

Q26 The Chairman: Professor Lucia Quaglia, welcome to Sub-Committee A. This is your first time. Professor Kern Alexander, you are a returnee to the Committee, and we are very pleased to see you here again. This is our second witness session after Sharon Bowles last week on the very interesting issue of the EU financial regulatory framework. We are hoping the two of you can help us fill in those bits and pieces that perhaps need greater study over the coming few months, as we have this natural pause with the European Parliament and the

Commission forming themselves. You will know the form; we will send you a transcript of this exchange. We will ask you to check it, look at it and improve it. If there are further thoughts that you have, please send them on to the Committee, because we will be taking evidence right up into the autumn and then hoping to report later in the year. I believe we are on transmission, so the magic eye is upon us.

Neither of you said that you wanted particularly to make an opening statement, so perhaps I may start the proceedings by saying: if you look over what has been done in financial regulation since the financial disturbances of 2008, would you say, in terms of where we are now in 2014, whether we are in at least a reasonable position to resist other asymmetric shocks that might come in to play, and indeed whether we have left sufficient flexibility in the system that we have been busily creating over the past few years? Professor Quaglia, may I ask you to start us off?

Professor Quaglia: First of all, thank you for inviting me. It might be useful to distinguish between two waves of regulatory reform in finance in the European Union since 2008. The first is really the regulatory response to the global financial crisis that reached its peak in October 2008. The second is the regulatory response to the sovereign debt crisis in the euro area since 2010 that is still ongoing. I will mainly focus on the first wave of regulatory reform—regulatory reform as a response to the global financial crisis—unless you want me to talk about banking union, which is the second wave of reform.

I would say, in overall assessment, that the glass is half full, in the sense that the European Union has issued new legislation or has revised existing legislation in banking and security markets. In terms of banking, there has been a revision of the Deposit Guarantee Scheme Directive. There has been a revision of existing legislation on capital and liquidity requirements for banks. There has been a new directive on bank resolution and recovery.

Recently, the Commission has proposed new legislation—to be precise, a regulation—on the structure of the banking system, as well as proposing new regulation on shadow banking. In security markets, there has been a new directive on alternative investment fund managers, new regulation on rating agencies, new regulation on over-the-counter derivatives and new regulation on short-selling, as well as the revision of existing rules on market abuse and on the market in financial instruments.

Overall, these are quite major reforms and they should enable the European Union to be better prepared for future financial crises. This comes with a caveat, which is that usually regulators are better prepared to deal with past financial crises. It is much more difficult to prevent or even to envisage future crises.

The Chairman: Before I ask Professor Alexander whether he agrees that the glass is at least half full, would you say that that half-full glass is strong enough to resist an asymmetric shock and does it still retain the important flexibility that is needed in financial regulation?

Professor Quaglia: I should add another caveat. There are at least two important gaps in the current regulatory framework. The first is how to deal with banks that are too big to fail, and the second is how to deal with cross-border banking failures or failures of cross-border banking institutions. The two issues are interconnected. In this respect, perhaps not enough has been done. At the very least, the Commission has proposed new legislation very recently, and the Bank Recovery and Resolution Directive has just been agreed between the European Parliament and the Council of Ministers a couple of months ago.

Q27 The Chairman: I shall bring in Professor Alexander with the question of whether you, too, feel it is a glass half full, and the same questions on asymmetric shocks and flexibility. I am going to put Lord Hamilton on call after Professor Alexander, because I know that he will

want to test Professor Quaglia on the concept of "too big to fail". Let us hear from you, Professor Alexander.

Professor Alexander: Thank you, Lord Chairman. I am very grateful to be here today. I would like to begin by attempting to answer your question. In my view, you can divide the phases of regulatory reform that we have had in Europe into two areas. We have moved through the first area, which focuses more on what I would call microprudential regulation: repairing the balance sheets of banks and other financial firms, enabling them to be more resilient to absorb future losses, should we have another banking crisis. We have moved through that phase now with the adoption of the Capital Requirements Directive, for example, and with ongoing work on the Solvency II Directive for insurance firms. Now we are moving into a different phase of regulatory reform that focuses more on the structure of the financial system. It focuses more on what some people call macroprudential regulation. Macroprudential regulation is looking at the links between firms and investors, and the structure of the financial markets. This area is trickier to regulate, because it impacts on economic policy very significantly. Therefore, we have to have central banks and finance ministries involved; it is not just about expert regulators recalibrating the regulatory rulebook.

So now we are moving into a more structural phase of regulatory reform. We have seen this happening in two areas recently. The European Commission has proposed a draft regulation on structural reform of banks, for the largest banking groups. That looks at the interconnected financial groups in Europe. Moreover, at the international level the Financial Stability Board has a consultation and a review of shadow banking going on right now. This is the non-regulated sector of banking that remains in the shadows. This is part of the new focus of regulation towards a more macroprudential framework. We are just entering that

now and it is a very difficult, complex area. There is a lot of room for error by policymakers and regulators, but it is an area that should come under scrutiny. I would say that the glass is half full.

Now, are we able to withstand an asymmetric shock? I would say that we are, in Europe at least, because essentially in Europe we have Germany standing behind the eurozone, wealthy enough to cover the cost of any major financial breakdown in the eurozone. We have the countries outside the eurozone, such as the UK, in particular, and Sweden, which are basically able to taxpayer-subsidise and to back up any banks that have problems. That is not optimal; we do not want the banking system to operate based on the fact that we have a taxpayer guarantee, but it is there for a public policy reason. That is not efficient, so the future of macroprudential regulation is to evolve the system away from the taxpayer subsidy, so that the system can absorb these losses without relying on taxpayer bailouts. Whether we will get there is very difficult to say.

The Chairman: Before I bring in Lord Carter, Lord Hamilton, on your interests.

Q28 Lord Hamilton of Epsom: I would very much like to pick up Professor Quaglia's point about "too big to fail." Both Vickers and Liikanen said that banks should not be split up. There are more and more people now saying that that is a mistake and that you should be splitting up banks. There is growing evidence that not only are they too big to fail, they are too big to manage. One gets the impression that the top management at these big banks do not actually know what is going on very often in the lower regions of their banks, where there are people fixing LIBOR and all these different dramas have come up. Was not a mistake made, both in this country by Vickers and by Liikanen, in ducking this issue? Were they not persuaded by the banks that they had to have these casino operations to rebuild their balance sheets? Should we not be going back and revisiting this? I am wondering

whether we should not be splitting these banks up to make them competitive, or to introduce a competitive marketplace—which we certainly do not have in the United Kingdom at the moment—and to avoid the problems of taxpayers having to come and bail them out.

The Chairman: Were some of your anxieties those expressed by Lord Hamilton, Professor Quaglia?

Professor Quaglia: I think it is an issue that banks that are too big to fail are sometimes too big to be saved, and sometimes too complex to be resolved. That is an issue for the European Union. I should also say that it is common to other jurisdictions as well, and there are discussions going on at the international level. As to what the European Union has done, the Commission has proposed new legislation on the structure of the banking system. This is indeed not proposing to split up banks, but it is mainly proposing to prohibit proprietary trading, and then to give national regulators the possibility of forcing banks to move other trading activities outside the deposit-taking institution.

So, I would say yes: in terms of proposing legislation, the European Union—or at least the Commission—has so far gone for a rather middle-of-the-road approach to this problem. I guess that there are two issues. First, what is economically feasible? Secondly, what is politically feasible? I think not only the big banks, but also perhaps some member states are less inclined to consider more radical proposals.

The Chairman: Let us pass on to Lord Carter because I am sure we will be able to return to this question.

Q29 Lord Carter of Coles: Looking at the EU regulatory framework, where do you think the biggest achievements have been made? Do you believe that there have been policy mistakes? That is the first part of the question. Secondly, looking at the four elements of

reform, perhaps you would like to give us a view on the most and least effective. The four elements are consumer protection, market efficiency, transparency and integrity—we would particularly like a bit of focus on the latter point there—and financial stability.

Professor Alexander: Probably the most proactive and, you might say, successful part of EU regulatory reforms dealt more with prudential regulatory reforms. It dealt with helping banks repair their balance sheets by the capital requirements regulation that we now have; the implementation of Basel III; and now a Bank Recovery and Resolution Directive, which is very important. It gets to some of the issues you raised. The Bank Recovery and Resolution Directive requires banks to write a recovery plan. A recovery plan is what management has to sit down and do to understand how the bank will respond to asymmetric shocks in the financial system. Banks were not doing this before the crisis; now they are required by law to do that in the recovery directive. Those are important areas of progress. I would say that they are steps in the right direction.

One area though that I feel has not been given enough attention has been the consumer side, especially with respect to bank selling practices. Of course in the UK we have a massive mis-selling problem, with an ombudsman busy with thousands and thousands of claims. This is an ongoing problem in the newspapers, of course, as you know. I do not think enough regulatory reform has been put into place regarding how we should allow consumers at the retail end to get redress. Every country basically has their own framework. The UK has an ombudsman and you can sue if you would like, but it is very expensive to sue so many people do not do it. There has been a debate about how we might allow collective mechanisms for consumer redress against financial institutions for engaging in mis-selling. There is no EU law on this. There is a debate, but I do not think there has been enough legislative or regulatory attention given to that. So I think there has been inadequate

movement on the retail side, but we have had a lot of progress on the prudential regulatory side.

The Chairman: Do you share that view, Professor Quaglia?

Professor Quaglia: Yes. I would say first that the main strength has been the extension of regulation to areas, activities, and financial entities that in the past were not regulated or were subject to self-regulation. I am thinking about rating agencies, hedge funds and derivatives. Also, existing legislation on capital requirements, for example, has been made more detailed. It has been tightened up, if you wish. Perhaps the weakest part has been the watering down, but I think I should not use this term because the Commission does not like it. It is more the toning down of legislative proposals during the policy-making process.

If we look at the main pieces of financial regulation, there has been a toning down of some of the provisions during the policy-making process. I am thinking, for example, about the Capital Requirements Directive or regulation, or the directive on alternative investment fund managers. Some people would argue that this toning down was welcome, in the sense that it improved the final text. But still, this process has taken place because of the different preferences of member states and because of some lobbying from the financial industry.

Besides this toning down of some of the initial proposals, the main gaps at the moment are still the issues of “too big to fail”, and how to deal with cross-border failing banks and financial institutions. It is more than a weakness; I would say in this case that the European Union has moved rather late. Indeed, the regulation on the structure of the banking industry was only proposed in January 2014. The Bank Recovery and Resolution Directive was agreed, informally at least, between the Council and the European Parliament in April 2014.

The Chairman: I am sure Lord Carter is very happy with the concept of watering down. Do you have any follow up to that?

Lord Carter of Coles: No.

Q30 Lord Dear: Professor Quaglia and Professor Alexander, good morning. I should like to invite you to go on a trip down memory lane so perhaps you can be wise after the event. Can you look at the legislative process over the course of the financial crisis and tell us what you think the effectiveness of all that was, and particularly whether the inputs of the Council and the European Parliament—their proposals—improved or weakened the position? It is a look back into the past. What were the big regulatory machines doing for good or evil?

The Chairman: I should tell you that we had a very clear steer from Sharon Bowles last week as to the work of the European Parliament.

Professor Alexander: That is an excellent question. The ECON Committee in the European Parliament really blossomed in the recent crisis. If you went back to 2008, no one really expected that the Economic and Monetary Affairs Committee would play such a significant role in legislative reform. No one would have thought that, but it did. It really initiated and worked with the European Commission on negotiating key pieces of legislation, and insisted on certain areas of regulatory reform that may not have been put in had the Parliament not played such an important role.

One area where I might say that the Parliament should have thought twice about the rules it adopted was in the area of bank remuneration. What happened there was that there were two phases of legislation in the Capital Requirements Directive III where it basically adopted a framework of principles for how bank supervisors would regulate compensation in banks. However, in the later CRD IV legislation, it adopted the 2:1 ratio for bankers' bonuses over base pay with the approval of shareholders. That type of prescriptive, legislative regulation at the EU level has not really produced beneficial results in the EU. We see many banks now

recharacterising a lot of their bonuses as allowances but not bonuses so they do not fall under variable pay, to get around that requirement.

Certain areas of banking regulation need to be more principles-based with some rules, but not excessively prescriptive at the EU level. That is where the European Parliament and the ECON Committee, with respect to the regulation of remuneration, became too prescriptive. I am not really criticising the role of the Parliament. It was very important, and the ECON Committee was very influential, but one might question some of its policies. The remuneration area is somewhat problematic.

The Chairman: What about the European Council and the Commission?

Professor Alexander: The European Council has been a brake on the enthusiasm that the Commission has in some of its proposals. It provides a good balance between the EU institutions and the member states. I am not so concerned about the Council of Ministers and the ECOFIN Committee. They played a very good role in overseeing and debating legislation. What was not anticipated was the prominent role that the ECON Committee would play. It is very important that it played that role, because it was very involved in approving and negotiating key pieces of legislation. However, I think it made some errors in the policy area.

The Chairman: That is really helpful. Lord Dear, do you want to come in?

Lord Dear: Only to invite you to have a look at burden-sharing as well and the impact of that.

Professor Alexander: Burden-sharing between the Council and the Parliament?

Lord Dear: Yes.

Professor Alexander: The Council probably could have played a more proactive role in influencing and insisting on certain provisions in legislation. The Parliament and the Commission were actually probably the main players at the end of the day. If what you are

suggesting is that maybe the Council should assume more of the political role of influencing legislation, then I would agree. The Council has the legal means to do that; it just was not as proactive. The ECOFIN was not as proactive as it should have been.

The Chairman: Lord Davies, will you come in here before I ask Professor Quaglia to answer the bulk of Lord Dear's question?

Lord Davies of Stamford: Professor Alexander, I just wanted to say that I think your remarks about remuneration can be questioned because clearly there was a big problem about bonuses. We have learnt the hard way that incentives do drive human behaviour—including incentives driving behaviour very perversely during the banking crisis. We had to do something. Had we done something on the basis of general principles, leaving it to member states to implement the actual regulations, there would have been a much greater diversity and fragmentation and much more regulatory arbitrage, with people wanting to move to different jurisdictions in order to get a better bonus deal. All I can say about banks trying to cheat by calling a bonus an allowance is that that happens in the area of tax the whole time. Whenever parliaments in this country and every democratic country enact a taxes Act or the equivalent, you have clever people who try to find ways around it. You just have to pursue them. I think that your remedy is itself slightly perverse; it would have made the position much more difficult, and much more variegated, had we not had clear principles uniformly imposed throughout the Union.

Q31 The Chairman: Let us return to the current inquiry and Lord Dear's questions to you, Professor Quaglia. Would you also not neglect the view you have of the role played by the European Commission? Many people thought that the Parliament was leading the Commission during this period. Do you think the Commission played a good and influential part?

Professor Quaglia: I think that the Commission has become more proactive, as compared to the pre-crisis period. While this is the case partly due to changes at the top level of the Commission, financial regulation has also acquired a lot of political salience. Therefore, that was a strong incentive for the Commission to be more proactive. I also think that the European Parliament is now a very important player. One can get a sense of this by looking at all the amendments that are usually proposed by the European Parliament with reference to different pieces of financial legislation. In terms of the Council, I would not use the word brake, but it often seems to me to be somehow more conservative than the European Parliament and the Commission. I guess one of the issues is that the Council is often internally divided, in the sense that different member states have different preferences and different views. That is why a compromise is usually needed in the Council for the Council to take a view.

Q32 Lord Kerr of Kinlochard: Last week, Sharon Bowles gave us an intriguing criticism of the Commission for not trying to enforce consistency across the new legislation. She argued that in the Council, member states looked after specific national interests and that therefore inconsistencies tended to come in. However, she was critical of the Commission for being consistent in each piece to its original template of previous legislation, rather than to the developing outcome of the process. She argued that it fell to the Parliament to try to make the individual pieces of legislation consistent with one another, whereas it should perhaps have fallen to the Commission. Is that a fair criticism?

Professor Alexander: I think that is a fair view. The Council is focused on issues as they are presented before it and, I agree, they take votes based on national interest. Although the member states being represented in the EU legislative process is very good for democratic accountability, it can lead to a certain fragmentation and lack of co-ordination in the

application and implementation of the legislation. The Parliament was probably playing a much more proactive role in working with the Commission to see how all these pieces of legislation linked together. I would say that is a fair criticism, yes.

The Chairman: Professor Quaglia, could you respond to Lord Kerr's question? Would you also respond to the criticism sometimes made of the European Parliament that it is a melange of national interests? Although some take the view that it did respond at a European level.

Professor Quaglia: Sorry, is your question referring to the European Parliament or to the Council of Ministers?

The Chairman: Is it true that the European Parliament reflected national interests from the MEPs or is it true that it rose above the waves and responded to some degree qua a European institution?

Professor Quaglia: In that respect the European Parliament behaved quite differently from the Council of Ministers. The Council of Ministers is mainly about national interests and national preferences. I would not make this comment with reference to the European Parliament, at least for most of the financial regulation that has been discussed. I can think of some specific exceptional cases, but I would say that the European Parliament is more representative of European interests or is at least more likely to be divided along party lines rather than national lines.

The Chairman: Unless you have a very different view, Professor Alexander, I am going to ask Lord Shutt to come in.

Q33 Lord Shutt of Greetland: How do you think the growth agenda and the support of alternative financing sources can best be promoted by the EU, with respect to regulation?

Professor Alexander: The European Commission now has a white paper out on the issue of non-bank finance and how to generate capital from non-bank sources. This is alternative sources of finance and that is a very important step. We have to recognise though that most continental European countries are heavily based on bank-led finance frameworks, so they do not have very sophisticated or deep capital markets like the UK or the United States does. In many ways, it is very important that countries try to diversify their sources of finance so they are not overly reliant on universal banks or large banking institutions. However, we should also recognise that many of these countries do not have very advanced capital market structures. They have a long way to go in evolving to that point, so it is very good that that is taken more into consideration. I see it more as a long-term policy objective.

Another longer-term policy objective that needs to be taken into account is the impact of financial regulation on sustainable economic development. We now have a policy objective by European Governments internationally to achieve a more balanced economic development agenda based on lowering carbon in our economies. There are areas of financial regulation that basically incentivise overinvestment in high-carbon activities, making it less economically attractive for investors to invest in green credit alternatives. That is something that regulators have not addressed. It is something that is on the agenda of the UN now. The United Nations Environment Programme has a working group studying how we can diversify sources of finance for sustainable economic development and how regulation plays a very important role here. However, regulators have not recognised their role or addressed this issue.

The Chairman: In response to Lord Shutt's question, Professor Quaglia, can you too embrace Juncker's concept of the capital market union, which he expressed as something that is important to him? I am not sure those around the table have a very clear idea, but Professor

Alexander was doing his level best to try to explain to us what Mr Juncker meant by that. It is clearly part of this growth agenda.

Professor Quaglia: I will give a rather general answer, which is that it seems to me that one of the key problems in regulating finance is how to solve what they call the “trilemma” between securing financial stability, protecting the competitiveness of national financial industries and securing or fostering economic growth. The financial sector, in particular in continental countries, and particularly the banking sector, is very much linked to the real economy. It is so difficult to regulate finance because it is not just a dilemma between stability and competitiveness; it is a trilemma between stability, competitiveness of the financial industry and economic growth.

Lord Davies of Stamford: You could add consumer protection.

Professor Quaglia: Yes. I guess I would include that under financial security. So it is the common good and then the private good of banks, which, in a way, is also the common good of the national jurisdictions that are hosting those banks, and then economic growth is the other common good.

The Chairman: May I ask the two of you: should we be promoting competitiveness, or should we focus on productivity? There is a subtle difference, is there not?

Professor Alexander: Productivity is very important for the broader economy. A competitive banking industry is very important to provide the services needed for businesses to increase their output and to increase the productivity of individual workers. That is how I see the linkage there. We want to have prudential regulation to ensure that banks do not get carried away and borrow too much and have too much leverage. However, we want them to be competitive, and to feel that they need to borrow short and lend long, and perform that necessary banking function in order to enhance economic output because a well managed

banking sector leads to positive externalities for the economy. We should not lose sight of that. Banks need to be regulated strictly because a poorly regulated and poorly governed banking sector leads to negative externalities on the other hand that you have to control. The link for me would be more about having a competitive banking sector that generates enhanced output for the broader macroeconomy.

The Chairman: Professor Quaglia, would you tackle that productivity versus competitiveness issue? Or is that a false dichotomy?

Professor Quaglia: Competitiveness of the banking industry, or the financial industry, has several meanings. The one I had in mind is basically to prevent regulatory arbitrage between different jurisdictions and also between different financial activities.

Q34 Lord Vallance of Tummel: I have three related questions, or perhaps sets of questions. In your earlier answer to Lord Kerr, you mentioned that perhaps the process of regulatory reform was not very good at picking up inconsistencies. Are there significant inconsistencies or contradictions between the various strands of regulatory reform that you would like to draw to our attention? You also both mentioned the phrase. “The glass is half full”. What are the gaps in regulatory reform that you think are required to be filled now? That is the first set of questions. The second is that regulatory reform nearly always brings with it costs as well as benefits. Where are the main areas of costs and inefficiencies that are coming out of these regulatory reforms, and do you believe that in those areas the benefits truly outweigh those costs? The third question in this set of questions is that regulatory reform also tends to produce unintended consequences. Do you see any unintended consequences coming across the horizon, perhaps in terms of potential regulatory arbitrage or off-balance-sheet creativity?

Professor Quaglia: Perhaps I will start with the last one, on regulatory arbitrage, because I have done quite a bit of work on that. There are two main ways through which regulatory arbitrage can take place. The first is geographically, which means across jurisdictions—between jurisdictions that are more tightly regulated and jurisdictions that are less tightly regulated. To give a practical example, the potential risk is that certain financial activities or entities might move outside the European Union to jurisdictions that are less tightly regulated. To deal with this regulatory arbitrage, or risk of potential regulatory arbitrage, international co-ordination is very important. That is why the activity of all the international regulatory fora—the Basel Committee, IOSCO and the political activity of the G20—is somehow to make sure that different reforms that take place in different jurisdictions are more or less, at least broadly, co-ordinated.

The second type of regulatory arbitrage is between different types of financial activities. Here, the one I have in mind is also a specific answer to your question. It would be moving activities from the regulated banking sector to the non-regulated shadow banking sector. To some extent, the Commission is aware of that, because in the very same month that it proposed a new regulation on the structure of the banking industry, it also proposed a new regulation on the shadow banking sector precisely at least to try to prevent or limit this type of regulatory arbitrage.

On the main gaps, I still think that there is an issue with "too big to fail" and the resolution regime, particularly for large cross-border banks and financial institutions. This is a problem for the European Union. It is also a global problem because many big US banks operate in the European Union, and the other way around. The international community is aware of this problem. The Financial Stability Board has been working on it, and is still working on it, but the issue is still open.

Professor Alexander: Some of the gaps relate to the fact that we have just come through one phase of regulation that focuses on microprudential regulatory reforms, but does not, for instance, cover the gaps in the shadow banking sector, such as looking at the structure of the financial system and where this type of arbitrage can take place. International bodies such as the Financial Stability Board and the European Commission are now looking at this. The EU financial policy focus is now on addressing these macroprudential gaps. It is of course very risky to do that, because once one starts to go down that path you impinge a lot on economic policy more generally, so you have to have other economic policy-making bodies involved in the regulatory reforms.

Cost/benefit is a very important question. We have seen a wave of regulatory reform across Europe, and I am constantly giving training sessions to bank management now about compliance with Basel III and the CRD IV, and this is very costly, with my airline ticket to London and all these things. Banks are having to go through ongoing training because of regulatory reforms, as well as so-called "bank re-education" after the LIBOR scandal. Many banks as part of their settlements have got to undergo training. That is very costly, but some of it is of course needed. It is like penitence, in a way, but you are learning from the process. A lot of the cost of complying with the new regulatory framework is beneficial and we derive benefits from it: we will probably get a safer banking system. We may not be richer because of it, but we might have a more stable economy for it because it does disincentivise banks from taking greater risk. Sometimes those risks that are seen to be very risky produce benefits for the economy if they are calculated correctly. The new cost of regulation might inhibit the taking of certain risks that could be beneficial for the financial system.

Economists are engaged in a great debate about whether or not we can precisely estimate the benefits and costs of regulation. Professor Charles Goodhart says in one of his important

works that this is almost impossible in financial regulation, because of all the different factors—different direct costs, indirect costs, direct benefits, and indirect benefits. Measuring all that out is really not practical in a policy sense, but we should not lose sight of the overall principle that we should have benefits from the financial regulatory reforms. Some of the unintended consequences have to do with banks responding to more intensive regulation in Europe by shifting some of their operations to other, non-EU jurisdictions. For instance, Switzerland has benefited a great deal. The asset management industry that was based in some parts of Europe has set up in Zurich and Geneva now. It has moved into a more lightly regulated jurisdiction that is close by, where there is no restriction on bonuses. The bankers and the hedge fund managers would rather get paid and have a residence in Geneva instead. We should not lose sight of the fact that we are in the global financial market. One of the unintended consequences of strict regulatory reforms is that financial practice can move abroad; it can move to the US or Switzerland, or to Hong Kong or Singapore. Those are challenges. It does not mean that we should not have strict regulation. I want to go back very briefly to Lord Davies' very important point: we do not want overreliance on principles in Europe because we will have many different approaches as a result and we will not have a harmonised framework. One of the examples in the EU regulatory reform where I think principles were combined efficiently with rules was the Capital Requirements Directive III, with its regulation of remuneration. It adopted, basically, a rule that said half of your bonus can be cash and half can be in shares; 60% of it can be paid in year one, but 40% of it has to be paid over years three, four and five, so you have an incentive to make sure that you are getting paid a bonus for the long-term benefit of the bank. That was a very good example of taking that longer-term focus. We want to incentivise bankers to take risks that produce benefits over the longer term, but have to have this

anchored in a rule-based framework that says, "We are going to split your bonus 50-50. The bank can pay whatever bonus it wants, but only half of it can be in cash at the most. Then you can get only a certain amount of it up front and you get paid the rest of it over three to five years". That was a very nicely calibrated regulation that was very helpful.

Lord Vallance of Tummel: Were you going to follow up that particular point?

Lord Davies of Stamford: Yes, very briefly. I think we are in agreement, but I just want to make what I believe is a pedantic but important point. You said that financial regulation may reduce volatility, but it will not make us richer. If in fact you reduce volatility, all other things being equal, we are by definition richer.

Lord Vallance of Tummel: I want to just bring it back for a moment to inconsistencies among the things that have already been done within the European Union. Are there any significant inconsistencies that you would like to bring to our attention?

Professor Alexander: There are not really inconsistencies, but there are gaps in the framework that create risk. As I mentioned earlier, the gaps include shadow banking, regulating alternative sources of finance and not having an agreed macroprudential framework at the EU-level yet. The banking union is a step in that direction, but it is only for the eurozone. We see a two-speed Europe emerging with respect to the regulation of the macroprudential gaps.

The Chairman: We will come onto that in a minute with Lord Balfe. Professor Quaglia, do you espy any of the inconsistencies that Lord Vallance is interested in or would you share Professor Alexander's view?

Professor Quaglia: I would share Professor Alexander's views. I would also talk more about gaps rather than inconsistencies. These are the gaps I have mentioned before: shadow banking, but also resolution and "too big to fail."

The Chairman: This Committee is very interested in shadow banking. We did a very brief survey, and we have exchanged letters with the Government.

Q35 Lord Balfe: Given your expertise in the area of regulation on bank capital requirements and resolution, do you believe that there are sufficient mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability? Should there be a period of calm before further reforms come in? Secondly, do you believe that the ESAs have the capacity to fine-tune legislation appropriately and is the EU process sufficiently nimble to adjust and calibrate the new rulebook?

Professor Alexander: That is a very important area of the implementation of EU regulation. With respect to the ESAs, they have had a tremendous amount of work. For instance, the EBA have adopted 40 different areas of regulatory technical standards over the past three years. The one criticism one might make of the ESAs is that while they have been very good at addressing focused individual issues and adopting and implementing technical standards, they have not had a focus on broader strategic objectives or broader policy objectives dealing with how these technical standards relate to broader financial policy. Now, the argument is that they are not supposed to be doing that because of the Meroni doctrine, a legal doctrine constraining their ability to be involved in policy-making. That does not necessarily mean that they cannot be involved in making strategic assessments about the impact of technical implementing standards that they adopt. In terms of broader policy discretion, the strategic decisions will be made by the Commission, the European Parliament and the Council. However, the ESAs should have in mind what those strategic objectives are and factor them in more in their adoption of the technical implementing standards. There has probably been greater room for inconsistency and gaps between the different technical

standards they have been adopting, because they have not been taking into account some of the broader strategic objectives of the financial legislation.

The Chairman: Incidentally, Professor Quaglia, this Committee has heard the Meroni doctrine being challenged from time to time. I do not know whether you share Professor Alexander's comments about the ESAs, but perhaps you would like to respond to Lord Balfe's question as well.

Professor Quaglia: Perhaps I will start with your first question about the regulatory framework and the resolution framework. It seems to me that in this case as well the glass is half full, in the sense that by now there is a very robust regulatory framework for the prudential regulation of banks. This goes back to the Capital Requirements I, II, III, and IV, and implementation into the European Union of the Basel agreements. I think the answer is slightly different with reference to supervision and resolution. Here I should qualify my answer by saying that it depends on whether a member state is a member of the banking union or not. In the case of the banking union, supervision and to some extent resolution have been moved to the euro area level or banking union level, which means the member states of the euro area plus opt-in countries. In the case of non-euro-area members such as the UK, supervision is still taking place mostly at the national level with some co-ordinating activity at the European Union level by the European Supervisory Authority. The same can be said with reference to resolution.

Professor Alexander: I will just add a footnote on that comment about the capital requirement regulation. I think it has introduced some element of uncertainty in prudential bank regulation. For instance, bank supervisors now have the power to conduct stress tests more frequently and more intrusively on the banks' operations. It is a good thing; they want to make sure the banks can withstand these shocks that you mentioned earlier. However,

under the CRR regulation the regulators have assumed the power to require banks to recapitalise themselves because they have not fully fulfilled a stress test objective. If they do not comply fully with the stress test the supervisor can require them to issue more capital, even though they may not be in violation of an EU rule on bank capital. They might be holding 8% regulatory capital, but the stress test scenario that they have been told to conduct by the regulator might say, "You have to hold 12% under this certain scenario. Therefore, because you are only holding 11%, you have got to recapitalise yourself some more". That creates uncertainty. I am not saying that stress-testing is bad; I think there needs to be a bit more strategic thinking about how it links up with bank management and allowing banks to plan for the future, because we want to have legal rules that provide stability of expectations for market participants. We have seen some discretionary uncertainty introduced into the CRR that could create some difficulties regarding compliance.

Q36 The Chairman: Your comments about whether the supervisory authorities could take a broader view were very interesting. Do you share the Committee's concern that the resources put by way of the EBA have been slender and scarce for the job that it has been asked to do? Do you share that concern regarding the European Banking Authority?

Professor Alexander: It should revisit the funding structure of the European Supervisory Authorities. Right now the Commission submits the request for their budget to the Parliament. The budget is basically run through the Commission and then the member states actually pay most of the running cost of the ESAs. That depletes some of the national budgets that member states have to operate their own supervisory regimes. The ESAs ought to have their own line item in the European budget and not have it run through the Commission. They would have a higher status. Lord Balfe, with his many years in the

European Parliament, would of course understand the fiscal implications of that much better than me. I might say that I think they were underfunded. One of the reasons they are underfunded is that they have to run most of their appropriations through the Commission. They do not have a separate line item in the European Parliament's budget.

The Chairman: That is really interesting.

Q37 Viscount Brookeborough: First of all, Professor Alexander, I was quite interested when you said that Germany would overcome any future crisis because it can and will bail out the rest of Europe. I do not know if everybody agrees that it would. When we were in Germany, we definitely found that there was a certain reticence to do that or, at least, that is what it was saying. You are very complimentary about, and, it would appear, a great supporter of EU regulation. You even go around the country and around the banks supporting it, and telling them how they will get around it. Would you like to comment for a moment on the impact of the regulations on the integration of financial markets in Europe? You have already mentioned competitiveness. Obviously, competitiveness between north and south within Europe is not exactly ideal. Perhaps the financial crisis has witnessed the reversal of financial flows to domestic markets. You even mentioned that some of that has actually gone outside, to Switzerland. Does this signal that certain clusters of regulations have led to greater fragmentation? To me, you do not have many reservations about what is going on. You just merely say there are gaps, and that everything is going swimmingly.

Professor Quaglia: I am a comparativist, so I am comparing what the European Union is doing to what other jurisdictions are doing, and to what has been discussed at the international level. In that respect, what the European Union has been doing is more or less in line with what was agreed at the international level.

Viscount Brookeborough: Even the financial transaction tax.

Professor Quaglia: Yes, that is correct. That is why I use "more or less". It is also compared to what the US has been doing. That is why it is a qualified endorsement from a comparative perspective. In terms of the comment about financial disintegration and market fragmentation, I believe that this is true. However, I do not think it is the main result of financial regulation post-crisis; it is a result of the global financial crisis.

Viscount Brookeborough: Should we be competing within Europe or should we be talking about Europe competing with the rest of the world? Competition within Europe merely means that you have winners and losers within Europe. This is one of our big problems with Europe.

Professor Quaglia: That is correct, but market fragmentation is more a result of the two crises—first, the global financial crisis, and then the sovereign debt crisis in the Euro area—rather than a direct result of the new financial regulation adopted by the European Union. Indeed, many would see the project of banking union as an attempt to solve or at least partly address the problem of market fragmentation, at least in the euro area, in order to break the so-called "doom loop" between sovereign debt and national banking systems.

The Chairman: Professor Alexander, would you tackle Viscount Brookeborough's point about the fragmentation of the single market, especially in financial services, and the very interesting comment from Professor Quaglia that that was broadly attributable to the global financial crisis?

Professor Alexander: In terms of fragmentation of financial markets, one of the responses in Europe was that many of the banks that were operating in many different countries reversed their investments and did not roll them over. They retreated to their home markets. That was a business decision that these banks made. There was no regulatory barrier or impediment that said they had to do that. They simply got out of markets where they had

established a greater presence. Is that a good thing? No. We want to have more integration in the European financial markets. Can regulators impose a diktat that all banks operate cross-border? No. We have to let banks know that they have a level playing field with rules and standards and they can move into markets more or less freely without having unnecessary barriers to their movement. When there is a shock to the system like the Lehman Brothers collapse, banks panic. People reversed; they retrenched into their own national markets. That was a management decision. I think that that is being steadily undone now. We are now seeing banks becoming a bit more active in Europe and establishing greater cross-border presence and also cross-border sale of products. There will be regulatory risks that have to be taken into account.

What we are seeing in Europe, which I feel is a risk to integration, is that because the new regulatory rules are very prescriptive in many ways, they have given host-country supervisors greater power than they had before the crisis to put conditions and some limitations on foreign financial firms coming into that host-country jurisdiction. That goes against the traditional principle in the EU of the home-country passport—the principle of home-country control. Because of the CRR, and I can cite a list of these regulations, host-country authorities are brought further in to the regulatory decision-making process. That is not necessarily a bad thing, but the risk is that the host-country supervisors become somewhat arbitrary or somewhat protectionist regarding foreign banks or foreign financial service firms coming into the local market. It is a concern I would have that you may undermine integration in the EU market by having more host-country authority to limit the cross-border movement of financial services.

I will make one quick comment on Germany. I do not think Germans would bail out the eurozone because they want to be angels; they would do it because it is in their interest to

do so. Germany has the euro, low inflation and a low interest rate environment. It is happy to keep the euro together because it benefits German industry. It makes more money; it is richer because of the euro. That is why it stands behind the European Stability Mechanism, a bank bailout mechanism for eurozone banks. It will continue to do so because it is in its economic interest to do it. Someone asked me three years ago in a cab coming from Heathrow, "Is the euro going to blow apart?". It was an American businessperson and I said, "No, because it is in Germany's interests to keep it together". They will find a way to prop it up, not because they want to be a good citizen, but because they make more money by having a greater eurozone area and a greater banking union.

Q38 Lord Davies of Stamford: Professor Alexander, on this very important matter of financial integration in the EU, you are right, and it is of course very encouraging, that banks are now moving back into what they often saw as slightly more marginal markets within the EU. It proves that they panicked. Does this issue not relate very much to the issue of developing capital markets in the EU along the lines of the United States? Banks are not going to set up lots of branch networks all over Romania, Bulgaria and so forth, but if you have a greater securitisation process then banks can hold a much wider range of debt without building up those overheads. You would get banks with balance sheets much more like you have in the United States, where they hold a great many loans that were not originally actually made by them but by other banks, and which they have required through the securitisation and capital markets mechanisms.

The Chairman: Professor Alexander, that was directed at you.

Professor Alexander: That is an excellent point regarding how banks can move not just by setting up different branches but through having financial innovations and securitisation structures. The problem is that in many of these markets in Europe, they do not have a lot of

experience in operating alternative financial markets, so the securitisation structures have to be under English law and the collateral has to be with a UK-based bank, because you cannot enforce on the collateral in Romania or in Bulgaria. It is very difficult to have that type of legal certainty for investors investing in bank assets in these countries because the creditor remedies are very limited and, in terms of the structure of those capital markets, investors themselves do not have a lot of money; a lot of the investment capital comes from the Government. The EU nevertheless should try to develop these markets.

Lord Davies of Stamford: It needs to address those obstacles.

Professor Alexander: Exactly, yes.

The Chairman: Professor Quaglia, would you like to come in on that?

Professor Quaglia: Perhaps I will just make a small qualification, which is that banks from the old member states have indeed moved into the new member states. Some of the Baltic states, for example, have earmarked 80% of their national banking system to be foreign-owned.

Lord Davies of Stamford: Not all major banks are going to open regional branch networks in all EU countries. That does not make any sense; it would not make any sense, but they can hold diversified portfolios.

Professor Quaglia: That is correct, but I still think it is important to point out that in many of the new member states the vast majority of the banking system is actually foreign-owned.

Q39 Earl of Caithness: May I move the discussion more into the international arena? How does the EU effectively portray its interests in international banking agreements? How are those agreements translated into regulations with any form of consistency and harmonisation? That is my first question. I will come on to the others in a moment.

Professor Alexander: First of all, I would say some EU countries already play a very important role in international financial organisations, like the UK, France and Germany, which are longstanding members of the Basel Committee and very influential in adopting international standards of bank regulation. It has been the tradition in Europe at least that EU policymakers take the Basel Capital Accord, transmit it into EU law and basically adopt almost all of it into the EU legal framework, and even give it more precise legal backing nad sanctioning power. At the international level, already Europe has already played a very influential role through the certain member states that have been members of the Basel Committee, for example.

However, now, because of the European Supervisory Authorities and the rising influence of other EU institutions, they have not been as influential as the other traditional member states have been. I do not know whether or not that is a plot of the big countries to diminish their influence, but I would say that, over time, the European Supervisory Authorities, the European Central Bank and other EU institutions will play a greater role in these international standard-setting bodies, especially as the EU becomes more consolidated regarding its structure of financial regulation. The other countries will still play an important role, like the UK. Mark Carney is Chairman of the Financial Stability Board, so the UK will always have its seat on the Basel Committee, the FSB and things like that, but the rise of the EU institutions will be gradual over time.

The Chairman: Before the Earl comes in with his second question, do you broadly share Professor Alexander's view?

Professor Quaglia: Yes. Perhaps I would qualify or distinguish between the influence and the preferences of the European Union in international regulatory fora and those of the member states. In particular, the Basel Committee is a very good example in which the European

Union has, over time, since 1989, been downloading—that it is the language I use—international rules at the European Union level.

If you look at the Basel III negotiations, which were concluded in 2010, it seems to me that the European Union did not really have a fully unified position in the Basel Committee. Indeed, it seems to me that different member states had very different preferences and this was highlighted when it was time to transpose this Basel III accord into European Union legislation. The European Union is becoming a more influential player in international financial regulation, but I would qualify that it is not always able to speak with one voice. It depends on the policy on the financial sector and also perhaps the specific agreement. I can think of cases in which the European Union was actually able to speak with one voice and try to upload its regulatory templates at international level, in international regulatory fora. In other cases, I know that the member states took rather different views.

Q40 Earl of Caithness: Following on from that, could you give us your brief thoughts on what the other financial centres of the world are doing implementing the international regulations? What is America doing? What is the Far East doing? Following on from that, picking up your point that the economy will become more stable, would you agree with me that because it is more stable, it is duller and more expensive? Europe gold-plates everything. Will Europe as a major financial centre be increasingly less important because it will be easier to do business in other parts of the world than Europe?

Professor Quaglia: I will start with the first one. In terms of what other jurisdictions are doing, perhaps I may just comment on the US, because it is the one I am most familiar with. What the US did as a response to the global financial crisis was to set in place a series of regulatory reforms, which are more or less similar to or in line with what the European Union has been doing. It is also in line with what was agreed at the international

level in the G20, which is perhaps not so difficult because, generally speaking, these international agreements are rather general and rather thin.

The different provisions of the Dodd-Frank Act are parallel or similar to what the European Union has been doing. I am also aware there was quite a lot of consultation between the US authorities and the European Union authorities, in particular the Commission, when the two jurisdictions were setting in place the new rules, to avoid gaps or overlaps.

The Chairman: What about Lord Caithness's point about Europe gold-plating and therefore driving people away to other financial centres?

Professor Quaglia: It is more than gold-plating. It is setting in place very tight rules, which might provide an incentive for geographic regulatory arbitrage, by which it is meant to be relocated outside the European Union. I guess that is a fair point.

Professor Alexander: There are two points I should like to make. Although there has been a certain element of gold-plating in Europe, with stricter regulations on average across most markets, we do see that Europe has a comparative advantage in many areas of financial service provision. On the front page of the *Wall Street Journal* today, Luxembourg is making a major bid to be the renminbi trading zone for Europe. Once the renminbi becomes fully convertible in international markets, it will probably become a reserve currency and, in Europe, there will be financial centres competing to trade it outside of China. Luxembourg has taken a big step in that direction. Luxembourg has strengths in the asset management industry that set it apart from most other EU jurisdictions. It is a small country but it has a very specialised comparative advantage in certain areas of financial markets. The UK of course is an international financial centre for foreign exchange trading and all the things that London has come to be known for. I do not think that that will be lost under these new

regulations. They will continue, otherwise the Chinese would not be considering London and Luxembourg as major places to trade renminbi.

There is a risk that some of the regulations might become somewhat of a hindrance. They will have to be calibrated and adjusted from time to time to take account of unforeseen inconsistencies and that kind of thing, but overall I do not think Europe is going to lose its competitive advantage. That is very important.

Internationally, with the international standard-setting bodies, it is not just the Basel Committee that is the only game in town. There is a new network called the Sustainable Banking Network, which consists of the BRIC countries—Brazil, Russia, India and China—and their regulatory representatives, as well as the representatives of major multinational banks, like Barclays and the Royal Bank of Scotland. They are in the Sustainable Banking Network, and they set standards for green finance and what they call "sustainable financial investment". They have adopted model standards of regulation across the financial sector. We are seeing that the UK has not played much of a role in that, but I think it should. Other countries in Europe have not played much of a role in the Sustainable Banking Network, but these are alternative sources of international standards that are emerging internationally. Overall, although Europe will not lose that important comparative advantage that London, Luxembourg and Frankfurt have in certain specialised markets, they need to stay competitive internationally so they can be a source of growth for the economy.

Earl of Caithness: May I just follow up that very quickly? You say they have got to keep competitive. Will they keep competitive?

Professor Alexander: I do not think that the regulations are so onerous now that they will diminish their competitiveness. There are some isolated gaps in the regulation. There is a possibility that some of the regulation is a bit too discretionary. I mentioned the

stress-testing example, but overall, over time I think we will see a better capitalised European banking sector, because of the Basel III framework. They will have higher levels of capital. As a result, investors will want to buy their shares more. I will want to buy Royal Bank of Scotland shares one day, when it becomes a private bank again. When its capital level goes up, I will know that they are not overly leveraged.

That is how I think confidence will be restored to the British banking sector, as well as to the European banking sector. It is when the banks get their level of capital up; they stop complaining and using CoCos and all these other things; and say, “Look, we’re going to issue more shares. We’re going to recapitalise ourselves and we’re going to invest in the right technology and the right management, and make a profit. We’ll be stable as a result, and we’ll be a great source of growth for the British economy”. Instead, they complain about the regulations all the time. All their lobbyists are trying to tweak them around the edges. It is not that much more expensive for them to raise more of their money from capital, as opposed to debt, to make more loans. That is what Basel III is all about. Over time, they will have a lower cost of funding as a result, because they will be perceived as more solvent by the market.

Professor Quaglia: I just wanted to add that it seems to me that, for the issue of international competitiveness with the European Union, in terms of being able to attract financial entities and services, it very much depends on co-operation with the US and whether regulatory reform in the European Union is more or less broadly in line with what the US is doing. Once these two main jurisdictions are in line, then any possibility of regulatory arbitrage becomes more difficult. They might relocate to Switzerland or to Hong Kong, but then that is a bit less likely.

The Chairman: Colleagues, as we are on the home straight, I am going to ask Lord Kerr to elide his supplementary with his own question before I turn to Lord Davies.

Q41 Lord Kerr of Kinlochard: Talking about regulatory supervision, is the balance correct between member states and centre? I suppose you could say that the proof of the pudding will be in the eating and the pudding will not be cooked for a few more months yet, but we have two celebrity chefs here: do you think the recipe is good? Do you think it is likely to come out right? By the way, was the balance between using regulations and using directives about right? Sharon Bowles was telling us last week that the latter stages of the CRD are becoming extremely prescriptive. The directive is looking very like a regulation.

Professor Alexander: That is a very good point. That is why CRD IV is broken down into a directive and a regulation, the CRR, which is the capital calculation rules and liquidity calculation rules. That was seen to promote a level playing field in Europe. It is very prescriptive and very rules-based. It is viewed to be a maximum-harmonisation regulation, a maximum-harmonisation directive.

This was criticised by Lord King, the former Governor of the Bank of England, who said that the Basel Capital accord and the old EU bank capital rules were minimum standards, minimum harmonisation rules, not maximum. We should not have a maximum-harmonisation framework in Europe, he argued, because some countries might want to have stricter capital requirements. At the time, he was suggesting that in the UK, under the new Financial Services Act, the PRA would want to have the flexibility to have higher capital requirements than the EU level, in order to have a better capitalised British banking system. That is an important debate.

The decision was made to go with the maximum-harmonisation route. The UK signed on to this. There are certain exceptions; the UK can have higher capital requirements in basically

four areas, but overall we have a maximum-harmonisation framework adopted by regulation for a level-playing-field approach. The UK signed on to this. Lord King made a very eloquent objection to that in his evidence before the Joint Parliamentary Select Committee on the Draft Financial Services Bill, in saying that the UK should have the freedom of having stricter standards if they want.

I would also say that Ms Bowles is correct that it is better to use regulations than directives to achieve maximum harmonisation because regulations are directly applicable and the directives have to be implemented into national legal processes through national administrative rules. Instead you get this harmonised rule at the EU level. Because the EU policymakers have decided to go down the path of maximum harmonisation, regulation is the most appropriate instrument.

There is a very strong view, which I would say has a lot of merit, that we should not have a maximum-harmonisation framework in Europe. We should have more diversity maybe between member states, which have a minimum standard, and then let states compete on different levels of regulation above the minimum standard. If the UK or Lord King wanted to have higher capital requirements than CRD IV, then they might be able to experiment with that. We are not able to do that now in the current maximum-harmonisation framework.

I would just simply say it depends on what your philosophy is. Do you see Europe being a big internal market based on one single set of rules—a level playing field for everybody—or do you want to foster a lot of different competing markets through regulatory innovation and through financial market innovation between states that might produce different rules over time? Those are the two different philosophies. If you want to do the latter, you have directives. If you want the former, you have to go down the regulation route.

The Chairman: Professor Quaglia, would you like to respond to Lord Kerr's several points, but also to Professor Alexander's intriguing notion of a more competitive supervisory or regulatory structure?

Professor Quaglia: Sure. I will start with the second question about the balance between directives and regulation in the European Union. After the global financial crisis, the European Union has made an increasing use of regulation rather than directives, as compared to the past. The main purpose of doing that was to ensure a more uniform implementation of European Union law in the member states and also to secure a level playing field. The typical example, which is often given by EU authorities, is the case of the Capital Requirements Directive III. When the financial crisis struck, there were more than 100 national discretions in the implementation of this CRD III in the member states. It was very difficult to co-ordinate among the authorities for a variety of reasons. Of course, having very different national implementation of CRD III did not help the co-ordination phase. Is the balance right? I would say, yes, it is more or less right.

The second point is about regulation and supervision. The proof of the pudding is in the eating. I would say there are two different recipes for this pudding. The first one is a recipe for the countries that are part of the banking union, because their supervision has been shifted or is in the process of being shifted at the euro-area level, whereas, for the European Union member states that are not part of the euro area, supervision is still mainly a national competence with some co-ordinating power for the European Supervisory Authorities.

The Chairman: At this point, I am going to bring in Lord Hamilton before Lord Davies, because he wants to pursue that angle that you have just raised.

Q42 Lord Hamilton of Epsom: I want to ask much more about the development of the eurozone. We have just had a report from the Centre for European Reform, which is chaired

by Lord Kerr and is a very euro-enthusiastic organisation. Its conclusions are that a more integrated, more federal eurozone would be the most desirable outcome for the eurozone itself, even if it posed difficulties for non-eurozone members, especially Britain. It goes on to say that there is no sign it is going that way, but supposing it does go that way, surely the United Kingdom becomes more and more isolated and increasingly from this decision-making body of 18 members of the eurozone, and it becomes completely meaningless whether we are part of this organisation or not.

The Chairman: Professor Quaglia, I will ask you to respond to that question, but also the rich area you touched on in terms of eurozone members and the non-eurozone members, of which this Committee sub-divides even further in the sense of what we call the pre-ins of those that want to go or will go into the single currency, and those like the United Kingdom that will stay out. Would you care not just to respond to Lord Hamilton's point, but also to those?

Professor Quaglia: Perhaps I will start with the political view, which is that I am not sure that, at least in the short or medium term, a federal Europe is on the cards. Indeed, if we look at the different components of banking union, in particular the most innovative ones, such as the Single Supervisory Mechanism in particular, and the Single Resolution Mechanism, the initial proposal was, to some extent, toned down over time during the negotiations. At the moment, we are a bit far away from a federal Europe.

Would the creation of a banking union pose a problem and potential issue for outside members, in particular the UK? I would say yes. There is some risk, in the sense that the risk would materialise only if the member states of the euro area or, to be precise, the banking union have very similar preferences on a certain issue and those preferences are very different, even incompatible, with those of the UK. In that case, there might be a division

between the banking union coalition and non-banking union member states. The main case I can think of for the moment—I think it is perhaps the only one—is the financial transaction tax, where this kind of division has materialised. There might be more of those divisions in the future.

Lord Hamilton of Epsom: A supplementary then is: can the eurozone survive without a federal Europe?

Professor Quaglia: That is a good question. We need to define what we mean by a federal Europe and whether we mean a full fiscal union.

Professor Alexander: I would say that the banking union has stabilised the eurozone and that is beneficial for the British economy. The worst thing that could have happened would be for the euro to collapse and blow up, and it create a financial crisis in central Europe on Britain's doorstep. It was good that the UK Government supported the development of the banking union. Of course, they assessed their own national interests in doing so and said, "We do not want to be part of it, but we think that it is good that they can stabilise their system under the ECB banking supervisory framework and German fiscal backstop support for bailout". If Germany and the ECB can stabilise it and keep it basically operating, that is better for Britain, for our trading interests and for Britain's banking and financial service sector. The internal market free trade rules still apply across the EU. British banks can still freely trade into Frankfurt, Paris and all the different financial markets.

There will be some market obstacles because the application of prudential regulation controls by the ECB might have a disparate impact on British firms. For prudential regulatory reasons, there could be some competitive effects of the ECB as a bank supervisor for British financial institutions. Overall though, the ECB as a bank supervisor has been an important stabilising factor for the eurozone. It is the correct path for the eurozone economies now.

Whether the UK or other non-eurozone states should be involved is another question. Countries that join the eurozone know they are joining up to it, so they have to make that assessment.

The Chairman: It is indeed another question and, for the next 60 seconds, Lord Davies, the floor is yours.

Q43 Lord Davies of Stamford: Thank you very much. Professor Alexander, you are a very well trained academic, if I may say so. You do your homework. You answer the question on the examination paper and you submit your essay before your tutorial. We know what your answer is to question 10, because you have kindly given it to us in advance as other answers. There is no point in my asking you that, because we know the answer. I am therefore going to ask you a couple of questions on your answer, because you have taken it a stage further forward than otherwise we would have gone, which is splendid.

If I may quote to you, and this goes to the heart of many of our interests, "The UK's financial policy interests are diverging significantly from the rest of the EU and will force the UK to make a decision soon on whether the benefits of the internal market exceed the costs of EU financial regulation". That raises two questions I want to put to you explicitly. The first is: if we were not in the EU, would we actually have a lighter, less onerous and therefore more competitive structure of financial regulation? I certainly have not noticed a lesser propensity in this country to regulate than on the continent, very far from it. We had contrary advice to your suggestion from Sharon Bowles when we last met at this Committee. Of course, we are all very conscious in this country that we had the worst banking collapses, Lloyds and RBS, of any western country, not just EU country; we had the worst mis-selling of scandals; we seem to be the locus of the worst kinds of scandals at the moment over the benchmarks, whether they are LIBOR or foreign exchange. It is hardly a basis on which to assume that we could

have gone in for a kind of regulatory holiday here to make ourselves more competitive. Let me put the question specifically to you: if we were out of the EU, is there any reasonable likelihood that we would actually have less costly, less onerous regulation in the financial services sector?

Professor Alexander: The scope and extent of UK regulation would be very similar, if not the same. I do not want to say "the same" because some of it smacks of a harmonisation in Europe, but the response to the crisis for the UK, if the UK was not in the EU, would be to adopt the international standards, so that they were being adopted by the Financial Stability Board for a bank resolution regime. The UK, for instance, was the first country in Europe to adopt a special resolution regime for banks, with the Banking Act of 2009. It was the first country basically to initiate the resolution debate in Europe. That was because of international standard setting that the UK was participating in at the Financial Stability Board level. The UK would also be a very important member on Basel III for capital requirements and OECD. A lot of the regulation would be very similar to what we have.

Lord Davies of Stamford: I think you have answered my question. There is, in other words, no antithesis or trade-off, in practice, between our being a member of the Single Market and the cost of the regulation.

The Chairman: Lord Davies, I think we are prolonging the question. I would like Professor Quaglia to respond, because I do want to draw it to a close here.

Lord Davies of Stamford: I have one more question.

The Chairman: No. Would you like to respond to the current question?

Professor Quaglia: I guess it would depend on the deal that UK authorities would be able to negotiate with the rest of the European Union and whether they would be able to keep

access to the European Union financial market by being able to comply with their own national rules or having to comply with European Union rules.

Lord Davies of Stamford: I think there is a contradiction there. The second question is: is there a contradiction between national interest and our being full members of the banking union? I have asked this question several times. No one has yet told me there is a contradiction in that. Is there?

The Chairman: Let us get an answer, Professor Alexander.

Professor Alexander: My definition of banking union is whether or not you are part of the Single Supervisory Mechanism, the Single Resolution Mechanism and the deposit guarantee framework, which has not yet been agreed. The UK said, “No, we are not going to be in it”. The UK said, “We can take a second-level membership in Europe”.

Lord Davies of Stamford: We know what they said, but was there a conflict between joining that banking union and national interest? Does it make sense? Was it a rational decision to stay out of that banking union? What was the national interest in doing so? You said there may be positives in doing so. What are the benefits of doing so?

The Chairman: Lord Davies, let us hear the answer, whatever it may be.

Professor Alexander: It is as much a political decision as an economic decision. Do you want to be subjected to German economic management in the eurozone? Germany dominates the eurozone economically. By joining the banking union, are you talking about adopting the euro? Is that what you are implying?

Lord Davies of Stamford: Not necessarily. It is possible to join the banking union without adopting the euro.

Professor Alexander: But then you are going to be regulated by the ECB. The vice-president made a speech in Malaysia yesterday saying that banking supervision would be linked to

monetary policy, and so financial stability, in other words, needs to be linked to monetary policy in the ECB. If we are going to be regulating a country's banks, the regulation of their banks would be linked to the monetary policy of the ECB. Britain will be subject to that. You have the Bank of England; you have your own currency. You want to have a financial stability policy linked to monetary policy in Britain. If Britain decides to join the eurozone, then they can join up to the ECB and then be subjected to that financial policy/monetary policy balance, but now the name of the game is linking monetary policy to financial stability policy. If you have your own currency, you do not want to join the Single Supervisory Mechanism and be subject to that.

Lord Davies of Stamford: There are some people who do say that.

Professor Alexander: Small countries that want to have prestige by being in the euro, such as Romania. The UK has a major reserve currency. The UK is a major player in the G10. I am not anti-EU; I am very pro-EU. I think the euro ought to be there. I am making a cold, calculated assessment of whether Britain should be in the eurozone. I would say no, because it does not suit its economic situation at the moment. On top of it, you do not want to join the banking union unless you are part of the monetary policy framework of the banking union. That is the main point. Romania can sign up because it needs prestige internationally. They have bank runs and things that we have been reading about in the paper but, in the UK, you have a more established reserve currency, which is very important in the international financial system. You do not want to just give that up, unless you have made a very calculated decision regarding the benefits and the cost of doing so.

Q44 The Chairman: Colleagues, I am going to draw it to a close, but I am going to allow Professor Quaglia to respond to any of the points that either Lord Davies has made or, in fact, that she feels she has not had the opportunity to make.

Professor Quaglia: Perhaps I will pick up whether the UK national interest is well served by not joining the banking union. I would say, in the short and medium term, perhaps yes. Why? It is because there is a big difference between the structural condition of the UK and non-euro-area countries, and countries in the eurozone. Countries in the eurozone face what I call the "inconsistent quartet", which means they need to secure or at least they should secure financial stability, financial integration, a single currency and national policies for resolution and supervision. These four objectives are incompatible.

In the case of the UK, the single currency, the fourth element of the quartet, is missing and, therefore, for the time being, the UK is more or less able to secure financial stability, financial integration and national supervision and resolution. For the members of the eurozone, that is not the case because the fourth element of the quartet is the single currency, which also means that the functions of the lender of last resort have now not really shifted to the eurozone level, but are in a sort of limbo. That is the big structural difference between countries in the eurozone and, in particular, big, large non-eurozone countries such as the UK. That is why the UK, at the moment, does not really need to join the banking union.

Professor Alexander: I am not saying the UK should not be subject to EU regulation. It is very important. The Bank Recovery and Resolution Directive was spearheaded by the UK. The UK adopted the first resolution regime in Europe and now we have a very effective Bank Recovery and Resolution Directive that has been adopted. We also have a deposit guarantee scheme that was spearheaded by the UK, and so the UK still has a lot of influence in driving financial policy reform in the European Union. That is different from saying, "We are going to join up to the banking union and be subjected to a Single Supervisory Mechanism, where the ECB is supervising Barclays and the Royal Bank of Scotland", or that the resolution of a

British bank is going to be subjected to a single resolution fund, requiring a Council of Ministers supermajority vote to decide whether or not to resolve a British bank. That is a big issue of sovereignty that you would be giving up by going into banking union.

I would suggest that for the time being in the short term, it is definitely not in Britain's interests. I would say that over the longer term it may not be in Britain's interests. That is why I pose that point. At some point, Britain will have to decide whether or not, over the longer term, joining up in the single banking union is in Britain's political and economic interests. I would say right now it is not.

The Chairman: Professor Kern Alexander and Professor Lucia Quaglia, you send us away on our summer holidays with many thoughts about the inquiry we are undertaking. We are most grateful for the thoughtful responses, which we will mull over in the coming months. Would you please respond to the transcript that we will send you? We are most grateful to Professor Alexander for sending some of the answers beforehand, but if you have any further thoughts, please do let us have them. In the mean time, our very grateful thanks to both of you for coming this morning and testifying to what we regard to be a very important inquiry, and setting us off on a flying start along with Sharon Bowles for the future months. Many thanks indeed.

Association of Corporate Treasurers and Financial Services Consumer Panel- Oral evidence (QQ 215-228)

Evidence Session No. 13 *Heard in Public* *Questions 215 – 228*

TUESDAY 21 OCTOBER 2014

Members present

Lord Harrison (Chairman)
Lord Balfe
Earl of Caithness
Lord Carter of Coles
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Shutt of Greetland
Lord Vallance of Tummel

Examination of Witnesses

Sue Lewis, Chair, Financial Services Consumer Panel, and **Colin Tyler**, Chief Executive, Association of Corporate Treasurers

Q215 The Chairman: Sue Lewis and Colin Tyler, a very warm welcome to Sub-Committee A. Thank you very much indeed for coming this morning and lending us your thoughts on this complex subject of the EU financial regulatory framework, which we are investigating at the moment. We will take a transcript of all that passes this morning. We will send it on to you for correction, but we would also ask you to look at it, and if you have any further good ideas as you walk out of the room, please add them and please send them on to us, as this inquiry continues for some weeks yet before we start writing it up.

I would ask both of you just to say a little bit about yourselves and the organisations you represent when you answer this first question. Looking at the EU financial regulatory

framework and all the storms and vicissitudes it has had over the past years since 2007-08, do you think that what has been put in place has strengthened the European Union's capacity to resist any asymmetric shocks? Does it have the flexibility to be able to respond to further changes? I am asking that of you, Sue. I understand that you come very much from the consumer's point of view, and we are very interested to learn about consumers, who have perhaps been neglected in this inquiry so far. Perhaps you could open the batting.

Sue Lewis: I will; thank you very much. You wanted to hear a little bit about the Consumer Panel first.

The Chairman: Please.

Sue Lewis: We are a statutory panel set up originally under the Financial Services and Markets Act 2000, and then when the FSA split into prudential and conduct arms, the role of the panel was rolled over to the conduct authority. We are a panel of 13, with expertise in various things from law to consumer advocacy to financial inclusion to banking. Indeed, Professor Moloney was on the panel until quite recently, and we miss her. We meet once a month and we advise the FCA, but we also challenge the FCA, because we look at the wider regulatory framework as well as what the FCA is up to in terms of its rules and regulations and policies. We do that through meeting members of the FCA and some independent research. I also sit on the EU Financial Services User Group, which does for the European Commission—if you do not know this—what the panel does for the FCA, so we look at emerging policy coming out of the European Commission from a user perspective. I have other roles, but those are the two most relevant to this Committee.

I am not going to answer the first question, after all that. The panel has not particularly taken a view on the stability reforms, because we concentrate very much on conduct regulation. We occasionally see the conflicts between prudential and conduct, so we might take a view on those, but on the whole we look at the conduct framework. Briefly, I would

say it is good. The EU has come up with some we think fairly useful conduct directives. We have concerns—we will probably come to those later—about consistency and whether all this is properly consumer-tested. Maybe we could come to those as you ask your questions.

The Chairman: That is very good. Colin Tyler, perhaps you would just say a bit about the ACT.

Colin Tyler: Yes. The Association of Corporate Treasurers is incorporated by royal charter. We exist to support corporate treasury practitioners that are working for typically non-financial corporates. We have been established 35 years and we have members and students in about 100 countries, about 70% of them in the UK. To become a member, you need to take certain exams. Typically about two-thirds of our members are already chartered accountants before they become qualified treasurers. I am a former practising treasurer. I have—I have forgotten how many years now—20-plus years' experience in treasury. We try to make sure that we represent the views of those who are doing the work of treasurers on a day-to-day basis for their business. We have a particular interest in making sure that non-financial corporates are perhaps not adversely affected by the changes that are taking place in financial services regulation.

I am afraid our experience since 2008 is that we have perhaps been dragged into certain areas that we feel probably would adversely affect individual non-financial corporates' businesses, and therefore if the objective was to boost real-economy trade post-2008, perhaps that is an area that we could look to work harder on. Finally, we very much welcome the work that has been done on bank prudential policy to improve financial stability. We certainly welcome the additional work on improving behaviour in the marketplace, but it is much too early to say whether it is going to have the positive effect we all hope it will.

The Chairman: They are two very useful introductions. Let us pursue some of the points that arise from those later on.

Earl of Caithness: Mr Tyler, can I just follow up on your introduction? In your paper of 1 September you have a very stark sentence: "Our view is that the FTT proposal should be abandoned". That coincides with the view of this Committee. Who do you make representations to in the Commission? Do you think they have listened to you at all, given your importance? You still have the minority pressing forward with this dreadful tax.

Colin Tyler: Absolutely. I would say first of all that most of the lobbying work that we do is through our European Association of Corporate Treasurers. There are 21 organisations across the whole of Europe, and we make sure that they talk individually to their national authorities as well as at European level. We are clearly watching the debate on FTT with interest. Certainly viewed from a corporate treasurer's perspective, it is utter madness to go down that track, because it will clearly have an adverse impact on pension funds and corporates that pay the bill for pension funds, and there is a cumulative effect to potentially all financial transactions, which will be passed back to the consumer. It would appear not to be a financial transaction tax but more of a tax on non-financial corporates. Fundamentally, that is how we see it.

Q216 Earl of Caithness: Thank you. As you said, non-financial companies have been dragged in by the reforms of the past six years, but consumer protection issues have not been prioritised in quite the same way. I am going to put two questions, one to you, Mr Tyler, and one to you, Ms Lewis. Mr Tyler, how would you explain the linkages and interconnections between corporate treasurers and investors and the European capital markets that have emerged since the crisis? To what extent has the pulling-in of the non-financial institutions been necessary to support market transparency and financial stability? We will leave it at that to start with.

Colin Tyler: We draw a distinction. I do not think that we have necessarily been dragged in since the financial crisis. Corporate treasurers, particularly in those mid-size and large companies, have always had good links with capital markets. The largest organisations look to diversify their funding requirements, so they have always had that need, and many corporates borrowed for extended periods, anticipating that we may well have a financial crisis. To that extent, diversification of funding through use of the capital markets has always been a positive criterion for non-financial corporates. We have been very comfortable with the transparency associated with issuing requirements, the prospectus directive and the market abuse directive, and there have not been material changes to those. It seems to work perfectly well. The areas that we probably would like to encourage are around some of the other smaller, more emerging markets, which we think are a positive development but, frankly, are very small at this point.

Earl of Caithness: Ms Lewis, while not prioritised, the EU legislators carried through various pieces of regulation affecting consumers of financial products and services. How successful have those reforms been in supporting good outcomes for consumers, particularly in ensuring that the products are transparent and effective and respond to consumer needs?

Sue Lewis: We think on the whole that the package of measures coming out is quite good for consumer protection. There is a focus on disclosure, which is fine up to a point, but it is no good if it is too complicated or consumers do not understand it. As long ago as 2007, the FCA worked on disclosure that showed that by itself it made no difference to consumer outcomes. While it is a good discipline on the firm, someone needs to think about the user end of that, whether that is consumers or their intermediaries, and what practically they can do with that information. The FCA is moving in that direction, but Europe is lagging a little bit behind.

The Chairman: Can you give a recent example of the disjunction with what the consumer can understand, which you mentioned to the Earl of Caithness?

Sue Lewis: Probably the most recent is the PRIPs key information document, which on the face of it looks as though it has some quite useful stuff in it, but it is long and complex, and you ask yourself, "How is this going to help consumers to compare and buy products? What is it going to do?". It almost seems to be protecting the firm rather than acting in the interests of consumers.

It is good that there is still room for national discretion in a lot of things. That means gold-plating in some cases, or something that looks a little like gold-plating—MiFID and the retail distribution review are examples of that—but we think that the protections in the retail distribution review are quite important for consumers. We would like to see something a bit stricter on conflicts of interest.

Maybe I will just make a high-level point at this point: conduct regulation should be focused on prevention and then backed up by good redress. It is worth mentioning the alternative dispute resolution in this context. We have in the Financial Ombudsman Service a really good model of redress. The really good thing about it is that it is binding. In future, we may see things coming from Europe that are non-binding, and we would be concerned about that.

Q217 Lord Carter of Coles: Good morning. I have a general question and then a question for each of you specifically. First, do you identify any overlaps, contradictions, inconsistencies and gaps when assessing and comparing the individual pieces of legislation within the whole of that regulatory agenda? Where do you think regulation can be either reduced or enhanced for both corporations and consumers when interacting with financial services firms and institutions? Mr Tyler, taking the whole securities trading chain, which covers pre-trading, trading and post-trading, we are interested to know where market efficiency has been enhanced and where it has been compromised for corporate investors.

Colin Tyler: It is probably worth saying here that when looking at corporate investors, non-financial corporates invest in real assets and intellectual property rather than financial assets. The financial assets they tend to invest in are basically cash; it is for very short-term purposes to make sure that they have liquidity to run their business on a day-to-day basis. That really is their focus: making sure that they can invest in real growth in their business.

As I mentioned earlier, the prospectus directive and the issuing requirements seem to work very well. Where we would look for some enhancement perhaps comes out of the capital markets union debate; if we can get even greater capital pools that seem to operate under consistent language, that should enhance the competitiveness across the marketplace and give corporates more choice. If banks are going to be reducing the amounts that they lend, or corporates—certainly the larger ones—are looking to diversify their investments, they want to make sure that they have plenty of choice. Plenty of choice for the non-financial corporates means a decent price and consistent terms. In the EU, where we have different underlying laws, it is important that we sweep away some of that and get some consistent language. If we can do anything to move that debate forward, we would certainly wish to. That also goes for perhaps some of the new emerging capital market products, for which, frankly, more choice has to be good news.

Q218 Lord Carter of Coles: Thank you. Sue Lewis, looking at MiFID, the mortgage credit directive, the revision of the payment accounts directive, the UCITS regime and the new regime governing packaged retail investment and insurance-related products—PRIPs, as you referred to earlier—how much consistency is there between EU rules that seek to support the consumer interest? In particular, perhaps you could comment on three: first, promoting and enhancing firm governance; secondly, strengthening consumer market disclosure; and, thirdly, addressing firm conduct.

Sue Lewis: We have supported a horizontal approach to governance and product development in particular, and we were pleased to see last year that the ESAs released a set of high-level cross-sector product oversight and governance principles across banking, insurance and investment management. We think that should go a long way to ensuring consistency on the product governance. As I mentioned in response to the last question, the ADR is not applied consistently across the directives. It is missing from PRIPs, although it has been incorporated into MiFID. It sometimes seems that that would be an issue, that it is quite easy to look at horizontally, so we would like to see much more horizontal looking across these directives.

We have not yet seen how the Treasury is going to implement the payment accounts directive, and in particular whether the voluntary agreement between the Government and the banks is permissible under the directive itself, so we have a bit of a wait-and-see on that one.

Disclosure I have also referred to. Although there does not seem to be any inconsistency in the principles, in practice there may be differences that are not entirely useful for consumers, because it is about format, complexity and, as I have said previously, usefulness. There does seem to be a consistent line, especially as regards costs and charges, so retail investors will get a clearer picture, but it does so vitally depend on how useful it is.

On UCITS, we would like to see the strict separation between management company and the depositary maintained, because we think that is important to prevent conflicts of interest, although the rest of Europe is not necessarily in line with us.

The duty of care is another important area where there are some inconsistencies. There is one in MiFID and the mortgage credit directive, and probably also in the insurance mediation directive, but it has not been incorporated consistently, and again it is not in PRIPs and the payment accounts directive. Again, that is a horizontal issue that we think it would have

been quite easy to look at across the piece. We also believe that there should be a duty of care on prospectus disclosures under the prospectus directive as well, which you did not mention but will be reviewed in 2016.

In summary, the EU should do a lot more to ensure those consistent horizontal principles, and hopefully this is something that the new Commission will take on board.

Q219 Lord Dear: Good morning. I want to address the issue of the law of unintended consequences, so far as the regulatory framework and its changes have produced any new risk. Perhaps I will ask a question first of Mr Tyler. Looking at the new sources of risk—and they grow almost exponentially—can we address, please, the risks that have come from new funding sources, particularly those that have grown as a result of the gaps left by the banks? I wonder if you can give us any examples that you can call to mind where regulatory arbitrage currently exists as a result of those changes.

Colin Tyler: What we would say at this point is that the new funding sources are very small, so, viewed from a financial stability perspective, we would contend that they are having no bearing on it whatever. A bigger issue on the unintended consequences is more to do with how the individual parts of legislation work with each other and the transparency across that. Because they are confusing, both from an EU perspective and globally, that gives great opportunity for misunderstanding and perhaps highlights the fact that people could have regulatory arbitrage. Because the legislation has not been fully adopted yet—it has been signposted; some has not even been written, and certainly the rules have not been written—we are not sufficiently far in to be able to identify what is happening as a result of this.

There is one example, perhaps, of where you could anticipate that it will have an effect. There is a requirement under EMIR that if you had a non-financial corporate that was outside the EU, it is pretty unlikely that EU banks would do business with them, because the non-financial corporate would have to post collateral. They would have to use their own

liquid resources for a non-productive purpose. If you look from that non-financial-corporate perspective, they would avoid doing business with anyone in an EU bank in London or Frankfurt. That would not appear to be a sensible approach. It is a result of differences in the interpretation of the derivatives legislation in different places around the world that people have different choices. Between the US and the EU there are big differences. At this point we would say that we would quite like to see what the map looks like and how it all fits together, because it does not appear to us to really knit together.

Lord Dear: Is there a timeframe on that at all that you would like to guess at?

Colin Tyler: It is always difficult for a practising treasurer to guess regulators' intentions, but I would give it a decade. For anyone to say, "This is what is happening. You have to let it run through and then see what the impact is going to be", we will put our hands up and say, "This is utter madness". If derivatives, for example, are bad news and regulators want to get their arms around them and have complete transparency on them, why has the US solved the problem in a different way with non-financial corporates from the EU? It does not really make sense to us. Even within the EU, why has a different definition been allowed to persist of what constitutes a derivative? A foreign-exchange forward is treated differently in the UK from the rest of Europe. It would seem, frankly, that we are looking at it after the event, whereas we would have expected people to perhaps have anticipated that. There is no walk-through test for new legislation. People do not tend to look at it and ask, "Is this going to work in practice?" We tend to find ourselves putting in our comments after the event. Either we are not involved at an early enough stage or we are often seen to be trying to paper over cracks, whereas in fact in the case of derivatives, for example, only 10% of the market is really derivatives from non-financial corporates out of the entire population. It is hardly systemically important. They are managing underlying granular risks in individual corporates that have no potential contagion possibility.

Q220 Lord Dear: Thank you. A question to Sue Lewis, if I may. I would like to focus, if I can, on consumer confidence and whether consumers can be confident that the new regimes are going to be appropriately enforced, particularly looking at items such as cross-selling, governance development processes, and transparency. Can you help us on that?

Sue Lewis: It depends what you mean. The regulations are good and they do the job—

Lord Dear: You think they do.

Sue Lewis: I think so. It is quite difficult, is it not, because the UK standards are often stricter than those required by EU directives, and we are quite keen to keep those stricter standards, but if you look across the piece at what has come out of Europe, on the whole it covers the waterfront pretty well in terms of consumer protection. In MiFID II there will be extra protections on non-advised or execution-only sales, which we see as a gap here. I am not sure that I can really say that there are huge gaps in this from a consumer point of view. The critical thing is how these rules are enforced, both here in the UK but also across Europe as a whole.

Lord Dear: Do you think the existing EU rules have been weakened or strengthened by the new processes?

Sue Lewis: Are you talking about the ESAs and their role?

Lord Dear: As an example, yes.

Sue Lewis: It is good that the ESAs have a consumer-protection objective, but we see quite a lot of problems. We do not really see how they are discharging that objective. We have a lot of concerns about consumer representation in Europe. The panel did some work last year and found that industry lobbyists in Brussels outnumber consumers by 700 to one, which gives you some idea of the imbalance of power there. The ESA stakeholder groups are heavily dominated by industry. It is often really hard for consumer groups to get in and acquire the technical expertise and resources either to take part in the ESA groups or to

respond to consultations from the Commission. A lot more needs to be done on that process architecture, and we would particularly like to see the ESAs pay a little more attention and be a little bit more explicit about how they are meeting the consumer-protection objective that they have. I know that those of you who have been MEPs will say, “Well, we represented the consumer interest”, and that is true up to a point—of course it is—but still it remains a fact that industry outweighs the consumer opinion by a huge amount. That is a problem. The Commission is getting better at testing things on consumers, it is quite good at consulting, but consumer groups just do not have the resources to respond effectively.

Lord Hamilton of Epsom: Industry buy bigger lunches.

Sue Lewis: Yes. I did not want to put it quite like that, but yes, they do. They buy bigger lunches. It is absolutely true. There is a very uneven debate.

The Chairman: Before I bring in Lord Balfe, I was an MEP once, and I was always surprised at the effectiveness of lobbyists from the non-business sector. They could convey the viewpoints of their organisations very quickly and in a way that left some others on the business side very flat-footed. But what you say may be the case.

I just wanted to tease out your response to Lord Dear. You drew a distinction between the UK and EU regulation and what has been done. You were quite relaxed about the generality of what the European Union had done, but there were times when the two clashed. I wonder whether you might give the Committee an example of where perhaps the UK had got it right sometimes with its additional protections, and of where sometimes the European Union had got it right by perhaps being a little more relaxed.

Sue Lewis: I am finding it quite difficult to think of an example of the second of those things. The retailer distribution review is an example of where the UK has got it right, but I was thinking more of enforcement and how individual member states enforce the rules that are

already in place. This is something I see with my FSUG hat on more than my consumer panel hat. For example, we visited Poland—a big EU economy—and found that the rules were very poorly enforced, to consumers' detriment. There is no binding redress system, so consumers lose out there. That is more the sort of thing I had in mind when I was talking about effective enforcement across Europe.

The Chairman: That is very helpful, but if you do think of any others afterwards, please write to us.

Sue Lewis: Where Europe has got it right?

The Chairman: Yes.

Sue Lewis: Let me just turn round and ask for a note to be made of that.

The Chairman: Thank you.

Lord Balfe: I had 25 years in the European Parliament. I always found when proposals came up MEPs were not blank sheets, and you tended to go to the lobbyists who would help you to sustain the case you wanted to make. Rather than say, "Let us listen to them all and decide", you start off thinking something and you then test it generally with the lobbyists who have your point of view, and only if they fail do you start to adjust your position. I never thought that lobbyists had that much of a sway. They would help refine arguments, but I do not recall them ever changing my mind fundamentally from where I started.

The Chairman: Mine was putty in their hands.

Q221 Lord Balfe: Well, I was very different. I have two sets of questions about bail-in provisions and deposit guarantees. On the first one, first, what is your assessment of the impact of the bail-in provisions and depositor preference rules? Secondly, what has been the impact of the move from bail-out towards bail-in for end users, particularly consumers? Thirdly, we have heard that one of the consequences of the bail-in regime is the transfer of risk from the taxpayer to investors and consumers, particularly through exposure to pension

funds, et cetera. On the second point, the European deposit guarantees, do you think that the current arrangements under the DGS directive will significantly improve the European framework for cross-border co-operation?

Colin Tyler: I come back to my point that non-financial corporates typically invest in cash for fairly short-term requirements. As a result of the bail-in and changes that are taking place, and the deposit guarantee system, retail depositors are going to rank ahead of wholesale depositors. That means that potentially, unless corporates have other places to put their cash—and one of those might be money-market funds—that cash on a day-to-day basis may well become hotter than it used to be. The slightest whiff of a problem with a bank will mean that that will move very fast. In days gone by, they were described more as "sticky deposits"; they tended to remain there for a period. Corporates are moving further down the chain from a creditor-stack perspective than they were.

In addition, it is relevant to look at the money market fund changes as well. Corporates only have cash to make sure that they are liquid to run their business. If they have to borrow in advance in order to be able to fund their business and diversify their funding sources, they will build up cash, which we have seen: since the 2008 crisis, there has been a build-up of cash. It is a conservative, prudent approach, but once you have the cash and it is costing you money, you want decent places to place it. We as corporate treasurers adopt the principle of SLY, the first of which is security—it is a very prudent approach—before you also make sure that you have the liquidity. The last thing you look at is how much money you make off the deposit, because you just need it as and when to be able to run your business.

The bail-in rules are not fully apparent to us yet in all aspects. We have some concerns about pension schemes. It is not clear to us exactly how they will operate. That is important to non-financial corporates, because ultimately if there is a shortfall in a pension scheme that arises as a result of this, non-financial corporates would have to fund it, which

again means that there is less cash available to invest in investment, jobs, real assets and intangible assets. Really, at this stage we would say that it is too early to draw a view, but we are concerned. If you are in a lifeboat and someone shouts, "Let's bail in", you start to worry.

Sue Lewis: The panel does not have a view on bail-ins. There is some very interesting work to be done on the impact on consumers, but we have not done it and we are not aware of anything that has been done in that area, I am afraid.

You also asked about deposit guarantee schemes. In a way, I do not think that is the biggest barrier to cross-border confidence. If you are looking particularly at banking, there are other reasons why people do not open accounts in other jurisdictions, not least because it is really hard to do so. I am not sure that the deposit guarantee scheme, although useful in maintaining confidence, is the biggest thing for cross-border confidence. I am very pleased about the temporary high balances now being part of that and waiting to see what the FCA does on that. That just seems very practical to us. We constantly have this debate with the FSCS about the per brand, because we still think it is confusing for consumers when they do not know that they have a particular account that is owned by another bank and that those deposits are not covered. It is not directly an EU issue, but it is something that we believe quite strongly in.

Q222 Lord Hamilton of Epsom: Do Mr Tyler and the corporate treasurers have a view on Glass-Steagall and splitting the investment banks from the clearing banks, as an alternative to Vickers and all these Chinese walls that everybody is trying to permeate?

Colin Tyler: There are many permutations. From a corporate perspective, the concern will be whether you have the right opportunity to trade with whichever part of the bank is appropriate at the right level. For example, if you are a wholesale non-financial corporate customer of a bank and you were restricted in what you could do with that bank because

the deposits of that bank were in the retail portion of the bank, you might take a slightly adverse view on the bank and its ability to be there for you over the life of whatever transaction you are constructing. We would be concerned that a barrier that is put between different aspects to the bank would give rise to other consequences. It is multiplied when you start saying that individual jurisdictions may well seek to solve the problem—which is effectively a proprietary trading discussion—in different ways, again highlighting that you have different views on how the problem may well be solved.

The devil is always in the detail. Even on Vickers and the debate that took place post that, there has been concern about who may well transact in the right and appropriate way with various portions of the bank. Our contention would be that if you are a corporate of appropriate size, you should be able to undertake risk-mitigating transactions to help cover the risks that are in your business. If you are in some way prohibited from doing that because of the way the splits have taken place, that needs to be looked at carefully to see whether that is a sensible outcome.

Q223 Lord Flight: Could I first make the point that Colin's answer a few minutes ago told me that the bail-in rules are likely themselves to create runs on banks very speedily, and so are almost self-defeating? Could I ask particularly about whether you feel that there has been a lack of joined-up thinking in the EU approach to financial services regulation? Decisions of both the FSB and the BCBS can impact consumers and non-financial institutions. Colin, is there a major problem of inconsistency across different parts of the world for companies needing services?

Colin Tyler: Lord Chairman, could I just correct the last comment that I made, just to make sure that the emphasis is right? I did not specifically say that we are going to get a run on a bank as a result of the bail-in regulations that we have; I am saying that aspects of it may well give rise to an impact on financial stability but in themselves may not be so great that they

would cause a run on a bank. It may be possible, but we have not yet seen them acting in practice.

Lord Flight: There are companies I am responsible for and, knowing that my deposits are downgraded against other forms of deposits, I can assure you that if there were any gossip about a bank I would move that money damn quick, which is exactly what you said. That is how banking runs start. I have lived through two major banking runs and they spread like wildfire.

Colin Tyler: We certainly made the point when the discussion was taking place that we are going to potentially create hot money out of this, but you also have to combine it with the work that has been done on money market funds. When you start reducing choice for corporates in terms of where they can place their money—this is hard-won money that they want to have available to their business in the short term to keep their business running—

Lord Flight: Could you just tell us what is happening with money market funds? There are some initiatives that I am aware would make them non-viable. I think the money market fund operators are fighting back, but I am not quite clear what it is all about.

Colin Tyler: I think it would be fair to say that we are all watching this space. The Commission has picked up the money market file from the previous Commission, which could not agree. The previous Commission had two aspects that we were most particularly concerned about. One was the suggestion that money market funds should not be credit rated. Non-financial corporates—and this would include major corporates right the way down to charities and other third-sector organisations that place their money in money market funds because they get diversification—do not have the time, effort or money to be able to credit-analyse whether something is appropriate. To remove credit ratings because you have some fundamental problem with them, which we do not understand, seems nonsense.

The second one is that there are two typical types of money market funds. Broadly speaking—it is more of a branding thing than anything else—one is branded as a constant net asset value fund and one is a variable net asset fund. Our concern is some of the changes that the Commission were considering could require constant net asset value funds to disappear, because they would put in place certain capital buffers that would make them uneconomic. As a result, corporates, particularly in the UK, which typically have used constant net asset value funds, would find that they would no longer feel comfortable putting their money there, hence it would go somewhere else. That is really the debate. If you are running out of places to put your money safely, that is a concern and we would be worried about that.

The Chairman: Lord Flight, let us press on. Are you going to bring Sue Lewis in?

Lord Flight: Certainly. I think you have just described one of the problems for corporates. Sue, the EU's crisis agenda has seen an intensification of EU rules towards consumer markets, albeit on a somewhat siloed basis. Do you feel that this has led to disproportionate reductions in the UK's discretion to regulate in the area? Would principles-based directives be more appropriate for retail financial markets? I just add that it seems to me that it has happened the other way round, in that one of the main things for retail markets in the UK has been RDR, which has removed the availability of any investment advice to more than half the population when—this was dreamt up by the FSA—the rest of Europe decided not to opt for RDR in terms of abolishing commissions.

Sue Lewis: They did; that is true. The horse has bolted on the principles-based, has it not? We have quite a lot of detailed regulation already and a lot of it leaves room for national discretion. That balance is probably okay. What we would like to see now is not more regulation but consolidation, enforcement and bedding-in of what is there rather than just more and more and more. A number of directives have been reviewed and now we have

UCITS V. Let us just concentrate on getting these markets working well—that would be our overall view.

If I could comment on the RDR, a lot of the advisers who have withdrawn have been in banks; the IFA market is still quite thriving.

Lord Flight: There has been a huge reduction in numbers.

Sue Lewis: There is a reduction in numbers, but I am told by the industry that there are younger people now coming into this market because they see it as a profession, with their higher level of qualifications.

Lord Flight: They are only interested in better-off clients. Clients with modest savings just cannot get advice anywhere now.

Sue Lewis: That is kind of the anecdote, is it not? Yes, you hear that advisers will not get out of bed for less than 50 grand, but then others tell me that they do advise clients with a lot less than that. I take your point, but I still think that those rules were very necessary, and ultimately making this a profession will help consumers in the long run.

Q224 Lord Hamilton of Epsom: Growth is what we are all looking for at the moment. We are getting quite robust growth in the United Kingdom and almost none in the eurozone. Is this because banks are lending more in the United Kingdom than they are in Europe? There is, of course, peer-to-peer lending, and crowdfunding in the United Kingdom, which I do not think happens much on the continent. Are there lessons to be learnt in Europe from what is going on in Britain?

Colin Tyler: There are always lessons to be learnt. Certainly from our perspective, looking at growth, we would probably say you need to look at those areas that are discouraging growth. You need to start with what is getting in the way of the growth rather than necessarily look at new initiatives, which, while welcome, are going to be very small and will take a very long time before they have an impact. One of the areas from a non-financial

corporate perspective in both the UK and the EU is that you need to remove uncertainty. Businesses take long-term decisions to invest in real assets and intellectual property—three years to 40 years. If you are sitting there considering making an investment but your concern is that regulatory change is going to have an impact on the project cash flows, you are going to think twice about whether you do it.

As an example, if it wanted to go out and raise money at this point in time in the capital markets, a non-financial corporate may wish to raise it in Europe, but if it wanted it in the UK it would have to swap the currency back into sterling. The concern may well be that if you have to do that, in future the underlying swap that you have in place may be subject to bail-in regulations. From a corporate point of view, what would you do? One way around that, bizarrely, would be to move your operations from the UK to Europe or the US, because you are already within a bigger capital pool. You would then not have to undertake the swap in the first place because you would raise the money in the currency that you needed. Certainly from a practical point of view, I do not think that non-financial corporates think that is a good idea. There must be another way to do that. New initiatives are welcome, but they are very small. We have to look at what is getting in the way of the really big issues and challenge those first before we move on to the new agenda.

The Chairman: Sue Lewis, could you take the aspect of protecting the consumer where you begin to have the development of alternative financing—peer-to-peer lending and so on? Is sufficient done to ensure the consumer has sufficient protection?

Sue Lewis: In peer-to-peer specifically?

The Chairman: For example.

Sue Lewis: The FCA has looked at this, and we looked at their proposals. You want innovative things that help to give consumers—and small businesses—access to finance as borrowers or new investment opportunities. With interest rates on bank deposits being

virtually zero, people are looking for higher yields, quite understandably, but with higher yields come risks. The question is how much you protect consumers against that. We thought on peer-to-peer that the FCA had got the balance about right between protection and innovation. It is a market that will need watching quite carefully. The UK is quite ahead of the rest of Europe in the volume of business done through those kinds of platforms. It remains to be seen, but I would not leap in with too much regulation at this stage.

Q225 Lord Carter of Coles: Could we look at, and could you help us with, the single rulebook? I know that you have been dealing with this—you have covered some of this in answers to earlier questions—but do you think the ESAs have been effective in supporting and promoting the single rulebook, specifically investment and reporting requirements, and conflict-of-interest management requirements? Do you believe that the stakeholder groups in each of the respective ESAs have successfully facilitated consultation—you touched on that earlier—with both industry and consumers?

Following from that, what additional ESA powers or enhancements to the ESAs' role, if any, would you suggest in both the consumer and the corporate area?

The Chairman: We should tell our witnesses, Lord Carter, that we interviewed the EBA last week and we have ESMA next week.

Sue Lewis: I am not sure I have a great deal to add to what I said. I do not think they need more powers; they need to use the ones they have and use them effectively. It is a little like my remarks on the legislation. It needs a lot of bedding-in. The one thing I would add is that a lot of national authorities do not have a consumer protection objective. In Spain and Germany, for example, the regulator does not have a consumer protection objective. That makes the job of looking across Europe and enforcing across Europe a little more difficult.

Lord Carter of Coles: How are consumers protected?

Sue Lewis: They are protected, but it is not specifically set out in statute, unlike with the FCA, that those regulators—BaFin or whatever—have a specific consumer protection objective, and that will dictate the way that they go about their role, which makes it different. Yes, of course, they have the same EU legislation to implement, but where there is discretion they will tend to do it in a different way because they do not have that overarching objective. That makes the ESAs' job a little bit more difficult from a consumer protection point of view.

The Chairman: Colin Tyler, perhaps you could respond to Lord Carter, perhaps not on whether there should be more powers for the ESAs, but whether they are sufficiently resourced.

Colin Tyler: Our view is definitely that they are not. ESMA, for example, has 160 staff members, we believe. I am not sure of the exact numbers, but I think the FCA has 4,000. I do not particularly want to pick on ESMA, but if you look at what has happened in practice, our experience on EMIR in particular has not been good. This is an example of where the regulations were delayed. ESMA had little time in which to implement them. It had not thought through all the issues. If you combine that with the fact that non-financial corporates were not represented on the stakeholder group, despite being asked to be represented—and we have been trying for many years—it was a bit of a shambles. If you are going to be reporting on derivatives, and one of the aspects is that you need to make sure that there is a unique transaction indicator on an individual derivative to make sure that it is just a single one, would you give the guidance for that on the evening of the day the legislation came in? That would appear a tad late to us. ESMA has produced 10 Q&A updates on what to do. Four of those have been issued after the legislation was enacted. Corporate treasurers were technically legally responsible and could be fined, so there is

reputational risk as well. It just seemed a poor outcome. You have to go back to the resourcing and the requirements. That has not been clearly thought through.

Lord Carter of Coles: So it was not their intent, it was their capacity to consult.

Colin Tyler: We are not sure. We do not have enough dialogue to know whether it was their intention not to have us in or the fact that they did not have enough people to ask us to be part of it.

Lord Flight: Do they know about you?

Colin Tyler: Absolutely.

Q226 Lord Shutt of Greetland: Sticking with the ESAs, does the silo-based structure and the related split of competence over banking, securities and insurance/pension markets pose risks to the quality of regulation and how it impacts on major investors and on consumers?

Colin Tyler: We would say that, like any silo-based structure, civil servants are all operating on their own individual parts. There is no overarching perspective to say, "Let us do a walk-through test across everything that we are doing. What is the key principle that we must maintain across all this legislation?". If, for example, it is to boost the real economy and that has been used as a test across everything you are doing, it might be easier, but everyone is working on their individual parts. Because they are being done at different times in the political cycle, this legislation is going to take place over time and it is going to be subject to political change. Embarrassment gives rise to additions to regulation; hardly ever do you get subtraction to regulation as the result of embarrassment. The corporate knowledge on regulation, frankly, will take a very long time over the next decade to take place, so the chances of it being joined up and perfect are minimal.

Sue Lewis: I agree.

Q227 Lord Vallance of Tummel: I have a general question and then two specific ones for Sue Lewis. Are there any significant challenges faced by UK corporate customers, retail consumers or investors in the new EU regulatory climate that you have not covered earlier? You have covered a lot of that. Is there anything you would like to add?

Colin Tyler: We would say merely that it is important that we distinguish between wholesale, or large corporates, and smaller businesses, which are probably more akin to retail customers. I am not sure necessarily that the EU or even the UK draws that distinction. In particular, if we are trying to encourage growth, you need growth in both areas, but you need protections certainly for smaller businesses and retail customers.

I would just like to emphasise what Sue said earlier about the new products that are coming through. Institutional investors in those new financing products can look after themselves. When there is competition, you tend to get loosening credit terms of the underlying instruments themselves. Institutional investors will be able to risk-assess those. Retail customers and small businesses that are chasing yield would not see it necessarily. No matter how big the disclosure is, it would not be in their normal understanding, and there clearly needs to be appropriate protection around that.

Sue Lewis: I would just highlight the disclosure issue as being probably the most significant, but also the challenge in the inconsistencies across directives, which are both points I made earlier.

Lord Vallance of Tummel: I just have a couple of specifics for you. A lot of people would argue that consumer regulation is best developed at the national level to reflect local markets. Do you think that is a fair comment? Perhaps the flip side of that is: what is the likely impact of further integration or, indeed, completion of the single market for retail products in finance?

Sue Lewis: The single market is quite a nice idea in theory, but in practice retail consumers tend to shop locally. You get a lot of people living in other EU countries and they have tremendous problems just opening a bank account or getting car insurance. It would be quite good if the single market concentrated on some of those day-to-day irritations for people living or working in other non-home EU countries.

The Chairman: Is Lord Vallance's question not even more powerful as we have the use of online facilities increasing across a single market?

Sue Lewis: We do, but people tend still not to shop across borders. A lot of people got their fingers burnt with saving in Iceland. People do a bit of cross-border shopping for things like saving products, but not very much. It is minimal. The question is: can a single market in what I would call everyday products be developed more effectively so that—there is enough choice of products here—there are real choices between different jurisdictions? It strikes me that that would be a useful development for consumers. It may be a little marginal, but then you might start getting competition between different jurisdictions and their financial services. On the whole, it would be nice to see the single market just looking at some of those day-to-day things.

Lord Vallance of Tummel: Nice but not revolutionary.

Sue Lewis: Thank you, yes. That is a very good way of putting it. Nice to have. Brand and reputation are important to consumers, but we are seeing some EU banks coming here now, so I think it will come.

The Chairman: Colin Tyler, do you want to respond to Lord Vallance?

Colin Tyler: I do not think we have anything else that we can add. Just to confirm what Sue was saying, we are starting to see people looking across Europe. SEPA is an example of where people are starting to think "single European currency, one operation". If there was a concern, it would be matters arising out of the payment directive as to whether that would

enhance the free movement of capital and support and payment of services, or whether there may be some potential problems in that. Only time will tell, and we will probably have to stick very close to the actual market practice. We would certainly welcome regulators being receptive to what is actually happening. I would have thought that commissioning studies and surveys on people's behaviour might help inform the discussion.

Earl of Caithness: Mr Tyler, I want to come back to an underlying theme of your evidence that concerns me. I hope you can write to us rather than answer this question. You seem to be reactive to a lot of what has been produced. Last week we got evidence from somebody in the financial world that said, "We are seeing good political and stakeholder engagement with regulators". You have given us evidence to the contrary. Could you write to us about why you think you are not influencing legislation while it is in gestation, both with the Commission and with the regulators, and what more needs to be done in that respect? I know that a lot of this touches on your European area, and that is why I asked you to write to us—so you could talk to them—but it does seem to me that there is a problem here that if your views are not getting through to the regulators and the people who are preparing the documents, you are always going to have to be reactive.

Q228 The Chairman: Curiously—I am going to ask you both to reply—I too had divined that. I was expecting to understand from Sue Lewis that sometimes the consumer voice is left on the shelf. I was more surprised by Colin Tyler's comments throughout this session. You might like to say something now, but please feel free to go and talk to your colleagues.

Colin Tyler: To put it in perspective, we work a lot with the UK authorities and we certainly have discussions in advance of some of the ideas that are coming through to help influence those, and some of that is not necessarily public. We work very hard on that. We also try that at European level. Most of what I have discussed here has been our experience on EMIR, where very early on, off the back of the G20 initiative, the ball got rolling very fast

and no one was really in a mood to ask anyone what they thought from a practical point of view. The European Association of Corporate Treasurers, supported by the ACT and a great deal of work across Europe, has been working diligently since 2009. We have not been shy about sharing our views. We cannot necessarily make people listen, though.

The Chairman: Are you shy about sharing your views, Sue Lewis?

Sue Lewis: Not in the slightest, no. Are you talking about influence with the FCA or with Europe?

The Chairman: In general. The feeling I got from you was that there is this thing called the consumer interest and it is an add-on; it is not incorporated into the system.

Sue Lewis: At European level that is definitely true. It is becoming less true within the UK, but the level 1 directives are negotiated by the Treasury, which—how can I put this politely?—

The Chairman: Please do not put it politely.

Sue Lewis: The Treasury might be rather less inclined to listen to the consumer view than to the industry view. At level 2, once the implementing measures come out, as consumer groups in general we can and do have more influence, even though some of the consultations are incredibly long and technical. I am quite optimistic in a way. Certainly the consumer viewpoint is listened to. Do we change the world? That is the test, is it not? A tiny, weeny bit, yes.

The Chairman: Colin Tyler and Sue Lewis, many thanks for your contribution this morning. It has been a fascinating hour. We will send the transcript to you and ask you to correct it and add all the bits and pieces that you have mentioned during the course of this conversation that you might add. We would be most grateful for that. It has been an interesting session and has perhaps given the Committee a bit of a different viewpoint on some of the aspects that we have been handling. Thank you, Sue Lewis, for sending us

Professor Moloney. We intend to keep her for the moment, if you do not mind. We are very grateful in the meantime to you both for coming this morning. Thank you very much indeed.

Association of Financial Markets in Europe (AFME)–Written evidence (FRF0012)

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the **House of Lords' Inquiry into the EU regulatory framework.**

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

As requested for documents longer than six pages, a one-page summary is provided below. This is followed by our complete response which is structured according to the main themes of the Inquiry. Although we have not specifically addressed the last section (implications for the UK), our response covers the majority of issues raised in the Inquiry's individual questions.

Summary of AFME's response to the Inquiry

The EU's far-reaching programme of financial reform has already been very effective in strengthen the resilience of the financial system. While the package of new rules will be fully phased-in over the next few years, banks have anticipated many of these requirements. For instance, core tier 1 capital, liquidity and leverage ratios have all improved significantly since the crisis. The effects of additional measures to reduce contagion effects caused by complex connections between banks and improve transparency in markets and infrastructure are also being felt. Central clearing of interest rate derivatives for instance has doubled within the space of a year. Moreover, the moral hazard problem inherent in the old system has been dealt with through improvements to bank resolvability with better preventative and planning tools as well as the innovative bail-in tool. In short, the EU financial system is safer, banks are no longer too-big-to fail and taxpayers will no longer be called upon to foot the bill of failure.

The benefits of reform are nevertheless accompanied by costs and, in AFME's view, the net cumulative cost of the reform package has not yet been fully quantified or properly understood. In particular, more work is required with respect to the transmission of costs to the real economy. For example, situations of undesirable bank deleveraging, where regulation has unintentionally created disincentives for activities that are economically and socially beneficial, must be examined more closely. With alternative sources of funding not yet being widespread in Europe, an appropriate framework will have to be put in place to ensure other financial services can fulfil their growth-enabling role. Securitisation in

particular is an important real economy financing tool where further regulatory efforts are needed.
With the bulk of reform having been completed, a period of calm in the regulatory agenda is necessary to finalise the technical implementation of the reform package and consolidate benefits already obtained. AFME does not think that any further fundamental changes are necessary and we are particularly concerned with the EU's new proposals for Banking Structural Reform. These proposals are an unnecessary duplication of existing measures and, if adopted, will have significant adverse economic consequences, including a withdrawal of EU capital market capacity. In fact, rather than broadening sources of finance within the EU, these proposals may end up increasing reliance on bank funding. AFME also continues to have serious concerns on the Financial Transaction Tax, where evidence shows that its introduction will have harmful economic effects for end-users of financial markets throughout Europe.
There are also a number of areas of overlaps and inconsistency within the current framework that need to be addressed. For instance, consideration must be given as to how the macroprudential oversight functions of the SSM and the ESRB will work together. Within the EU, creating a single set of rules that is consistently applied is necessary to benefit fully from a Single Market for financial services. AFME is therefore support of a Single Rulebook but believes that this must go hand in hand with the development of an EBA Single Supervisory Handbook. Lastly, improved regulatory consistency at international level must also be a priority going forward. In this area, we believe that IOSCO is well-positioned to play a leadership role in addressing the many cross-border challenges facing global financial markets.

AFME's Response to the Inquiry

SECTION 1: Broad assessment of the EU regulatory framework

The EU's far-reaching programme of financial reform has been effective in improving the financial system

1. The EU's unprecedented programme of financial reform has fundamentally reshaped the European financial services sector and its supervisory environment. Out of the 41 proposals put forward by the European Commission in the context of its reform agenda, no fewer than 29 have already been adopted into EU legislation, 11 are awaiting final adoption by co-legislators and only 1 is outstanding[3].

2. As a result, the European financial sector is now significantly more resilient than it was before the crisis. The implementation of the Basel 3 framework into EU legislation through the Capital Requirements Directive and Regulation (CRD4/CRR) has greatly reduced the likelihood that banks will fail. Comparing like with like, the CRD 4/CRR will require banks to hold ten times more equity capital than before the crisis[4]. The quantity and quality of capital in the system have already improved, with

[3] European Commission, A new financial system for Europe, State of play: June 2014
[4] Paul Tucker, "Regulatory reform, stability and central banking", Hutchins Center on Fiscal & monetary Policy at Brookings, January 2014

the largest EU banks' average core tier 1 capital ratio having doubled since 2007[5]. New liquidity and leverage ratios under the CRD4/CRR have already lead to Europe's largest institutions tripling their holdings of cash and halving their leverage compared to 2007[6]. Other measures, such as higher capital requirements for exposures to financial institutions and mandatory central clearing for OTC derivatives have been taken to reduce the level of interconnectedness of banks and prevent contagion effects. These impacts are already being felt. For instance, the amount of client transactions in interest rate derivatives cleared through the 2 largest clearing houses active in this product more than doubled from early 2013 to early 2014[7]. Groundbreaking measures to ensure that taxpayers no longer foot the bill of bank failure have been introduced under the Bank Recovery and Resolution Directive (BRRD). These include better preventative and planning tools as well as the bail-in tool which is designed to significantly reduce the moral hazard problem inherent in the previous system. In combination with additional requirements, coordinated at international level by the Financial Stability Board and that apply specifically to the most systemically important banks, the measures in place as part of the EU's comprehensive reform agenda mean that no European bank will be considered as being "too big to fail" going forward.

3. The EU's ambitious financial reform package also goes beyond this. A host of new rules to increase transparency in financial markets and infrastructures have been established under the new securities market framework (MIFiD 2/MiFIR). The EU's supervisory architecture has also been fundamentally transformed and strengthened through the creation of three new European supervisory authorities for the banking, securities and insurance sectors. These authorities are responsible for micro-prudential level supervision and are complemented by the European Systemic Risk Board (ESRB) which has responsibility to detect risks to the financial system as a whole (macro-prudential supervision). Lastly, a Banking Union for Eurozone countries has been created to break the negative sovereign-bank feedback loop from which several weaker European economies have suffered. Banking Union will also promote market integration by creating single supervisory and resolution mechanisms for Eurozone banks and should facilitate cross-border supervisory collaboration.

4. Taken together, these measures have greatly increased the stability, transparency and integration of European financial markets. The system has been protected as much as it can be from future shocks and, although it is impossible to know now whether unforeseen crises will be avoided, the risk of future financial crises occurring and leading to severe, prolonged economic crises has, without a doubt, been substantially and effectively reduced.

The benefits of reform are nevertheless accompanied by costs that affect the important economic role the financial system plays. These effects must be better quantified.

[5] Increase in average core tier 1 capital ratio of EU G-SIBs from 2007 to 2013; source: SNL
[6] Source: SNL
[7] CME Group, LCH Clearnet

5. While the reform programme has already led to fundamental improvements in the financial system, and will undoubtedly give rise to further economic and societal benefits, it is essential that reform, particularly when so extensive, does not prevent the financial sector from carrying out its basic economic functions. A thorough assessment of the net cumulative impact of the changes outlined above is therefore necessary and must include in-depth, quantitative analysis of the impacts of reform on the industry's ability to support real economy participants and help the EU economy return to sustainable and sustained levels of growth.

6. The European Commission's Economic Review of the Financial Reform Agenda (ERFRA) is the first European-level attempt to provide such an assessment, and following our longstanding calls for comprehensive analysis, is a welcome step in the right direction. It provides an extensive analysis of the academic literature on benefits and costs of European financial reform, including an overview of the results of the Commission Services' own modelling to assess the cumulative net impacts of new capital requirements, bail-in and resolution tools.

7. While we are extremely supportive of this attempt, we nevertheless consider that it is partial and can only be viewed as the first in a series of ongoing assessments to ensure that the right balance is struck between the costs and benefits of the reform package. As it stands, we consider there are several areas where the ERFRA probably under-estimates the cumulative costs of reform:

a. Firstly, while we do appreciate the difficulties of the exercise, we think that more work needs to be done to quantify the net cumulative impacts of measures that are part of the reform programme but have only been analysed in a largely qualitative manner in the ERFRA. For instance, the combined net effects of other parts of the CRD4 package, such as the liquidity and leverage rules, and MiFID 2 /MiFIR, to name but a few, need to be taken into account together with those aspects of reform already quantified in the ERFRA.

b. It will also be crucial to undertake detailed analysis of the influence of new regulation on the composition of banks' product mix and pricing and to acquire a more refined understanding and quantification of how changes in these areas are affecting the end-users of financial services.
c. In this respect, some of the conclusions drawn in relation to the transmission of costs of the reform to the real economy need to be revisited and finessed. For example, while we acknowledge that bank deleveraging in Europe can largely be seen as positive (e.g. banks have cleaned up their balance sheets and reduced holdings of excessively risky assets), it is still important to identify and factor into the analysis situations of "bad deleveraging" where regulation has unintentionally created disincentives for activities that are economically and socially desirable. For instance, long term investment funding has become much more expensive for banks to provide. Alternative funding sources are not yet prevalent in Europe, which potentially leaves an important gap that needs to be examined carefully. SMEs, the category of business facing the largest external financing constrains, may be experiencing similar funding gaps. Other real economy participants are also likely to

be affected. For example, although corporates are not reported to have financing difficulties per se, the reform package still affects them, for instance via new wholesale market regulations that impact on the cost and availability of certain hedging activities linked to their financing activities. In our view, these elements have not been fully captured in the ERFRA.

d. As the ERFRA rightly points out, it is currently not possible to fully comprehend the overall impacts of adopted measures as some aspects are still in flux. In the area of resolution for instance, issues such as the impact of resolvability assessment and the cost of raising a "minimum requirement for own funds and eligible liabilities" (MREL) and gone-concern loss absorbing capacity (GLAC) still need to be factored into the quantitative impact assessment. The Commission Services' impact analysis work should therefore be repeated on a regular (yearly) basis to take into account the effects of implementation of the reforms as they are phased-in and their technical elements finalised through the level 2 legislative process. Moreover any new data or research findings that become available will need to be included and modelling assumptions adapted to ensure they remain relevant.

e. The assessment must also be widened to include measures being taken outside of the immediate context of the Commission's financial reform agenda set up in 2009 such as the implementation of a Financial Transaction Tax (FTT) in some Member States.

f. Last, but by no means least, the scope of the assessment will also need to account for the impacts of major parts of the reform programme that are as yet not finalised. We refer in particular to the Commission's proposals for imposing structural reform on some EU banks which we believe will have significant real economy consequences if they are to go ahead.

With the bulk of reform having been completed, the EU should focus on measures to support economic growth and recognise the role that financial services have to play in this.

8. AFME believes that it is crucial for Europe to consolidate the EU's emerging but fragile return to growth and that the financial services industry has an important part to play in achieving this. We consider that the following potential solutions could help unlock funding to enable investment and growth of the real economy and that regulation designed to facilitate these could be beneficial:

a. Small businesses – for the time being, banks are expected to remain the primary source of finance for small businesses (due to the size of transactions and the local nature of the commercial relationship). However, given the financial pressure banks face as a result of the CRD4 / CRR and other measures, increasing their lending capacity to the SME sector may require further support, either through increased capacity or increased risk appetite. Improving access to existing lending schemes through the consolidation and simplification of pan-European and national SME schemes would help, as would the creation of an SME risk and information database and the establishment or expansion of credit mediation services. AFME also believes that further education of SME borrowers on how to obtain both bank and non-bank finance is important. Additionally, the expansion of SME securitisation is necessary to help increase the funding and capital capacity for bank lending to SMEs and allow capital markets to channel funds to these businesses. Securitisation encourages

existing originators to extend more loans to SMEs and, to the extent that it partially removes credit risk from bank balance sheets, it may also help smaller, less diversified originators to enter the SME loan market. It also increases the capacity for non-bank investors to finance to SMEs. A well functioning ABS market therefore helps SMEs diversify their funding sources and reduces their reliance on a limited number of lenders, thereby contributing to economic growth. We have recently seen strong support from the senior officials calling for revival of securitisation. For instance, the ECB has recently noted there is an urgent need to build "a financial landscape that is more diversified, more capital market-based for all segments of financial products"[8]. We provide suggestions on how the European securitisation market can be revived below.

b. Large and mid-sized corporates – rather than additional funding sources, mid-sized and large corporates require market making and hedging services. Separating trading activities out from core bank divisions would significantly increase the costs of these services and is therefore not desirable. We discuss this issue in more detail in paragraphs 11 to 14. Companies of this size would also benefit from a pan-European private placement market, similar to the US private placement market. To help achieve this, AFME is active in a pan-European cross-industry group which is seeking to develop a consistent set of guidelines and standard templates for such a market.
c. Infrastructure investment - infrastructure is of course crucial to long term growth and productivity. However, similarly to SME lending, funding infrastructure investment has become much more expensive for banks. This market must therefore be made more accessible to non-bank investors. A range of reforms should be considered, including rules to reduce political risks associated with infrastructure regulations or tariff structures and efforts to encourage greater acceptance of capital market instruments as part of an overall financing package. In this respect, further education of issuer municipalities across Europe on how to access capital markets in order to fund infrastructure projects could be useful. AFME also believes that the European Long Term Investment Fund (ELTIF) initiative of the European Commission could be a means to make infrastructure investments accessible to a wider group of investors.
d. Lending to businesses in distressed economies - funding issues in these countries may require consideration of solutions including the possible relaxation of certain European Investment Bank eligibility rating criteria for partner banks and refinement of sovereign CDS regulations and swap contract triggers to improve investor ability to hedge the sovereign risk component of corporate financing transactions.

Securitisation is an important real economy financing tool and further regulatory efforts are needed to support its revival

In the existing European economic climate, securitisation constitutes an important tool for financing the economy and facilitating its recovery. The European Commission, as well as the ECB and BoE, have noted that "the reform agenda may have penalised higher quality and safer securitised products compared to other similar forms of financing". The regulatory treatment of securitisation therefore needs to be addressed urgently. Some progress has already been made, both at international and European levels. For example, capital charges for insurers (under Solvency II) and banks (under the Basel Committee for Banking

[8] Speech by Peter Praet, Member of the Executive Board of the ECB, Europlace Financial Forum, Paris, 9 July 2014

Supervision's (BCBS) revised securitisation framework) have improved compared to original proposals. The Commission's intention to include a wider range of securitisations than just residential mortgage backed securities in the liquidity buffer of its Liquidity Coverate Ratio (LCR) is also welcome. However, a lot more needs to be done if we are to see investors effectively return to the market. Proper calibration of the BCBS's securitisation framework, Solvency II and the LCR will be crucial in achieving this. Other areas where improvements are required include the margin posting and clearing obligations for securitisation swaps under the European Market Infrastructure Regulation (EMIR). An exemption should be introduced here for securitisation swaps, as it has been for covered bonds. We also consider that development of the concept of "high quality securitisation" or "qualifying securitisation" by the ECB and BoE will be essential in reviving market and welcome the efforts they have made to consider definitional issues and the consequences of falling out (or in) of the "high quality" classification[9]. Nevertheless, for this concept to bear fruit, it is important that work being undertaken by the EBC and BoE is coordinated and reflected in other relevant workstreams such as those of the BCBS and European Commission mentioned above. Lastly, while AFME is committed to transparency and considers that information on the quality and performance of the underlying assets and structure of securitisation transactions is of course vital for investors, we caution against placing an overemphasis on transparency as being a panacea when regulatory issues are hampering the rejuvenation of the market. These must be resolved as a matter of priority.

SECTION 2: Interconnections, overlaps and gaps in the EU regulatory agenda

A period of calm in the regulatory agenda is necessary to finalise technical implementation and consolidate benefits already obtained

9. Although it has been necessary to address the flaws revealed by the crisis, the pace of change in EU financial services legislation is neither sustainable nor desirable if Europe is to fully reap the economic benefits of transformation that has already taken place. With the bulk of level 1 reform having been completed, and with a new European Parliament and Commission soon to become fully active, we think that now is the natural time to pause, reflect on the legislative programme of past years and its impact, and consider priorities for the future. We do not think that any further, fundamental changes are necessary at this stage and are pleased to see that the creation of a new post of EU Commissioner for Better Regulation seems to recognise the need for careful reflection before legislative action is taken at EU level[10].

10. In our view, before any additional major, level 1-type measures are considered, it is necessary to first complete the technical and detailed specification of the elements of reform that have already been adopted. Having now benefitted from first experiences of regulation developed under the level 2 process, AFME believes that it can be made more efficient and robust. We attach particular importance to the development of level 2 measures. This is because a single set of rules for the European financial sector is very much necessary for industry to reap the benefits of

[9] More information can be found in AFME's response to the ECB and BoE Joint Discussion Paper and the AFME report High-Quality Securitisation for Europe. The market at a crossroads
[10] Press release, European Commission, 10 September 2014

the Single Market and for the positive impacts of regulatory reform to be fully felt to the benefit of society as a whole. However, we think it is important to stress that the Single Rulebook will only be truly effective in reaching these goals if it is implemented by supervisors that share common practices when applying these same rules. These points are discussed further in paragraph 25.

EU proposals to restructure banks are an unnecessary duplication of existing measures and will have significant adverse economic consequences if adopted. They are not the way forward.

11. AFME is particularly concerned with the EU's new proposals for Banking Structural Reform (BSR). Given that the system has already undergone radical transformation and is now significantly more resilient, in our view there is no need to adopt such measures. At international level, work has already been undertaken to impose specific, stricter requirements on the largest international banks. Moreover, the new tools under the BRRD, such as resolution planning and bail-in in particular, will already enable banks to be wound down in an orderly manner and without recourse to the taxpayer. Additionally, pursuant to their resolvability assessments, authorities have strong powers to impose structural changes when necessary.

12. Moreover, the effectiveness of the BRRD is already being felt, with rating agencies having begun to remove the uplift for implicit government support that some banks benefited from in their credit ratings. For instance, in May 2014, Moody's changed the outlook to 'negative' for 82 European banks' long term debt ratings to reflect the likelihood of a reduction in state support and increased risk of senior creditors being bailed-in. Given that such changes are already taking place, there seems to be no need to introduce structural reform measures to address the so called "implicit subsidy" issue.

13. We understand that there may still be particular types of risks, for instance in trading activities, which regulators are concerned about. However, the Basel Committee's Fundamental Review of the Trading Book will address the capital allocation, transparency and supervisory control of these activities. Consequently, the implementation of this new framework for the trading book will substantially increase authorities' ability to address any capital adequacy or structural concerns that these activities may pose.

14. Using proposals like the BSR to mitigate the risks associated with trading activities will interfere with the provision of client-facing activities such as the market making and risk transformation services that are part of banks' fundamental economic role. These types of client-facing activities are not high risk and they are necessary for banks to be able to trade and price financial instruments and their associated risks. AFME expects that adoption of the structural reform proposals would lead to a consequent withdrawal of capital market capacity that is likely to increase concentration and reduce competition as well as the availability of products. This would impact on end-users, creating issues that are particularly acute for smaller corporates trying to diversify funding sources and hedge business risks. We therefore

find the Commission's proposals to be contradictory to its stated objective of broadening the sources of finance available to the European economy and building up capital markets in Europe. In fact, the BSR proposals are more likely to increase the European economy's reliance on bank funding rather than reduce it.

There are areas of overlaps and inconsistency within the regulatory framework that need to be addressed

15. In the new European supervisory system, characterised by the creation of the Single Supervisory Mechanism (SSM) within the Banking Union, the ESRB will have to frame its activity in a complex system composed of three different layers: the European Union, the Eurozone and individual Member States. In a recent report on the mission and organisation of the ESRB[11], the Commission recognises that the establishment of the SSM will have an impact on the role of the ESRB. Therefore, in order to avoid fragmentation of the European macroprudential supervisory framework, more consideration needs to be given to how the Banking Union macroprudential oversight approach relates to the ESRB and its role with non-SSM countries. Indeed, there should be greater clarity on the respective macroprudential roles and modes of cooperation of the ECB and the ESRB. The former, together with national authorities, should be clearly responsible for the implementation of macroprudential policy within the "Banking Union zone". The latter should be responsible for monitoring macroprudential risks across the EU as a whole, developing strong analysis and making act-or-explain recommendations to national or regional authorities. In this respect, the ECB should be in the same position as the EU-28 national supervisory authorities.

16. We also think it is important to point out that evidence[12] continues to show that a Financial Transaction Tax will have serious harmful economic effects for end-users of financial markets throughout Europe. Moreover, it is an inefficient way to raise public funds and we are also concerned about its wide scope as FTT would also apply to non-EU entities.

Improved international consistency is necessary and must be a priority going forward

17. The wider context of regulatory inconsistency at a global (and not just EU) level cannot be overlooked. In a 4 April 2014 letter to the G20, Mark Carney, Chairman of the Financial Stability Board, highlighted the need for enhanced cooperation, outcomes-based approaches to resolving cross-border issues and the building of trust between regulators. Efforts must be made to address these issues on a global scale, in order to reduce transaction costs, foster competitive markets and facilitate cross-border trading and investment - especially for corporate end-users. It is our view that IOSCO has the unique regulatory knowledge and experience to develop a framework that enables coordinated approaches to cross-border policy making and regulation.

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[11] COM(2014)508 Report from the Commission to the European Parliament and the Council on the mission and organisation of the European Systemic risk Board (ESRB)

[12] See for instance "What would be the economic impact of the EU proposed financial transaction tax", Oxera, June 2012 and "The Impact of the EU-11 Financial Transaction Tax on End-Users", Oliver Wyman, 2013

18. We believe that IOSCO is well-situated to take a larger leadership role in addressing the many cross-border challenges facing global markets today. They can serve as a global “clearing house” for the identification of key goals, issues and possible conflict areas arising in cross-border political and regulatory spaces. This would open the lines of communication between jurisdictions, encouraging trust, coordination and transparency.

19. In particular, we view IOSCO’s establishment of a Task Force on Cross-Border Regulation as a positive step forward in dealing with the emerging multiplicity of jurisdictional regimes. The Task Force will help IOSCO to take the lead in improving the cross-border challenges facing markets. Their specific role could include facilitating international dialogue between policymakers and legislative/regulatory authorities at the initiation of policy development, encouraging international coordination amongst regulators in establishing reasonable and agreed implementation timetables for new rules and developing cooperation/consultation mechanisms for identifying areas of conflict and bringing together regulators once these differences emerge. Our view is that these principles and mechanisms would assist in fostering a more consistent and coordinated regulatory framework.

20. We consider that a good example of international cooperation has been in the field of financial benchmark regulation where the FSB played an important role in coordinating the work of national financial authorities and standard setting bodies on benchmark reform. Reform is needed and should be focused on sound practices, harmonised internationally, and commensurate with the significance of the benchmark in the marketplace. At the European level, we think that the Commission’s proposal for a Regulation in this field could better embody the concept of proportionality embedded in the IOSCO Principles developed at international level in such a way that its provisions are commensurate with the risks posed by a benchmark to the financial system and with the importance of a benchmark to market participants, investors and consumers. For example, we believe that there are implementation aspects such as the equivalence regime approach for non-EU benchmarks, the limited number of proposed exemptions from the Regulation and the suggested transition measures that may need to be modified to better reflect market practicalities and risks.

21. With respect to bank structural reform, it is currently unclear how the EU's proposal would work in practice, not only in the context of the EU’s BRRD, but also with respect to other international legislation. For example, EU subsidiaries of US banks are subject to the US Volcker Rule, but could also be affected by the EU's proposals in this area, and even the UK's ring-fencing. It is not yet known how Asian regulators will respond to these proposals. What is clear, however, is that the proposed changes would have a significant impact on EU banking institutions and their ability to meet the needs of their clients

22. Another area of risk of international inconsistency lies in the way local regulators will apply the provisions the BCBS/IOSCO margin requirements for non-centrally cleared

derivatives[13], especially with regard to reuse of initial margin. We are concerned that this could be to the detriment of firms established and trading under the laws of EU Member States. If Europe does not wait for the US to implement the rehypothecation provisions and then follow with its implementation, there is a high risk that a pragmatic and globally consistent approach will not be achieved.

The shifting of activities to unregulated areas of the system is not a major threat to financial stability

23. As long as regulation is activity focused rather than entity focused, which is the approach that the FSB has taken, a shift of risks from the banking sector to non-bank credit providers is not a major concern in our view. Firstly, through its credit intermediation function, this sector provides an important source of alternative funding to the real economy. In our view, this function should be encouraged as part of efforts to develop a more diversified financial system with less reliance on bank funding, increased direct capital market financing and greater involvement of institutional investors and alternative financial markets. Additionally, a number of international and EU level initiatives are already underway to monitor and reduce the transfer and build up of risks in the non-regulated sector as a result of increased banking regulation. These rules include prudential oversight and resolution frameworks and will also ensure that regulated activities are not overly interconnected with this sector. These initiatives will be important to ensure that the same types of activities will be subject to the same types of rules, regardless of by who they are undertaken.

SECTION 3: The EU Single Rulebook and the consequences for the Single Market

Creating a single set of rules that is consistently applied throughout the EU is necessary to benefit fully from a Single Market for financial services.

24. There are still a number of elements required to consolidate the Single Market for financial services so that market participants are able to meet their clients' needs in the most optimal manner. For instance, differences and uncertainty generated by Member States' flexibility in transposing legislative requirements must be addressed. Going forward, we therefore favour the use of regulations over directives whenever possible, but we also need a current single regulatory framework for the financial sector that is uniformly applied across the entire EU. The establishment of the Single Rulebook is therefore paramount, but must go hand in hand with the development of an EBA Single Supervisory Handbook.

A number of measures should be taken to improve the role of ESAs and the level 2 rule making process

25. Overall, in assessing the balance of competences between Member States and the EU, it is important to acknowledge that the basic architecture for making the rules has generally been fit for purpose, and continues to have a key role. Nevertheless,

[13] Issued in September 2013

we consider that there are a number of actions that can be taken to improve the process, particularly with respect to the European Supervisory Authorities (ESAs):

a. The leadership capacity of the ESAs should be improved and enhanced by strengthening their independence, including from the European Commission and from national authorities[14].
b. The emphasis of the ESAs' work, which to date has mainly focused on rule-making, should shift towards fostering convergence in supervisory practice. We therefore welcome the inclusion of this specific point in the recent Commission report to the European Parliament and Council.[15] It is necessary that the EBA's work now turns to the development of a comprehensive and coherent corpus of material articulating to an advanced level of detail the purpose, mode, approach, and manner of supervision of the full range of financial services issues and promoting a consistent supervisory culture. The Single Supervisory Handbook to be developed by the EBA under the Banking Union legislation is an important new formalised feature of the landscape in this regard. AFME attaches great importance to this issue and believes it needs strong resourcing.
c. The level 1-level 2 relationship has not always functioned as it should and needs to be improved. We think that this could be achieved by ensuring greater clarity and certainty in level 1 texts and in mandates for the development of level 2 rules at the outset of the legislative process. The Commission has recently proposed that the role and influence of ESA staff within preparatory bodies could be reinforced[16]. We agree with this suggestion and believe that it can be achieved by involving the ESAs in the preparation of Commission mandates, allowing their participation as observers in technical discussions during the ordinary legislative procedure and asking for their opinion on the time necessary to deliver technical standards. Additionally, the ESAs could produce an initial timeline for the implementation of the level 1 rules and conduct periodic reporting on how the rule-making process is being implemented between level 1 and level 2 to ensure quality control. Lastly, the ESAs should also be able to implement a mechanism for pause in the process of their rule-making when deadlines are not realistic.
d. An important challenge for the ESAs will be to ensure that the development of the Single Rule- and Handbooks do not become confused with undue prescriptiveness. While eliminating unjustified differences between the rules and practices of different jurisdictions is essential, this is a different matter from reducing the role of supervisory judgement.
e. This could be improved by conducting cumulative, net impact assessments. We welcome the Commission's proposals to enhance the transparency of the ESA's process for preparing draft technical standards and advice and its recognition of the need for high quality cost/benefit assessment in these processes[17]. The ESAs should indeed conduct cumulative, net impact assessments as a matter of course. Their dialogue with market participants could also be further improved by organising it into

[14] We provided further suggestions on how this can be achieved in our January 2014 response to HM Treasury's Balance of Competences Review
[15] Report from the Commission to the European parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), (COM(2014) 509), page 12
[16] Idem, page 12
[17] Idem, page 12

two distinct layers: the high-level representation of wide interests that can be obtained and structured within the Stakeholder Groups and a technical dialogue that would benefit from the expertise in specific practices areas. It may be necessary to review the selection criteria and process for appointment to the Stakeholder Groups and to more systematically involve technical consultative groups, composed of relevant subject experts. Nevertheless, while interactions between Stakeholder Group and ESAs are important, these should neither be taken as a substitute for public consultation, nor as exhausting the technical dialogue with market participants.

f. Lastly, the ESAs' role in helping deliver an international level playing field for financial services should be significantly enhanced. This includes providing them with the resources and authority to take the leading role in equivalence determinations, relevant international discussions, and cross-border convergence. A proposal for enhancing the leadership capacity of the ESAs in international discussions could include entrusting the ESAs with adequate powers to ensure that they have the ability to interact at arm's length with third-country regulators (for example, by giving a leading role in the EU-US Financial Market Regulatory Dialogue, and enhancing their visibility and "voice" in international bodies).

30 September 2014

Aztec Group–Written evidence (FRF002)

Broad assessment of the EU regulatory framework

1. What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?

With regard to the regulation of private equity managers (and partnerships), we believe that the Alternative Investment Fund Managers Directive (AIFMD) is technically incorrect and has been misapplied by the Financial Conduct Authority (FCA) in the UK. These mistakes will undermine market integrity.

We base this assessment on a paper that we prepared recently for the Luxembourg market place in relation to the société en commandite spéciale (or the new Luxembourg LP), see: http://www.aztecgroup.co.uk/james-bermingham-industry-comment/the-aifmd-mistake

2. Will the new regulatory framework enable the EU to withstand further asymmetric shocks and future crises as yet unforeseen? Is there sufficient flexibility in place to enable it to do so?

The AIFMD increases systemic risk within Europe. This is achieved by transforming passive co-ownership arrangements into active holding vehicles. This transformation gives rise to significant cross-contamination risks within partnerships and across different partnerships.

Systemic risk is also increased through extending depositary obligations. This 'product underwrite' in relation to a diverse range of assets creates additional risk within the financial system.

3. Where do you think the biggest achievements have been made, and why? Do you believe there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?

The FCA made 2 technical mistakes and 1 policy error in relation to the implementation of the AIFMD.

- The FCA failed to recognise the difference between an asset manager and a private equity firm. An asset manager actively invests wealth in accordance with a defined investment policy and risk parameters to achieve an optimum portfolio of investments, and is paid for this. It is trading like a MiFID investment firm. A private equity firm, in broad terms, acquires businesses with investment partners (co-ownership) and implements strategic changes to the business through a handpicked management team, sharing in any resulting increase in the value of the business. It is more similar to management consultancy where the focus is on the business acquired (and not designing and maintaining an optimum portfolio of securities within a fund).

- The FCA failed to understand what a 'fund' (or UCI) is, because, they do not seem to have had a sufficient grasp of the UCITS jurisprudence on which the AIFMD was based.

These two technical mistakes resulted in the FCA identifying AIFM's and AIF's in a private equity context where neither exists.

The FCA also made a policy error in PS13/5 by suggesting that part of the purpose of the AIFMD was to regulate the private equity industry (i.e. buyout transactions) and not simply private equity AIF. The 2 are not necessarily the same.

4. Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency, transparency and integrity; and financial stability?

The AIFMD is only appropriate in relation to AIF. The FCA's misinterpretation of this term has had the most damaging consequences.

5. How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

The AIFMD represents a failure of the Commission, in technical expertise, the Council, in understanding, and the European Parliament in political terms, especially in relation to transparency and accountability. The AIFMD arguably displayed many of the worst aspects of the EU.

Similarly, the UK authorities appeared to have had a limited grasp of the issues and there was no clear decision making with an obvious demarcation of responsibilities. For example, the roles of HM Treasury and the FCA seemed to overlap and, latterly, HM Treasury appeared to rely on the FCA to take core policy decisions that were political and legal in nature.

6. How do you think the 'growth agenda' and support of alternative financing sources can best be promoted by the EU with respect to regulation?

There are 2 parts to the growth equation: (a) the cost of capital; and (b) the rate of return on capital. The AIFMD is counterproductive in relation to both, and the benefits of a marketing passport are largely illusory in a private equity context. The AIFMD undermines the 'growth agenda'.

Interconnections, overlaps and gaps in the EU regulatory agenda

7. Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?

Terms used in the European rulebook should have meaning and be consistently applied, which is something that the Commission denies. This means that terms like 'private placement' are used although it has no clear meaning and the term 'AIF' means one thing under the AIFMD and something else under the European Markets Infrastructure Regulation (EMIR). This undermines the development of reliable jurisprudence, which is invaluable in defining rights and liabilities in a high value context.

8. Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?

Without commenting on the EU decision making process and with regard to the AIFMD, PS13/5 is incorrect and should be re-stated. The FCA's response to question 2.25 is a good example of the difficulties faced:
http://www.fca.org.uk/static/documents/policy-statements/ps13-05.pdf

9. The Commission argues that the new and/ or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?

10. Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?

11. How concerned should we be about the range of unintended consequences from such regulation – such as regulatory arbitrage and transferring risk off balance sheet?

We are very concerned with regard to systemic risk and cross-contamination of liabilities under the AIFMD. These are so serious that we have sought to point them out to HM Treasury and the FCA directly. Co-ownership arrangements should always be 'risk transparent' with the structural containment of risks.

The EU Single Rulebook and the consequences for the Single Market

12. Is there now an effective balance between Member States and the EU in terms of regulation and supervision of the financial sector? If not, how can such an effective balance be struck?

13. Is the EU process for adopting rules efficient and nimble enough to adjust and calibrate the new Single Rulebook? Which single element of the new Rulebook is in most acute need of careful monitoring and review?

Concepts are understood differently across the EU in accordance with domestic jurisprudence. This often results in discussion at cross-purposes and the resulting rules can

be very confused. For example, as a result of PS13/5, complying with material sections of the AIFMD Regulation became simply impossible.

14. What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to 'equivalence'? Is there a danger of 'multiple jeopardy' arising from the multiplicity of regulatory regimes across the EU and beyond?

The AIFMD appears to unfairly favour the European finance industry by restricting external access to European capital. Protectionism is counterproductive as it reduces choice and increases costs for European investors making European financial centres less attractive.

More precisely, the AIFMD has resulted in the fragmentation of 'private placement regimes' across the EU which has made cross-border capital raising uncertain. Meanwhile, access to the passport is limited and its design is sub-optimal. It also results in unforeseen fees.

The AIFMD is not sufficiently consistent with international regulation, audit standards and industry best practice. This is forcing the creation of costly parallel structures within the EU.

15. In light of the fact that some of the regulatory framework applies at EU-28 level, and other elements for the eurozone only, is there a danger of a two-speed or inconsistent approach to regulation?

The implications for the UK

16. What are the challenges of the regulatory reform agenda for non-eurozone Member States? In particular, which specific challenges does the UK face? How has its approach to the regulatory reform agenda compared with that of other non-eurozone Member States such as Sweden and Denmark, as well as those such as Poland who are required to join the Single Currency in due course?

17. Overall, do you believe that the UK's interests have been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?

A bad financial services' rulebook is unlikely to benefit the UK as an international financial centre. Rather than seeking to limit the impact of bad rules, however, in the case of the AIFMD, the FCA exaggerated matters. As a 'lead regulator' in the EU, this has had an adverse impact elsewhere as others have followed their lead.

17 July 2014

Bank of England- Oral evidence (QQ 252- 269)

Evidence Session No. 16 *Heard in Public* *Questions 252 - 269*

TUESDAY 4 NOVEMBER 2014

10:40AM

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witnesses

Andrew Bailey, Deputy Governor for Prudential Regulation, Bank of England, **Sir Jon Cunliffe**, Deputy Governor for Financial Stability, Bank of England, and **David Rule,** Executive Director, Prudential Policy, Prudential Regulation Authority (PRA), Bank of England

Q252 The Chairman: Sir Jon Cunliffe, Andrew Bailey and David Rule, you are most welcome to the Committee in this our penultimate session of speaking to witnesses about the EU financial regulatory framework, as it has panned out. As ever, we are being televised and webcast. As ever, the House of Lords will send to you a transcript of the exchanges we have this morning. We ask you not only to correct it, but to improve upon it. This is a fast-moving target. We are due to write and publish at the end of the year or maybe the end of January, so if you have further thoughts that you think are of importance to the Committee, I should be most grateful if you would send them to us. I will, indeed, attempt

to finish by midday, so that David can get away, but perhaps, Sir Jon, you may like to introduce colleagues first of all, before I put an opening question.

Sir Jon Cunliffe: I am Jon Cunliffe, the Deputy Governor for Financial Stability. On my left is Andrew Bailey, who is Deputy Governor for Prudential Regulation and Head of the PRA, and David Rule, Executive Director, Prudential Policy, who covers both financial stability and prudential regulation.

The Chairman: Let us start off by asking what your assessment is of all the changes that we have had since 2007 or 2008, which have been designed to try to stabilise the system and ensure the functioning of the financial sector remains successful. What is your view on that? How well have the authorities done so far?

Andrew Bailey: I will start off, but I am sure colleagues will come in. Obviously, we have had a very extensive response to what was a very severe crisis. It is important to have in mind that major changes have already occurred and those major changes, I would say, predominantly addressed the evidence and the consequences of the crisis that was at its head in 2007, 2008, and 2009.

There are some important parts of the response that are being taken through the policymaking process. One of the ones that I would highlight there, really at the top of all our lists, I think, is making substantial progress on the "too big to fail" issue with major banks. As you may know, there is a very important event coming up in Brisbane in Australia this month with the G20 summit and that is very important in terms of resolution for major banks and loss-absorbing capacity. As I have said a number of times, none of us want to jinx it, but I think we are quietly confident, because we know how much work has gone into that, but that is a very important further building block.

The second and final thing I would say is that you have to see the last seven years as obviously first a prudential crisis, being at its peak in 2008 and into 2009, but we still have

further phases of the general set of issues emerging. What I sometimes tend to call the second phase of the crisis, which I think we are still in, has had a stronger conduct of business theme to it, if you like, both domestically in retail markets; in terms of financial markets, LIBOR, issues around FX and some of the benchmark setting;, and a third leg of it being general issues around financial crime, anti-money laundering, financial sanctions and some of the issues, particularly in the US, that we are having to deal with. In terms of policymaking, the responses to those elements of the crisis are still very much emerging. The one thing I would highlight there is the Fair and Effective Markets Review, which is being led by our colleague Minouche Shafik, working with Martin Wheatley and Charles Roxburgh. That is a very important further element of what I would call the reaction to the symptoms and the causes and the consequences of the crisis.

Q253 The Chairman: Still on the same theme—perhaps Sir Jon on this one—are we now in a better position to withstand asymmetric shocks? Have we retained the flexibility to be able to respond to a changing scene?

Sir Jon Cunliffe: Starting a bit where Andrew left off, the first point is this response to the crisis is an international response and what Europe has done, not exclusively but in the main, is to take international agreement on the main planks of reform and bring that into European legislation. So we have improved bank capital, both the quality and the amount of capital and liquidity. That was one of the main vectors, if I can put it that way, of the crisis and that has been addressed.

Too big to fail: as Andrew said, we hope to take a significant step forward at the G20 in Brisbane this week and, again, to deal with that problem, bringing over-the-counter derivatives onto clearing and getting more information about them and addressing shadow banking. We are more resilient on the banking side. There is £150 billion more capital in the UK banking system—globally about $500 billion. Europe, following the stress test, has

tested that capital position and we are more equipped to deal with that sort of crisis coming. We are more equipped also on the derivatives side with central clearing and the like.

The one area where I think the work programme is still moving forward is shadow banking. Parts of that were issues in the crisis, but clearly the worry is that as you regulate more in the regulated sector—in banking and insurance—you push risks out into the unregulated sector. Now the international community and the European Union is thinking more about how we deal with crises coming from that area, so I think there is more resilience in the overall system internationally, in Europe, and in the UK.

On this question of how we would cope with an asymmetric shock, by which I think you mean something that hits the UK in a different way, I draw a distinction with regulation: common rules that are necessary for the single market and that need to be lined up to ensure that we do not get regulatory arbitrage—that people do not take advantage in a single market by applying rules to a lesser extent in one jurisdiction than another. I draw a distinction between that and responding to financial stability concerns, which is what the Financial Policy Committee of the Bank of England does—the so-called macro-prudential policy. We now have increasingly in a number of jurisdictions, particularly in the UK, macro-prudential authorities that can try to act against specific financial stability risks in jurisdictions. For example, what the FPC has done on housing in the UK, what we have done on leverage with the proposal we published at the end of last week. That balance is quite important. We have to leave financial stability, if you like, to the authorities that are accountable for it and accountable to the electorate for it while, at the same time, have common rules commonly applied coming from Europe. At the moment, I think we have that balance, but it is very important we keep it.

Q254 The Chairman: Could I give you a chance to comment on the asset quality tests from the European Central Bank and also the ECB / EBA stress test, especially if you could

line them up with the tests that the Bank of England propose as well, about which there has been much comment?

Andrew Bailey: Let me start with the asset quality review work. What the ECB is doing and what I think all of us are now doing is something that, of course, should have been done before the crisis but was not done effectively—that is, a much closer examination of the quality and risks around major asset portfolios and the major groups of assets held in banks, with a view to thereby challenging the views and decisions that banks have reached, for instance, on provisioning on asset valuation. Bear in mind that is important in the context of provisioning, because we still exist in a world where there is not what in the language is called forward-looking expected loss provisioning, so having an asset quality view that is explicitly a more forward-looking view of the likely quality of assets under a series of scenarios is important.

It is also important just to comment on the current conjuncture, because for all of us, we are living in a world where monetary policy is being used very extensively and very correctly, in my view, and of course, therefore, we are living in a world of very low debt servicing costs and that has been a correct thing to do.

Lord Davies of Stamford: Could you speak a little more clearly?

Andrew Bailey: Yes. In terms of judging asset quality on a forward-looking basis, we are currently living in a world where obviously monetary policy has been used very extensively and correctly on a forward-looking basis. However, we have very low debt servicing costs, and so it is important in all these tests, looking at asset quality reviews and stress tests, to judge them in the context of the world we live in today and the world that we could live in and, at some point, will live in, in the future. Therefore, I welcome the work the ECB has done. I think it is a big step forward. We, too, have stepped up the asset quality review

work that we do and, therefore, the engagement we have with banks on that and it naturally goes alongside stress testing.

The asset quality review, in a way, you can see as putting the foundation down, saying, "Let us look at the quality of what you have today and then let us subject it to a forward-looking stress". One way of looking at a stress test is to say, "This is a test in the tail of the distribution of risks, the bad things that can happen in the future". Now, as is well publicised, the EBA has had a difficult history with its stress tests. That is no secret. That is one of the contributing reasons to the emergence of the Single Supervisory Mechanism, which we may come on to later, but we welcome very much. This stress test has been done on the basis of a well defined scenario. It is very transparent and one of the things to note about EBA stress tests is they are very transparent. They publish very large amounts of information, and that is important, because it allows analysts and markets to form their own views on the quality of it. This process has been more robust than the processes that have come before, but when I say that—because I would say that about everybody's stress tests—that does not mean to say it is the finished article. We are all evolving, learning and going on. It is a point Jon and I made about our stress test when we launched it earlier this year. We are on a road to get to a point, but please do not assume that we have got there now, in the early days.

We will publish our own stress tests, which are a variant of the EBA stress tests, in the middle of December. There are two things I would say about that. They are a variant in the sense that we had very much in mind the work and the views that the Financial Policy Committee has taken and a particular interest to look at the UK housing market. Therefore, the scenario in the UK variant has a scenario of a particular shock that runs through the whole of banks' balance sheets, but has a particular effect in terms of the UK housing market. However, the final thing I would say—I have said this quite a few times, but

I will just caution again—is because of the various differences in the methodologies and the approaches used it is not possible for anybody to extrapolate from the results that the EBA published to what we will publish. Our stress test has some different methodological elements to it, some different assumptions in the scenario and so you cannot do the extrapolation easily.

The Chairman: Andrew, I am most grateful for you speaking up. I am afraid some of us have left our ear trumpets at home this morning. David, we have not heard from you, but please indicate when you would like to come in on any of these questions. Sir Jon, did you want to add anything to Andrew's comments?

Sir Jon Cunliffe: No, thank you.

Q255 Lord Shutt of Greetland: Good morning, gentlemen. How would you assess the effectiveness of the European Union legislative process over the course of the financial crisis? Would you suggest any necessary legal changes to improve the functioning of that process?

Andrew Bailey: The three of us have a number of different views on this and the roles we have played.

Lord Shutt of Greetland: Let us have variety.

Andrew Bailey: Yes, let us have some variety. Jon can come in with obviously huge experience in this field during the crisis.

Sir Jon Cunliffe: The crisis was a once-in-70-years event; the legislative response and the reform programme is a kind of secular reform programme, and it has been difficult wherever it has happened. In the US, Dodd-Frank—because the US can only ever have one piece of legislation in a presidential term, they did a huge piece of legislation that they are now trying to implement—is throwing up all sorts of issues. In Europe, it was divided into chunks and the chunks themselves were pretty large, but then lining up all the secondary legislation afterwards is a huge endeavour.

In terms of addressing what I called before the main vectors of the crisis and putting the international consensus on where regulation should go into European legislation, the end result is not bad. It has implemented international standards in Europe, not perfectly everywhere, but they have not been implemented perfectly in other jurisdictions. It has managed to bring 28—we started with 27; it was 28 by the end—European member states with very different financial sectors together. By and large, we now have a much stronger legislative regulatory programme than we had before.

The European legislative process is not pretty. It is not pretty. Towards the end, particularly the interaction between the Parliament and the Council, the so-called trilogues can be quite difficult, and my own observation—and I think I said this when I appeared before you some months ago—is that in terms of the technical detail there is often a lot that you have to revisit afterwards. You could argue the same is true of Dodd-Frank, and we are seeing that in the US process. I think we need quicker, better mechanisms in Europe for being able to spot where there are problems and fix them and fix them sensibly. The technical expertise of the national supervisors in EBA or ESMA or EIOPA needs to feed more directly into the Commission when it comes to fixing some of those problems. The Commission now has 400 pieces of secondary legislation—delegated Acts, implementing Acts—to do over Lord Hill's terms and that is a huge challenge, but it is a huge opportunity then to fix some of these details.

You asked me overall whether the international community has taken regulation forward to address the causes of the crisis and whether Europe has done its part in legislation. I would say yes.

The Chairman: David Rule, you were nodding away when Sir Jon was speaking. Would you like to embroider your response to that?

David Rule: I agree with Jon that, broadly, the achievement has been immense. We have a broadly coherent set of regulations that are much more effective than those pre-crisis, and I am confident they will help to preserve financial stability in Europe more effectively.

The Chairman: What do the three of you think about the role of the Commission? You have talked about the role of the Council and the role of the European Parliament. Have the Commission been helpful? Have they been knowledgeable?

Sir Jon Cunliffe: My view is yes, they have been knowledgeable. Commissioner Barnier, who I know has come in for some criticism, took the international programme, took the G20 reform agenda and made that the centrepiece of his reform programme. In the pieces of individual legislation—and I am speaking now with memory of a previous existence rather than from the Bank of England seat—I think there were compromises. There are things in that legislation that we might not have chosen as the best for us, and there are things in that legislation, as in all legislation, which will turn out to need some fine-tuning or some bedding down. By and large, though, I think the Commission did a good job on the main planks of this reform programme bringing it into European law.

The Chairman: We saw Michel Barnier and he was very proud of his 41 pieces of legislation, and I think he has every right to be.

Q256 Lord Kerr of Kinlochard: Could I ask Sir Jon: do you think that, over time, it got better? And I do not mean because you left Brussels. I really do not mean that. If you look at some of the early priorities, they look a bit odd: short-selling, credit rating agencies. If you look at some of the early legislation, AIFMD, for example, it is a bit flawed in places, whereas later on one gets the impression that the machine was working rather better. Is that right?

Sir Jon Cunliffe: First, has it got better since I have left Brussels? I have learned in the Bank of England that correlation is one thing, causality is another. I do not see any causality in that issue.

Initially, when the crisis happened, in a number of jurisdictions there was an outburst of public anger and dissatisfaction and a real political impetus to tackle certain things, and some of the initial legislation, like hedge funds, for example, the AIFMD, credit rating agencies—although the credit rating agencies did not distinguish themselves at all in the run up to the crisis, I have to say—there were a number of political hot button issues, if I can call it that, which legislators pursued. They did that in Europe through the European Parliament and the Commission, it happened in the US, it has happened here, and that is, I think, a natural societal and then political response to a very, very bad crisis. So the initial pieces of legislation, I think, had problems and sometimes we overshot. We have just done work with the ECB on securitisation. Securitisation was seen as a problem because securitisation of subprime was the cause and carrier of much of the crisis. People wanted to address some of that and we are going back, in the international community in Europe, to revisiting that. When the regulators had a bit more time and a bit more space to take the reform programme forward, I think it did get better.

Lord Kerr of Kinlochard: It is very hard to kill something, is it not? The financial transaction tax—it is a zombie and yet it still stalks the land.

Sir Jon Cunliffe: To my mind, that is not part of the reason for the crisis. That is part of the societal response, if I can call it that, to making bankers pay. However, if you are thinking from a regulatory point of view in financial stability terms or, for the PRA, in terms of safety and soundness of firms, about what the financial transaction tax will deliver, the answer is nothing.

The Chairman: Andrew Bailey, I think you wanted to respond to some of Lord Shutt's questions and points.

Andrew Bailey: No, Jon's answer was very comprehensive. I just wanted to add one thing, which really develops a point that Jon was making about shaping the role of institutions looking forward. I should say, in saying this, that I am a member of the Board of Supervisors of the EBA and the Management Board of the EBA. There is obviously a lot of debate, particularly with the Single Supervisory Mechanism coming into existence, about what the role of the EBA is. By the way, I say that not because there is no role for the EBA, because there clearly is; it is laid down in the framework. However, picking up on a point that Jon made, what we do need is the ability to have greater debate and challenge around the success of individual elements of this legislative programme, bearing in mind that it would be remarkable if all of it was laid down at the outset and worked smoothly and perfectly. That would be a remarkable outcome for any organisation, frankly. My own view is encouraging the EBA, which, after all, is an interface between national authorities and the European institutions that we have just been talking about, to have that debate in a way that is not viewed as damaging, threatening or, in some sense, undermining the confidence of this legislative programme, which it should not as a debate. That would be a good thing.

The Chairman: Let us plod a little further into what we have been left with.

Q257 Earl of Caithness: Good morning, gentlemen. Sir Jon, can I press you a little bit more? You have answered generally the question I want to ask, but where are the overlaps and contradictions and inconsistencies in the existing legislation, and have we got the right system to be able to deal with those sensibly and practically? I am thinking also of the CRD IV package, a question on definitions and exemptions there, and how does that tie in with the Bank Recovery and Resolution Directive and EMIR?

Sir Jon Cunliffe: An honest answer is that we do not know yet how all these pieces will fit together, because we are halfway through the implementation of much of the package, and we will have to deal with these things as they come up. People have put to me the idea of, "Should you not sit down and review the consistency of everything?", but my view is the financial sector evolves so fast and is so complex that you have to deal with problems as they come up, possibly in groups. Therefore, my first answer is whatever I think today there will be other issues.

On the specific point of BRRD and CRD resolutions, those were lined up and should line up going forward, although we may find that things do not. There is a more interesting question: we also have state aid guidance, which has to line up with resolution, and there is some more work to be done in that space.

On the question of how we line up, there is also a question between Solvency II for insurance companies and CRD IV with both of our solvency standards for banks; David might want to comment about where you line those two things up. I think some of it, though, is also lining up on dealing with unintended consequences. You probably heard a lot from the industry that many of the changes we have made on leverage and on capital have led to liquidity in market-making being reduced. The answer is liquidity in market-making does seem to have been reduced. We are not sure how much of it is the result of regulatory action and how much of it is to do with a change in business model for the institutions. However, it is also worth making the point that a lot of the liquidity that people hark back to in the pre-crisis era was illusory. It was there and freely available and you could sell what you wanted, when you wanted, where you wanted until one day you could not and then the whole system came to a crash. We are not going back to that. People will have to pay more for liquidity. It is what the industry often refers to as "unintended consequence". We will need to come back and look at various regulations. Have they had a role in limiting

liquidity? In the end, is that a bad thing? Should we accept that there is an element of that because the system beforehand was not safe?

Q258 Earl of Caithness: Is it going to be easy to come back and have a look at it, or is it a hugely complicated process?

Sir Jon Cunliffe: In Europe, my guess would be we need an easier process for doing that, but I defer to Andrew, who is on EBA and EIOPA. Luckily, I am pleased to say, I do not sit on any of those.

The Chairman: We will hear from Andrew but, David, did you want to come in to supplement Sir Jon?

David Rule: Yes. It is a more complicated regime—the bank regulation regime—and we have added more elements to it: we regulate remuneration now; we take more interest in bank governance. Therefore, it is a more multifaceted regime and more complicated, but it is broadly coherent. As Jon said, we are early in and not all of it is even implemented yet, so we will have to watch it carefully. However, the coherence of having buffers that absorb losses in a stress and then capital requirements and then thinking more carefully about how banks might fail and what debts they have that can absorb losses in resolution as well, that lifecycle of having capital requirements for each of those is a more coherent regime than we had previously, albeit they are more complicated. What we have also learned is that you cannot look at the adequacy of a bank's capital through one lens only, because the banks will always optimise to the lens that you focus on. Therefore, we are now looking at it through different lenses, so we have stress testing, we have the risk-based capital requirements, and we also have the leverage framework, and the FPC announced plans there in the UK last week. That makes it all more complicated, but it is coherent and more robust none the less.

The Chairman: Andrew, do you want to respond to the Earl's question?

Andrew Bailey: Thank you. I would just add one thing. We always have to ask the question: do these regulations, taken individually and in combination, create the right incentives? I think it is probably a criticism, but quite a reasonable criticism bearing in mind the severity of the crisis that the initial phases were very much responding to. However, as we become more reflective we have to constantly ask the question, as regulators: are we creating the right incentives for behaviour and performance? The reason that that question is crucial is we must never substitute ourselves in running firms; this is clear, and so getting the right incentives for the people who are running them is therefore all the more important.

Q259 Earl of Caithness: Sir Jon, you led me on to my next question when you were talking about the business model, so I think it is more for Andrew and David on this. How are the financial institutions, who are suffering from indigestion with 41 pieces from the Barnier bible and I think you said 400 more bits of regulation in the next five years, adapting to the new environment? David, are you helping them adapt when they have difficulties? My last question is to David: who regulates you? If you regulate them, who can get at you when you get it wrong?

Andrew Bailey: The answer to the second question is quite simple: you do; Parliament does. We have to be accountable to Parliament. It is a very good question. My own view on this is about one of the reasons why we have inherited what I would describe as an unsettled institutional structure of financial regulation—by the way, just as we had an unsettled structure of monetary policy in this country prior to the reforms in the 1990s. You could write a book on the subject, but one of the reasons is that we have to be clearly accountable and we have to be transparently accountable. Now, it is a bit harder in our world, because we are, by necessity, dealing with a very large amount of obviously commercially sensitive information and dealings, so we have to have ways of handling that. However, one thing that

I am absolutely clear on is that if this system is going to work we have to have clear and transparent accountability and Parliament plays a very big role in that. You are a very important part of this for us, because otherwise, you are right; we are not adequately accountable. I will let David do the other part.

David Rule: You are right; there has been a huge amount of regulatory change. I like to think of it as before the crisis people often said that regulators could not keep up with financial market innovation; since the crisis, banks have struggled to keep up with regulatory innovation. I suspect we will come back to a world that is a bit more balanced in that respect, where we see a bit more financial market innovation over the next few years and maybe a bit less regulatory innovation.

As Jon said, it is quite early to know how markets will adapt, but they surely will, because banks look at the regulatory constraints they face and, quite naturally, adjust the mix of their business accordingly. They are starting to do that, but we have not really seen the full cycle of that yet, I do not think.

Some of the things that you can see are, broadly, banks have been reducing their financial markets activity relative to their, what you might call, real economy activity. That is probably a part of the back-of-the-mind intention of the regulators, although they maybe were not trying to engineer a precise outcome. Certainly banks have reduced some of their pre-crisis trading activities such as credit correlation trading. Those types of activities have largely gone from banks' balance sheets.

There has also been a reduction in the interconnectedness of the system. We can see that in the data. Banks' exposures to one another have decreased. Some of that has been a substitution into the central counterparties. Again, that is a deliberate regulatory outcome.

The conduct regulators have had quite a big impact on banks' activities. A number of UK banks, for example, have ceased remunerating their staff in terms of commission, and I think that changes the way they behave. Products are generally becoming a bit simpler.

In the way that they organise themselves and, again, I think there is a lot more to go here, there has generally been more of a trend towards activities and legal entities cohering. Whereas previously groups would run themselves as a group and they would book to the legal entity that was most convenient for them for tax or regulatory reasons, now—and this again is partly regulatory-driven with things like the ring-fencing initiative—there is more coherence in group structure between the entity that does the business and the activity that it is doing. That is a trend that we will see more of and we will encourage, because that helps to make it easier to resolve banks when they fail.

Q260 Lord Flight: Jon has already briefly referred to shadow banking and I would first like to ask you how adequate you think EU reforms so far are to deal with shadow banking and, in particular, its transparency and, on the other side of the coin, to encourage the development of capital markets where, if banks are less involved because they are shrinking, you have to have bigger capital markets. Also, could I ask you about emerging new risks to financial stability, such as central counterparties, market fragmentation and volatile capital flows? We had a very interesting session with the DG of the Association of Corporate Treasurers, who made the point that, given the known conditions of bail-in, any whiff about a bank and corporations will move their money like that. So, in a sense, bail-in will create more volatility, at least on the wholesale side, for bank deposits where there is often no lender of last resort facility any more.

Sir Jon Cunliffe: First of all, to pick up your second point, "shadow banking" is an unfortunate term, because it has a pejorative sense to it and some of it is simply capital markets financing and, at one and the same time, we want to encourage, if you like, another

financial engine as well as the banking system. That is what capital markets union should be about in the European Union, but then we have this phrase "shadow banking", so we have to be alive to the possibility of risks moving out of the regulated into the unregulated sector but remaining the same risks. We also have to try to stimulate and develop capital market financing through things like good securitisation and transparent securitisation—I will put it that way—so within the term there are two different things.

The second point I would make is that the main areas where shadow banking created problems in the crisis, such as money market funds and securities financing transactions, have been addressed with specific international reforms. David was very involved in those internationally and might want to say something on that. On minimum haircuts, the FSB has just put out some proposals for securities financing transactions. So there were some areas where the shadow banking world created problems in the crisis and those were addressed specifically.

The issue now, for us, particularly internationally, is we know a lot about the banking sector, we know a lot about the insurance sector and they are quite regulated. We do not know that much about the universe of asset managers, different funds, different investment funds, who all have different strategies and, if I can put it this way, mutate very quickly in that environment. Globally, I think there is something like $70 trillion in the so-called shadow banking system, which is about 100% of global GDP and is a bit less than what is in the formal banking system. Much of that is in straightforward asset managers; some of it is in bond funds. It is in a variety of institutions and the international community—and the European Union is part of this—is, if I can put it this way, trying to get its arms round this. The information and the data are nowhere near as good as the ones we have for banks and the regulatory tools we have to deal with risks in asset managers or exchange traded funds, et cetera, are very different and not as developed. This was not an issue during the crisis in

the main. We have addressed the main ones, but one does not want to fight the last war. As a macro-prudential authority, the FPC particularly needs to look forward internationally.

Lord Flight: The risk is of it drying up, basically.

Sir Jon Cunliffe: The risk does not seem to be, in the main, for this $70 trillion the leverage that we saw in the banking system that can lead to some of the explosions, but the risk is that a large amount of this money all tries to move in the same direction on the same day in response to what is happening in US interest rates and, as a result, we get so-called fire sales of assets. That destabilises markets; that destabilises banks. Therefore, at the moment, internationally we are going through trying to identify which activities carry which risk and what is the best way of dealing with it. However, this is the area where the international community is least advanced, because it is not really looking back to the past; it is looking more to the future. I do not know if David wants to say anything, because he is working on some of this reform.

David Rule: I think you are right. You have to distinguish market-based financing from what is called shadow banking, which I think of as leverage and maturity transformation. That is where people who are not banks make promises to repay people at 100%, on demand, something that looks like money. That can be a problem and that is where we would focus. There are two areas where that happens; one is money market funds and the other is a repo-like liability, so where essentially you collateralise someone with a government bond so that it looks like a very safe asset. There is a lot of demand for this money-like asset from different types of investors, so if you do not meet that demand then you actually cause other problems. The question is: how do you meet that demand without creating systemic risk?

Lord Flight: I do not understand the worry about money market funds, because they are really just there to spread credit risk for corporations or individuals, and, all right, they could sustain a loss on part of it, but so what? What is the worry?

Andrew Bailey: I think there it relates to the point David has just made. It really depends upon the contract and the promise that is given to the people who place the money with them. You can see this on a spectrum. There is a world of asset management where I would characterise it as, "I place money with you. You manage it. You pay me back the consequences of your management."

Lord Flight: "You lose money."

David Rule: Which is fine.

Andrew Bailey: Is it the famous Woody Allen quote that, "The stockbroker is there to manage my money until it is all gone"? There is another end of it. The bank deposit contract: "I give you my money and I expect it back when I want it back, and all of it please, and you will pay me some return." Now, what David was pointing to is that there is a certain section of the money market fund industry, most present in the US, and often known as the constant net asset value, where actually they are writing a banking contract. They are saying, "Give me your money. I will give it back to you, and I will manage it." So it looks like a bank, it squawks like a bank, but it actually is not a bank.

David Rule: Also, "I will give it back to you any day you want it, on demand".

Lord Flight: Yes, and they have existed for a long time in the States, so fundamentally they have to have short maturities so they are not exposed to too much interest rate risk, but I do not see them as a great threat to the system.

David Rule: It is when they start not having short maturities and go up the yield curve to try to make a bit more money.

Andrew Bailey: Yes, and so you will remember there was the break-the-buck moment in the US, and that was one of the big moments of the crisis in the US.

Sir Jon Cunliffe: Looking forward, there are number of asset managers and asset funds that promise daily liquidity, so they promise that you can have liquidity out of them. What are

their liquidity management practices? How well do they manage their liquidity? If they all got stressed in the same direction, and one can see possibilities why that might happen, do we then get a run on those and what does it do? We have to ask those questions.

Q261 Lord Davies of Stamford: Following on from Lord Flight's question, is there a particular risk in asset managers being able, as far as I know without any restriction or reporting, to borrow or lend stock as a means of going short or long? Secondly, is there a particular systemic risk from synthetic ETFs—that is to say ETFs where the fund managers do not actually hold the underlying stock?

David Rule: There can be risks in stock lending. We saw that with AIG. Again, it depends how it is done. If a fund is lending its stock and taking gilts as collateral or taking cash and reinvesting it in something very safe, then it is probably not a particularly risky activity, but clearly we saw with AIG, which was lending US Treasury bonds and reinvesting the money in five-year illiquid paper, that it can become leveraged investment management, effectively. Part of what we have done internationally is to set regulatory regimes for how you do securities lending and the risks that you take in the process.

Lord Davies of Stamford: Are those transactions notifiable?

David Rule: There is an initiative in Europe to have a trade-repository type arrangement for repo and securities lending, such that that would all be reported. That has not yet happened, and it is not a simple endeavour, but there is much better reporting now to the underlying investors. This tends to be done by the custodian of the investment fund.

Lord Davies of Stamford: Okay, but they are not notifiable. That has answered my question. What about synthetic ETFs?

David Rule: Again, synthetic ETFs can be risky. There can be leverage in the structures. This was something that the authorities looked at very closely a year or two ago. My impression

is that synthetic ETF business has actually tailed off a bit, but Jon may be more up to date than me.

The Chairman: Colleagues, we have to move on. I am anxious to return to Lord Flight but, Sir Jon, just come in on that last point.

Sir Jon Cunliffe: I would say with all of these that the question is: is it posing a risk, and how big is the risk? So we have looked very strongly at ETFs in the main, including synthetic ETFs. There has been some action to try to make the risks more transparent. It may be that we have to do more. These are not regulated for prudential regulation. They are not part of the prudential regulated sector. They are regulated in their conduct, in the main, by conduct supervision. When I said the international community is trying to look at which activities or business models create risks, those are the sorts of areas we are looking at.

Q262 Lord Flight: What do you like and not like of the new EU rules on governance and remuneration, clearing and trading obligations? Do you think they create a harmonised sanctions regime and what do you think about that? Do you think these measures have been effective to create better management of risk for financial institutions?

Andrew Bailey: We will carve those up, but I had probably better start on remuneration because I am a commentator on this subject. The issue here comes back to the point I made earlier about creating incentives. I would also make the point very strongly that we are not, in my view, pay-level regulators. That is not our purpose in life. If there is a desire to do that then some other mechanism should be found for it. It is not our purpose. We want to do two things, in my view, in the context of getting the incentives and structures right. This, of course, is relevant to high earners, given that there are very high earners in these institutions. The first one is that I think it is entirely sensible, given that structure of remuneration, that there is a capacity to vary some part of the level of remuneration, looking forwards, in the context of the institution. If the institution gets itself into trouble

and needs to conserve capital, then it is sensible as a prudential regulator to want it to be able to say, "Yes we can scale back that level of pay", and that is the first point in which there is a conflict.

The second point is closely related to it, which is that there is a benefit incentive-wise, in my view, and not only in being able to defer an element of pay, which is then variable, and that deferral creates the right incentives, because rather like the old partnership system it is then tied up in the firm, and it can then be subject to what is in the language—I will have to be a bit careful about this—called "malus", which is a Latin word. Every time I appear at Parliament I get a transcript back saying I have got a policy of "malice", which I can honestly say I have not, contrary to what you might hear. That is about being able to say that that element of deferred, unvested remuneration can be taken back in the event of, during a period of deferral, problems or misdeeds emerging, and that really does happen today. Over the last few years, this has really happened in institutions and you have seen some of it reported. Again, that is an appropriate incentive device. It is all about getting a structure of remuneration that has the appropriate incentives in it. I will finish by saying I do not think the bonus cap delivers that.

Q263 Lord Dear: Good morning. I want to stay with the international scene, of course, and talk about playing fields and whether they should be even or not. It is probably something that Sir Jon will want to pick up on, but all three of you may want to comment. The whole canvas of this is a search for harmony and consistency, as we all know. Against that background, my question is a very simple one, really: will we ever get to what is often called a level playing field? Is that possible? What would it look like if we got it? There seems to us to be, and certainly to those who have given evidence to us, the risk of fragmentation on the borders of all of this. That leads one to suspect—I doubt if there is any real evidence of this—that you have got elements of national protectionism at work in this: "We will play

up to the general principle that actually we are going to look after our own side". Now, there is no evidence for that, but there is this lurking doubt that seems to have come through the evidence that we have got. It would be helpful if you could comment about that general premise.

Sir Jon Cunliffe: We still have quite an integrated global capital market and global financial sector. We have banks and businesses that come from different jurisdictions, models, structures in their home markets, and histories of regulation. It will be many, many years—and I probably will not see it—until we get to a perfect consistency between the rules as they apply in every jurisdiction, and that every jurisdiction tries to achieve the same thing in the same way, and of course we have national and in Europe a European political system that still creates the regulation.

On the other hand, there is regulatory arbitrage, and all of us have had institutions come and say, "The problem is not what you are doing. That is fine. You are implementing. We have no problem with that, but over there they are not doing it," and then when I speak to my international colleagues they have had the institutions from over there saying exactly the same thing, and saying, "But in Europe they are not". Regulatory arbitrage is a real danger. One of the lessons from the crisis was that you can get a race to the bottom quite easily if you allow that to happen. You have to find the place where there is enough consistency that as regulator or a supervisor in one jurisdiction you can have confidence that things are being done to meet the same objectives in another jurisdiction without knowing that they have done it in exactly the same way.

We are a huge distance further down the track with that post-crisis than we were before. When I look at all of the common principles that we have developed internationally, the next step is reviewing, naming and shaming, and identifying the places where that is not happening. There is a lot of that going on; people are actually doing work on whether Basel

III has been implemented consistently in other jurisdictions, and we need to keep on with that. We will never be perfect and we will always have differences between jurisdictions, but we are a lot further on than we were. I will say one other thing. One of the advantages in the EU, when we get it right, and we are going for common rules and being able to trust, is that we can put that into European law, and that actually has strength of law when we get it right, and if it implements international rules that gives us some security here that others are implementing, because it is law. We should not go too far and try and make sure that everything is exactly the same in every jurisdiction, because then you are not taking into account national risk and national structures. We have come a long way with it.

Lord Dear: Could I just dance on the head of one very small pin on this? We have had some evidence early on in this session—and indeed on other subjects for this Committee—where it seems that the terminology that they use, and the interpretation of words and phrases, with the best will in the world, is frequently subject to different interpretations. That might be partly language and it might not. Is that inherent in what you are saying: that in this search for the level playing field, one needs to make sure there is absolute common understanding of certain basic principles?

Sir Jon Cunliffe: One needs to make sure that there is common understanding and agreement of certain basic principles. Internationally that is done through the FSB Key Attributes. It is done through the Basel Committee Agreements, et cetera. Until we come to a rather different form of global governance, there will always be an element of national or regional specificities, which is the name it goes under. Some of that can allow for an un-levelling of the playing field. Some of that is actually recognition that structures are very different in different countries. The trick is getting enough of a level playing field to avoid major regulatory arbitrage and to allow us to have an integrated global financial sector without, on the one hand, falling back to where we were before, as I said, with a race to the

bottom, or, on the other hand, trying to do everything identically in every jurisdiction, which simply would not work.

Q264 Lord Hamilton of Epsom: My question is about growth and in particular the costs of compliance. One of the problems the Government have at the moment is the lack of revenue coming in to the Treasury, and one of the reasons for that is that financial services are not producing the tax revenues that they used to. One of the reasons for that is the cost of compliance, and we are rather inclined to ignore costs, and certainly the EU seems to assiduously avoid talking about the costs. We had Douglas Flint here giving evidence not very long ago, who said it was going to cost him £2 billion to actually separate his investment banks from his clearing banks, and this is very serious money. You talked earlier, Mr Bailey, about the question of money laundering. Money laundering seems to have gone completely berserk. It has become a third structure now, which actually affects people who have been banking with the same bank for the last 25 years, and are you actually catching the drug traffickers? I suspect you are not and they have found another way around all of this, and an awful lot of this is completely otiose. So, is there not a risk that we are over-regulating? We are also reaching the position now where it is very difficult for new entrants to build up businesses in fund management because of the costs of compliance, and this is not doing anything for competition and means that all the fund managers are now consolidated and we are being left with very little choice as consumers. There is a cost to all this, is there not? Is this really taken into account?

Andrew Bailey: That is a very good point. I have a few responses on that. By the way, I should say that we are responsible for macro-prudential policy and prudential policy. We are not conduct regulators. Some of these are questions for the FCA, but I will speak across the breadth of your question. To start with, I would say that I am, I am afraid, very dogmatic about the view that a stable financial system is the one that will best support growth in the

economy. This debate comes up quite frequently—surprisingly quite frequently, I have to say. We have had the experience of having a critically unstable system and what that has done for the macroeconomy, and we have observed that, so I am afraid I do strongly take the view that a stable financial system, which means a well-capitalised financial system, will best support growth in the economy. If you do not mind me saying, the question of structural reform is quite interesting, because what Douglas Flint was responding to was in fact domestic legislation passed by the UK Parliament. I am sorry to be blunt about that. It is not because I disagree with that legislation; I am a supporter of that legislation, but it is actually not European legislation. Europe has not actually reached a conclusion as to what it wishes to do in the area of structural reform, if anything.

Lord Hamilton of Epsom: But on the other hand the Liikanen proposals are going down a very similar road.

Andrew Bailey: But the Liikanen proposals are nothing more than proposals. The UK Parliament has legislated in response to the Commission that Sir John Vickers chaired, and that has been an entirely appropriate piece of legislation.

Let me just move on, then, to money laundering. What I would say is this, and I have said this publicly: it is of course important for all of us that we regard financial crime as something that, frankly, has to be cut out. We have no sympathy with money laundering. As I have said publicly, we are facing, frankly, a very serious international co-ordination problem in this respect. I have to spend a large part of time dealing with some of the issues that come up in this field, and not because I am a conduct regulator; I am not. It is because some of the consequences of the actions taken are potentially what I might call existential. This is a very serious field where I hope, and I have said this publicly, that we will get more international co-ordination of measures, because, to your point, one of the things that concerns a lot of us is that we are, as you have said—and I have corresponded with Lord

Flight on this subject—seeing clear evidence of parts of the world and activities being cut off from what I might call the mainstream banking system, because of the concern of the banks at the consequences of the actions that will be taken if they are, frankly, put under question and at risk of action.

Now, we want high standards, as I said, but it cannot be a good thing for the development of the world economy and the support of emerging countries and developing countries that we get in to that situation. That cannot be a good outcome so, again, we are very keen to have more co-ordination internationally to try to get sensible approaches that lean against that.

The final thing I would say on new entrants—and obviously I am a banking and insurance regulator, not an asset manager regulator—is that this Parliament has given us an objective in respect of understanding the competition implications of our actions. We take it very seriously. We have done a number of things on the conditions for new entrants. We are now looking at the capital regime. It is not as easy there, because Europe actually does not have a competition objective in its framework of legislation. I would say that is an important point that does need to be borne in mind. Where we can, we take this objective that Parliament has given us very seriously, and we are making changes, and I would imagine we will make further changes.

Sir Jon Cunliffe: Some of this goes to the question that the Earl of Caithness asked about who regulates us. When we come forward with proposals and when the international community does the Basel Committee, et cetera, we try to do a cost-benefit analysis. We have published that. We have just done one last week on the leverage framework we propose. It is important that we try to explain that balance between cost, on the one side, and regulation on the other. I have to say, though, the UK economy is about 15% below where it would have been on its pre-crisis trend, which I guess valued in today's money is about £250 billion. That is an awful lot in terms of lost growth. Andrew's point that the

best thing for growth is a stable financial system in which banks and financial institutions are well capitalised such that they can take a real shock and continue to lend to the economy is extremely important. One of the lessons I think we have learnt over the last few years is that banks that are well capitalised can lend, and banks that are in capital preservation mode, desperate to hang on and slowly grow their way out, do not lend. We learnt that in the UK over the last few years. In continental Europe they are learning that now. There is a balance.

Q265 Lord Flight: The PRA quite correctly was set up to oversee the banking system for safety, not to have endless rules and endless directions, and I think it has worked extremely well. It is the other areas that are actually getting cluttered up with unjustified costs and excessive tick-box rules.

Andrew Bailey: It would be hard for me to comment on that. It is very kind of you to say that, if you do not mind me saying so.

Lord Flight: The other areas being conduct and what has happened with AIFMD and all sorts of things that are nonsense.

Q266 Lord Kerr of Kinlochard: Under the ferocious pressure of our Chairman, who is worried about timing, I would like to ask four quick questions, which are drawn from a reading of the written evidence that we have received, mainly from practitioners, which was extremely interesting. First, do you think that the principles of proportionality and subsidiarity have been followed in all this legislative work? Some of our correspondents say yes; some say no. The Building Societies Association, for example, is doubtful. The BBA think that there is too much detail in level 1 legislation, whereas the BVCA think there is too little accountability at level 2, so the evidence conflicts.

So, subsidiarity and proportionality, and perhaps a slightly separate question: is too much done by regulation rather than directive? It is suggested once or twice that wholesale

markets need to be regulated by regulation but quite a lot of, say, consumer protection could be left to member states provided they were in line with the overall directive. Second question: are there any areas for requiring immediate review, reform, or change? Everybody says, and all the written evidence suggests, that a period of calm is required, and then each individual practitioner interest suggests where immediate reform is required. What is right? Thirdly, in relation to the supervisory agencies, most people seem to think they are under-resourced for the tasks they have to do. Is that correct? Finally, there is the impression that, say, in the EBA what really matters is not the extraordinarily subtle and brilliant Cunliffe double-majority rule, but whether the two great gorillas get on with each other—whether the Bank of England and the ECB are working well together. I must say my impression is that they do work very well together, but it would be good to hear a reaction.

Sir Jon Cunliffe: If I start with subsidiarity and proportionality, by and large the answer is yes, it is being observed. I would go back to the distinction I made at the beginning, which is that the single market requires common rules commonly applied, and we have learnt that they have to be a bit more detailed than they were before. That is what a lot of this has been about. Financial stability is a different thing. The way in which the European Union approaches financial stability? Financial stability is not even mentioned. You will not find a reference in the treaty about allocation of responsibility for financial stability. The way in which the European Union approaches it is through a single-market lens; it wants to ensure that financial stability is not used as a way of encouraging the regulatory arbitrage that was talked about before. Where it is about common rules and mechanisms to apply them, I think it is okay. The area where subsidiarity applies, to me, is in the application of those rules to firms, and supervision, and in financial stability action, and sometimes in the action of being able to go further, being super-equivalent, doing more than the European rules when you think you have a national danger.

One of the biggest discussions in the CRD IV process was whether member states should have the ability to go further, to put larger capital requirements on their firms, because they saw a danger macro-prudentially. In the end, we came out with a compromise but it was very hard fought, and getting the bank the macro-prudential tools it and the Government felt were needed to manage risks in the UK economy against an argumentation that said, "But the single market needed regulation, and we all need to do the same thing" brought those two things into opposition. For the euro countries—and I think I said this when I was last here—as they share a central bank and a currency they have to take some of those financial stability issues to the euro level, bearing in mind they do not yet have euro-level taxpayers to stand behind it, which is one of the huge tensions that you see in the banking union, but I think over time they will solve that. For the single market, common supervisory institutions and the regulatory authorities—the EBA and the ESMA—getting into that territory goes over the subsidiarity line. Up until now, I do not think we have had that, but I know there is pressure. There is always pressure in Europe to go in that direction. As long as we can keep to common rules, consistently applied, and mechanisms for doing that, and then financial stability as predominantly national, or in the euro area a euro-area-level responsibility, we are on the right lines. When we blur those two things, bluntly, it does begin to get a bit more difficult.

The Chairman: Do you think the ESAs are under-resourced?

Andrew Bailey: For the two that I am involved in, which are the EBA and EIOPA, the thing they have in common is that they are both having to put into effect very substantial amounts of legislation. It would be hard to imagine, going back to Lord Kerr's point about calm, that this would be steady-state, but they are both faced by a blizzard of legislative implementation. Before we came here we were counting up: EIOPA has 102 working groups currently. This is a vast amount of activity for any body. There is no question, they

are struggling in terms of resources for the amount of activity that they are facing, given the big legislative programme that has happened, but you would imagine that that is not steady-state, or you would hope it is not. There is a real question about resourcing at the moment, but you and I would hope that the long-term answer is a rather different one.

Just to finish on EBA and the gorillas, as you described them, you are absolutely right that it is critically important for all sorts of reasons that we have a very strong relationship with the ECB in all respects of our and their activity, but, of course, the new one as of today, in fact, actually is the SSM. We are starting in a good place, and the relationship between the Bank of England's PRA and the ECB is good, so we are building on very good foundations. We have consistently said that, although the UK has not joined, we are very supportive of it because we see it as a means to address the institutional problems that have existed, but recognising that they have a huge task on their hands. The final thing I would say on that is I think it is not just a benefit in terms of our bilateral relationship. It is also potentially—and I will emphasise "potentially"—a big development in terms of getting better co-ordination amongst the major global authorities in regulation, because it simplifies the landscapes.

Q267 Lord Dear: My question is really quite a simple one, and comes almost on the coattails of my previous interest in the question I posed to Sir Jon earlier; it is really whether you think the banking union poses any challenges to the EBA—particularly so far as the single rulebook and the development of the single market generally is concerned. It would help us if you focused on one small aspect of that, which is your understanding of whether there is an interplay and a tension between the single supervisory handbook that the EBA have put out and the supervisory manual that has been developed by the ECB. But it is broadly, as I say, on the coattails of what I asked before.

The Chairman: We will take Lord Davies, and then we will get a response.

Q268 Lord Davies of Stamford: Earlier on, in response to Lord Dear, you were all saying that there is a problem in the world about un-level playing fields and regulatory arbitrage. What we have in the European Union is a single market with common rules, commonly applied. But we decided not to join the banking union. There are therefore very important areas where there is a very big difference in regulation and supervision between the eurozone plus the non-eurozone members of the banking union on the one side, and the United Kingdom on the other. Some of them have been mentioned this morning, like the stress tests that happened on the continent and still have not happened here. Another one is the structure; we talked about that this morning. Few things have been more important economically than that. There are many other examples of differences in the whole area of supervision and regulation. So, surely it is a misnomer to talk about a single market because incentives and rewards are different, and regulation and supervision are inevitably different. It will be more onerous in some areas and less onerous in others. It will be more intrusive in some areas and less intrusive in others. It is bound to be that if it is different, and it is different.

Sir Jon Cunliffe: I will just make one quick point. The UK was part of the EBA stress test. Four UK banks went through that. The regulation is now written to quite a level of detail, and it is regulation, not directive, so it is more consistent.

Lord Davies of Stamford: Some regulation is. Some of the rules are commonly applied, like the liquidity ratios, but I could mention other examples where there is a considerable difference.

Sir Jon Cunliffe: The ESAs are there to do the next level of rule-making below the primary legislation. They are there, and they were set up to do that, and they have processes to do that, which are more advanced than in other areas of the single market. Supervisors can challenge each other and talk about the way in which individual rules have been applied. So,

they are there to take my "common rules, commonly applied" down to a level of detail, I have to say, and with some institutional machinery, that you do not see anywhere else in the single market. Where you have to allow national and eurozone discretion is in how your supervisors work with individual institutions, and what your supervisory approach is. You have to have convergence between those two.

There is a point of tension. It would be much easier in terms of consistency if we had one European Union supervisor supervising all banks. From a single market point of view, you could say that that is great. But when it goes wrong, where does accountability and responsibility lie? If you like, that is the tension that is inherent within the system. That tension can be managed and you can come out in a good place. My last point would be that I think we are in a better place in Europe to manage that tension. Internationally, of course, we have no law; these are standards. Ensuring consistent application of the standards is a bigger challenge.

Lord Davies of Stamford: I think everybody would agree that we are in a better position within the EU to manage that tension. My point is that the tension still exists. Therefore, I am not sure you can talk accurately about a single market. Can I ask another question quite quickly?

The Chairman: We must finish soon. Andrew, did you want to reply?

Andrew Bailey: I was just going to bring David in, because it is not true to say that there is no co-ordination of supervision between countries where banks are operating across borders. Until quite recently, David was responsible for the supervision of some of the major UK banks, and had to run those co-ordination processes internationally within Europe. As David would say, it is quite a big undertaking.

Lord Davies of Stamford: I did not suggest that there is no co-ordination. I know that there is a good relationship between you and the ECB. But simply they are different supervisory regimes. That is my point.

David Rule: Yes. The SSM is developing. It is new, but the early indications are that their approach will actually be quite similar to ours in a number of ways.

Lord Davies of Stamford: They are ahead of you in terms of the stress tests and the asset tests.

David Rule: We are doing our own stress testing as well. They are only ahead of us in terms of the timing of the announcement. I do not think they are ahead of us in terms of the approach.

Q269 The Chairman: Let me ask one final question of our witnesses. Lord Hill from this House now assumes the role of Commissioner for Financial Services. I wonder if you could help him with the idea of a capital markets union. Is there anything you would like to say on that that would be helpful?

Sir Jon Cunliffe: It is a good initiative, with a lot of potential for the future. Europe saves about 19% of GDP in the European Union. The US saves about 13%. So, Europe is not short of savings. The issue is that they are compartmentalised in countries. They are locked up in the banking system, rather than existing as well in the capital markets system. Worldwide, we tend to be very heavily focused on debt rather than equity, which is risk-bearing. There are really big gains to be made for investors in improving the efficiency with which savings are applied to investment; for companies in improving the sources of finance and diversifying those; and for all of us—but particularly for the euro area, which lacks risk-sharing mechanisms—to find a method of cross-border investment that allows losses in one country to be spread. Prior to the crisis, cross-border investments in the euro area happened through the banking system, so the only way for losses to be spread from the

country in which the losses happened to investors elsewhere was through the failure of banks. So, as a risk-sharing mechanism it is also very powerful.

There are some short-term gains on securitisation, possibly credit registers and credit information for SMEs. There are some things that could be done quite quickly around infrastructure. But to do it properly we have to look at why we have this home bias in European countries, whether there are distortions that favour the banking system over a capital markets system, and what more we can do. We have been doing this since the Giovannini Report 15 years ago, but we need to look at what more we can do to ensure that an investor in Lithuania could feel confident and be able to buy some assets in Portugal with very low friction costs. Europe will never be the US, in terms of financial market activity between states in the US, because it is not one country. It has very different cultures. When people compare us to the US and say we could be there, I am not sure that is true. But we could do an awful lot better in applying that €2.7 trillion of savings to productive use in the economy.

The Chairman: Sir Jon Cunliffe, Andrew Bailey and David Rule, the Committee is enormously thankful to you for coming this morning. We are most grateful for your thoughts and replies to our questions. As I said, please examine the transcript. Please improve upon it. If you have further thoughts that have been stirred by some of the robust questioning this morning, please do feel free to give more extended answers. But in the meantime, as I say, we are most grateful for you coming this morning and withstanding being denominated as “gorillas in the mist”. You have admirably communicated with great transparency with the Committee, for which we are most thankful.

Graham Bishop–Written evidence (FRF006)

Summary

I. The Juncker Commission is set to implement the European Council's priorities and his own Political Guidelines (see Appendix II for extracts) to deepen the single market and strengthen euro area governance and co-ordination.

II. Banking union pools sovereignty massively but a capital market union (CMU) can offset that whilst deepening the single market.

III. CMU can also avoid the pro-cyclicality that is inherent in most EU financial intermediation lying in the hands of financial institutions that are subject to strict rules on matching assets and liabilities. Probably there cannot be a single regulator for such a union.

IV. As a first step, the new Commission should start with a stock-taking exercise to confirm what still needs to be done to create the single financial market. As the pre-eminent centre for such activities for the entire EU, the City should be well placed to benefit from CMU.

V. My proposal for a Temporary Eurobill Fund (TEF) would create a genuine, single European yield curve for this market sector. Participating governments would also have the right to re-finance maturing issues by borrowing from the TEF – thus removing roll-over risk, enhancing financial stability and increasing financial integration. The TEF would constitute a natural foundation for CMU - thus facilitating the private sector raising large volumes of cheaper, short and long term funds to invest in the economy. (See Appendix: What is the TEF?)

VI. However, the loss of influence of the UK (and other non-euro states) in EU legislation is a risk and will be exacerbated by the `Putin game-changer' in the Council. If Poland now acts as a serious EMU `pre-in' and votes with the euro area, it will pass the threshold for a QMV. Such `caucus' votes can be expected on matters they believe to be vital to the future of the euro, even if that means that non-euro states are outvoted.

VII. Possible example: UK Government action at the European Court of Justice against the ECB on the location of CCPs. Implications for the City and UK are significant. If CCPs were to move to the eurozone, how much of London's euro-denominated trading would wish (or need) to follow?

The EU's strategic agenda for the next five years: Commission and Council

2. Europe is now acutely aware of the mechanisms that led a loss of financial confidence to feed through into the real economy: rising spreads for `stressed' governments followed by rising funding costs for banks thought to be guaranteed by them. The net result for the most vulnerable was (and still is) a lethal squeeze from a

tight fiscal policy and a monetary policy impact in terms of interest rates paid/loans available which fails to transmit the ECB's easy money policy.

3. Amidst the sound and fury about the appointment of Jean-Claude Juncker as President of the European Commission, it is easy to miss that he was actually elected on a programme of reform and that the Heads of Government – in placing his name before the European Parliament – wanted jobs, growth and competitiveness at the top of the agenda for the next five years.

4. The relevant European Council priorities included:

- *fully exploit the potential of the single market in all its dimensions;*
- *promote a climate of entrepreneurship and job creation, not least for SMEs, by facilitating access to finance and investment; by ensuring more resilient financial regulation;*
- *invest and prepare our economies for the future by addressing overdue investment needs in transport, energy and telecom infrastructure as well as in energy efficiency;*
- *make the Economic and Monetary Union a more solid and resilient factor of stability and growth, with stronger euro area governance and stronger economic policy coordination, convergence and solidarity*"

5. As co-legislator, the ECON Committee of the Seventh Parliament fully recognised that the package of financial regulation reforms and micro (in the sense of individual national) economic reforms would be insufficient to make robust the rapid and deep economic integration which was suddenly forced upon the euro area. The Committee examined various ideas – including Eurobonds and Eurobills – to provide a macro-economic policy framework for the euro area as an integrated entity.

6. President-elect Juncker set out his "Political Guidelines" to the European Parliament reflecting these Council priorities and was elected on that basis (see Appendix II for key extracts). His letters of appointment to each Commissioner incorporated these guidelines explicitly. **So scrutiny by national Parliaments should be forward-looking and focus on the implications of this next phase of EU regulation.**

Banking Union pools sovereignty

7. The entire Eurozone banking system is now subject to the single supervisory mechanism (SSM) operated by the ECB. It will apply very detailed regulations drawn up by the European Banking Authority. These derive their legitimacy from legislation of the European Council and Parliament. When the process is fully operational, "Europe" will have rules that should ensure the nearly-absolute safety of customer euro deposits equal to about 150 per cent of Eurozone GDP. These deposits are part of the support for banking assets that are closer to 300 per cent of GDP. But 85 per cent of these assets are under the managerial control of the 120 `SSM' banks – and 5 groups control around 45 per cent of them. That is a massive concentration of

financial power and any major failure of these European rules will surely have grave consequences for European citizens. By any definition, that is a major centralisation of the political sovereignty used to protect those citizens.

Capital Market Union: de-centralising power – both economic and political

8. **What is Capital Market Union?** It is the smooth flow of capital – at savers' own risk - from them directly to users throughout the European Union, so both stakeholders in society benefit from cutting the cost of intermediaries. The credit standing of users will range from outstanding to just-acceptable, and the maturity of transactions will range from overnight to decades. The financial institutions that intermediate these flows will be regulated by the EU's single rulebook for all participants in financial markets. As savers are taking the investment risk, they must be suitably educated/informed but protected against non-investment risks.

CMU would complete financial integration and bolster financial stability, as well as promoting the effective implementation of euro monetary policy in all parts of the eurozone economy. Crucially, it is profoundly de-centralising of economic, and thus political, power.

9. A properly-designed Capital Market Union would deepen the single market in finance and simultaneously offset some of the pooling of sovereignty inherent in Banking Union. It would be an open union enabling the savers of Europe to make their own choice about where they put their money – a de-centralisation of power, both financial and political.

10. Such de-centralisation is critical to avoid the vicious pro-cyclicality that is inherent in the fact that the great majority of EU financial intermediation is in the hands of financial institutions that are subject to strict rules on matching assets and liabilities. The requirement to maintain minimum capital buffers – even though they are large – forces sudden de-leveraging if there are major losses on assets. If the risk of a major loss due to currency shifts becomes apparent, then we have already seen how quickly the single market is forced to fracture as a natural consequence of these rules.

11. In contrast, if the bulk of financial intermediation is done via securities held by citizens, then citizens are not compelled by law to respond in such a leveraged manner. However, if a risk becomes obvious, there should be no doubt that they will still respond in what I call a `rolling referendum' on the economic policies of the state concerned. That would be a powerful force for corrective action.

12. Capital market union is an explicit dimension of the single market and a clear requirement for the types of finance needed to pump-prime the economy. The citizen-savers who own €7tn of UCITS (or should it be €10 trillion in five years?) should be empowered to make their choices. They will not be hampered by the capital adequacy rules that could deter banks from lending or rules to match the term structure of their assets to that of their liabilities. Such savers who forsake the safety and low return of bank deposits may also be far bolder in locating their assets than highly-leveraged banks might be: they will be less driven by the fear of utter ruin, for example, if a currency mis-match appears. Undoubtedly, capital markets will

continue to show some home-country bias but it would be interesting to compare the movements in UCITS allocations back to the `home state' compared with the movement of bank assets.

13. This vision is much wider than the non-exclusive list in President-Elect Junker's appointment letter to Commissioner-designate Hill requesting him to complete the Capital Market Union by 2019.

14. The foundations of CMU could include the Temporary Eurobill Fund (TEF): The last ECON Committee was instrumental in persuading the European Commission to set up an Expert Group to examine the pros and cons of proposals for a Debt Redemption Fund and for Eurobills. I had the honour of serving on this Group and gave evidence to ECON immediately after our Report was published. My proposal would create a genuine, single European yield curve for this market sector – with a TEF size of €0.8 trillion (nearly 10% of GDP) and perhaps twice that size. The participating states must finance all under two-year issuance through the TEF.

15. Participating governments would have the right to re-finance maturing issues by borrowing from the TEF – thus removing roll-over risk and enhancing financial stability. By common agreement, states could use any flexibility in the SGP to increase their borrowings from the TEF to stimulate public investment in the productive categories outlined in President Juncker's Political Guidelines. This would give the euro area a modest, `targeted fiscal capacity' as a modest public contribution to the €300 billion investment plan. As an example, the €20 billion funding of the required gas interconnectors would help Europe as a whole by enabling each state to play its own part.

16. Such a Fund is a natural foundation for Capital Market Union so that there is an unquestionable yield curve at the short end of the market for the highest-possible quality issuer and the greatest possible liquidity. That curve will provide the yield comparison for any short–term ABS etc, or floating rate bonds/mortgages – promoting the integration of these markets across the euro area. Non-bank suppliers of loans to say SMEs will be able to calibrate the yield increment needed to persuade citizens to fund directly, whilst providing a cheaper source of funds to companies for productive investment.

17. The TEF has the added advantage of providing powerful incentives for sound economic policies, and of being an insurance policy against possible future market misperceptions about the stability of public finances. (See Appendix I for more detail).

18. My plan for a TEF has been widely discussed with market participants and officials, as well as by the Commission's Expert Group. I believe that no technical obstacles remain unsolved.

Regulating Capital Market Union

19. Another key contrast with banking union is that there is not – and probably never can be – a single regulator with the power to delve into the micro-management of

decisions about asset allocation. ESMA clearly has ambitions to operate a single rule-book and chairman Maijor did not mince his words in a speech to the International Capital Markets Association *“What is needed now, is to complement the legislation issued in the past years, with the following two essential elements:*

- *The EU single rule book for financial markets needs to be implemented and supervised. Implementing measures like technical standards are needed to ensure that the legislation works in practice and the rules need to be subject to credible supervision; and*

- *Supervisory convergence between the 28 EU member states is needed to ensure that the single rule book also results in a truly single EU financial market. Differences in supervision, and regulatory competition, will undermine the achievement of the objectives of stability and investor protection.”*

20. Many (probably the vast majority) of these legislative building blocks are already in place but each element needs to be re-scrutinised all the way along the transaction chain: from issuing and trading to final settlement in all its parts of central counterparty clearing, payments, custody and depositary. This author was part of the Commission Expert Group that advised then-Commissioner Monti on the creation of the Financial Services Action Plan in 1998, the first Giovannini report on the changeover of capital markets to the euro and then the reports that identified the 15 “Giovannini Barriers” to efficient settlement across Europe. **A decade and a half later, that work is far from complete. Perhaps the new Commission should start with a stock-taking exercise to confirm what still needs to be done.**

21. Some of the most recent legislative steps were analysed in an excellent ECB report in April, “Financial Integration in Europe”, but the special article on “initiatives to promote capital market integration” laid bare some of the missing essentials. Critically, a proposal on Securities Law Legislation has still not appeared from the Commission, despite consultations in 2009 and 2010. However, on the good news side of the balance sheet, the ECB’s T2S securities settlement system should be a major step forward when it comes into operation in less than a year. It will be a single, pan-European platform for securities settlement in central bank money, removing the differences between cross-border and domestic settlement and cutting costs.

22. The type of scrutiny that led to T2S needs to be applied all the way along the yield curve from the shortest money market instruments to the longest of bonds, and the perpetual liability of equity. The riskiness of the investment is also a key factor – from low-risk Treasury bills to junk bonds and the ultimate risk bearer – corporate equities. Success in creating an integrated euro capital market is widely accepted as a necessary condition for restoring sustainable growth – highlighted by the ECB’s drive to re-start `good’ securitisation. The plan put by this author for a Temporary Eurobill Fund (TEF) (see Appendix I) should be seen as part of such a drive.

What is the legal structure of `capital market union'? Some legislation that may be required

23. First, major changes to MiFID and Solvency 2 should **not** be required as they have only just been completed. However, they are scheduled for a routine review in due course. CRD 5 is now on the horizon, which should mean that securitisation can be boosted by removing the reported absurdity that the same SME assets require eight times the capital if held as an ABS rather than directly. That will also provide an opportunity for a far more profound re-think about the zero-risk-weighting of government bonds (and thus the associated large exposure rules). UCITS 6 and Solvency 3 may be needed to make corresponding amendments on large exposures. The Money Market Funds proposal will need to be reviewed and the pressure for a new regime for private placements may need legislation. The benchmarks proposal will need to be finalised, though the TEF itself will provide a reliable short-term interest rate structure.

If my plan for a Temporary Eurobill Fund (see Appendix I for more details) is taken up, then it will require a Regulation for administrative aspects and – far more substantially – an inter-governmental Agreement amongst the participating states to limit their short term borrowing to only use the TEF. It would also provide the governance arrangements.

What does this new "union" mean for the City of London?

24. Any significant shift in financing the economy away from the banking sector into the securities markets would be transformational for all those involved in issuing, trading and managing securities. As the pre-eminent centre of such activities for the entire EU, the City should be well placed to benefit.

The loss of influence of the UK (and other non-euro states)

25. For the City of London, what counts is its clout in EU financial services regulation. What say does the City have within the European Commission, Parliament and Council? What are the greatest risks to the City's voice being heard? It might surprise that the City's influence could turn out to be part of the `collateral damage' inflicted by President Putin of Russia as he obliges the EU to come to terms with its belligerent neighbour. In this, the most direct – and potentially damaging – consequences are most likely to flow through Council votes.

European Council: the `Putin game-changer'

26. The European Council is where the member states often vote to reflect their national interests, rather than taking the loftier, pan-European view. The seizure of Crimea and invasion of Ukraine by Russia has re-awakened fears about Russian ambitions – especially amongst the states that border it. The selection of Polish Prime Minister Donald Tusk as the next President of the European Council reflects many strands of policy. The most relevant one for the City is the resurgence of arguments favouring an early Polish accession to the euro on the grounds of security – rather than on careful economic calculations. Council President-elect Tusk was quoted by Reuters as saying "Poland will join the euro in the future because adoption of Europe's common currency would raise its status among the Western nations and increase its security".

27. From 1 November 2014, the voting rules for a 'qualified majority' in the Council change: "a qualified majority shall be defined as at least 55 per cent of the members of the Council, comprising at least fifteen of them and representing Member States comprising at least 65 per cent of the population of the Union". (TFEU Article 16). In January 2015, Lithuania will join the euro area. In the event of a much-feared (in the UK) euro-area caucus next year, the group would still be just short of a qualified majority vote (QMV) - though only 24 council votes short, as both the population and number of states criteria would be satisfied easily.

28. **The `Putin game-changer' is simple.** If Poland now acts as a serious EMU `pre-in' and casts its 27 Council votes with the euro area, 22 states and 77 per cent of the population will have voted in favour. This represents 10 council votes above the 260 vote threshold for a QMV. Will the euro area plus Poland always caucus on financial services measures? Probably not, but they may well do so on matters they believe to be vital to the future of the euro, even if that means that non-euro states are outvoted.

29. Such a situation could arise in the current debate around where central counter-parties (CCPs) should be located (see belowhttp://www.grahambishop.com/ViewArticle.aspx?ID=26755&CAT_ID=64&Search=). On the basis of the UK's case before the ECJ, it would bitterly oppose a full directive of the Council and Parliament on CCP location, which is something that the euro area plus Poland could demand. At the same time, it would be extraordinary if the ECB's strong view about the prudent need for control over CCPs were not given full support by all euro area states – particularly given the importance of financial stability in the eurozone at a time of political upheaval.

European Parliament

30. It is difficult to find a specific metric to estimate the level of UK influence within the group that really matters – the Committee on Economic and Monetary Affairs (ECON). What is clear is that UK influence has gone down with a bump in the new parliament as our six (out of 59 members) include only one with both EU parliament experience and serious financial knowledge. She is now the only UK co-ordinator – but as a member of the European Conservatives and Reformists (ECR) is not part of the grand coalition in the EP.

31. In the last ECON, eight or nine UK members/substitutes were active out of just 50 members. The UK's performance record was outstanding – led by Lib Dem MEP Sharon Bowles as chair. Influence is most easily exercised as rapporteur for the Committee's opinions and reports. The Committee produced 162 reports and this author judged that roughly 52 were of significance to the City. The UK provided five of the 30 rapporteurs on these, and they wrote 10 of the key reports – so punching at about twice the UK's weight.

32. What of the future? There is a significant risk that the UK may punch at about zero per cent of its weight in this Parliament, rather than 200 per cent in the last one, as UK Rapporteurs are unlikely to be given any major City-sensitive dossiers.

Possible example: UK Government action at the European Court of Justice against the ECB on the location of CCPs.

33. The Lehman crisis of 2008 persuaded the Heads of the G20 Governments to require that, as far as possible, all derivatives would be cleared through Central Counter-Parties (CCPs). The aim was that risks flowing from the failure of a major bank could no longer cascade through the whole financial system because of the "inter-connectedness" created by derivatives. The natural result of this policy is that huge risks are now concentrated into these CCPs – potentially making them the nuclear power station of the financial system: brilliant in success, catastrophic in failure.

34. The European Central Bank was created by the Maastricht Treaty to run the euro and was given specific responsibility for the "smooth operation of payment systems" (TFEU Article 127 (2)). Securities and derivatives transactions are by far the dominant flow of value through payments systems such as the ECB's TARGET2 system. Hence the ECB has a natural interest in the functioning of CCPs that are handling euro-denominated transactions. Europe's biggest CCP `nuke' has its home in the United Kingdom – LCH.Clearnet (which is now majority owned by the London Stock Exchange Group).

35. The European Market Infrastructure Regulation (EMIR) is now largely in operation. In particular, EMIR put the CPSS-IOSCO[18] "Principles for financial market infrastructures" (PFMIs) into EU law – with full UK participation and agreement.

36. For two decades or more, global financial regulators have been trying to boost the safety of payments systems. A decade ago, they moved to the next phase and published the first recommendations for the safety of CCPs. The latest comprehensive set of recommendations on PFMIs was published in April 2012 by CPSS-IOSCO. These were designed to remove any of the regulatory `underlaps' exposed by the crisis. The working group's membership included both Bank of England and FSA. Amongst the principles enunciated, a CCP should "manage its liquidity risk" and "should conduct its money settlements in central bank money where practical and available." Responsibility B requires that **"**Central banks, market regulators… should have the powers and resources to carry out effectively their responsibilities in regulating, supervising, and overseeing [CCPs]…including the ability to obtain timely information and to induce change or enforce corrective action."

37. In July 2011, the ECB stated that "it is clear that the Eurosystem has a keen interest in ensuring the proper functioning of clearing and settlement systems across the euro area. This stems from the importance of clearing and settlement systems for the smooth conduct of monetary policy, from their close links to payment systems and from their relevance for the stability of financial systems in general". The issue at the ECJ is: should the ECB be allowed to require that LCH move its euro activities into a eurozone jurisdiction on the mainland? The ECB argues that only then can it oversee these activities and understand exactly what is happening if, say, LCH should unfortunately need emergency euro-denominated liquidity during a future crisis.

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[18] Committee on Payment and Settlement Systems (CPSS) - International Organization of Securities Commissions (IOSCO)

38. Reading the globally-accepted CPSS-IOSCO Principles, it is easy to see why the ECB would argue that, as a direct consequence of the Principles, such crucial parts of the Eurozone's financial infrastructure should be within the Eurozone's own jurisdiction. Indeed, now that the Bank Recovery and Resolution Directive (BRRD) is in force, it could be argued that such infrastructure should take the form of a bank directly supervised by the ECB.

39. The scale of the sums involved is almost incomprehensibly large. To select the most eye-catching numbers: according to LCH's annual report for 2013, it cleared various derivative contracts and foreign exchange with a `notional/face amount' value of $1,569 TRILLION. That was precisely 100 times the Eurozone's entire economic output that year, or nearly 500 times the UK's output. Its total liabilities were equivalent to about 20% of UK output. All this activity is supported by a capital base of €0.8 billion, buttressed by a default fund of €7 billion and commitments from its clearing members to provide about twice that if needed, as well as tightly–controlled collateral. LCH is at the heart of settling euro-denominated securities trading in the City of London.

40. The UK Government has launched three separate actions against the ECB requesting the annulment of the relevant parts of: the Eurosystem Oversight Policy Framework of July 2011; its Statement of Standards of 18 November 2011 and its Decision of 11 December 2012 amending the terms and conditions of TARGET2. The UK's pleadings underline why it would make bleak reading in the City if the cases fail.

Implications for the City and UK

41. If LCH/other CCPs were to move to the eurozone, how much of London's euro-denominated trading would wish (or need) to follow? How much of the City's £61 billion foreign earnings would be affected – correspondingly swelling the UK's existing £74 billion current account deficit? At 4.5% of GDP in the last 12 months, this is the largest deficit in the EU, and second only to South Africa amongst the G20 nations. **So this Court case does matter to the UK – enormously.**

42. The key commercial problem for CCPs in the UK is that absence of any <u>entitlement</u> to access euro liquidity facilities from the ECB/ESCB as their customers might be very nervous about a liquidity crisis in turbulent times. This is a practical matter that is quite separate from the regulatory oversight issue flowing from the PFMIs. In principle, the Bank of England could provide euro liquidity but as it does not have the power to print euros, it would have to liquidate the UK's foreign reserves, or borrow from the ECB itself. The ECB reported in October 2013 that it had set up the legal aspects for a swap network that included the Bank of England. However, it seems that the size and conditionality would be agreed at the time of any request for activation.

43. Activation on the scale that could easily flow from a major CCP problem could pose many technical problems – but certainly also political. If heavy losses were at all likely, the ECB's paid-in capital to meet such losses is only €7.6 billion so it might have to call for fresh capital from ESCB members very quickly. The members – or the

governments that own them – might raise questions about the wisdom of massive loans (with what collateral – the UK's foreign reserves?) to a foreign central bank/regulator which had self-evidently failed in its supervision – perhaps even after substantial behind-the-scenes prodding. Could anyone be sure about the size of the black hole to be filled as the giant `nuke' exploded? Or how quickly the loan would be repaid? After all, RBS's losses now match the entire £46 billion bailout since 2008.

44. If the home state of this central bank had left the EU and gone `off-shore' partly to adopt a lighter touch on financial regulation, then it would be an entirely different world. It is difficult to imagine the sovereignty implications of an ECB regulatory oversight arrangement that would justify the eurozone running up major risks to bail out such a state. **The cost for the UK of not having joined the euro may now be creeping over the horizon.**

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Appendix I: What is the Temporary Eurobill Fund?

45. It would follow a similar legal structure to that of the ESM with *pro rata* callable capital - but with a crucial difference: only euro states in `good standing' could join, thus excluding those in the ESM `sin bin'. The economic structure would be the plainest vanilla. The Fund would borrow from the markets - exactly matching quantities and maturities requested by borrower states – for maturities ranging up to two years. The key step is that participants would bind themselves to borrow all new funds in this maturity range only from the TEF. In short order, there would be a genuine, single European yield curve for this market sector – with a TEF size of €0.8 trillion (nearly 10% of GDP). Members would also have the right to re-finance maturing issues by borrowing from the TEF – thus removing roll-over risk and enhancing financial stability.

46. **Political Governance:** The decision-makers will be the Finance Ministers.

47. **Can it be done? Yes** – The Expert Group was clear that an ordinary Regulation of the European Union could set up the operational platform although a separate Inter-Governmental Agreement would be necessary to bind participants to decisions about the financial management of the fund: membership, size, maturity etc. The key is that there would be no need to change the main European Treaty.

48. **The Plan would be good for Europe because:**

I. It binds the participating euro area states into closer financial solidarity – thus encouraging greater observance of the economic governance commitments.

II. Politically, the broadening of the `common interest' of each EU member in the economic policies pursued by fellow members would be accelerated.

III. Monetary policy would also be simplified as the TEF would purchase more than half the securities of each state that the ECB would consider buying for OMT purposes. With current talk about QE, TEF bills would be a natural public asset to purchase as they would not represent monetary finance of governments and the state-by-state

exposure would already have been agreed at the politically-accountable level of finance ministers.

IV. Banking union would be re-enforced as short term TEF bills would be the most natural High Quality Liquid Asset (HQLA) for banks to hold. The `doom loop' between banks and their sovereign would be cut by more than a third - at a stroke.

V. The concept of a Capital Market Union would be boosted as all financial institutions – insurance companies, pension funds, corporations and mutual funds – would have a `European' asset to satisfy their legitimate economic needs for holding short-dated safe and liquid securities.

VI. A minor practical benefit - but perhaps looming larger in restoring public trust in financial markets – is that a public authority would provide reference pricing based on massive activity for all financial contracts that need to specify an interest rate for any particular short maturity. That would include the variable interest rate on say longer term mortgages and bonds.

VII. The existence of a yield curve for the safest and most liquid asset would naturally encourage the markets to innovate products with somewhat higher credit risk, and thus return. This should provide a welcome boost to `good' securitisation of say packages of loans to SMEs that would back commercial paper issued by banks and non-banks. The ECB's easy money policy could then reach SMEs across the entire euro area.

Appendix II: Extracts from President-elect Juncker's Political Guidelines

(Bold = author's emphasis)

49. "I do not believe that we can build sustainable growth on ever-growing mountains of debt – this is the lesson learnt in the crisis that we must now heed. I also know well that it is mainly companies that create jobs, not governments or EU institutions. However, I do believe that we can make much better use of the common EU budget and of the European Investment Bank (EIB). We must make use of these public funds available at Union level to stimulate private investment in the real economy. We need smarter investment, more focus, less regulation and more flexibility when it comes to the use of these public funds. **In my view, this should allow us to mobilise up to € 300 billion in additional public and private investment in the real economy over the next three years...**

50. The focus of this additional investment should be **in infrastructure, notably broadband and energy networks as well as transport infrastructure in industrial centres**; education, research and innovation; and renewable energy and energy efficiency...

51. As regards the use of national budgets for growth and investment, we must – as reaffirmed by the European Council on 27 June 2014 – respect the Stability and Growth Pact, **while making the best possible use of the flexibility that is built into the existing rules of the Pact,** as reformed in 2005 and 2011. I intend to issue

concrete guidance on this as part of my ambitious Jobs, Growth and Investment Package…

52. **The crisis has only been paused.** We must make use of this pause to consolidate and complement the unprecedented measures we have taken during the crisis, simplify them and make them more socially legitimate. The stability of our single currency and the solidity of public finances are as important to me as social fairness in implementing necessary structural reforms…

53. **I want to launch legislative and non-legislative initiatives to deepen our Economic and Monetary Union during the first year of my mandate.** These would include a stability-oriented review of the "six-pack" and the "two-pack legislation" (as foreseen in this legislation); proposals to encourage further structural reforms, if necessary **through additional financial incentives and a targeted fiscal capacity at Euro zone leve…"**

25 September 2014

Sharon Bowles- Oral evidence (QQ 1-25)

Evidence Session No. 1 *Heard in Public* *Questions 1 - 25*

TUESDAY 22 JULY 2014

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Earl of Caithness
Lord Davies of Stamford
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland
Lord Vallance of Tummel

Examination of Witness

Sharon Bowles, former Chair of the European Parliament Economic and Monetary Affairs (ECON) Committee

Q1 The Chairman: Sharon Bowles, it is not only a great honour but also a great pleasure to see you once again before us on this occasion of a fresh inquiry, when we are looking into the EU financial regulatory framework. We can think of no one better to give us a flying start to the subject than you. We will take a transcript of the exchange, and we will send it to you. As ever, we ask you not only to correct it but to improve it. When you have those thoughts that come into your head when you are on the number 87 bus leaving Parliament, please send those on to us as well. I remind my colleagues to declare any interests they have, which are listed at the back of the room, when they first ask questions. Perhaps it is appropriate to

welcome Rose Crabtree back to the Committee and thank her for the work that she did with us so well for so long. Sharon, you might like to make an opening statement.

Sharon Bowles: Yes—just very briefly. It is more by way of caveats. As ever, what I say is an analysis by me, from my perspective. I will make it clear if I am speaking generically on behalf of the view of the Parliament, for example. Of course, it is unresearched, so it is only what is in my head. As we are to some extent exploring what are or are not the problems in some of the regulation, your questions may be directed towards whether there are flaws. I may say things that are pointing out some flaws in either the UK or the UK approach. I would like to emphasise that, again, that is from my perspective. I am not necessarily included in the working-up of the stances taken by the Treasury. It is not that I am shut out from them; it is just that often I have had to work on it ahead of them. Also, there has not been time. But when looking at flaws, you are looking at the tip of the iceberg. You hear one or two criticisms of things and you think everything is wrong, but there is a huge iceberg underneath that you hear nothing about because there is nothing wrong with it. So, I would just like to point out that I am not saying, in anything that I say, that the UK has not done a good job. I actually think that over the last five years it has done a brilliant job in general.

Q2 The Chairman: I hope we can encourage you to speak in vino veritas—without recourse to a bottle of wine—and get the truth from you about your analysis and observations. Perhaps I can start by saying we have had this crisis from 2007-08. What do you think has been done and put in place that will help the situation—and help the European Union's financial regulatory framework to deal not only with all these matters, including the mundane seven-eighths of the iceberg underneath, but also the threat of asymmetric shocks that appears from time to time? Have we something in place now that deals with that threat?

Sharon Bowles: The way I would like to approach this is first of all to point out that there have been quite a lot of different categories of response to the financial crisis. Going back to 2007, there have been those things that we did that were either left over or were already in train when the financial crisis started. I would say that Solvency II was a project that had been in the making for a long time. Indeed, the second capital requirements directive was dealing with some of the things that had not been done in Basel II, such as large exposures. So they were leftovers, but of course by the time we actually got to do them the crisis was upon us, so we were able to modify them in our amendments and update them to take account of the state of the crisis as we understood it at that time. Then we have had a second round of regulation that has stemmed from the international G20 agenda, the most notable of those being the derivatives legislation, EMIR, which was completely new ab initio. We have had the further updates and more tweaking of the capital requirements in CRD III, and then the whole Basel III proposals in CRD IV, and parts of MiFID, which all fall into that category. As it is following on from G20, I think it is of course fair to say that the UK has already had a huge influence, because of what it has done at G20. Indeed, it was possibly one of the biggest inputters at that stage.

Then you have got the third category: these were all the things that we had done in the original Financial Services Action Plan that were up for review. The most significant of those were of course MiFID and the market abuse directives—we have also got a regulation now. Then there was a fourth load of things that we did, about continuing to remove barriers for the completion of the single market. They were not, as such, necessarily a response to the crisis, but a lot of them had relevance, particularly in the post-trade space—for instance, the central securities depositories. It is no good if the back office is a total mess, or you have not got a handle on where things are going. There have been other things to try to begin to help

with growth, like venture capital funds and social entrepreneurship funds. This was all the completion of the single market. Within that category, one would also put the AIFMD. So, you have got the UCITS world and you have got the AIFMD world. That is actually completing the single market, even though there are some controversies within it. Of course, we have had several updates of UCITS.

Then you have those that are, if you like, again part of the international agenda, but where you could say there has been some front-running now by Europe and in some instances by the UK as well. Chief among those is bank recovery and resolution, which has been a subject very much led by the UK at the international level. There has been primary legislation here, once the direction in Europe was seen to be stable. That particular case is actually a very good example of how Europe and the UK have worked well together. However, there are issues to do with the front-running. Then we have got the leftovers that we have not done or completed yet, like benchmarks, money market funds, and structural separation, where again we are ahead of the international agenda in some respects, but there might be problems in not disconnecting. There is a sixth category, which is banking union. The seventh one is the creation of the ESAs. So, you have got all these different drivers.

I think that for the main part, the reforms have been timely, and have been either upgrades, completions, or parts of the international agenda. There has been a massive volume of work, which was probably borne more by me than by anybody else, as I am the only person that is always down in the detail of every negotiation while the teams for the other people change. But the outcome is a co-ordinated and reinforced regulatory landscape. We have got very much more capital in banks—very many more ways in which those loss-absorption things come along. There are issues we might want to explore later in and around this whole bail-in notion, because on the one hand that makes the banks more secure but it opens up other

problems. We are saying that the taxpayers are not in the front line again; actually, the truth is that the sovereigns are not in the front line again. The public—taxpayers by another name—are of course directly in the line because it is their pension funds that would get bailed in.

Q3 The Chairman: We will of course explore some of those in detail. That tabulation into six or more categories is very useful indeed. My ears brightened up when you said “AIFMD” because that is one of those areas that we have already heard criticisms about. Could I just ask you for your view about not only the stability of that framework dealing with asymmetric shocks but also whether there is a need for flexibility there, before we go into some of these detailed areas?

Sharon Bowles: I think it is too early to tell yet whether the degree of flexibility is right, because you should bear in mind that a lot of this legislation does not come into being or enforcement until 2016, 2017 or 2018. In fact, it is really quite stunning that we are going to be able to build airports and go into space before we can actually get our banking regulation on stream. That shows it is perhaps a bit slow in how long it is going to take to come. Of course there are all of the level 2 measures. The flexibility to a large extent is built into the level 2 measures as far as possible, because one needs the light of experience sometimes in terms of gathering in the international scenarios. You need to do the consultation on exactly how it is going to work, which is just the same as the UK regulatory bodies would do under similar circumstances. Of course, if you do need to change and update, it is a very much quicker process to update a regulatory technical standard than to have to go through a co-decision procedure. So, I think that, in the scale of things, it is about right. You do not want flexibility that means that our industry has no certainty about anything.

Q4 Earl of Caithness: Good morning. I declare my interests as written down. There has obviously been a lot of work over the past few years. What have been the three biggest achievements, and why? From your new position of freedom, what would you have done differently to improve what has happened, or change it?

Sharon Bowles: If I may, I think there are probably four achievements. The three biggest include obviously derivatives legislation: ab initio new legislation, very internationally co-ordinated although we have had some EU-US spats in trying to get it to absolutely mesh together. The European Union has played a very good and strong job there in standing up to the United States. I have stood shoulder-to-shoulder with Michel Barnier on that and have taken on the US Treasury. In a way, perhaps the UK would not necessarily have been so forceful on its own for a variety of reasons.

Completing CRD IV is also a very big achievement. There is lots of interesting and good stuff within it. Likewise, MiFID is very important for a whole range of things, and for what it paves the way for going forward. The add-on to that is the banking union project, which of course is not financial services regulation; it is a more structural thing for the eurozone.

It is hard to pull out those things that are specifically important within these when you are looking at thousands of pages of legislation. I can see my hand in every page, although not quite every line. There are things that the European Parliament has done—and that I have had a very big hand in—which have helped to make CRD IV an improvement, and which have reflected back into the work of the Basel Committee and the FSB. If you go back and look at early thoughts on liquidity, which were following on very much from the ideas from the Bank of England, it was all just sovereign debt. I remember sitting on a platform with Mario Draghi, then the chair of the FSB, and saying, "Here we are, going into the euro sovereign debt crisis and you are telling me that the only liquid instrument we are allowed to have is

sovereign debt". With a little bit of humour and humiliation, he did say, "Yes, Sharon, we know what you are saying, and we are listening and we are trying to do something". With colleagues we pressed very strongly and said, "Look, you have to have wider range of liquid instruments". This was in our early discussions of things, and of course it was loosened at Basel.

Going forward, more work needs to be done on that because I think we are still far too sovereign debt-centric. In fact I would point out that the Maastricht treaty actually says that we should strive to get away from banks being addicted to sovereign debt. So, there is a long way to go in that area. I think the Parliament did some good things to do with what we called our growth package. This was to do with trade finance and SMEs. Indeed, we changed the standard model risk weights for SMEs, which seems to be something that the PRA is now trying to suggest that Basel should do. I thought I had already done it. So, that is another area where again, more work could be done. This was for challenger banks, I think.

The Chairman: We will explore that.

Q5 Earl of Caithness: You mentioned sovereign bank debt and the obvious failure of the ability of the EU to break that sovereign-bank link. That was one of the highlights of many of the reforms, and this is what they were going to achieve. What other failures have there been? Do you agree with what has been put to me—that many of the recent reforms have just made the EU more uncompetitive in relation to the rest of the world?

Sharon Bowles: I think that is rubbish. Since I have been back in the UK—and I have done quite a lot of speeches—there seems to be this all-pervading notion that in the absence of EU regulation there would be no regulation. I can tell you that it would probably be worse, and more of it, because there are many places in CRD IV where I have pushed back against

what the United Kingdom wanted. So, CRD IV and quite a lot else is lighter in some places as a consequence of the EU.

Lord Davies of Stamford: Can you give us a specific example of that?

Sharon Bowles: Trade finance. The Basel Committee had jerked up the amount of capital that you had to hold, and the risk weights and everything, on all of the trade finance on a precautionary basis. They said, "There is not enough information about the level of defaults so we will be cautious". The IMF, the World Bank and the WTO all said, "No, this is wrong; this will be damaging for international trade". We changed it in CRD IV. The Basel Committee has now largely followed. However, the UK would have blindly followed what was in Basel. There would not have been the pressure to change it had I not pushed it forward. There are quite a few other areas. Take the credit valuation adjustment charge, which is particularly damaging for industry. If the UK had gone and done Basel III on its own, it would have had very strict CVA charges. It would not have exempted the non-financial institutions from having to pay it on their legitimate corporate hedging. All those kinds of things were put in there by the European Parliament and we mentioned them right from the beginning. There is a very long list of these things. If you read my submission, which I will give to you—my balance of competencies review—I have listed a few more there. But go and ask the industry.

Q6 Viscount Brookeborough: You said that the United Kingdom "blindly followed". Can you give us an explanation as to why they appeared to do that? Is it because they did not look at it intelligently enough, or did not consult the City enough? Why do you use those words—"blindly followed"?

Sharon Bowles: Because the UK has had a big input into what happens in the BCBS, but there is no oversight of what our regulators are getting up to in these international fora.

There may well be some high-level view of it from the Treasury, but it is our regulators who are going and sitting on those committees. They are not interrogated about what they do, and then it is done and dusted. It would appear that possibly the only place in the whole world where there is any significant analysis of what has been going on in the Basel Committee—certainly in terms of the level of detail—is where the co-legislators are making European legislation. It is only during trialogue processes at some times when the Parliament has been arguing for one thing that the Commission representative, who has been at the Basel Committee, has actually elaborated on who wanted what and where. But at the time, post-crisis, the UK regulatory thought process was, "If it moves, slap on capital; even if it does not move, slap on capital. Require more liquidity. Ring-fence it. Tie it down. You cannot have too much because we have had such a disaster". That was the mind-set. That is fixed in, and the UK backtracked itself, saying it had gone too far and too fast on liquidity, and that had had a bad knock-on effect into the real economy. So, in a sense, we are catching up with that. I wish there was a lot more interrogation about what our regulators were getting up to in the Basel Committee, by either this House or by the Treasury Select Committee.

The Chairman: Lord Flight, I think you had a follow-up on this.

Q7 Lord Flight: If I may. Can I declare an interest? I come from 40 years in the fund management industry. Generally, I think that the industry perceives that you have done a great deal to look after the interests of the UK. My only reservation is that, while in the banking area by and large sensible things have been done, if potentially not enough of them, in the fund management area there is a feeling that we have got excessive regulation from the EU. Most of the sophisticated fund management is in London and not in the rest of the EU anywhere. I am banging my gong particularly about AIFMD, which is perceived by

everyone, including the UK regulators, as way over the top in terms of the information required—the reporting that will never be read by anyone. On that front, quite a lot of business is already moving to Singapore.

Sharon Bowles: It is one of those problems: if you delay getting something for too long and then you get it at the height of the crisis, you get overkill. We are now into the eighth legislature. The last one was the seventh, and the one before that was the sixth. At the end of the fifth legislature there was a report done by John Purvis, the Conservative MEP, saying that there should be some regulation of hedge funds. Of course, there was typical pushback. I can think of a country that might happen to have been at the front of that. If we had had something done then, it would have probably fitted the bill rather better. Rather, it was put off, and put off, and put off, and then done in a crisis—and at the start of the Parliament when everybody was trying to prove everything and load in their favourite bit of the Christmas tree. In terms of the way that was negotiated, there was a balance to be made between the left and the right. The sensible middle got squeezed out. My own group—the ALDE group—and the ECR had to fight very hard. All I can say is that you do not know how lucky you were. We spent 30 sessions of trialogue on that. Actually I do not think it is by any means anywhere near as bad as you make out. Nobody ever likes additional reporting requirements. The fact of the matter is that we did need to know what was going on, because these things were not understood. Hedge funds are probably in less of a bad odour now than they were then because people understand them more. It would be good to revise it. But as I said, just because the fund management is in London, that does not mean that London can have carte blanche to regulate. An awful lot of bad things have happened in London. The London Whale was in London. Benchmark fixing was in London. FX fixing was in London. When these things continue to come out—and are happening under our noses—

you cannot stand up to the rest of Europe and say, "We should make the regulation because it is all with us. The fact that it has gone wrong is nothing to do with us—and, by the way, we want to export it all to you, because we are the largest exporter of financial services". They do not want toxic exports.

The Chairman: I am going to quickly go to Lord Kerr before we pursue the question of the analysis of the institutions and how they have operated.

Q8 Lord Kerr of Kinlochard: I just have a quick follow-up to what you said about AIFMD possibly requiring review. If AIFMD was reviewed in the new Parliament, would the effect be to make it simpler or more complicated?

Sharon Bowles: That is always the danger. People tell me that they think they can live with AIFMD. Under those circumstances, I would suggest that it is probably better left alone than opened up, and you risk making it worse. However, the UK did not vote against AIFMD. May I point out that the UK was happy with the outcome?

Lord Flight: That is the Treasury, not the industry.

Sharon Bowles: We do not make legislation voted by the industry. That is generally considered not to be the best way.

Lord Davies of Stamford: That is called regulatory capture, I think.

The Chairman: Lord Davies will ask about the commentary made about the institutions, and how they have operated during this crisis.

Q9 Lord Davies of Stamford: Although we are of different parties and no doubt disagree about many things, I will start by paying tribute to the great distinction and almost universal approbation with which you conducted your role during these very difficult few years.

Lord Flight: Hear, hear.

Lord Davies of Stamford: You have already given the Committee an assessment of how you think we have done on financial regulation in the EU, in terms of where the achievements have been and what the disappointments or shortcomings have been. Can I ask you to break that down by institution? Would you like to comment on, and if possible evaluate, the roles played by the individual institutions? That is to say, I assume you are happy with the European Parliament's record, but you may want to make some comments about institutional weaknesses there—decision-making processes not being ideal and so forth. What about the Council of Ministers, both at the COREPER level and the ministerial level? How have they performed? Have you found them to be thorough, effective, and to make decisions reasonably quickly? What about the tier 2 administrative component in the decision-making process—the supervisory regulatory organisations, the ECB, and so forth? Would you like to make a comment about the individual institutions, and how they fit together in this process, so as to give the public a sense of how the whole thing is articulated?

The Chairman: Including the Commission.

Sharon Bowles: All the institutions have basically performed well, and I think that there is a reasonable institutional balance, although at times there is a lot of yelling and screaming by one side or another that is trying to get the limelight. In terms of the process, the Commission has first go. In most of the things, as I made clear, they are not starting with a blank page, because there is either some pre-existing legislation that is up for review or there is an international agenda that they are following. There is always lots of consultation. They take an awful lot of notice of consultations. I gave a lot of keynote speeches at consultations, and you can see them avidly writing it down. I can see my words in their drafts

and other things. It is the same for input that has come from industry. So, they do not sit in some ivory tower to make it up. It is actually a lot more inclusive than many people realise.

Lord Davies of Stamford: My impression was that their consultation process generally before they legislate in any field is a good deal better than in most national Governments, including our own. I do not know whether you would agree with that.

Sharon Bowles: I have more experience of the European level than the level here, but I think that you are probably correct in that analysis. But there are difficulties when you are making law for 28 member states—or 27, as it was—rather than just one. It is very difficult to get that best fit first time round. So, I would say that the legislation that the Commission makes is always a less good fit than it is coming from an individual country for itself. That is when the co-legislators set to and start amending it. It is probably 30% or 40% changed—much more changed than legislation is as it goes through this place. Both the Council and the Parliament make very significant changes. The Council tends to concentrate, as you would expect, on making it fit where they have national problems with it. It is what you would expect. They sometimes have to come with compromises. If there is new stuff to put in as you are going forward in your learning—which does happen—then the Commission often takes the opportunity to try to introduce that in the Council amendment procedure. That happens.

In the Parliament, we obviously come from different member states and there is an overlay of where you come from, shall we say, in the thinking of Members. But we are actually more in political groupings. So there is, if you like, party-political input. You can see the distinctions between the left and the right: the left, generally speaking, perhaps wanting more and tighter controls, and the right being more industry-friendly—although sometimes that seems to reside more in the middle. They are all broad churches and, anyway, we go for

a consensual approach in the first instance. What the Parliament does a lot more of is to introduce a lot more new ideas. In times past, if I think back to when I was first in the Parliament in my previous mandate, a lot of these things would tend to fall by the wayside when it got to the trialogue process. The Parliament is the institution that has grown in stature during my chairmanship. It is a bit embarrassing because I have to confess that maybe I had something to do with that. If you listened to the Council and the presidencies, they were saying things like, "We cannot keep up with the expertise of the ECON Committee, and in particular with its chair. Why does she know so much?"—that kind of thing. I thought that I was in that place to do a job at that point in time, and that I could be a nerd. Being a nerd happened to work quite well.

Q10 The Chairman: What about some of the other institutions that Lord Davies has talked about? What is your assessment there?

Sharon Bowles: I think that the ESAs—the European supervisory authorities—are in general performing well. Of course, they are again not an ab initio invention, because we had the Lamfalussy process already. They are, if you like, an upgrade that was already being talked about before the financial crisis. So, regulatory committees became regulatory authorities, following a pattern than we have in telecoms and lots of other areas. It is not anything that is completely new. They have continued to work predominantly by consensus. I think that they have had a phenomenal amount of work to do. They have come and reported to the committee. They have learnt through their engagement with the committee. There was one round, the first round of regulatory technical standards with EMIR, where the Parliament had not been properly listened to. I think this was to some extent a fault of the Commission as well as ESMA. So, we voted down some of the standards in committee and forced some FAQs to solve the problems before letting them through. We have shown that we were

prepared to use our veto. In fact, I think it has been noticed that it would be the Parliament that probably would veto a technical standard rather than the Council, because our regulators are involved in the ESAs. Once the PRA or the FCA have ticked it off, it is unlikely that the Government is going to go against it. So, if industry has a problem with anything, it is going to come knocking at the Parliament.

Q11 Lord Davies of Stamford: I wonder if I can ask you one question. I was going to ask it later on in our proceedings, but I think most logically it should be asked now in light of what you have just said. Do you think that the system you have just described has a sufficient amount of flexibility to respond to new technologies, new market practices, and new threats to stability? Or, do you think that it has perhaps too little flexibility? There is a balance to be struck because investors need a clear, credible, long-term regulatory horizon within which they can invest with confidence. On the other hand, you must maintain flexibility to respond to the unpredicted. So, have we got that balance right, or not?

Sharon Bowles: We will not really know because we have got hundreds of level 2 measures waiting to be dumped. It is a little bit early to draw conclusions. But I would say that it is broadly right, in that we wanted the stability of having a framework that was the same across all member states. You have to have that more fixed. You cannot have supervisory discretion in Spain being different from supervisory discretion all over the place. We have been on the end of things where member states have not implemented it properly. When MiFID I was not implemented properly, this left us open in this country to boiler-room scams operated out of Spain. There was not enough attention in the past to looking after this cross-border contamination. So, I think we have dealt very much with that. Of course, the regulatory agencies do not have the power of discretion. Even if you go to the Commission for delegated acts, there are limits as to what you can delegate under the treaties. This is

why our level 1 legislation has to be very much more detailed than the equivalent type of legislation if you were doing it here.

Q12 The Chairman: Germane to that, do you think the ESAs are properly resourced? We saw the EBA early on, when we did a report in 2011. We discovered that they really did not have the resources to perhaps do the job that was being asked of them.

Sharon Bowles: That is probably true in that they are very small. However, it is the Commission and the member states that are maintaining that underresourcing. The Parliament has always voted for more resources. In the budget, we actually showed where the resources would come from. We put forward a neutral proposal that gave more money to the ESAs but recouped it elsewhere, but that was not wholly followed. I think there are elements within the Commission that regret the handing over of some of their powers to the ESAs. They have built up their expertise and they are trying, if you like, to claw some things back. If you look at the way that they draft the legislation in the first instance, they are quite often putting it in with delegated acts so that it gives more power to the Commission, whereas both the Parliament and the Council tend to change that and say, "No, we actually want some of this to be more independent from the Commission. We want it in the ESAs; we want it with the regulators; we do not want everything sucked into the Commission". So, there is that tension going on. We want to build up the ESAs because we think there is this role for the regulators rather than the Commission, but there are tensions. This is an area where the UK's schizophrenia about what it wants to happen or not at the EU level ties itself up in knots. On the one hand you want the PRA and the FCA to be in there doing their stuff in ESAs, but actually you would much rather that they were able to do it all by themselves. You like the discipline when it applies to somebody else, but not when it comes back to

discipline the UK. If I may say so, the thinking process on this is, as I said, schizophrenic and immature.

The Chairman: On that sanguine note, let us pass to Lord Hamilton.

Q13 Lord Hamilton of Epsom: I would like to declare my interests as they are on the register. I think, Sharon, that you have concerned yourself a lot about growth. This is understandable, as there is not any in the eurozone. Would you not accept that regulation is not a free lunch? Somebody has to pay for it at the end of the day, because this cost has got to fall somewhere. You have already pointed out that that would be pensioners and so forth. Also, when you come to look at the banks, there is a big problem in the eurozone—as there is in the United Kingdom—about lending to SMEs. On the other hand, if we are asking the banks to increase their reserve ratios and so forth, that actually runs contrary to asking them to lend to SMEs—which they might consider quite high-risk lending. So, a lot of the things that we are doing in regulation are actually anti-growth. How are you squaring that circle?

Sharon Bowles: It is a circle that cannot be squared, in that sense. We have been quite vocal in the Parliament in recognising this. If I may say so, I think we have been more in recognition of it perhaps than some of the things that have been said on banking back here in the UK. We tried to deal with it as best we could in areas in CRD IV—I mean, for instance, with the risk weights on SMEs and with trade finance in particular. I devised a proposal that the Parliament voted and that you can still operate under CRD IV; it is not excluded. My suggestion there was that you could ring-fence capital, or put in a minimum amount of capital that banks had to apply to their SME lending portfolio, so that they did not get any capital advantage by de-leveraging. Obviously, if they lent twice as much, they would have to hold more. The Bank of England actually phoned me up about this when they saw my amendment and said, “We have had some similar thinking”. We had a discussion about it,

but they then decided that they preferred to go down the line of a carrot, and Funding for Lending, rather than my line, which was more of a stick, of saying, "Well, you can de-leverage your lending portfolio all you like but it not going to make any difference to your capital balances". I still think that you could utilise that in some way. I do not believe that it is excluded. At one point, it was actually even specifically written in as a possible macroprudential control.

So, we have tried to find ways. But you are absolutely right that if the line is that, one way or another, we are going to have more capital assets and more loss absorbency in the banks—and it has increased now by basically an order of magnitude from where it was—then of course that is going to have a knock-on effect into the financing from banks. This then moves us on to the fact that we have to recognise that, so there will be these other lending mechanisms that come to the fore, such as peer-to-peer lending. Rather than regulate itself, the Commission has already encouraged member states individually to have a look at peer-to-peer lending and to try to work out what regulation is necessary, because these things are much more tailored to the circumstances of individual countries. But I guess that at one time in the future when we have absorbed it and got more knowledge about it, there might be some proposals coming. It points to the fact that we have to be more like the United States, where we rely more on capital markets. That takes us into this mantra running now about the market union.

Q14 The Chairman: Do you understand what Mr Juncker means by "capital market"?

Sharon Bowles: The capital market has been around for some time. We used to call it the single capital market. Again, in shorthand, it links in to the aspirations to be more like the United States—to have dynamic capital markets. At the moment within the Commission it is really still a mantra. They are sweeping into it ideas and the leftovers of things that have not

been done. What you need to do is to look at the remaining Giovannini barriers, and all of those kinds of things, that are holding us back. We have not done securities law. We will be about to get TARGET2-Securities going live. So, the moment is right to do something about Europe's capital markets and it is a tremendous opportunity for the UK as the major centre of capital markets. Of course, there are plenty of banana skins around that no doubt some people will do their best to tread on. But if it is handled right it is an opportunity, and we should be endeavouring to try to put some content into that space, because at the moment it is content-free. I think it would be quite a good idea if we filled it. I am actually seeing the Treasury next week to go through some ideas.

The Chairman: Before you take some banana skins into the Treasury—interesting though that may be—perhaps we will just return to Lord Vallance and the present inquiry.

Q15 Lord Vallance of Tummel: I declare my interests, as are in the register. I have three related questions, at least one of which you have touched upon already. If we look at what is going on as a big jigsaw with lots of different pieces in it, you have mentioned some of the gaps in the jigsaw but are there any others that you have not mentioned so far? Are there any overlaps or inconsistencies in terms of the design that you would like to point out? The second question, which again we have touched on a bit before, is that regulation comes at a price; it can bring costs and inefficiencies. With the benefit of hindsight, are there any things that might have been done that would have not incurred so much cost and inefficiency but would have had just as good an outcome? The third question is around whether we should be looking out for any of the unintended consequences that often seem to follow regulatory initiatives—perhaps in terms of regulatory arbitrage, or the transfer of risks off balance sheet or into the shadow banking sector?

Sharon Bowles: The jigsaw more or less fits together without excessive amounts of overlap. I do not think that just out of my memory I can say where I think there are contradictory overlaps. There probably are a few little glitches between MiFID, MAD and EMIR in terms of some of the definitions, but I am hoping that it will be possible that those can be fixed by the way in which the level 2 measures are clarified. I have to say, it has been very difficult to get consistency at times, because there does not seem to be anybody interested in it except me. As I said, I am the only person that is down deep in the dirty detail in every dossier. When you are in a three-way negotiation, which you get to in the trialogue with the Parliament, the Commission and the presidency on behalf of the Council, nobody is prepared to give away some negotiation point for the sake of consistency. The rapporteur will not argue for consistency on something because that would be chalked up as, "That is your victory; now we will take something from you," or, "You have got to give on this". That is where I have tried to be a bit of a scourge.

Having the privilege of chairing the trialogues, I have tried from the chair to adopt a bit of a bullying approach at times to get consistency. To be honest, I think that this is the job of the Commission, and they have fallen down on it again, because they are in the negotiation. It has happened a lot, especially on third countries. Third-country regimes always seem to get pushed right to the end. There is a big danger that you get what is, if you like, some rubbish compromise out of it. I think MiFID was a case in point. The UK position on MiFID was that it did not want anything to happen that would upset the existing bilateral arrangements that were going on, but the Parliament and the Commission wanted a European regime with passporting and all this kind of thing. The UK was not against this, but it feared that it would have some conditions in there that it did not like. In the end, we have got a twin track that is a little bit "have your cake and eat it". It potentially creates a situation where different

things might go on in different places. It was agreed like that because that was actually part of the package. If you look at EMIR, it was done specifically for infrastructure, and there was a declaration—and I think it is even written in the text—that this is a particular kind of third-country regime for infrastructure. In a sense, this is where you make sure the infrastructure in third countries is up to scratch, because if a CCP in Asia goes down, it reflects the bad news back into the EU or the UK. However, then the Commission waltzed off and in the very next proposal that was not the infrastructure they wrote in that third-country regime. It is very difficult to achieve.

The Chairman: Before I go to Lord Kerr for a comment, could you answer the other points Lord Vallance made, about regulatory arbitrage for instance?

Lord Vallance of Tummel: Yes, or shifting risk off into the shadow banking sector, or wherever.

Sharon Bowles: You have to look at the shadow banking sector with care. Shadow banking, quite often, means markets. They are not bad. There is this feeling that everything shadowy and shady is bad, and markets are not bad. Banks do not like losing market share and so they would like to keep it under their control, although I think they are also reconciled to the fact that we need more vibrant markets, and that one way or another they would have a part in it. The central banks also tend to talk too much about things going off into shadow banking. The central banks do not like markets because they are not in their control. The central banks like to have things in banks and absolutely under their control. So, we have got a lot of interesting dynamics going on here: needing to grow capital markets; banks still actually having a job to do in the right kinds of things; and some new mechanisms that we need control of. But if you look, everybody is now saying, "Well, we want securitisation to come back". This is one of the biggest "let's get it off-balance-sheet" vehicles ever invented, but of

course there is good securitisation. So, one has to be very careful when you are just using these headline terms, and get down and dirty in the detail of what it is that you mean.

There are always going to be other types of arbitrage. For instance, there is arbitrage now between the US and Europe because we have implemented the CVA charge differently, at my bidding. But if you had the precise words of Basel, you would still have arbitrage because of the difference in the banking models between the United States and the UK. This is something else that we have to look at: risk is not just defined by the activity that you do; it is defined by the entity that is doing the activity, whether it is systemic or not, and whether its model is the same or not. I do not think we are talking about these things in a sufficiently sophisticated way, often in the political rhetoric at least.

The Chairman: Lord Kerr wanted to resist the idea, Sharon Bowles, that you are a natural bully in the chair.

Q16 Lord Kerr of Kinlochard: I was struck by your modest statement that you were the only person bothered about consistency. I think your description of the dynamic of negotiation at the Council meaning that consistency just gets forgotten about is completely correct. I agree with that. But you went on to be mildly critical of the Commission. I must say that I have always been rather impressed by DG MARKT when you compare it with, say, these lunatics that introduced the financial transaction tax proposal, for example. DG MARKT are very powerful people. Why are they not internally consistent? Why is there not some quality control before the proposal emerges? Surely you have an uphill task if the original proposal is inconsistent with the rest of the statute book, or another proposal. I agree with you that you cannot expect that to be put right in the Council. It would probably get worse in the Council. Surely, it all depends on whether it is consistent at the start. Tell us a little bit about how the Commission performs.

Sharon Bowles: I think the Commission does tend to aim for consistency, because they find the last proposal and copy A to B—as they did on third countries, even when it was the wrong third-countries type of thing. The Commission keep on doing exactly the same things, but they follow what was their starting point, not what was the outcome of the previous legislation. A simple example is in the time limits for approving regulatory technical standards and delegated acts. Right at the beginning I said that the Commission standard of two months plus two months on delegated acts was not enough in financial services, where some of these were very big, with thousands of pages, and the Parliament would need potentially more time—especially if you have got holiday periods and other things in the middle of it. So, we changed it to three plus three. I have had to change it on every single piece of legislation because the Commission kept writing in two plus two. At every single trialogue I had to argue for it all over again, to explain it to a new lot of Commission people and a new lot of Council people, and to annoy another set of rapporteurs with it: "We are going to have three plus three, and we are not having an agreement until I have got three plus three, so why do you not just give in now?" Eventually, I got so fed up with this that I demanded that we change it in an omnibus piece of legislation. I did not allow this to go anywhere until we changed it because I was just sick of doing it, and I could not envisage that the chair in this mandate was going to behave like I had done. So, that is an example: the Commission is consistent to its own template drafting, not to the outcomes.

Q17 Viscount Brookeborough: Looking at all the regulations that have been recently introduced, many of them as a result of the crisis—and perhaps you would like to tell us whether you think the crisis is actually over—do you think there is a requirement for immediate revision or reform on any that have so far been put in place? Do you think that the review clauses are effective for this? This brings you on to flexibility. You pointed out

that you are not sure that we wanted too much flexibility because it then would not give a period of calm. Perhaps you would like to tell us where your balance is.

Sharon Bowles: If you actually look at the review clauses, we are almost reviewing some of the legislation before it has come into force.

Viscount Brookeborough: Some of it is not coming into force for three or four years, and therefore we may see flaws in it then.

Sharon Bowles: That is correct. By the time it is coming into force, you are already into some of the review clauses. Now, that is not quite the nonsense that it might look like, because the international regulatory situation is changing. I certainly know that I have written until I was blue in the face several times that some of these reviews shall take account of the international regulatory reviews.

Viscount Brookeborough: On that very point, do you think we are in tune enough with other international regulations?

Sharon Bowles: We are largely in tune with what the United States and the G20 is doing. I think that there is an issue now, if you are going back to the FSB and Basel, that the Asian regulators that previously were prepared to sit and wait and see what Europe and the US did are perhaps now feeling a bit more confident. They are beginning to speak up, in particular over the issue of bank resolution. It may well be that they will not go along with what the UK, Europe, and US have agreed is the way forward. That is very much a "watch this space" because they are feeling that we are resolving what our problems were, not what their problems were. So, there are issues there.

Q18 Lord Kerr of Kinlochard: I doff my hat like everybody else to your record of achievement while chairing the committee. However, if one wanted to be horrible, one could say that you presided over a period where the legislation on the single market grew

vastly, and the reality of the single market shrank enormously. In the first 10 years of the euro, you see a massive expansion of cross-border lending. You see a real single market developing, fed by good factors and bad: the fiction connived at by the ECB, that the risks of euro lending were the same, whether in northern or southern Europe; and the expansion of the Italian, Austrian and German banks into eastern Europe. During your five years in charge, all of that reverses. The renationalisation of banking systems takes place. I do not mean that your legislation caused the shrinking of the single market—but is it going to bring about the re-expansion of the single market, or does that entirely depend on what happens to the real economy?

Sharon Bowles: It is not the regulation that has caused fragmentation; it is the response to the crisis. It is regulators or supervisors that have caused a lot of the fragmentation by demanding the hoarding of capital, liquidity and ring-fencing. I think maybe the UK was leading the gang on that. So, in a sense, we proclaim that we like the single market but things like Vickers ring-fencing and so forth are not single-market measures. That is why it is always very difficult to get the right workarounds so that the legislation will sit conveniently with it. Banking union will potentially bring around a big reduction in fragmentation, dependent upon exactly how it is operated by the supervisors in terms of the liquidity flows on the cross-border basis. But potentially, banking union is banks without borders, freely moving the assets around.

There are massive opportunities within the banking union but also for us having access from the outside to the banking union, in the same way that one single currency area was very good for business. I really enjoyed it when I started not having to send my currencies off in lots of different denominations. The American hedge funds are very to the fore in recognising the potential of banks without borders. So, the banking union potentially

addresses fragmentation quite a lot. This whole capital markets union was also brought up in the context of the annual fragmentation report that is done jointly by the ECB and the Commission. They are looking again to reduce the fragmentation through this market union idea—which is still, as I said, an area waiting to be filled. There was a gentlemen's agreement at one point between the major eurozone member states that they would not pull away from one another's sovereigns. The agreement that they would not pull away was the starting gun for exactly that, because of course the banks and the regulators were not necessarily doing the same things as the ministers were saying.

Q19 Lord Shutt of Greetland: Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Are there risks in relation to consumer protection arising from the reforms?

Sharon Bowles: Broadly speaking, I think consumers have been well looked after. The whole of financial supervision is really about consumers. I kept having this argument with Malcolm Harbour, the chair of the IMCO Committee, as they were saying that they were in charge of consumer protection and so they should have supervision. They kept trying to get in on the act. Generically, consumers are looked after in that way.

There have been certain specific measures like PRIPs and perhaps the biggest of them all, the deposit guarantee schemes, which have been for consumers. So, the deposit guarantee scheme, which used to be a minimum requirement, then became maximum, harmonised to stop people moving money to the country that had got the highest deposit guarantee scheme. This was done in response to Ireland putting theirs up to an unlimited deposit guarantee. UK consumers are better off, because our guarantee scheme was only £50,000 and you had to lose the first 10%. Under the harmonised rules it became £85,000 with no skin in the game, if you like. You can argue whether that was a good thing or a bad thing.

Consumers are now much more protected in the sense that it has been made mandatory for there to be upfront contributions into deposit guarantee schemes. There were not that many countries in the same situation as the UK, which was recognised as a country that could deliver on its deposit guarantee promises. Given that we are impacted by what goes on in other countries—you have only got to look at the problems with Espirito Santo roiling the markets now—we need there to be good regulation, good protections and stuff throughout Europe so that we do not get negative feedback from it.

The biggest thing that consumers are exposed to is this shift because of bail-in, so that now your pension fund potentially suffers big losses. Anybody that is now going to be in defined contribution pension schemes—which is most people—or any other asset management where they have shares that are invested in bank bonds for the regular returns are in danger of being bailed in. So, they are in the direct line of fire of bank failure. If a big bank goes down and large chunks of people suddenly find their pensions halved, the Government is at arm's length from it because it is automatic.

The Chairman: Despite what you said earlier—that you think that is less likely to happen than before?

Sharon Bowles: Because there are more buffers before you get to bail-in, it is less likely to happen. I do think we are a little bit too self-congratulatory about saying, "We have taken the taxpayers out of the line of fire". What we have actually done is taken the sovereigns out of the line of fire, so the Government does not have to take the responsibility of going to the taxpayer. It is actually now done, if you like, in an automatic loop. But it is correct that if you are getting a return on a bond that does not have the same security there—so, you are getting a higher return—you have to bear the risk of that. Previously, people were getting the bond returns that related to a risk that turned out not to exist, in a sense.

The Chairman: That was a very useful insight.

Q20 Lord Vallance of Tummel: Do you think that we have got the right balance struck in this general area of supervision and regulation between the role of the member states and the Union itself? If not, what might be done to address it? Specifically, do you think that the EU has struck the right balance between the use of regulations and directives in this area?

Sharon Bowles: Broadly speaking, I think the balance is right. It took me 26 pages to answer this in the balance of competencies review, so I will spare you some of that. The right balance between member states and the EU comes in at various levels. We have to have the regulation at the EU level for single-market passporting and the confidence that things are not being sold cross-border and so forth. To some extent that was going to be there whether we were in the EU or not, because we require it in equivalence terms with the rest of the world anyway. There is lots of input from the member states through the presence in the ESAs of the regulators. Knowledge will out; so, the knowledge and the experience of the UK regulators is very powerful because they have got more of it than many other countries, in areas where the big markets and big activity is here. That is not ignored. It is taken notice of. I think that there is sometimes perhaps too much emphasis put on the whole business about loss of veto. When we went from committee procedures to the ESAs, instead of it having to be consensual within the committee—so, essentially there was a veto—it has gone to majority voting. That is not a treaty change as such, but it is a legislative change that has, if you like, taken away a veto that was perceived to be there. But I do not see how you could ever go back on that. It is unrealistic. Everybody is very interested in what we, as a big exporter, are up to now because they had their fingers burnt before.

The Chairman: I am anxious to get on to our last subject. I know that Lord Hamilton wanted to contribute to the implications for the United Kingdom.

Q21 Lord Hamilton of Epsom: I have to go in a second, but I would just like to raise a rather bigger point. This is something that has concerned other members of the Committee as well. We are seeing the eurozone progressing, and if it does not integrate then it is going to fall apart. Many decisions will be made to do that. We are not part of the eurozone. It is foolish in politics to ever say never, but on the other hand I think we can pretty well guarantee that we will not be members of the euro for 10 years. During that time, lots of decisions are going to be taken by the eurozone and handed down to us on qualified majority voting, and we will just have to accept it. Does this not mean that the UK gets more and more marginalised over this period?

Sharon Bowles: There are two points here. First of all, there is this assumption that they will harmonise along eurozone in-out lines. That is not actually the experience. We have to do things quite carefully. One suggestion I have made is that when the Eurogroup meets, it should meet after the ECOFIN council and not before it, so that there is not a pre-discussion over things that are really single market. It should be done the other way round: you have the single market discussion, and if there is a sub-set decision to be made, that is then done subsequently. That should help to guard against that. Those are the kinds of things that could quite easily be part and parcel of the negotiations that the UK has in the area.

The Chairman: What was Mr Dijsselbloem's reaction to your suggestion that they should meet after ECOFIN?

Sharon Bowles: A lot of people would agree with that. I think the view of some in the Parliament is certainly along those lines. It has not been a formal proposal as such. The UK should also look for reasons to be included in things—including sometimes as an observer—rather than reasons to be excluded.

The Chairman: Can I come on to that? I know Lord Hamilton has to leave shortly. We did ask the former Financial Secretary whether, when she was in post, she had any first-hand discussions or negotiations with the Eurogroup. It was quite apparent that she did not. We felt that was a lack in terms of the engagement of the United Kingdom with a very significant group of players whose importance has perhaps grown over the crisis.

Sharon Bowles: I cannot fully remember the history of this because it was not an area I took the greatest of interest in when I was not chair. I think that originally there was an open invitation for the UK to attend it, and Gordon Brown did not like to do it. Again, time moves on and I think that we need sometimes for there to be reasons to stay. You know I got quite cross about the way we present ourselves. With regards to the Bank of England, it was always Charlie Bean that was sent to the informal ECOFIN and governors' meetings rather than it being the governor. There are times when just the presence makes a difference: how long the Chancellor stays at the informal ECOFIN, or whom he sends. I was so cross about this that I stood for the governorship of the Bank of England to make the point, and got rather scarily shortlisted.

The Chairman: We are not very clear about who was scary.

Sharon Bowles: Who was scared? Me—everybody. There are whole ways in which I think that our relationship with the EU, and how to maximise what we get out of it, can be changed by some things that appear to be window dressing.

Q22 Lord Kerr of Kinlochard: This is bang on what you have just been saying. Were we right to treat the banking union as a eurozone concern rather than a development of the single market? We could have decided to go either way on that, it seems. Secondly, are the Poles, the Swedes, and others who are not in the eurozone—and who are not showing any immediate sign of wanting to join the eurozone—better at managing to keep a droit de

regard over what is going on inside the eurozone than we are? We quite ostentatiously say, "This is not for us; go ahead and do your thing". Indeed, sometimes we have been shouting, "Do your thing very fast. Do it as deeply as you can; you need to, to preserve the euro. But it is nothing to do with us". Have we made a tactical mistake?

Sharon Bowles: What we have done and what we have said are not necessarily the same thing. The banking union has some discomforts for us—there are banana skins, as I said before—but there are also opportunities when it is handled right. The first response was, "Well, it is good for the UK because it is good for euro stability, so we are happy to let you go on and do it. You have our permission to do it, and we will not interfere unless it interferes with us". But actually when it came to it, we were quite active in making sure that there were things to do with the single market embedded in it, both on the Council side and on the European Parliament side. When it came to the single resolution mechanism, I know behind the scenes at the technical level there was a lot of good, useful, helpful technical input that went from the UK. This was acknowledged, and we were thanked for it during one of the intergovernmental conferences. It was all very topsy-turvy and in different formations: Parliament in with the intergovernmental conference, the Eurogroup in the trialogues, and people who should not be in places, in places. However, it worked from a pragmatic point of view. But yes, we do tend to take this hands-off approach, but then we actually have to come in and help out.

With banking union, the euro-outs had a far greater understanding of the loss of sovereignty involved in it than the eurozone countries themselves. They were basically desperate to hurtle towards it for a variety of reasons: some because they thought it would help to get stability, and some because they thought they were then going to have access to some bail-outs—although of course Germany kept moving it further and further away and they never

quite got there, but just about. A lot of the better parts of the structure, such as the insistence that I had that we had an intergovernmental agreement with the ECB so that there was oversight of what they were doing on the supervisory side, came in from people like me, the Hungarians, the Poles and the euro-outs. It seemed to take a while for the rest to catch up. But there are obvious trades that I can see in the area of how you compensate for things where the eurozone is getting closer together and doing things together, and the impact of this on the UK. Some of them are more subtle. That is in another balance of competencies submission I have done somewhere—the economic and monetary affairs one, I think.

Q23 Lord Kerr of Kinlochard: There is one supplementary from me, and this is a bit personal. Is it not the position of the British in the European Parliament that the extent to which we would be able to affect these dossiers in the way you have done is eroding pretty fast? I would guess that if you had chosen to stay in the Parliament you would not be the chairman of the ECON now. I think I remember that even in ALDE, your own group, there was an attempt to evict you from the chairmanship of the committee after the British took the position they took on fiscal union—an attempt that you defeated. I think all round the Parliament people know you did a very good job, but the fact that you are British would have meant that you could not have been reappointed to that job had you stayed in the Parliament. Is that right? Can you confirm that, and what conclusions should we draw?

Sharon Bowles: It is slightly different from what you said. The way you become chair is partly because of the weighting that each delegation and each political grouping has. So, I would not have been it simply because there are hardly any Liberal Democrats left. We would not have had a strong position to pick within the ALDE group, but also the bigger groups have decided this time that they wanted to pick the ECON Committee. I think it was a second pick

this time, so obviously a smaller group would not have got in. But I do not think that it said that it could not be a British chair. There is this feeling that it has been a positive experience to have a British chair. If you listen to what people have said in the last committee meeting, it was said that it had not been a bad experience. I think that it would be quite difficult for the Conservatives, for a variety of reasons, but I do not see that a Labour ECON chair would necessarily have been refused. If the character of the person is known, then I think it could be anybody else. But we have some very effective MEPs from the main political groupings who have all contributed. A lot of the time there has not been big party-political differences. We do not club together and say, “You do this and you do that”. We have just been able to pursue things. If there have been others there, then I have tried to fill in where there were gaps. But yes, I think we were lucky that I was perhaps the right person in the right place at the right time. We should just say, “If we had to choose five years to have a British chair that happened to be like me, then that was the five years”.

The Chairman: We are going to be very disciplined, if we may. I am going to ask Lord Vallance to speak, Lord Davies to speak and Lord Flight to ask a question, but could you do it in order? Then I am going to ask Sharon to respond to those three points. I will make a suggestion right at the end. I am so sorry.

Q24 Lord Vallance of Tummel: All I have is a quick heeltap from my earlier question, which is whether you wanted to comment on the balance between the use of regulations and directives.

Lord Davies of Stamford: I was wondering if you could help me to understand the rationality of the British position in all this. We always seem to think it is a great achievement if we get a derogation or an exemption. We have of course got an exemption from the banking directive in favour of our Banking Reform Act. We are not going to be part of the banking

union, although we have taken a strong interest in how it has evolved, particularly on bank resolution, as you say. Then we get terribly worried about how we are going to influence things, and how we are going to protect ourselves. You have already dealt with some of the efforts we have made to do that—not always very effectively—and the threats to our influence. Why did we not start from the other side of the telescope, on the assumption that we would be part of these things unless there were very strong reasons not to be? What was the reason for adopting that approach?

The Chairman: I am going to take those two, and then I am going to ask Lord Flight and Lord Caithness to do the last two. But perhaps you could respond to Lords Vallance and Davies.

Sharon Bowles: Yes, I knew there was something that I had missed. I think that broadly speaking the division between regulation and directives is about right, in the sense that the EMIR infrastructure had to be a regulation, and in the way that CRD and MiFID are one of each. Those are about right. I do not think that they got it right on benchmarks, for example—although of course it is not finished yet. They tried to do benchmarks, where it was very much an evolutionary process in international terms, through a regulation. We did not get it finished, because the Commission said I was building in too much flexibility for regulation. My view there was that we should have had two. We should have had a regulation for the critical benchmarks such as the EURIBOR that needed to be done quickly, and then we could perhaps have had a more flexible directive for the rest that needed to be dealt with more sensitively. But broadly speaking, it is about right.

The Chairman: Sharon—looking from the other end of the telescope, from Lord Davies?

Sharon Bowles: You are quite right. We tend to have this slightly selfish approach: “If we can do it ourselves, please still let us do it ourselves”. We do not see the EU as the prime mover. We play the game at Basel and IOSCO and so forth, and we want to play the game here, but

when we have got an idea we do not say, “Right, let us take this idea to Europe”. We go and we do it ourselves, and then we do not want a European one because it will not be 100% the same as ours. So, we spent all of our time arguing for derogations. We have done Vickers, which does not come in until 2018 or 2019, and it completely distorted our view of things all the way through CRD IV. It has caused us so many enemies because every time there has been special pleading for Vickers. Other countries have come in, put things in place, enacted them, and we still have not got anything.

Lord Davies of Stamford: So you agree that we are irrational in pursuit of our own interests. But why are we so irrational?

Sharon Bowles: I think it is regulatory selfishness. Our regulators oscillate. I have already said how we slapped on all these liquidity things then changed our minds; now we want proportionality in Basel-type things for challenger banks, which we actually argued against when we were doing CRD IV. The UK opposed some of the things like that that the Parliament wanted.

Q25 Lord Flight: I have two very different points. The UK regulators—the PRA, FCA, City Corporation, Crown Dependencies, and I have probably forgotten some—all maintain offices in Brussels that are really there to lobby. Are they any use, in your experience? My second, rather different question—and again, declaring my interest—relates to the fact that in the retail investment management business there are really still enormous cultural barriers to trade. Not only do you really have to have a Luxembourg fund, but if you try to market it in Germany, France, Italy, you should almost forget it. There are one or two that have succeeded, but there are cultural barriers to entry to the single market.

Earl of Caithness: I hope you can revisit my supplementary on question two, Sharon. I asked about the EU in international terms. You answered it partly in response to Lord

Brookeborough's question, but how does the EU sit internationally with regard to regulation, and is it less competitive as a result of what has been enacted over the last five to seven years?

Sharon Bowles: On the offices, I think that there is always advantage to having an office in Brussels because then you can get an on-the-spot flavour of what is going on faster than if you are trying to do it remotely. Lobbying is about as effective as its content, its sophistication and the recipient. I think that is very variable. I am not a lobby-hater. Nobody would ever consider that they would do legislation to do with the law without consulting lawyers. So, I think that you need to consult. Certainly the Parliament has always been very keen to consult the buy-side when we are doing banking regulations and these other things. We are not so stupid as to only consult the interested parties. You want both sides and the middle, and all sides. So I think that being on the spot is—

Lord Flight: Useful.

Sharon Bowles: Useful. But just because somebody lobbies for it does not mean by any means that they get it. I do think we are capable of engaging brains and making up our own views. I tend to have my own thoughts in advance, but somebody might write something that solves my problem. I tend not to look at where ideas have come from. I look at what they say. I do not have a clue where lots of stuff has come from. That is what I do with my colleagues' amendments. I do not care whose words they are; if they are right, then I will have them. That is my view.

The cultural thing is very true. We had trouble in MiFID. We could not go anywhere near as far as the UK RDR because of vested interests. You could say that maybe that actually puts the UK in a different space—I am not sure whether it is a less competitive or more competitive space—because we have got stronger controls. But to go back to the consumer

point, where Europe has not covered it, it has not undermined the consumer protections like the UK's RDR that have been enacted. I do not think that we are less competitive, because apart from one or two isolated points, I really sincerely do not see that the regulation would be very different or less if it was done UK-only. In places it would be tougher, so we would be less competitive. I do not think that the UK is in a worse position.

Earl of Caithness: No, not the UK, but the EU vis-à-vis America and so on.

Sharon Bowles: The EU as a whole? Well, if some other jurisdiction wants to go forward with the kind of light-touch regimes that got us into so much trouble, yes, they will out-compete us. They can have their crisis to follow. I think that it is generally agreed—and I mean there is a 100% sign-up to this from the UK as far as I am aware—that we are not going there. I have sat through so many humiliating apologies from the FSA as was; the message is loud and clear that Europe does not want to go there and the UK does not want to go there. So, until somebody can actually say to me, "This particular piece of regulation is causing this problem," I just cannot accept this as a blanket generality. If the Wild West is going to happen in Asia, then so be it. However, my experience of the Asian regulators is that it is not the Wild West there. They are quite strict in some things—a lot stricter in some things than we are. They have not got their exchanges and other things full of the HFTs and all of these other things that we have. If we do put a little bit more of a brake on some of the high-frequency trading, then maybe that is no bad thing. We backed off from some of the biggest changes in the MiFID trialogues. ESMA could still bring some in, but I think the mood has moved in the direction of where the Parliament was going on those to stricter controls, even since we finished MiFID.

The Chairman: Sharon Bowles, I add my descant to the paean of praise that you have had from Members of this Committee in their sincere thanks to you for all that you have done,

especially in heartily defending the UK position in your very significant role over the past five years. Can I thank you for coming here today? We have an important debate on the euro area crisis tomorrow in the House of Lords. Some of your thoughts have already been added to my putative speech. Can I also say that there are some other interesting areas like shadow banking that we may like to explore with you in the future? We would be very grateful for your two essays on the balance of competencies, which you forwarded to the Government and to the Treasury. As I always say, we will send you the transcript. We hope you can correct it, add to it, and respond to it. But it has been a veritable tour de force by you, and it could not have been a better start to our interest in the EU financial regulatory framework, in part as you left it when you left the European Parliament. For that we are particularly thankful.

British Bankers' Association and JP Morgan- Oral evidence (QQ 187-198)

Evidence Session No. 11 *Heard in Public* *Questions 187 – 198*

TUESDAY 14 OCTOBER 2014

Members present

Lord Harrison (Chairman)
Lord Balfe
Earl of Caithness
Lord Carter of Coles
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witnesses

Anthony Browne, Chief Executive, British Banking Association, and **Sally Dewar**, Managing Director, JP Morgan

Q187 The Chairman: Colleagues, we resume with our second session. A very warm welcome to Sally Dewar, who has not been before us before, and a warm welcome to Anthony Browne, who has. We look forward to your answers. I remind you that we will make a transcript of the engagement. We will send it to you. Please do check and improve it. Just to give you notice, we are being broadcast at the moment and we have an audience. Sally and Anthony, perhaps you could remind us of your positions and respond to a first question, which is: what is your overall assessment of the reforms that have developed since

2008 in response to the financial sector crisis? Do you think that we now have a system in place that is resistant to any asymmetric shocks but at the same time still carries the flexibility that perhaps we need in order to respond to these matters? I will ask you, Sally, first, if I may and, because you are an expert on third countries' access to these markets, I ask you to go a little further and tell us at the end of all that whether you think that what we are doing still ensures and enhances access for third-country players to come into the single market of the European Union and indeed when we are transacting here in Britain. Welcome to the Committee.

Sally Dewar: Thank you very much. I will do my best to answer those questions. Just to set the scene, my name is Sally Dewar. I am the EMEA head of regulatory affairs at JP Morgan. Previously I was at the FSA. I have been with JP Morgan for three years and I have responsibility both for policy initiatives and for helping to guide JP Morgan in their implementation. I am also responsible for thinking about conduct and culture in the organisation.

The first point I would make about the reforms that have been put in place is that it has been an absolutely mammoth effort by regulators. In my view, the markets are definitely more resilient than they were in 2008, more transparent and more accountable. That is the overarching message that I would give. A considerable amount of time and energy has been spent by a whole variety of stakeholders in achieving that: the European Commission, the Council, the Finance Ministries, firms themselves. Those are all very valuable contributions. When we talk about the positive impacts on resiliency, I would point to the capital requirements directive in looking at capital and liquidity, the bank resolution and recovery directive, and the banking union itself. All those come together to create resiliency. As Mr Enria has described, the role of effective supervision—of ESMA and the EBA in particular—is critical to that. Then we take EMIR and MiFID. All those efforts on the market structure

definitely lead towards making the system more transparent. If you look at it as a combination of resiliency, transparency and supervision, all these come together in conjunction with the efforts that banks and other institutions are making, and that gives us the confidence that we have a more effective system today.

On the question about whether we have sufficient flexibility to prevent asymmetric shocks, honestly I think it is probably too early to tell. A lot has been done, but a lot of it is still in train. A lot still has to be implemented. No two crises are ever the same. Yes, we have made huge efforts to think back to what the causes of the crisis were and to make the system stronger, but we do not know what the future will bring. We can never say with certainty that the system is sufficient to withstand asymmetric shocks, although, having said that, I think the right areas have been tackled.

The other point is that up till now a lot of the response has been reactive. At some point we should stand back and turn our attention to what might come and what we think. We have a lot of people who could put their minds to what else could happen and whether what we put in place would be sufficient to prevent that. There is probably still some work to do there, particularly in thinking about the unintended consequences of the work that we have done. One good example—and regulators are fully aware of this—would be CCPs. In an effort to make the market more resilient and transparent, the G20 said that all OTC derivatives should be centrally cleared as far as possible. That has been delivered, but it has led to a risk concentration in the CCPs that we now need to be able to resolve through effective resolution plans. But there is increased transparency and better stress-testing to give that piece of the market structure more resiliency. There is still work to be done on asymmetric shocks.

In terms of cross-border activities, as an American firm we are very concerned about making sure that there is a level playing field and consistency of application. We have the G20

foundation and the FSB and we know the direction of travel, but then regulators take their legislation off in different directions and we need to make sure that there is that consistency of objective and consistency of application. We always need to be mindful of that. To me, that is where there may still be a risk of global markets not being as effective or efficient as they could be.

Q188 The Chairman: Before I turn to Anthony, could you help us in marking the scorecard of the other significant actors in the making of regulation: namely, the Council of Ministers, the European Parliament and indeed the Commission? Which parts of the regulatory framework did they do well in and where were they perhaps weaker and less effective and efficient?

Sally Dewar: It would be unfair to pick out any particular component.

The Chairman: We occasionally like to be unfair if we get the opportunity.

Sally Dewar: There are always opportunities, you are right. That is the way to look at it. It is a hugely complex process and it necessitates different players looking at it from a variety of different perspectives in order to make sure that the interests of all the different stakeholders are met. That is important. The Commission, the Parliament and the ESAs are all very important in delivering that collectively. Of course, because everybody comes at it from a slightly different perspective, there are going to be challenges. The Commission knows that it has not necessarily got it perfect the first time round. The most important thing is that there is a willingness to review the impact of regulation post-event. You cannot underestimate that impact assessment, from both a cost perspective and an effectiveness perspective. The relationship between the ESAs and the Commission is important. Sometimes where the advice of the ESAs is not taken, there could be better transparency around that decision-making. If a legal position has been taken, that could be made public to help the market understand. That is an area where more could be done. The ESAs have

found themselves constrained by resourcing and time constraints. A lot of the period of consultation that they have had has been constrained. I cannot emphasise enough the importance of that consultation process—getting all the market participants engaged and getting the right degree of expertise. But often the ESAs find themselves pushed into a legislative timetable that curtails that piece of the process. More could be done in that. It is all learning around the edges as opposed to asking fundamentally, "Does the system work or not?".

Q189 The Chairman: Anthony Browne, you might like to tackle those same questions, but I should tell you and Sally that we saw Michel Barnier in September and we saw Members of the European Parliament, including the outgoing Sharon Bowles, who was our first witness on this inquiry. Anthony, perhaps you will give us your thoughts on the changes and the scorecards, as it were, of the important players in Brussels in particular.

Anthony Browne: Thank you. Thank you for inviting us to give evidence here. Obviously, we have already provided written evidence. Just to set out who we are, I am the chief executive of the British Bankers' Association. To make it clear, we do not represent just British banks, we represent banks operating in Britain. We have 170 different members, including JP Morgan, and pretty much all the international wholesale banks that operate here as well as the major UK banks and smaller banks.

My broad assessment is that the reforms have been done very well. It was an extraordinary set of circumstances in the wake of the financial crisis. The institutions were not set up to do such a wholesale reform of the industry in what is actually a comparatively short space of time in the grand scheme of things. There have been three major sets of reforms. The first was implementing international agreements. That is really the G20 agenda set out by the Financial Stability Board as well as the Basel III agreement. That has been the main work programme of the European Commission, of Michel Barnier. I am sure he went through it.

His job was to implement those G20 commitments, many of which Sally outlined, to make sure that the crisis did not happen again.

The first set of reforms was implementing the international agreements to improve the resilience of the system. The second was developing the single market, in particular the ESAs—you just had Andrea Enria giving evidence. The third set was banking union, which was obviously about bolstering the union. A lot of individuals did an amazing amount of extraordinary work—you mentioned Sharon Bowles—over a comparatively short time.

Was it absolutely perfect? No, with the benefit of hindsight, there are things that could have been done better, which is why it is good that you have a review like this. I am sure—I hope—we will not be in the same situation again, but it is important to learn lessons.

You asked about the scorecard for individual institutions. The European Parliament did an extraordinary job improving and passing the legislation. It could have done with more technical support, as a lot of the parliamentarians were involved in quite technical writing of amendments but without a lot of technical input. One way of doing that would be to enable the European supervisory authorities to lend more technical support to them. But also, simply in terms of resources, the institutions, the European Parliament in particular, were not necessarily resourced to deal with this level of technical legislation. There is a timing point as well, which Sally touched on: a lot of this legislation came through very quickly, and often delays at the earlier part of the process meant that the latter parts of the process, such as the consultation with industry, ended up being very rushed from our point of view. Often, we were not really able to get considered input into it.

In terms of the outputs, we do have some concerns—again, Sally touched on some of this—about consistency between bits of EU legislation. There are some bits that are slightly inconsistent with each other and it is important, as the legislation lands and is implemented, that we have a period of reflection, to borrow a phrase from Tony Blair, and look back at

what lessons can be learnt, what unintended consequences there were and what revisions might need to be made in the wake of it.

Q190 The Chairman: Before I bring Lord Flight in for a supplementary, could each of you give a ready example of an imperfection that perhaps needs to be concentrated on and needs adjustment that might feature in our report—something that springs forward to you as really quite outstanding?

Anthony Browne: I can give a few examples, some of which are more live than others. For example, at the moment—I have given evidence on this before—European legislation is being proposed on bank structural reform. Lots of countries, including the UK, have already done this: there are the Vickers reforms in the UK, and France, Germany and Belgium have also done it. However, you would not design a process with lots of individual, national bits of legislation followed by sort of pan-European bits of legislation, where it is not entirely clear how all that would fit together. We have quite a lot of concerns about the consistency of international regulations, some of which Sally touched on, such as third-country rules, which she is far better placed to speak about than me.

One example of part of the process that we do not think landed quite rightly is the relationship between EMIR, which is about clearing derivatives, and MiFID, which is more broadly about reform of the securities markets. The definition of a derivative is held within MiFID but the rules implementing it are through EMIR. The result is that you have now ended up with quite different types of derivatives that are affected by EMIR in different national jurisdictions. It is being implemented in different ways. So a measure—EMIR—that was meant as a regulation to create a pure single market has in fact been interpreted in many different ways because of the interaction with MiFID, a directive that allowed national discretion.

The Chairman: Sally, do you want to give a couple of examples?

Sally Dewar: Yes. As I mentioned before, there is the CCPs issue, which I think is an important one. How do you square the circle between requiring more capital and liquidity for institutions while increasing the amount of lending in the system? That is an important issue to tackle. Transparency is another one to mention. There is an implicit assumption that transparency is always a good thing, and at the highest level you cannot argue with that. But when you get into the detail, it is not always evident that in every single circumstance, at a point in time, immediate transparency is good for markets, particularly when markets and volumes are thin and you want to ensure that a market participant gets a fair price. You might just want to think about that. The broad assumption might not always hold true.

The Chairman: I think we raised that in our own MiFID II analysis, where we thought that pre-market transparency actually acted against the market. Lord Flight.

Lord Flight: Sarah has raised this in part, but surely by far the most important issue for the safety of the banking system going forward is adequate capital. The inadequacy of capital going into the system was a disgrace, and how the regulators ever permitted it, I cannot imagine. I would argue that adequate capital is more than 3%. When I studied old-fashioned banking economics, it was about 8%. We know the problems when you are trying to increase lending, and so it has to be a long-term aspiration, but it seems to me that the EU has not done terribly well in following Basel; if anything, it is behind the coach and certainly does not have a target of capital basis to an adequate level as the main promise of the safety of the banking system.

The Chairman: Would you like to respond to that, Sally?

Sally Dewar: The level of capital has increased enormously as a consequence of the regulatory reform agenda. In fact, that was the principal piece of legislation from Basel and what was tackled first. Capital levels keep on rising. It is not about just the minimal level of capital, it is about all the extra buffers that are put in place. Some of those buffers are

obviously there for use by institutions in the tough times, so it is not just all about minimum levels of capital. They are being considered in different ways. It is not just through Basel III, it is through recovery and resolution—a combination of factors. The way I think about resiliency, capital is clearly a component part, but my point is that if you want to have a fully functioning capital market that has the ability to lend and support the economy, there comes a point where it cannot just be about adding capital layers above capital layers; you have to look at the combination of factors that are helping to make the system more resilient. That is the way that I would look at it.

The Chairman: Anthony, did you want to respond to Lord Flight?

Anthony Browne: I am very happy to. Clearly, the industry needed higher levels of capital than it had before the crisis. The banks have also been working hard to recapitalise themselves. In fact, in the UK, the banks now have a three times higher level of core capital up to tier I than they had before the crisis and, as Sally said, that is continuing to rise. But we have not reached the end game yet. Basel is still looking at what the definition and calibration of the leverage ratio should be on an international basis. Also, at a G20 level, Mark Carney, as chair of the FSB, is looking at TLAC—the total loss absorbing capacity that would apply to SIFI banks—which is the additional layers of capital above and beyond the 3% that you were citing, which the banks could absorb in case they suffered big losses, such as with a bail-in, which is where investors, or bank bondholders, would suffer losses as a result of banks suffering losses themselves.

Q191 Lord Kerr of Kinlochard: Looking across the board of all this legislation, there must be inconsistencies such as gaps, overlaps and underlaps. Can you mark our card as to where the really important ones are? Where does it matter and where is action required to put it right? Could you also think about our old friend subsidiarity and about proportionality? Did it all need to be done at this level?

Anthony Browne: On your subsidiarity point, our broad view is that for wholesale markets, because they are international and are generally cross-border, you do need pan-European legislation. Most of the reforms that we have been talking about would need to be done at a European level. What we do have reservations about is some of the retail banking legislation, of which there has been a fair bit already; indeed, Jean-Claude Juncker, the President-Elect of the Commission, has put down on the work programme for the next Commission doing more legislation on retail banking. Retail banking operates largely on a national level. Each country has its own practices and cultures—for example, we have six times the number of credit cards per capita in the UK than they have in Germany—and often those do not fit the subsidiarity rules.

In terms of the overlaps, the most significant one is the one I mentioned earlier, on bank structural reform, with all the different initiatives being done at national level already and the EU subsequently trying to do it at an international level. Those would be the main conversations.

Sally Dewar: I will mention a couple of others. If you take CRD IV, some of the terminology—for example, "material risk-takers"—could be interpreted differently by home jurisdictions as they take those rules and put them into national law. One of the big issues that we all have to be mindful of is the really important role of EBA or ESMA in making sure that there is consistency of application. Where there is room for interpretation on terminology, definition or standards, that could result in differences of application. I am not saying it is a problem, I am just saying it is something that we should be mindful of as we go through the review period.

Similarly, sovereign risk issues should be borne in mind. Some of the interpretations of CRD IV might make you think that sovereign risk is limited or not controlled, but then you take that in conjunction with the LCR, which was quite a sensible interpretation. Some of these

things are not a straightforward yes or no: "is it going to be good or bad?", but we should keep them in mind as the implementation takes effect and the impact can be more broadly seen.

Generally, as Anthony said, the principles of subsidiarity and proportionality have been respected through the process, particularly at level 1. It is particularly difficult to argue at level 1, because by the nature of getting agreement at level 1 you have to have a certain degree of high-level generality. The challenge comes as we go through the level 2 process to see exactly what that implementation at national level or through the ESAs results in. It is something that we have to be mindful of as we carry on.

Lord Kerr of Kinlochard: Can I pick up your point about the slightly different definitions in different legislations? Sharon Bowles, in giving evidence to us, argued that the Commission tended to be very internally consistent—each proposal coming out was consistent with previous proposals—but therefore inconsistent with the legislation as amended in Council and Parliament. She maintained that one had to go back to each successive proposal and say, "No, listen. We have reached a view about, say, implementation periods and you must reflect the view that the other two institutions have reached". Do you think that is fair? Is it a genuine criticism of the process?

Sally Dewar: I am just trying to think. It is definitely true that through that negotiation process you could end up with a different outcome, but I cannot think of a specific example to support what Sharon said, I am sorry.

Anthony Browne: I have not heard that criticism before. I cannot think of a specific example either, but I can certainly go away and see if we can come up with some. They say of policymaking that it is a bit like making sausages: you do not want to see the process. As you know, it is not a straightforward process in Brussels. You have the trilogues, where you have three different groups putting in amendments or changing things. It goes through a complex

iterative process, so the end result will often be quite different from the starting point. You might start off with a series of consistent proposals, but it ends up being more varied. We keep urging all policymakers not just to see things in individual silos but to see the big picture of reform of financial services at a European level and see how all the different bits fit together to make sure that you get the right connections between different bits of legislation. It is not always easy to do that, because people focus on the bit of legislation that is right in front of them at the time.

The Chairman: If you remember some examples later on, if you could bring those to the attention of the Committee I would be most grateful.

Q192 Earl of Caithness: Taking an overall view of the securities trading chain, there have been seven directives and regulations covering this, from pre-trading to post-trading. I have three questions. Has market efficiency been enhanced? Has it been compromised? Were they all necessary and would the UK have implemented them if we had been outside the EU?

Lord Flight: Hear, hear!

Sally Dewar: As with all of this, as you say, there has been a huge number of different pieces of regulation to adjust the end-to-end process. I think it is still too early to say whether efficiency has been achieved or whether they are collectively doing the job that was set out by the G20 without duplication, overlap or inefficiencies. We will not know that for some time yet. Particularly as we go through the level 2 process for MiFID, for example, there are still a lot of undetermined regulatory outcomes, particularly around calibration. Thinking about the equities market versus the non-equities market, the biggest mistake we could make is to assume that those two markets are the same and that therefore you can apply one set of regulations in a straight read-across to the other. If we do that, shame on us, really, for not thinking about the subtleties of what we are trying to achieve and the fact that they are global markets, they operate differently and they have different stakeholders. With

some things, of course there is read-across, but not with everything, and we just need to be mindful of that as we go through the process.

The good news is the level of stakeholder engagement. Those messages are getting through. We are seeing good political and stakeholder engagement with regulators. But that is still something that has to bottom out. Similarly, around transparency, as I mentioned before, we should not just assume that the same degree of transparency is appropriate across all markets. Yes, we all want to see transparency in markets as a high-level principle, but we have to get that right. I would say that we probably need a bit more time before we can answer that question. The direction of travel and engagement with the regulators is good, but I cannot, hand on heart, say that we are going to hit the right outcome straight off.

Anthony Browne: I would echo that point. There has been an enormous number of different bits of legislation—you counted seven; I would probably go a bit higher—that have rewritten the rules of the securities markets. Some of them have not even been implemented. We are still doing level 2 of MiFID, for example. We will not know how effective they are or what the impact is until they have all been implemented and had time to settle down. It is difficult to say whether it was necessary or it will work. Clearly, the broad rules did need to be changed in the securities market to ensure that it was more stable. There are things that we can already see are not working. One example of that is trade repositories, where trades have to be reported. That is regulated by ESMA, but the data that are sent in make it very difficult. The theory behind it was to give regulators greater clarity on the derivatives trade so that they can work out where the vulnerabilities and the system risk are. But the way the data are reported is inconsistent, so it is very difficult for regulators to match different trades, so the value of those data is really very limited. This is something that ESMA is quite open about. The system needs to change in order to fulfil the role that was set out for trade repositories.

Q193 Lord Carter of Coles: I think we are all aware that work is ongoing at the FSB level on solving the "too big to fail" problem. What in your view is the best way to get out of the illicit subsidy to large and unconnected banks?

Anthony Browne: We totally support the notion that we need to end too big to fail and we need to get rid of the implicit subsidy of the so-called too big to fail banks. We have been very supportive, and the banks have been very supportive, of the broad thrust of legislation to require higher levels of capital, as Lord Flight was talking about earlier. For example, we pushed forward very strongly on the recovery and resolution directive. We absolutely need to land that.

In terms of further action, as I mentioned earlier, the G20 is looking at the total loss-absorbing capacities. This is a new requirement on the GCIFs to have extra levels of capital that could be called upon in the case of losses. Again, we support that. We are pleased to see there has been movement in the right direction in reducing that implicit subsidy. A recent report from the IMF looked at that. There is also increasing evidence from the credit reference agencies that actually that subsidy is decreasing. So we are definitely heading in the right direction. Critically, we need to have confidence in making sure that the recovery and resolution plans of the banks are credible. We think that increasing the role of TLAC in that will help.

Sally Dewar: Again, I fully endorse the fact that we need to ensure that taxpayers do not bail out banks. That fundamental framework going forward is fully endorsed. The first question that I would look at is what the implicit subsidy is. Certainly from a US banking perspective, the evidence would suggest that for at least large banks there was and is no implicit subsidy. There have been various studies; for example, the US Government Accountability Office did a study and set out that large banks do not enjoy an implied subsidy. In fact, the US banks were recently downgraded by credit rating agencies when their

research determined that the Government would be less likely to help those firms. However, having said that, the extent to which there is a perception that there is a subsidy is something that we all need to deal with. Of course, from our perspective, having something in the BRRD that sets out that there could be state intervention does not help to eliminate that issue. That is one issue that we have to get through.

The most important thing is whether institutions are truly resolvable. That is what we have to get to the heart of. We have to be able to solve that. From our perspective, the single point of entry framework that was adopted in the US provides for a large financial institution to be resolved either through bankruptcy or through the FDIC's liquidation authority. So we believe we are on the right track.

There is still some work to be done, but the important thing to remember is that this is the highest priority on the FSB's agenda. Both regulators and financial institutions are working together. Whether it is on operational simplicity or the structure within firms to enable resolution or the resolution plans themselves, there is a huge amount of effort going towards that resilience, not forgetting the fact that with the increased liquidity and capital structure, you hope that you do not get into that position in the first place.

Lord Flight: I find it very strange that everyone takes for granted that these arrangements will mean that the taxpayer never has to bail out a bank. Thirty-something million citizens have bank accounts, and certainly what has been done reduces the risk of that happening, but any Government anywhere is going to have to keep the banking system afloat if there is a major run caused by whatever, and I think there is quite a lot of delusion going on. Meanwhile, we spend hours doing things such as derivative reporting, which is completely unnecessary as the derivatives market came through the crisis perfectly satisfactorily.

Anthony Browne: The truth of the situation is that we will never know for sure if we have ended too big to fail because we cannot see the future of anything at all. What we can do is

look at the rules governing banks now and their capital ratios, the arrangements they have, the liquidity they have, and see whether any of the banks that went through the crisis would have failed if they had had those levels of capital—remodelling the crisis to make sure that the institutions that did fail have sufficient levels of capital that they would have remained solvent throughout the crisis. That you can do. Indeed, a lot of the negotiations we have been involved in have set that as a minimum hurdle. Actually, the new rules on capital and regulations must be sufficiently strong that none of the institutions that failed in the previous crisis would fail again. But is there something else in the future?

Lord Flight: Who knows?

Sally Dewar: I totally agree with you. You can never say never. Of course, it is absolutely right that politicians and Governments push us as far as we can to get to that point.

Anthony Browne: To phrase it in a slightly clearer way, we need to make sure that if the current rules applied before the crisis, no institution would have failed.

Q194 Lord Balfe: Do you think the new regime contains sufficient regulatory incentives to manage risk better? In particular, I am thinking of the new sanctions regime, the rules on securitisation, the Government's remuneration rules and the rules on clearing and trading obligations. If you want to comment beyond those, that would be welcome, but I would certainly like to know whether you think those are sufficient.

Anthony Browne: One of the themes throughout all the different bits of European legislation has been reducing risk. Whichever bit of legislation you look at, there will be elements in there the sole or main aim of which is to reduce risk. In terms of EMIR, for example, the aim of clearing derivatives through CCPs is to reduce risk and provide greater transparency. The fact that there are new requirements on collateral for the counterparties is an example of reducing risk. Obviously, CRD IV covers remuneration. It is not just the bonus cap, which you asked Andrea Enria about; there are a lot of other elements in there

that are about reducing the risk of incentives, payment, and non-cash instrument deferral against guaranteed bonuses, such as malus and clawback. There have been a lot of different incentives to reduce risk across the piece, and what you need to do really is go through all the different bits of legislation and tally the measures to reduce risk.

Lord Balfe: The key word in my question was "sufficient"—it was not "what do they do?", but "are they sufficient to do it?".

Anthony Browne: I will hand over to Sally in a second. You can never eliminate all risk; indeed, you do not want to. If you had a completely risk-free banking sector, you would not have a banking sector that is doing its job. You want banks that can actually lend to businesses and to individuals who buy their houses. What you have to reduce is the systemic risk across the piece. There has been an absolute transformation in reducing systemic risk, but as you mentioned with the earlier answer, you cannot predict the future and know that nothing will ever happen again on a systemic basis.

Sally Dewar: All I would say is that I believe that the collective rules, taken together, do provide the right incentives. You have to take the reform in aggregate. As I think Sharon Bowles said, more than 40 pieces of legislation have been implemented in the last few years. That is a mammoth piece of regulatory reform for the regulators, politicians and institutions to absorb. It definitely has served the purpose of looking at resiliency and reducing risk in the system—albeit we talked about the concentration issues earlier. But now I really believe that we have to get ourselves to a period of sufficient regulation; let us embed it, implement it, observe it and then amend it if we need to.

The Chairman: Do you agree with that, Anthony Browne? Do we need some degree of stability and calm?

Anthony Browne: On the regulatory front, absolutely. There are still a few pieces going through—we mentioned MiFID II earlier, which has not been implemented yet—but we

need to see where all this legislation, regulation and rewriting of the rules lands and what impact it has on industry. We know what it is designed to do, but there is nothing like seeing what happens in real life. Some tweaks will probably need to be made and some reforms might need to be made beyond that, but we need a period of stability on the regulatory front to see exactly what the impact of all this is and to see whether any future reforms are necessary.

Lord Hamilton of Epsom: Following on from that, I meant to ask Sally about JP Morgan. Compliance, cost-wise, is not a free lunch, and JP Morgan must be carrying a considerable overhead. It is unfair to ask you for figures and things, but perhaps you could supply us with them. It would be helpful to know what the cost to JP Morgan is today of compliance in the department that you run, versus the turnover and profitability of the company—if you cannot do it for London, perhaps globally—and compare it with pre-crisis, when of course the cost would have been, I suspect, a fraction of what it is today. We sit here and regulate absolutely constantly, but nobody ever asks how much this is costing and who, ultimately, is paying the bill. We whinge because our bank costs go up all the time, but that is hardly surprising. Even if you take out the irrelevant nonsense of the whole business of identifying who people are, in case we are laundering drug money or something, this all comes at an astronomical cost. We sit here increasing these costs daily and we never actually ask what they are. It would be very helpful if you could provide us with that information.

Lord Kerr of Kinlochard: I have a piggyback on that trenchant question. Perhaps there could be a footnote to the answer, in which you identify how much of the additional costs result from G20 decisions, G8 decisions or global decisions, which we would have had to carry out ourselves even if we had not been part of the EU.

Lord Hamilton of Epsom: I expect it is more difficult to break up the figures.

Sally Dewar: We are very happy to have a go at providing you with the right information. One point to make is that of course the cost has increased, and we have public figures on what we have been doing. It is the cost not just for JP Morgan but for the whole industry of the regulatory reform agenda. That is why I say that impact assessment is very important. Every regulator does a cost-benefit analysis. Sometimes it is not very sophisticated, because it is very difficult to put some costs on the impact. That is why going back and looking at whether regulation has done its job, and at the risk-reward around that, is the right exercise. Again, I would say that, like anybody when you have to put measures in place, you may go too far. The regulation and the compliance costs may have gone too far in certain instances, and at some point we will need to all just rebalance and make sure that we are delivering effective regulation at a cost that makes sense.

Anthony Browne: I am very happy to solicit from my members what evidence there is on the costs of compliance. They have grown enormously, as you said, although I do not have industry-wide figures at the moment. One international bank—far smaller than JP Morgan and definitely not JP Morgan itself—recently told me that a quarter of its staff were now involved in compliance functions. That is clearly a cost. Picking up on Sally's point, one thing I could have mentioned earlier, which we do not think has been done well, is the impact assessments from the European Commission. Very often they emphasise the positive element of things and do not take account of the costs side. A lot of the impact assessments have not survived very close scrutiny, even by other institutions within the European Union. That is one thing that could have been done a lot better: emphasising both the benefits and the costs of different bits of legislation.

Q195 Lord Hamilton of Epsom: I will move on to my main question, which is about the growth agenda and whether there is much to be done to encourage venture capital and those sorts of areas, and whether that will really make a lot of difference. Is the problem of

the lack of start-ups and new businesses, particularly in continental Europe, more to do with the cost of labour than the unavailability of capital?

Anthony Browne: We have recently published a report on promoting growth in Europe and looking at the EU legislative agenda. We wanted to make a proactive contribution to what the Commission and the new European Parliament think about over the next five years. We think there is an awful lot that can be done. A lot can be done to revitalise the securities market, which would provide another form of capital for the banks. A lot more can be done to provide direct access to capital markets for companies—the mid-cap bond market works well in the US and reasonably in Germany, but does not work well in the UK. There are reforms to things such as the prospectus directive. That is a good piece of legislation for encouraging cross-border investment by creating a single set of rules for prospectuses, but the burdens fall disproportionately on small businesses. The rules there could be made more proportionate. You could do more to encourage private placements as well, and have clearer pan-European rules on that. There is an awful lot that can be done. This is a personal comment, outside the remit of the BBA, but a lot more could also be done on structural reform to labour markets in Europe.

The Chairman: Sally, would you like to respond to Lord Hamilton?

Sally Dewar: I do not think I have anything to add. I agree with all those points.

Lord Shutt of Greetland: Just before I move on to my question, I will put something to Anthony in particular. To what extent, in terms of the membership of your organisation, is the whole business of regulation now the major constraint on any new entrants that might be subscribing to your organisation?

Anthony Browne: Lord Flight is here, who is a non-executive director of Metro Bank, one of the challenger banks and a member of the BBA. We do a lot of work promoting competition in the industry. We believe in competition, and this is about looking at reducing

barriers to entry and barriers to growth, and increasing the ease with which customers can switch between different banks. A big concern—a legitimate one—for a lot of the smaller banks is that they are disproportionately affected by a lot of the regulation. In effect, although not by intention, the end result is that you create bigger barriers to entry or growth by introducing a lot of new regulations and applying them on a one-size-fits-all basis, as opposed to having some sort of broad proportionality test in there. One example of a live issue at the moment is the senior managers' regime, one of the recommendations of the Parliamentary Commission on Banking Standards that the FCA and the PRA are currently looking at. As it will be applied currently, if it goes ahead as it is, it will have a far bigger and disproportionate impact on smaller banks. A far greater proportion of their staff will be covered by it, even though the responsibilities of the staff who will be covered by it will be far smaller in those small organisations than in bigger organisations. You would have people in very big banks who would not be covered by the senior manager's regime but who have far more responsibilities than comparatively small-scale operators in some of the challenger banks. A major concern for some smaller banks is that they will find it more difficult to operate as a result of this senior managers' regime, when no one has accused the smaller banks of being systemically important or risky.

Q196 Lord Shutt of Greetland: Do you think the ESAs have been effective in supporting and promoting the single rulebook? Do you believe the stakeholder groups within each of the respective ESAs have successfully facilitated consultation with the industry in the areas of the single market most relevant to you, your institution or your members? Sally, you talked earlier about the constraints of ESAs. Are there any additional ESA powers, or enhancements to their role, that you would like to suggest?

Sally Dewar: The first thing to say is that the ESAs have worked incredibly hard on their various mandates. They have had very limited resources and significant time constraints. In

addition, ESMA for example has taken on the role of supervising credit rating agencies, which in and of itself is not an insignificant role to have. Because we are still in the midst of implementing some of these big pieces of legislation, it is difficult to say whether the ESAs have done enough to promote the single rulebook. They have been in place for only three years, and arguably their workload is at its peak today.

In terms of their effectiveness, the market has felt constraints because of the tight timelines. Whether there has been sufficient stakeholder engagement is one of the issues that might come back when we revisit regulation post-implementation and say, "If we had just spent more time getting the views of all the experts, we might not need to make adjustments going forward".

The stakeholder groups have been successful. I sat on the ESMA stakeholder group for three years. They have a valuable role but, again, they can be improved further. The composition of the stakeholder groups is necessarily constrained by regulation and the need to have certain numbers to balance jurisdictional and diversity issues and to balance academic versus practitioner issues. You can only have a certain number of people on your stakeholder group, and there are too many constraints to manage it effectively. We need to be mindful of that. As for the consultative groups, my experience of ESAs has been hugely helpful. If you were to ask the ESAs, they would say that they benefit from that broader degree of consultation.

In terms of whether they could do with more powers or other enhancements, we have to consistently review the mandate they have been set against the resources that they have. We spoke about that earlier. We need to make sure that the relationship between the ESAs and the European Commission is clear. As I said before, if the Commission chooses not to accept the technical advice of the ESAs, there should be transparency around that and a degree of explanation; the legal advice should be public. Those issues are incredibly

important, both for the credibility of the ESAs and for the market itself. Those would be the points that I would pick up on

The Chairman: Anthony, do you share those views?

Anthony Browne: I do and can amplify them a bit. As a representative of the main banking centre in Europe that is outside the banking union area, we are massive supporters of the ESAs in terms of ensuring there is a single market and a single set of rules for that market. They have generally done a good job. Could they be more effective? Absolutely. We think that the ESAs are too weak and underresourced and that there is a lack of clarity about their roles. That is through no fault of their own, but about the circumstances in which they find themselves. The ESAs should be strengthened in various different ways. Sally touched on quite a few of the issues: for example, there is insufficient independence from the European Commission. It is not clear that they provide technical advice, nor is there real transparency when the Commission overrules that. They have suffered from inadequate timetables, which I touched on earlier. Legislation tends to be set out with an absolute date when something has to be done by, and delays earlier in the process mean that ESAs are given a very short time to do a lot of very detailed technical work, in consultation with the industry, over incredibly short timetables. As a result of that, you do not necessarily get good results. They often get unclear guidance at level 1, while level 2 reforms are often overprescriptive, which makes it very difficult for the ESAs to define the regulations and technical standards properly. This comes back to the question you asked earlier, which I did not answer, about flexibility. It reduces their flexibility. Some of the things that are included in level 2 are very technical, but the ESAs have not had any chance to change them.

We think the ESAs should be able to provide technical support to the Parliament, and to any other part of the legislative process, so that they are not just presented with something at the end of the legislative process which they then have to try to make sense of. They should

be inputting their thoughts, not to try to change the intention of Parliament but to advise on what is workable or what the consequence of a certain sort of reform would be, rather than trying to make the best of it at the end.

In terms of the powers of the ESAs, they could certainly use better resourcing. You asked the chairman of the European Banking Authority earlier about the number of staff he had. It actually has a remarkably small number of staff relative to the work that it does, which definitely impacts its ability to do high-quality work. It also could do with greater powers. For example, it has a role mediating between different European players, but the mediation is voluntary and non-binding. Two countries—or other players—have to come to the EBA and say, "Will you mediate for us?". It can then mediate if there is a discrepancy between the interpretation of different rules, but the sides are not bound by the outcome. It would be better if the EBA had the right to initiate mediation and if the results of that mediation were stronger, in the sense maybe of some comply or explain structure. That way, if the individual players or countries decided not to abide by it, they would have to explain and justify why not. Quite a lot of reforms could be made to strengthen it.

The Chairman: We are on to the final two questions. Lord Kerr.

Q197 Lord Kerr of Kinlochard: I think the question I was going to ask has just about been answered already by what Mr Browne said in his recent remarks. Say you were Lord Hill and you were thinking of how to improve this process. Is what you have been saying for the last three or four minutes what you would want to say to Lord Hill? The EBA should be involved upstream a bit in the legislative process, with the Commission perhaps backing off a bit downstream and paying more attention to the drafting of the particular rules rather than sitting on them or changing them—is that right?

Anthony Browne: Absolutely, yes, as I set out earlier.

The Chairman: Before I bring in Lord Hamilton, in addition to that question, could you both say a little bit about capital markets or indeed any other issues?

Anthony Browne: I am glad you asked that question because I was going to suggest that it is something that you should look at as part of this whole agenda, because it is clearly part of it. There are different elements of capital markets union. I have spent a bit of time wandering around Brussels trying to find out what people actually mean by it. It is a phrase that has caught the zeitgeist. As I understand it, work is going on in three different areas. One is looking at how to improve the securities market in Europe. We are massively supportive of this. We know that the UK Government are supportive of it. It includes some of the issues that I touched on earlier, such as promoting securitisation, helping direct access to the securities market for mid-sized companies and further reforms that can help promote cross-border investment and clearing within Europe. That is definitely a good thing and something we should be proactive about. It is good for the UK and London. Work is also going on looking at the tax treatment of equities versus debt. Obviously, the tax treatment is biased against equities in that dividends are not tax-deductible, unlike interest payments on debt.

The third part, which is the most sensitive part and which I would urge you to look at it, is the single supervisory framework for capital markets in the EU. There are many different forms of this. You could have a full single supervisory authority that may or may not be ESMA and may or may not be based in London or Paris. You could have stronger rules on securities supervision. This is certainly a concern for the UK Government. It is not an issue that we as an industry have particular views on at the moment, because there is no proposal there to get views on, as it were, but it is certainly something that we know is being discussed in Brussels.

The Chairman: Sally, can you respond to that and also take on board the spillover effects on the capital market of having banking union, as it were?

Sally Dewar: Yes. Like Anthony, we are still trying to work out what the capital markets union will mean in practice. Nevertheless, it provides an opportunity for us all to think about what it should encompass. In the short term, the focus should possibly be more on capital markets integration, but then really thinking about how the financial markets can maximise their role in funding to the real economy. If that is the focus of it, that is a very admirable objective to have. The key criteria for us would be that it should be to remove any obstacles that prevent the free flow of capital in the European Union, and it definitely needs to encompass the European Union as a whole. You do not want to carve out pieces. This is about how the European Union as a whole works. It should look at the full breadth of the EU capital markets—who are all the players?—and think about all those actors and all those processes. It should be based on good supervision and sound regulatory practices. That would be my starting point, although we all wait to see how that is going to be interpreted in practice.

The banking union itself we see as a net positive and not contradictory to any of what I have just said. When the banking union delivers its regulatory agenda, it is the same regulatory agenda that we all have in the European Union. There is no discrepancy there. The key observation I would make is that as the banking union develops and as the ECB becomes a very influential and powerful regulator within that, the number one need is to ensure consistency of application within the banking union for its members. Again, this goes back to the importance of the role of the EBA in supervision, consistency and quality assurance, and making sure that the ECB does not unduly influence that independent process. That would be the risk that I would highlight.

The Chairman: Lord Hamilton, the final word.

Q198 Lord Hamilton of Epsom: With the development of the eurozone, we now have a two-track Europe, with the United Kingdom, for the foreseeable future, on the outside

track. Do you have concerns that the 18 members of the eurozone will be handing down edicts that the remaining members of the EU will have to accept on qualified majority voting? What effect might this have on cross-border banking—people headquartered in London—and on banks that do not have any influence outside the United Kingdom?

Anthony Browne: We produced a report about this fairly recently, which I am happy to send to you. We are big supporters of banking union. It is a very necessary part of ensuring stability in the eurozone. As you mentioned, next month the members of the banking union get qualified majority voting under the Lisbon treaty. There are other developments, such as a full-time eurozone president, that could change the way that rules are made. The argument against it is that there are actually not that many areas where the members of the banking union agree with each other. So far there has been no evidence that there is a caucus, where they pre-agree a position and it is presented and imposed on the rest of the European Union. That really has not been the case so far. At the moment banking union considers regulatory issues. Its roles and powers are fairly well described. Under its interpretation of the rules, it does not get involved with the actual legislation at a European level. There has been a lot of confusion in the commentary on this. It is not as though the banking union countries get together at an EU Council of Ministers level and say, "Right, this is the legislation that we want and the rest of Europe has to put up with it". That definitely has not been the case. We suggest various things in our paper—various reforms that could help ensure that the single market is maintained and you do not end up with a fracturing of the single market. Some of them are reforms to the ESAs, to boost the power of the ESAs such as the European Banking Authority, which I mentioned earlier.

The Chairman: Sally, please reply to Lord Hamilton's question, but if there is anything else you would like to throw in at this late stage, please do.

Sally Dewar: There are definitely challenges in the way that the regulation between the eurozone, the EU and the UK is evolving. They are well versed. The UK is responding well. We do not have any particular issues from that perspective. I guess an underlying issue for us is the importance of the single market and us all being focused on that as a very important agenda, and trying to make sure that whatever we do from a regulatory perspective does not undermine the single market. As a firm, we are very grateful to be able to do business both in the UK and across Europe, and both those markets are very important to us as a firm. The challenge for cross-border banks such as ours as the regulation evolves and develops is the ability for us to continue to be able to serve our customers and to operate efficiently in a global market. That is what we are trying to do. As different sets of rules apply, often the same transactions have to be treated differently across different entities and jurisdictions, and that just adds to the complexity. That is particularly true with regard to the EU rules and those of third-country jurisdictions, particularly for the US. Having said all that, we think that the FSB and IOSCO are alive to those issues. They are working really hard to foster greater co-operation and co-ordination among regulators. There is still a lot to do to rebuild the trust and get that information-sharing among regulators at the right level. But, again, I think everyone is alive to the problem and is working hard to resolve it.

The Chairman: In thanking our witnesses for their very thoughtful replies to our testing questions, I remind them that we will send a transcript. Please do correct it and we would be most grateful for any further answers you have. I apologise to both our witnesses, first for the Aeolian harp that came in from time to time and for my own outrageous interruptions—being a typical male—of Sally when she had not quite finished answering. You have to be quick here. We are most grateful to both of you and look forward to both of you returning at some point to this Committee. You have been so helpful. Many thanks indeed.

British Bankers' Association–Written evidence (FRF0015)

This is the British Bankers' Association's ('BBA') response to the above request for evidence; we welcome the opportunity to provide our views.

The BBA is the leading association for banks active in the UK. It represents over 170 banking members which are headquartered in 50 countries and have operations in 180 countries.

Summary of key messages

Broad assessment of the EU regulatory framework

- The overarching objective of the post-crisis reform programme has been to deliver a more resilient financial system. Measured against this benchmark the programme has been a success.
- Reform has not, however, been achieved without cost. The focus on stability has not been matched until recently by a recognition of the need to promote economic growth.

Interconnections, overlaps and gaps in the EU regulatory agenda

- Further steps should be taken to deepen the Single Market and promote growth.
- The consequences of measures such as the proposed Bank Structural Reform Regulation should be assessed to explore whether their objectives are met via other initiatives.

The EU Single Rulebook and the consequences for the Single Market

- The European Supervisory Authorities provide a framework through which to deliver more consistent implementation of rules via the Single Rulebook and implementation monitoring. That said, the ESAs could be more effective.
- It is important for EU rules to be equivalent to those in other jurisdictions to ensure the competitiveness of the Single Market.

The implications for the UK

- It is debateable how different the substance of UK rules would be if they were a purely national competence. That being said, given the significance of financial services to the UK and the degree to which legislation is set at EU level, there is an overwhelming case for the UK to devote further resource and expertise to engaging in the European process to increase the level of influence in priority areas.
- The deepening and further liberalisation of the Singe Market will benefit stability and growth in the Eurozone as well as other Member States. As the Eurozone develops, however, it will be vital for the European Commission to defend the Single Market.

Broad assessment of the EU regulatory framework

1. **What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?**

The European policy initiatives advanced since 2008 can be broadly sub-divided into three categories: those giving legal force to international commitments agreed in response to the financial crisis, those to develop the Single Market and those to establish 'Banking Union'. The first category has been the main driver of the post-financial crisis reform programme for the banking sector.

The overarching objective of the post-crisis reform programme has been to deliver a more resilient financial system. Measured against this benchmark, the programme has been a success. Credit and investment institutions now hold more capital and liquidity and are subject to a more rigorous and consistent supervisory regime than before the crisis. A new toolkit has been developed to address the failure of banks, which insulates taxpayers and exposes creditors to loss; addressing the moral hazard of too big to fail. The financial system overall is also more stable due to the adoption of macro-prudential supervision and the move towards central clearing for OTC derivatives, and regulators have greater visibility of the derivatives markets due to mandatory trade reporting.

These successes have not, however, been achieved without cost. The focus on stability, whilst necessary, has not until recently been matched by a recognition of the need for policy to promote economic growth. Indeed, the post-crisis regulatory framework incentivises lending to governments and housing rather than to SMEs and infrastructure. Additionally, international regulatory divergence has significantly complicated the implementation of derivatives market reforms for both industry and regulators alike.

2. **Will the new regulatory framework enable the EU to withstand further asymmetric shocks and future crises as yet unforeseen? Is there sufficient flexibility in place to enable it to do so?**

As noted above, the robustness of the financial system has been enhanced significantly in response to the financial crisis. The changes to the prudential framework together with measures such as recovery and resolution planning make individual institutions in aggregate much more robust than before the crisis. These important steps are supported by a more intrusive and forward-looking approach to supervision. Stress testing exercises - such as that currently being coordinated by the European Banking Authority - have become a routine part of the supervisory toolkit and enable supervisors to test the financial health of firms and to require them to take remedial steps if found wanting[19]. Macro-prudential oversight is an important complement to the new supervisory approach, giving supervisors the ability to look at risks emerging across the system and to make policy choices to mitigate these. It is important to recall, however, that a balance must be struck between minimising risks related

[19] In addition to the EBA stress test, the ECB is conducting a comprehensive assessment of those institutions in the Member States participating in Banking Union which will be subject to direct ECB supervision. The PRA is also conducting a stress test of the eight largest UK banks and building societies. These reviews utilise different assumptions (even for the UK economy) and methodologies. The announcement of the results will therefore require careful handling and opportunities to enhance the coordination of such exercises in future should not be overlooked.

to asymmetric shocks and wider objectives for economic growth. We welcome the European Commission's recent recognition of this in its work programme.

3. **Where do you think the biggest achievements have been made, and why? Do you believe there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?**

We regard the agreement of the Financial Stability Board's Key Attributes for Effective Resolution Regimes and the subsequent Bank Recovery and Resolution Directive ('BRRD') as the most significant regulatory reform. In hindsight, the absence of a robust framework for recovery and resolution was a significant amplifier of the financial crisis. New powers such as 'bail-in' alter incentives in the financial system and provide the authorities with tools and strategies to address failure when it occurs without recourse to the taxpayer.

In a purely European context, the establishment of the European System of Financial Supervision and the three European Supervisory Authorities ('ESAs') should be viewed as an important and necessary strengthening of the consistency of the supervisory regimes across the European Union. The period prior to the crisis was characterised by notionally consistent rules and standards across the Single Market but marked differences in the way these were enforced. The Single Rulebook developed and enforced by the ESAs mitigates this problem by ensuring greater consistency in the implementation of rules. This is beneficial for firms, as it reduces complexity and promotes a level playing field, but is beneficial too for authorities acting as 'hosts' with activity taking place in their jurisdiction authorised and supervised by the 'home' Member State under the 'passport' regime. We discuss our recommendations to enhance the Level 2 process in response to question 5.

On the negative side, we note below our concerns over the proposed Financial Transaction Tax ('FTT') and European proposal for Bank Structural Reform.

4. **Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency, transparency and integrity; and financial stability?**

<u>Consumer protection</u>

The BBA's assessment is that there is a marked difference between the characteristics of the markets for wholesale and retail financial services and therefore the allocation of the competences to legislate in these areas should differ. Wholesale markets are by their nature cross-border and thus require consistent rules for the conduct of business whereas retail markets are characterised by consumers with a home-country bias and are subject to distinct cultural conditions and policy choices.

<u>Market efficiency</u>

Prior to the onset of the financial crisis, reforms to the Single Market focused on the goal of promoting greater market efficiency through the adoption of uniform standards and the induction of greater competition. The Markets in Financial Instruments Directive ('MIFID' I)

adopted by the UK in 2007, did much to further these objectives, and continues to serve as the foundation for the effective functioning of the Single Market. Since that time, major reforms have been driven by the lessons of the financial crisis, which has reduced the focus on initiatives to promote market efficiency.

The impacts of the latest round of major market infrastructure reforms (European Market Infrastructure Regulation ('EMIR'), MIFID II) are still to be seen. Some initial challenges can, however, be identified:

- OTC derivative trades are being reported, however, trade repositories are unable to match the majority of trades. This has weakened the ability of regulators to monitor systemic risk in derivatives markets and can be attributed to shortcomings with the reporting standards adopted by the Commission.
- The question of third country CCP equivalence is still unresolved, which may seriously hurt competitiveness of European banks operating in emerging markets.
- Divergences in regulatory standards adopted by the European and US regulators have inhibited cross-border derivatives trading and capital flows, leading to increasingly fragmented global derivative markets.

Transparency and integrity

Market transparency is an important component to the proper functioning of the capital markets, not only for the purposes of accurate price discovery, but also for market abuse prevention and systemic risk monitoring. Additionally, transparency in regards to service and product offerings has led to better informed clients and greater competition. Both MIFID I, EMIR and the Market Abuse Regulation ('MAR') have done much in this regard, providing both regulators and industry with powerful and effective tools with which to inform their decisions and enforce high standards of market conduct.

That being said, mandating greater transparency regardless of the circumstances does not necessarily always result in positive macro-market outcomes. For example:

- Equities: In equities markets, increasing transparency via the removal of deferral and waivers gives, in effect, a surplus to those who trade in small sums frequently but 'a loss' for those who trade large volumes less frequently e.g. pension funds. The impact on such firms can be considerable and have significant material consequences for these kinds of participants.
- Fixed-income markets: Fixed income markets are characterised by more infrequent trading but in larger volumes. Applying the MIFID I equities regime to non-equities products (as proposed in MIFID 2) will have a significant impact on these markets, potentially leaving holders of these assets subject to significant losses during times of illiquidity.

Instead of focusing on transparency, a fair market should be assessed on how susceptible it is to market abuse (i.e. market cleanliness). Again, this has been the focus of significant regulatory reform through the introduction of the MAR.

Financial Stability

As discussed in answer to questions 1 and 2, much of the post-crisis regulatory agenda has been driven by initiatives to promote financial stability. Much has been achieved – not least via the BRRD and CRD IV – but there remains a need to balance objectives to achieve financial stability with those to promote economic growth. As noted elsewhere in our response, proposals such as the FTT would undermine this.

5. **How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?**

It is clear that the European legislative process has been under tremendous strain, with the volume and complexity of the legislation under construction resulting in examples of sub-standard outcomes. At Level 1, the financial crisis coincided with the expansion of the European Parliament's remit. Whilst this has been positive in many respects, it has no doubt complicated the negotiation of important files.

More often than not, the Council has played an important role in ensuring the technical soundness of legislation. At times, however, national interests have dominated proceedings and have resulted in reduced levels of effectiveness or inconsistent outcomes. For example, the process for resolving a failed institution via the Single Resolution Mechanism is convoluted with multiple steps in the decision-making chain negotiated to satisfy different interests.

In our view, the Level 1 process could be enhanced by:

- setting appropriate timeframes for negotiations;
- ensuring that the co-legislators have sufficient access to technical advice before and during the negotiation process – in particular the European Parliament should have the power to commission advice from the ESAs on technical matters;
- permitting the Jurists-Linguists to provide technical legal drafting advice at an earlier stage of the legislative process to mitigate the need for substantive changes to text post adoption which can reduce the clarity of the co-legislators' intent;
- setting standards for issues to be delegated to Level 2 to bring consistency to the areas addressed by the ESAs. This should include a requirement for the co-legislators to consult the relevant ESA ex ante on delegated acts and the wording of the remit given in each delegation. Doing so would ensure that political disagreements are not downwardly delegated to the technical level where ESAs do not have the mandate to find solutions and would also add discipline to ensure the delegation is sufficiently clear, precise and practical to implement; and
- ensuring robust, independent impact assessments are conducted for all proposals, including for proposals introduced during trilogue negotiations, where significant obligations can be imposed without prior impact assessment.

At Level 2, it is evident that the ESAs have been held back by unclear guidance at Level 1, inappropriate timetables for delivering technical standards, insufficient independence from the European Commission, inadequate resources and a lack of transparency and engagement with stakeholders. Steps to counter these issues, could include:

- setting deadlines for Level 2 standards not in absolute dates but as a drafting period which begins from the date at which the Level 1 text is published in the Official Journal. This period should be no less than 12 months post-adoption, to ensure appropriate consultation with industry;
- clarification regarding the respective remits and roles of the ESAs, the European Commission and the co-legislators;
- providing the ESAs with the resources necessary to fulfil their roles. This includes both funding and staffing arrangements, including consideration of the seniority of staff the ESAs are able to recruit;
- a reconstitution of the ESA consultative committees;
- consultations on technical standards should be subject to standard timetables to permit industry review. This reinforces the first point above that there must be a minimum drafting periods for the production of standards;
- ensuring Level 2 standards do not disproportionately impact any one Member State; and
- a greater focus on high-quality impact assessments.

6. How do you think the 'growth agenda' and support of alternative financing sources can best be promoted by the EU with respect to regulation?

There are a number of areas where the calibration of existing regulations can be tweaked to ensure support for a diverse financing system which supports growth. The EU is too dependent upon bank financing (close to 70% of the flow of financing whereas in the US non-bank financing is much more dominant).

There are a number of initiatives underway aimed at promoting a more diverse financing system. These include infrastructure and export financing, a greater role for capital markets (debt and equity finance), revitalising the securitisation market in Europe and promoting alternative finance sources for SMEs.

In infrastructure financing the EIB plays an important role in supporting long term financing. This includes direct financing and also via its Project Bond programme which serves as a form of credit enhancement to ensure that specific projects are investable for private sources of capital. Given the weakness of investment and the need to support the productive potential of the EU economy enhancing the role of the EIB will serve to support both cross border and national infrastructure projects. This can be achieved by more active pipeline promotion and identification, expansion of direct lending and continued support of project bond activities.

Export promotion requires that trade finance is not hindered in terms of its capital treatment. We believe that the capital requirements for trade finance assets under CRD IV should be reduced, recognising their strong performance through the crisis. In addition other regulatory interventions (for example the leverage ratio) should be calibrated so as not to impact the supply of trade finance. Finally the treatment of export credit agency (ECA) assets under central bank refinancing windows should be reconsidered, a move which would greatly enhance the liquidity of such credits.

In the SME space there are a number of initiatives at national and EU level designed to diversify sources of finance. One important focus is the attempt to revitalise the securitisation market across the EU. The recently announced ECB Asset Backed Securities ('ABS') purchase programme is still being detailed and the question of whether national guarantees will be available for junior tranches of ABS remains open. Whilst the current capital treatment of securitised assets for real money investors (under Solvency II) remains a barrier to more direct participation by the buyside.

Another area where regulation could hinder more diverse finance sources is around the development of mid-cap bond markets and the capital treatment of direct lending to mid-caps. Here the SME growth market category under MIFID II should be supported in the 2015 Prospectus Directive Review to make it easier for SMEs to offer securities to a wider investor base at lower cost. In addition, the post IPO liquidity of SMEs can be enhanced by the flexible application of conflict of interest requirements under MIFID article 16(3) in respect of investment research. Investors should not be dissuaded from investing by actual or perceived regulatory barriers.

In terms of promoting more diverse sources of finance for SMEs the UK has a lot to contribute to the debate. One example is the angel investment community where the EU could play an important role in promoting best practice. Other areas like the Business Growth Fund could also be replicated across other Member States. Finally there are many elements of the UK system such as promoting investment readiness amongst businesses including the promotion of mentoring activities which could be replicated across other Member States.

Many of these ideas are discussed in more detail in our recent publication "Financing European Growth".

Interconnections, overlaps and gaps in the EU regulatory agenda

7. **Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?**

Bank Structural Reform

With the UK Government having accepted the recommendations of the Independent Commission on Banking in 2011, and the primary legislation completed last year, the UK is committed to implementing structural reform of the banking sector via ring-fencing. The concept of structural reform is, however, still the subject of fundamental challenge by the European banking sector with many believing that it cuts across the benefits of universal banking model.

Many would argue that the European Commission has failed to prove the need for structural reform at the EU level given the many regulatory initiatives already underway and further effects of existing regulation yet to be felt.

Proposed MMF rules

Proposed reforms for some classes of Money Market Funds ('MMFs'), involving the introduction of a capital buffer, would render these funds uneconomic. This could lead to risk concentration of short term deposits held by corporate treasurers in larger banks. Nevertheless, new prudential requirements may reduce the number of banks operating in this market, which in turn may further increase the systemic risk in those banks remaining.

FTT

We note elsewhere, the risks of the FTT and the potential for this to undermine long-term growth and lead to consumer detriment.

8. **Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?**

Review clauses are important for two reasons. First, they permit an assessment of the impact of a measure and provide the opportunity to fine-tune as necessary. When using review clauses for this purpose it is important to identify the correct time horizon to permit a robust assessment to be made.

Review clauses are also important as much of the EU regulatory agenda has been driven by international agreements. Whilst it would be preferable for EU legislation to follow the conclusion of international discussions, there are times when this is not practicable. In these circumstances review clauses should be used to permit the European legislation to be aligned with the international agreement; this is the approach being taken to the implementation of the Basel III/CRR requirements for the leverage ratio, liquidity coverage ratio and net stable funding ratio. Such flexibility can be used to enhance the coherence of regulation across jurisdictions, to the benefit of the users of financial services.

A key lesson from the most recent wave of regulatory reform is the necessity for EU authorities to be able to apply targeted regulatory relief. The concept, drawn from 'No Action Letters' utilised by authorities in the US, would allow regulators to exclude cited obligations from immediate enforcement until such times as technical solutions to intransigent problems have been developed. Nowhere has the need for such a tool been more obvious than in EMIR trade reporting, where the obligations to report exchange traded derivatives has been shown to be over-ambitions, technically unfeasible and practically challenging. Despite public acknowledgement of the challenges, and the reluctance on the part of all stakeholders – regulatory and otherwise – to see these obligations become due, policy makers were unable to provide any regulatory and enforcement relief. The result was very poor compliance rates, and a failure of policy.

As a final point, the appointment of Frans Timmermans to the European Commission as First Vice-President in charge of Better Regulation is an encouraging indication that the Commission will prioritise principles of good regulation.

9. **The Commission argues that the new and/ or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?**

Whilst much has been achieved, there remain a number of potential initiatives which should be considered by policy makers in order to deepen the Single Market and promote greater efficiencies. Some examples would include:

- Reforming the EU's 'admission to trading' and publicity requirements, with the aim of achieving a single set of regulatory requirements for securities issuers. In particular, focus should be on inducing greater regulatory convergence to the way key requirements of the prospectus and transparency regimes are applied by national supervisors;
- Reforming the Prospectus Directive with the objective of reforming the disclosure requirements for SME's to make them more proportionate;
- Reform of the securitisation market, amending capital rules to promote securitisation activities by intermediaries and facilitating greater take up by end users and investors;
- Reforming the covered bond market to promote greater harmonisation;
- Driving regulatory convergence so as to promote cross-border activity in the corporate bond and equity markets.
- Delivering on the long-awaited Securities Law Legislation; and
- Reviewing the legal framework around venture capitalism, with the aim of growing this sector.

There are significant differences between the EU Bank Structural Reform proposals and the UK ring-fencing requirement, not least the inclusion of corporate deposit taking in the scope of 'core credit institutions'. Nevertheless, as noted above, many would argue that the European Commission has failed to prove the need for a structural reform at the EU level.

10. **Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?**

Retail banking customers have benefited both directly and indirectly from much of the regulatory reform agenda. For example, the Deposit Guarantee Schemes Directive substantially increases the protection available for covered deposits to £85,000, and is complemented by the introduction of depositor preference under the BRRD. Consumers also benefit indirectly from a more stable banking system. That being said, these changes do not come without a cost which, must inevitably manifest itself in lower levels of competition for deposits and lower levels of return.

Our overarching view in respect of regulation applicable to retail financial services, however, is that, in areas other than consumer protection, the interests of consumers are often best served through national legislation and that European level action must be firmly tested against the principles of proportionality and subsidiarity. These principles should hold good throughout the law-making process to ensure that amendments to legislation as it passes through the European Parliament do not bypass this important part of the process.

11. **How concerned should we be about the range of unintended consequences from such regulation – such as regulatory arbitrage and transferring risk off balance sheet?**

The unintended consequences of regulation should be a high-priority for policy makers. Below we focus on the impact regulatory change has had on the ability of banks to support market making activity on behalf of their clients.

Changes in regulation are impacting the ability of banks to make markets across a range of asset classes. We agree with the overall objective of the net stable funding ratio ('NSFR') to require banks to maintain a sustainable funding structure and to reduce funding risk over an extended time horizon. The calibration of this tool however is causing some concerns especially given the moves that banks have already made to improve the funding structure of their balance sheet. It may be argued that the changes might have a modest aggregate impact, however, in terms of specific business lines the impacts are very significant and may lead to a reduction in activity or even exits in certain important areas.

Overall we feel the effects of the NSFR will increase customer costs, see the funding market shift from banks to non-banks, reduce liquidity in fixed income markets with the potential for increased volatility and increase the costs of hedging thus again raising the cost of capital.

Significant increases in funding costs for equity market making as a result of stable funding requirements, will hinder the ability to offer many products, in particular where there is a use of derivatives markets to hedge market risk (for example total return swaps) the new regulations make these products largely uneconomic.

On OTC derivatives the changes to the credit valuation adjustment (CVA) capital charge has made a number of long dated derivatives markets uneconomic from a market makers perspective. This has meant a significant reduction in the duration of many banks' derivatives books. Given the need to ration the use of balance sheet and regulatory capital some have exited some of the less liquid or peripheral markets.

Recent research[20] shows that total trading assets of the largest 10 US and European banks have fallen by 17% from their peak back in 2010. In particular the rates business has been hit particularly hard with assets down by a third. The research goes on to show how under this new regime dealer balance sheets will be less able to function as safeguards of liquidity. In particular dealer balance sheets become less responsive to large selling on behalf of the buy side. The concern is that whilst this is not an issue under current market conditions should

[20] Credit Suisse (Downside of Prudential regulation: Lower liquidity May 2014)

markets come under stress we will see significant price moves and an explosion in volatility. In particular the incentives of non-bank providers of liquidity in these markets may not be aligned to support the provision of stabilising liquidity during times of market stress.

Additionally, we are concerned that the increased regulatory requirements are creating an environment which promotes a level of risk-aversity that potentially stifles innovation, to the detriment of consumers in the retail market. We recognise that there is a difficult balance to strike between protection and innovation; however, given that there is a reliance on competition in the market to drive good customer outcomes, we feel that it is an area that requires careful consideration by law makers[21].

The EU Single Rulebook and the consequences for the Single Market

12. **Is there now an effective balance between Member States and the EU in terms of regulation and supervision of the financial sector? If not, how can such an effective balance be struck?**

The financial crisis highlighted failings in both the detail and application of regulation and supervision for the European financial sector. As discussed above, important steps have been taken to address the failings in regulation and, whilst not without flaws, many of the underlying weaknesses have been addressed. The European crisis, however, demonstrated shortcomings in the application of the rules. National authorities applied rules differently resulting in divergent outcomes, the application of the capital framework being a prime example. The development of the European System of Financial Supervision is therefore to be welcomed as the ESA provide an important framework through which to deliver more consistent implementation via the Single Rulebook and robust implementation monitoring.

In terms of the balance between Member States and the EU, fundamentally, any assessment of the use of minimum and maximum harmonisation must focus on the underlying objective of the measure in question. Maximum harmonisation is justified where markets and consumers are cross-border and when differential rules would give rise to undesirable externalities. Minimum harmonisation is appropriate when supervisory judgement is required in the application of rules. The issues underlying current UK challenges before the CJEU are examples of where this balance has not been struck appropriately or where action is being taken at an inappropriate level – the application for the annulment of the EU Council Decision of 22nd January 2013 authorising enhanced cooperation in the area of the FTT being a prime example. That being said, we note that the UK has successfully negotiated flexibility to meet its desired policy outcomes even within the constraints of Regulations – the Capital Requirements Regulation being a prime example.

Finally, we note our continued support for the enhanced subsidiarity and proportionality protocol under the Lisbon Treaty, which provides a role for national Parliaments to challenge legislative proposals. It is encouraging that there are signs of national Parliaments beginning to make use of this provision but thought should be given to how the effectiveness of this process might be enhanced to improve the democratic accountability of the policy-making

[21] The Payment Services Regulator has a statutory requirement to consider innovation in the markets it regulates

process. We note the Dutch Government has been vocal on the importance of subsidiarity and has indicated it could be a focus for their Presidency of the EU Council in 2016.

13. Is the EU process for adopting rules efficient and nimble enough to adjust and calibrate the new Single Rulebook? Which single element of the new Rulebook is in most acute need of careful monitoring and review?

As is noted in our responses to questions 5 and 8, the Level 2 rulemaking process is constrained by a lack of flexibility and resource. This is particularly important when it comes to the equivalence of the Single Rulebook with the regulatory regimes in third countries since it relates to competitiveness. In particular, there is a need to grant the EU authorities the ability to apply targeted relief to regulatory requirements until such time as solutions to technical problems can be implemented.

14. What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to 'equivalence'? Is there a danger of 'multiple jeopardy' arising from the multiplicity of regulatory regimes across the EU and beyond?

There has been a shift in the EU's approach to third country access in the wake of the financial crisis. The result has been a less liberal approach than adopted in the past with the common EU approach based on the principles of equivalence and reciprocity. This has given rise to a number of instances of market uncertainty:

- EMIR Article 25 - which prohibits EU bank branches from clearing any product in central counterparties (CCPs) based outside the EU unless and until its home regulatory regime is assessed as "equivalent" by the European Commission and the CCP is recognised by ESMA;
- EMIR and trade reporting - Under EMIR, all derivative transactions must be reported to an authorised trade repository. These reports must be populated with detailed information specifying the type of trade, value of the trade and the name of the counterparty, amongst other requirements. Where an EU counterparty trades with a non-EU counterparty, in order to be compliant with EMIR, the EU entity must obtain information about that counterparty in order for it to complete its own trade report. Where the laws of the non-EU counterparty's jurisdiction prevents the sharing of that information however – such as in South Korea, where the sharing of such information with a non-South Korean entity is severely restricted – the EU entity will be unable to meet its EMIR reporting obligations without also breaking the law of that foreign jurisdiction. Asking firms to choose which law to break is untenable; in such instances, firms are withdrawing from dealing with those entities completely;
- CRA Regulation - there was a drawn out and uncertain process for third country equivalence assessments and ESMA recognition of third country ratings produced outside the EU, before banks could rely on ratings from the biggest agencies for calculation of their capital requirements; and
- Financial Benchmarks Regulation proposal - as currently drafted, the third country provisions would effectively prohibit EU financial firms from offering investors an S&P 500 tracker fund.

That being said, the complexity of negotiating third country access issues has increased significantly as jurisdictions have responded to the demands of the financial crisis with domestic legislation to govern activities conducted through global markets. The scale of the EU Single Market endows the European authorities with significant leverage in such negotiations, particularly with the US. We recommend that to maximise this advantage the EU should rely on a third country's law in lieu of EU requirements when the regulatory outcomes achieved are broadly comparable but not necessarily identical.

A specific retail-related example of 'multiple jeopardy' is the requirement to provide payment accounts with basic features to EU *residents*, as opposed to EU *nationals* in the Payment Accounts Directive.[22] This seemingly innocuous nuance in wording brings US citizens resident in the EU into the scope of the directive, requiring providers to account for FATCA regulations in their distribution processes

15. **In light of the fact that some of the regulatory framework applies at EU-28 level, and other elements for the eurozone only, is there a danger of a two-speed or inconsistent approach to regulation?**

It is important to note the two current parts of Banking Union relate principally to the *application* of rules within the Eurozone rather than representing an alternative regulatory approach. For example, the Single Resolution Mechanism Regulation is fundamentally concerned with the institutional structures for the application of the BRRD toolkit.

It is evident, however, that Banking Union will fundamentally alter the way the EU operates and there is a risk that there might be a divergence of interests between the 'ins' and the 'outs' and a consequential reduction in the UK's influence or attractiveness for Eurozone business. It is vital that the European Commission acts to protect the Single Market to ensure the Eurozone does not become a market within a market. The safeguards negotiated to the EBA decision-making process are very important in this regard.

It is particularly important to ensure that enhanced cooperation procedures are not used in a way that damages the Single Market and the rights of Member States under Articles 332 and 327 TFEU. The FTT is an example where these criteria have not been respected and the UK is fully justified in challenging the decision.

The implications for the UK

16. **What are the challenges of the regulatory reform agenda for non-eurozone Member States? In particular, which specific challenges does the UK face? How has its approach to the regulatory reform agenda compared with that of other non-**

[22] DIRECTIVE 2014/92/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 23 July 2014
on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features

eurozone Member States such as Sweden and Denmark, as well as those such as Poland who are required to join the Single Currency in due course?

Eurozone ins and outs

We believe that the deepening and further liberalisation of the Single Market will benefit stability and growth in the Eurozone as well as Member States outside the Eurozone. Any artificial division of Eurozone interests versus the interests of non-Eurozone countries ignores the powerful trade and financial links within the economy of the European Union. Currently we do not see a split between Eurozone ins and outs on most legislative issues – the dividing lines in the Council mostly cut through the Eurozone itself. However, as the Eurozone develops its institutional structure (which is perfectly justified), we see the risks for Eurozone Caucusing increasing:

- the Eurozone will reach qualified majority in the Council as of November 2014;
- the Ukraine crisis has increased the willingness of some new EU Member States to join the Eurozone, increasingly aligning their interests with the existing Eurozone members;
- a full-time Eurogroup president (if elected) may be driving discussions in the Eurogroup to cover more legislative areas; and
- the Banking Union may create a divergence of interests between Eurozone ins and outs – the location policy of the ECB being the first possible example of this.

It is vital, therefore, that the European Commission defends the Single Market. The UK Government should insist on the use of "community method" whenever possible, instead of intergovernmental agreements. If the use of intergovernmental agreements cannot be avoided, they should include clear provisions establishing the principle of equal treatment between participating and non-participating Member States.

Due to the high impact of the implementation of new EU laws it is of the utmost importance that more attention and resources are provided to both the European Banking Authority and European Securities and Markets Authority.

Capital markets union

Since the election of Jean-Claude Juncker to the post of European Commission President, there has been increasing discussion within European policy circles about the concept of a European Capital Markets Union ('CMU'). At present, the concept remains vague and ill-defined, with policy makers unclear on its meaning, and the European Commission yet to develop a coherent policy platform. Regardless, any proposal which deepens the Single Market should be looked at closely as it presents opportunities to deepen the Single Market. At the same time, it will be necessary to ensure there is no EU/Eurozone delineation.

17. **Overall, do you believe that the UK's interests have been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?**

It is debatable how different the substance of UK rules would be if they were purely a national competence. The UK has led much of the international regulatory reform agenda which has shaped the EU programme of reform. Even within the constraint of the European legislative process, the UK has managed to secure important flexibility to apply EU rules in a way that fits UK market structures or priorities. By way of example, we highlight the definition of default under the CRR (which permits the UK to continue to follow the existing approach of 180 days). It is, however, possible that there would be a difference in the timing of the implementation of international standards. Even in this regard, however, the UK has the option to front-run EU rules and has done so.

We have been encouraged by the engagement of the UK authorities in recent European negotiations and the willingness of the UK government to challenge inappropriate rules which disadvantage the UK national interest.

That being said, given the significance of financial services to the UK and the degree to which legislation is set at an EU level, there is an overwhelming case for the UK to devote further resource and expertise to engaging in the European process to increase the level of influence in priority areas. In particular, we believe there should be a significant increase in the number of UK officials appointed to the European institutions – particularly the European Commission and ESAs. A posting to the European institutions should be regarded as a key part of career development for UK officials.

30 September 2014

British Private Equity and Venture Capital Association–Written evidence (FRF0010)

Introduction

This response to the House of Lords EU Sub-Committee on Economic and Financial Affairs is made by the Regulatory Committee of the British Private Equity and Venture Capital Association (the "**BVCA**").

We have sought to prepare a response which makes a constructive and serious contribution to the debate about modernising, reforming and improving the regulatory framework surrounding financial services by explaining the impact of current EU rules on the UK's private equity and venture capital ("**PE/VC**") industry. The BVCA is generally supportive of the single market and our members (and the businesses they invest in) have experienced the benefits of this.

The BVCA is the industry body for the UK PE/VC industry. With a membership of over 500 firms, we represent the vast majority of all UK-based PE/VC firms and their advisers. Our members have invested £33bn in over 4,500 UK companies over the last five years. Companies backed by UK-based PE/VC firms employ over half a million people and 90 per cent of UK investments in 2012 were directed at small- and medium-sized businesses ("**SMEs**").

The UK PE/VC industry continues to be the largest in Europe. Data from the European Private Equity and Venture Capital Association (the "**EVCA**") shows that out of a total of €23.6bn raised in Europe in 2012, €13.5bn (that is, 57 per cent of the total amount) was raised by funds managed in the UK.

As this call for evidence is intended to help further the analysis of what EU regulation means for the UK national interest in the context of financial services, this response has been prepared by the BVCA as opposed to the pan-European PE-VC industry association, the EVCA, which aims to improve the understanding of the industry's activities and its importance to the European economy as a whole.

We set out below answers to the call for evidence which we consider are of particular relevance to the UK PE/VC industry or in respect of which we consider that we have sufficient information and evidence to provide a contribution to the current debate.

HOUSE OF LORDS EUROPEAN UNION COMMITTEE

EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE (SUB-COMMITTEE A)

INQUIRY INTO THE EU FINANCIAL REGULATORY FRAMEWORK

1. In order to focus our response appropriately, our submission does not set out a comprehensive analysis of how all EU financial services rules have affected our members. Instead, it takes two recent legislative developments – the Alternative Investment Fund Managers Directive (the "**AIFMD**" or the "**Directive**") and CRD IV (the prudential regulation package comprising the Capital Requirements Directive and the Capital Requirements Regulation) – and uses those to illustrate the impact which EU financial services rules can have on PE/VC firms.

Topic 1: Broad assessment of the EU regulatory framework

Volume

2. The volume of EU financial services legislation that has been developed/published/come into effect in the last 18 months has caused major difficulties for PE/VC firms. It has also caused difficulties for regulators in terms of their ability to implement on time, but the principal difficulty has been for firms because whilst the regulators only have to implement the law, firms have to comply with it. When the pressures on regulators mean that they are not able to publish their own implementation proposals until late in the day, it is the firms which bear the burden of a compressed timeframe.

3. **We consider that many recent EU financial services rules are not proportionate in either their focus or their application.** This is in part because of the 'one-size-fits-all' approach often taken by EU policy- and rule-makers, where the bar is set at the highest possible level in most cases. This results in standards which are often not only inappropriate but also provide little room for realistic implementation by firms.

Proportionality

4. The constant drive to set regulatory standards for non-banks to the standards required of banks, or in the case of the AIFMD to force a regime based on funds directed at retail investors onto firms which manage funds for professional investors, seems inappropriate, unnecessary and representative of an approach which does not take account of the risks which different sectors of the financial services industry pose to broader financial stability.

5. The AIFMD is one example of where EU financial services rules are not proportionate in their focus. EU policy- and rule-makers did not have a sufficient understanding of the industry which they were seeking to regulate before embarking upon the Directive's development. This lack of understanding has resulted in an overly blunt legislative framework which focuses on the wrong issues and/or tries to regulate many firms in the wrong way. Such firms have been forced to focus on and implement measures which will neither afford any increase in investor protection (as acknowledged by many investors) nor make any meaningful contribution to financial stability.

Impact

6. On an aggregate basis, we consider that the single market in financial services enables investment firms to operate in multiple EU Member States should they wish to do so. This contributes to the achievement of certain objectives, particularly growth and competitiveness. Without the single market in financial services we believe that the provision of financial services to clients in other EU Member States would, in some cases, be harder and, in other cases, be impossible. In the absence of those rules, only banks and very large investment firms, which could afford to establish subsidiaries, would likely be able to operate in large parts of the EU.

7. However, we would note that in some cases the opposite is true: **some EU rules have made it harder for investment firms to provide financial services to clients in other EU Member States and, in our view, provide no discernible benefit.** This can happen particularly when EU financial services rules do not take into account fundamental differences between Member States (e.g. the extent and nature of private pension provision) and between provision of services to different customers (e.g. public versus private equity). Examples of this are the initial plans to develop Solvency II-type rules for pension funds and the extension of UCITS-type rules to private company investments through the AIFMD.

Legislative process:

8. **We are concerned that the EU policy-making process for developing financial services legislation is not always effective and accountable, in part because consultations and impact assessments carried out by EU institutions and regulatory bodies are often insufficient.**

9. In the context of the AIFMD – a piece of legislation with far reaching and significant consequences – the initial proposal emerged as part of a suite of measures developed in great haste following the financial crisis and no specific pre-consultation was carried out. As a result of this the Directive is in many places ill-focused and difficult for firms to apply in practice. Many provisions have been poorly thought through, drafted in ambiguous and unclear ways and certain key concepts have been left undefined and open to interpretation.

10. Where formal consultations relating to the AIFMD have subsequently been undertaken they have often been conducted in haste with only very short windows for stakeholders to respond. This is particularly an issue where, for instance, the European Securities and Markets Authority ("**ESMA**") is required to consult within unrealistically short timelines set by the Commission. Such an approach to consultation undermines the effectiveness and accountability of the EU policy-making process and damages the confidence of financial services firms in the EU rule-making process.

11. In addition, when key stakeholders have sought to assist the EU authorities in developing regulation which would reflect the way in which the financial services industry functions in practice, EU authorities have often been unwilling to engage. We are aware that representatives of the professional investor community found it difficult to engage in constructive discussions with the EU authorities about the AIFMD.

The European Supervisory Authorities (ESAs):

12. Overall, whilst we consider that there is certainly a role for the ESAs to play in the context of promoting and, where necessary, mediating/enforcing consistency of application of regulatory standards amongst national Member State regulators, this should not be without prejudice to the ability of national competent authorities to exercise their oversight and supervisory responsibilities.

13. In addition, in order that the ESAs do not have an adverse effect on financial services firms they should have adequate resources, benefit from sufficient time to carry out consultations and impact assessments and be subject to a clear and transparent governance structure where they are clearly accountable for their actions.

14. **It is vital that ESAs do not have the ability to introduce through guidance and technical standards legislative provisions which were rejected during Level 1 negotiations.** For example, the European Securities and Markets Authority ("**ESMA**") AIFMD Remuneration Guidelines apply the remuneration rules to delegates, a concept not provided for in the Level 1 Directive. If confidence in ESMA is not to be undermined it is vital that it is subject to proper constitutional arrangements and does not have the ability to legislate 'through the back door'. Its apparent ability to do so seriously undermines regulatory certainty and means that firms cannot be sure that the position set out in Level 1 or Level 2 materials will be the final position.

Topic 2: Interconnections, overlaps and gaps in the EU regulatory agenda

Interconnections

15. The CRD IV (the prudential regulation package comprising the Capital Requirements Directive and the Capital Requirements Regulation) reporting requirements encapsulate one of our fundamental concerns about the current approach to EU level financial services legislation, namely the regular cross-contamination of requirements between non-comparable sectors of the financial services industry. They are clearly appropriate for banks given the systemic risks which they pose to European financial stability, but are wholly inappropriate in the context of the PE/VC industry. The failure of much EU level financial services legislation to differentiate appropriately between different sectors means that firms are often significantly affected for no discernible reason.

16. Whilst not all PE/VC firms will be caught by CRD IV, those that are caught will be required to implement measures to undertake extensive reporting (COREP and FINREP). Such firms will be required to make significant investment in the necessary software in order to meet these reporting requirements, the cost of which appears to be wholly disproportionate to the value which will be derived from such additional reporting. Not only are affected firms concerned about the cost such reporting will entail, but also about the ongoing uncertainties as regards what must be reported and the risk of being deemed non-compliant. Firms' concerns are compounded by frustrations caused by a failure to understand what the FCA (and other EU competent authorities) will do with the additional level of information received.

Overlaps

17. A clear example of overlaps in the regulatory framework occurs when a fund and/or its manager is listed on an EU market and regulated under the AIFMD. Those entities which are listed in the UK are already subject to: the FCA's Listing Rules for the purposes of Part VI of the Financial Services and Markets Act 2000; the FCA's Disclosure and Transparency Rules, and the FRC's UK Corporate Governance Code. As well as the additional compliance burden placed on entities affected, there could be scenarios where the differing sets of requirements do not fit well together or are unduly complex, for example when looking at the governance arrangements of a regulated, unlisted manager and its listed funds.

Unintended consequences of regulation:

18. Overly stringent EU financial services rules can result in the clearly unintended consequence of hindering growth and/or driving financial services business out of the EU entirely. **We consider there to be a very real risk that inappropriate regulation will cause PE/VC firms to consider the cost/benefit of having a European presence from which to operate globally.** The result may well be that firms have a smaller European presence and operate their global (non-EU) business from elsewhere, raising funds from investors in non-EU jurisdictions and managing them from outside the EU, thereby causing significant harm to the EU's overall growth and financial stability. The less that PE/VC firms are based in the EU and raise money from EU investors the less incentive for them to invest in EU companies.

Topic 3: The EU Single Rulebook and the consequences for the Single Market

Subsidiarity:

19. **We consider that the balance of supervisory powers and responsibilities is arguably misaligned at present and that a better balance should perhaps be struck between the EU and national levels**.

20. We understand that the principle of subsidiarity is concerned with determining the level of intervention that is most relevant in the areas of competences shared between the EU and the Member States and that the EU may intervene only if it is able to act more effectively than individual Member States. Whilst we are not well placed to analyse from a legal perspective whether EU financial services rules respect this principle, from a practical perspective we believe that in a number of areas EU legislation could be more effective than individual Member States acting alone, but only if the relevant legislation were properly consulted upon, developed and implemented (see *Legislative Process* above).

21. In the context of the AIFMD, for instance, one of the key benefits of developing the rules at an EU level could have been the availability of the cross-border management and marketing passports but, because the rules are fundamentally unclear in this area and widely varying approaches have been taken by Member States to the interpretation of the relevant rules, they are rendered much less useful.

22. The UK, for instance, considers that "marketing" under the AIFMD does not begin until a fairly late stage (i.e. 'pre-marketing' or 'soft' marketing does not constitute "marketing")

and a UK AIFM cannot apply for the marketing passport until the relevant documentation is in "materially final form". Certain other Member States consider that 'pre-marketing' or 'soft' marketing does constitute "marketing" under the AIFMD and will only allow non-domestic firms to conduct such activities if they have the benefit of the marketing passport. UK firms are therefore in an impossible position – they require the marketing passport in some jurisdictions before the point in time at which they can apply to the FCA for it.

Third-country access:

23. Whilst the AIFMD creates a third country regime it is too early to say whether this will affect the ability of UK firms to market their funds in third countries. As a general comment it is important that the EU's approach to Third Country issues does not give rise to the risk of "retaliation", with third countries adopting an approach which restricts EU firms. For example, EU PE/VC firms raise a significant proportion of their funds from investors in jurisdictions outside the EU. If their ability to access these investors is restricted, the funds available for investment in Europe may significantly decrease. We would encourage the UK to continue its support of a constructive approach to third country issues and to build a wider understanding within Europe of the importance of such an approach to the EU generally.

Topic 4: The implications for the UK

Impact of regulatory shift to EU level:

24. **From the perspective of a UK PE/VC firm, the short-term impact of the shift towards regulation and supervision at the EU level has been: (i) increased complexity of regulation and two levels of iterative and changing guidance (at the EU and the national level); (ii) longer periods of greater uncertainty as to regulatory outcomes; and (iii) shorter timeframes for firms to comply with resulting regulation (such as the AIFMD). This has resulted in increased costs, both in terms of direct costs (such as legal and other advisory fees) and indirect costs (such as opportunity cost and delays to new business).**

25. In the longer term, the stated aims of harmonisation of EU Member States' regulatory regimes and the reduction of restrictions on cross-border flows of capital and financial services products should in theory lead to increased competition, reduced barriers to market entry, more accessible capital within the EU and be of benefit to firms, investors and consumers. However, these aims will only be achieved if our concerns about the legislative process set out elsewhere in this response can be addressed.

UK influence:

26. Given that critical elements of EU financial services legislation are developed and made without any public visibility of the underlying process, it is frequently unclear how the final version of the relevant text has been reached. We are therefore not aware of the extent of the UK's level of influence during these critical discussions. For example, after the draft AIFMD was published for consultation a further provision was inserted imposing restrictions on the activities which could be carried out by an AIFM in addition

to fund management. We do not know how this provision came to be inserted, but it has caused a number of firms to have to undertake expensive corporate restructuring. We believe it appeared almost overnight in discussions which took place between Member States. All that the UK authorities could do in the circumstances was make a few hurried calls to UK stakeholders to try to assess the implications of the provision. **This is not a satisfactory way for legislation which fundamentally affects a firm's business to be made, and it is not clear to us that the UK had any real opportunity to debate the issue.**

27. We would fully support HM Treasury and the FCA in seeking to ensure that they have the appropriate level of influence in formal EU-rule making procedures, particularly given the importance of the financial services sector to the UK economy. We are aware that HM Treasury has undertaken initiatives to achieve this, but this work needs to be developed to ensure that the UK has an appropriate level of influence, just as other Member States have sought to ensure that this is the case for them in respect of industries which are important to their national economies.

28. In the absence of sole responsibility for the rules we consider that it would be helpful if HM Treasury and the FCA could do more to assist firms by providing their interpretation of EU financial services rules, as they do in respect of UK legislation. This need not be a binding view but some guidance as to their approach to interpreting EU legislation would help firms in determining how to comply. There are some areas in which the FCA has publicly stated that it disagrees with views expressed by the Commission (such as in relation to the passporting of MiFID 'top-up' activities under the AIFMD). It has been helpful for firms to know the FCA view and we would encourage the FCA to publicise its views on interpretation issues relating to EU financial services rules in a greater number of cases.

30 September 2014

British Property Federation–Written evidence (FRF008)

Introduction

1. The British Property Federation (**BPF**) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses, comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry, including law firms, surveyors and consultants.

2. We welcome the Committee's call for evidence in this area and the opportunity to comment on the issues it raises.

General comments

3. The recent crisis exposed the vulnerability in the financial system to insufficient regulatory oversight and a failure by market participants to appropriately price risk. The reaction of policymakers – to swiftly impose corrective measures to mitigate the chances and severity of future crises – is entirely understandable; although in our view those measures were introduced at precisely the wrong time in the economic cycle.

4. We do not disagree with the need to correct failures in the regulatory system or to amend the behaviour of market participants. Neither do we disagree with the need for a sensible regulatory framework at the European level to address the risks arising from the increasing interconnectedness and complexity of the financial sector across EU member states.

5. However, the links between the financial sector and the rest of the economy are deep and often not well understood. In our view the post crisis regulatory response failed to sufficiently consider these links and the knock on impacts of financial sector regulation on other parts of the economy.

6. Indeed, the recent wave of regulation may well have acted pro-cyclically to exacerbate the length and depth of the recession by making the environment in which the financial sector operates even more uncertain and inhibiting its utility to the real economy. At its best, financial sector regulation should act counter-cyclically. It should be reinforced during cycle upturns in order to mitigate 'frothiness' in asset markets and relaxed during cycle downturns - when the sources of finance are constrained – so as to support the real economy.

7. The measures adopted should increase the information that regulators have available to them regarding developments in financial markets, which should in turn facilitate better calibration of future regulatory intervention; all positive stuff. However, ultimately only time will tell how effective the new regulatory architecture is at identifying and dealing with build ups of risk. It is currently far too early in the economic cycle to accurately judge this.

Responses to call for evidence questions

Q5: How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

8. When measured purely by the quantity of EU financial sector regulation produced over the past five years it could be argued that the legislative process has been very effective indeed! However, we have some very real concerns about the quality of that regulation and the thoroughness of the process by which it was prepared.

9. Intense political pressure to act following the crisis meant that policymakers often had to work to very tight timescales, which did not favour detailed consideration of potential unintended consequences and did not in all cases allow sufficient time for rigorous impact assessment.

10. The negative effects of this hurried approach to regulation were compounded by the high level of staff turnover at European institutions (the Commission in particular but also ESMA and EIOPA). This lack of consistency of personnel made it practically impossible to establish long-term constructive relationships with officials and prevented the build-up of institutional knowledge.

11. That in turn resulted in officials having a poor understanding of how different parts of the financial sector (let alone the real economy) fit together. Without such knowledge and understanding of the 'bigger picture' the result was regulation not well-tailored to those to whom it is intended to apply and which does not support the real economy.

12. One example of this is the Alternative Investment Fund Managers Directive (AIFMD), which was designed very much with hedge funds in mind and whose requirements apply awkwardly to real estate funds, whose business model and investment and risk management processes are very different. It was only after extensive engagement with EU and UK policymakers that some sort of clarity was obtained on issues like the role of the depository – fairly straightforward in a hedge fund context – in a real estate fund.

13. A further example of inadequate market understanding leading to poor regulation is the European Market Infrastructure Regulation (EMIR). EMIR was introduced in order to provide additional visibility to regulators on activity in the OTC derivative market and to ensure that where derivatives are used for speculative purposes they are adequately collateralised.

14. In setting the scope of EMIR policymakers divided the world into 'financial' and 'non-financial' counterparties, the former being subject to more onerous requirements than the latter. Financial counterparties were identified by reference to a number of other pieces of EU regulation, including the AIFMD (such that AIFs and AIFMs are considered financial).

15. That division completely disregards the fact that certain financial counterparties (such as real estate funds) overwhelmingly use derivatives for hedging commercial risks (such as

the risk that interest rates increase) rather than for speculative purposes. By requiring such derivatives to be centrally cleared and margined, thereby making them more expensive, EMIR could make traditional hedging (carried out for prudent business reasons) unviable for some real estate funds, forcing them to either accept higher levels of risk or to hedge less efficiently.

Q7: Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?

16. The approach taken in EMIR to identifying financial and non-financial counterparties is in our view inappropriate as it ignores the reasons why businesses use derivatives, focusing instead purely on whether a business is otherwise covered by financial regulation. Identifying financial counterparties by reference to other pieces of EU legislation is arguably dangerous, as that separate legislation will have been designed with a particular objective in mind and it may not be appropriate to 'borrow' it for other purposes.

17. For instance, the definition of 'AIF' in the AIFMD was designed to identify certain types of collective investment vehicle. It does not necessarily follow that all of these collective investment vehicles use derivatives for speculative purposes or even that they are genuinely 'financial' businesses. Owning, managing and developing real estate is often a 'hands-on' activity that tangibly facilitates the carrying on of economic activity such as retail or manufacturing. The regulatory treatment of real estate businesses should therefore reflect that operational essence.

18. The AIFMD/EMIR combination is the one that has generated the most significant costs for real estate businesses. Much of this cost is likely to relate to initial implementation and will tail off over time. However, both pieces of regulation entail ongoing costs – such as the appointment of a depository or the reporting of derivative trades – for (as yet) little appreciable benefit to the business or its investors.

19. By way of illustration, one of our members – a medium-sized real estate fund manager – reports having incurred £100k in legal fees to obtain AIFMD authorisation and a further £150k in annual depository and additional legal fees. They are further required to maintain three months' overheads (c. £2m) in cash in an inefficient on-demand facility.

20. With regards to EMIR, the potential impact the daily clearing obligations could have on smaller entities classified as financial counterparties if they were applied to interest rate swaps would be significant. The cash requirements and administrative burden would effectively mean some smaller property funds would not be able to use interest rate swaps, which would limit their options for mitigating interest rate exposure. Moreover, if these obligations were to apply to all current swaps (i.e. no grandfathering provision) then there is the additional cost of having to break the existing swaps if the use of them is not sustainable.

21. More generally, EMIR places reporting requirements on all users of derivatives, with no de minimis limits on size of transactions or counterparts. In particular it covers inter-company transactions for non-financial parties, not just transactions with the financial markets, and also obligates entities to self-report where financial counterparties do not

offer a delegated reporting service. The cost to report this large quantity of data is borne by the real economy, with no appreciable benefit to financial market regulators. Our view is that the burden of recent regulation is being disproportionately borne (in terms of cost and time) by small/ medium sized companies.

22. EMIR implementation has also been a fraught process, with numerous teething problems reported by Central Counterparties and Trade Repositories (TRs). In particular, the quality of data held by TRs on derivative trades is frequently incorrect; a breach of the rules for which the OTC counterparty is technically liable, even though the counterparty can have little oversight over how information on a trade is reported to the TR.

Q8: Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?

23. There should absolutely be a period of calm before further reforms are introduced. The volume of recent financial regulation and the speed of its introduction are unparalleled and it would be most unwise to subject it to extensive reform before people have had the chance to get used to it. We note that many of the recent measures have in-built reviews/evaluations to take place a certain number of years after implementation.

Q11: How concerned should we be about the range of unintended consequences from such regulation – such as regulatory arbitrage and transferring risk off balance sheet?

24. Our main concern here is that the increased cost of complying with regulation is likely to require real estate funds and their managers to accumulate a certain scale if they are to be economically viable. In other words, regulatory requirements may make it uneconomical to operate funds of under a certain size, raising barriers to entry which restrict the amount of competition and choice in the market. They will also inhibit the emergence of new and innovative managers (the SME part of the real estate fund management sector) as only large investment houses will have the financial and technical wherewithal to navigate the new regime.

25. The increased cost of compliance has also resulted in a number of firms expending considerable effort to try and remain outside of the regulatory perimeter. Whilst the temptation may be to dismiss such actors as irresponsible avoiders, the truth is that many of these are perfectly responsible businesses for whom the demands of post-crisis legislation are too much to bear. We are not convinced that the policymaking process devoted sufficient time to considering the costs for businesses.

Q14: What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to 'equivalence'? Is there a danger of 'multiple jeopardy' arising from the multiplicity of regulatory regimes across the EU and beyond?

26. While there have been some efforts to co-ordinate or harmonise regulatory responses to the financial crisis (for instance at the G-20 level), this has not really been achieved in

practice with the result that regulatory initiatives often partially – but not entirely – overlap.

27. For instance, while the US and the EU have implemented broadly similar requirements regarding OTC derivatives, there are plenty of differences at a detailed level. As a result of these differences, businesses operating across boundaries now need to dedicate greater resources to compliance than ever before, detracting resource away from their principal activities.

28. Differences of interpretation can exist even within supposedly single jurisdictions such as the EU. We understand that certain aspects of the AIFMD (such as the depository rules or the fund marketing conditions) are being applied differently across member states. The Directive itself has also been implemented at different speeds across the EU. This all adds to the complexity faced by businesses and also creates scope for regulatory arbitrage. That said, we are supportive of national regulators in the EU having a certain degree of latitude in interpreting areas of EU legislation that are unclear.

29. We remain at your disposal should you wish to discuss any of the above in more detail.

29 September 2014

Building Societies Association–Written evidence (FRF0004)

1. The Building Societies Association (BSA) is pleased to provide the Committee's Inquiry with a short submission focusing on a limited number of topics drawn from the Call for Evidence that are directly relevant to our members and their experience of EU financial regulation in practice.

2. The Building Societies Association (BSA) represents all 44 UK building societies. Building societies have total assets of over £325 billion and, together with their subsidiaries, hold residential mortgages of over £240 billion, 19% of the total outstanding in the UK. They hold nearly £240 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for about 28% of all cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,600 branches.

3. BSA members at present operate primarily, and in most cases exclusively, within the UK. However, all BSA members are for EU purposes credit institutions, and as such have been uniformly subject to the increasing volume of EU banking legislation ever since the First Banking Coordination Directive in 1977. The BSA is pleased to be associated with the European Association of Cooperative Banks and works with EACB and its other members on EU matters.

Broad assessment of EU regulatory framework

4. Our members' concentration on personal savings and mortgages means they, and we, do not encounter the full spectrum of EU financial regulation in day to day business. The principal items of post-crisis EU legislation that have directly impacted (or are likely to impact) our members are: the "CRD 4" package – the Capital Requirements Regulation and revised Directive, the Mortgage Credit Directive (MCD), the amended Deposit Guarantee Schemes Directive (DGSD), the Bank Recovery and Resolution Directive (BRRD), the European Market Infrastructure Regulation (EMIR), the Payment Services Directive (PSD) and PSD 2, the Payment Accounts Directive (PAD) and the 4th Money Laundering Directive (MLD 4).

5. Our first general observation is that the scope of EU competences in financial regulation has grown significantly, while the scope for independent national decision making on regulatory matters has correspondingly shrunk. And although many of these key measures have been designed to stabilise the financial sector and protect consumers, they are still being implemented through the vehicle of single market legislation, with some indications of confused thinking at various EU levels as to what the actual priorities are, and loss of both subsidiarity and proportionality along the way. We comment on this below.

6. Post-crisis EU legislation addressing financial stability (primarily CRD 4, DGSD, BRRD and EMIR) cannot be viewed in isolation from international agreements, as typically the initiative starts in an international forum – the G-20, Financial Stability Forum, the Basel

Committee or IOSCO – and a broadly agreed framework is then implemented in the EU by legislation. But the focus of international accords is on large, internationally-active (universal or investment) banks – and these accords or frameworks are not designed for application to small domestic institutions. Once implemented in the EU through single market legislation, applying to all credit institutions, there is an immediate loss of proportionality unless this is simultaneously written in to the Level 1 text. There have been some recent, and welcome, moves towards explicit proportionality in Level 1 texts – for instance Article 4 of BRRD. But CRD 4 generally lacks such proportionality, and in the absence of explicit authority in the Level 1 text, it then proves impossible for the EBA to bring in sensible proportionality when drafting the Level 2 Technical Standards. This became evident during an otherwise excellent all-day workshop on proportionality at the EBA on 22 October 2013, in which the BSA was pleased to participate. We welcome and support the EBA's genuine desire to act proportionately, and regret that this has been frustrated in so many instances by an absence of proportionality in Level 1 texts.

7. We also welcome the greater recognition afforded to mutual and cooperative banking in the EU, corresponding to its importance and market share in both personal and small business markets. Unlike the UK, the rest of Europe manages to avoid the trap of assuming that the PLC model is the desirable norm, and anything else, especially mutuals, are aberrations. Instead, as we evidence below in relation to CRD 4, the EU generally succeeds in giving mutual and cooperative models parity of esteem with the proprietary company.

Interconnections, overlaps and gaps in the EU regulatory agenda

8. As the first wave of post-crisis financial stability reforms (particularly CRD 4, BRRD and EMIR) take effect, the regulatory appetite for further measures seems to remain undiminished – even though it will be difficult, if not impossible, to distinguish the incremental effect of new measures (and so, whether or not they are justified) from the concurrent effect of measures already enacted but phased-in over several years – such as the increased capital requirements under CRD 4. Nor are there any clear answers to whether, and when, the cumulative policy cost of these financial stability measures pass the "tipping point" where they become a greater burden than the problems they are intended to remedy. The BSA has previously called for a period of stability, reflection, assessment and recalibration before further prudential measures are introduced. We are pleased that the Committee is focusing on this question.

9. The Commission proposals on Bank Structural Reform also create uncertainty and risk of disruption in the UK, as the ICB's ring fencing recommendations, enacted in the latest Banking Reform Act, start to be implemented. Although the Commission proposal includes a derogation designed (inter alia) to permit the UK to continue with its ring fencing and not to have to change to the different EU separation model, there is now significant doubt in the highest EU legal circles as to whether this derogation is compatible with the Treaty basis of the proposal, and if not, is therefore illegal. The absence of this derogation could lead to wasted costs and effort. Building societies are carved out of the UK ring fencing regime, but could be both directly, and indirectly, impacted if the EU proposals proceed without a satisfactory derogation for the UK.

The EU single rulebook and the consequences for member states

10. The Single Market represents a trade-off, for member states, and for individual firms, between market access, and imposed uniformity / loss of local control. But that trade-off will work differently for different member states, and for different types of financial firms. For major banks or investment firms with significant operations across the EU, market access is paramount, and uniformity will also be beneficial. For essentially domestic institutions, such as BSA members, market access to other member states is less important, or unimportant, but the imposed uniformity can prove costly and burdensome. We give some practical examples of the disadvantages that can arise from the single market inspired uniformity in the CARRP.

11. First, the harmonisation of pre-contractual disclosure through the ESIS[23] under MCD has been taken much too far. The UK's existing KFI[24] is a well-established and recognised consumer document, providing entirely adequate content and protection, but under MCD rules it will be displaced. Instead, the ESIS will unnecessarily prescribe both content and layout, with no scope for sensible national derogations or specificities – and with no consumer benefit for the UK, only avoidable costs and upheaval. Other poor outcomes from MCD include the 7-day reflection period – entirely unnecessary at the point in the UK mortgage process where MCD requires it – and the worst case interest rate scenario, which will only serve to confuse.

12. Perhaps the clearest recent example of bad outcomes for UK from the EU process – through failure to respect, and build in, either subsidiarity or proportionality in the Level 1 text – is the imposition of harmonised regulatory reporting under CRD 4, known as COREP. Especially at the level of smaller deposit-takers, such as many BSA members, COREP has imposed a colossal burden and very substantial costs (as confirmed by the PRA's own estimates[25], which give alternative costs for building societies only, on two different methodologies, of £189 million and £278 million), but to no apparent benefit – PRA does not intend to make much use of COREP outputs, but instead will impose its own entirely separate prudential reporting regime. So the effort and resource involved in COREP reporting appears largely unproductive and wasted.

13. Another error we identify, with hindsight, was applying the requirement for centralised clearing of over the counter derivatives under EMIR to the smallest financial counterparties, where non-financial counterparties doing comparable amounts of OTC business are not covered. This leaves small building societies with uneconomic volumes of derivative clearing business, which are not attractive to mainstream providers of CCP clearing services, and therefore struggling to find clearing services at reasonable cost.

14. On the positive side, we would cite two instances where the EU process has led, or is likely to lead, to better outcomes for our members than would otherwise have been the case. First, regarding definition of capital. The Basel 3 Agreement addresses the situation of mutual and cooperative banks (which clearly cannot issue PLC-type ordinary shares) in a dismissive footnote. The Capital Requirements Regulation by contrasts fully respects

[23] European Standardised Information Sheet
[24] Key Facts Illustration
[25] See PRA's CP 5/13, pages 56-7. The estimates for the whole banking and investment sectors range from £ 1.7 billion to £ 3.1 billion.

the specificities of the mutual and cooperative models in relation to capital in two crucial articles (Arts 27 and 29) modifies the criteria for CET 1 capital for application to mutual and cooperative banks. As a direct consequence of this, our member societies can now issue a new model of fully mutual CET 1 instrument– core capital deferred shares – successfully pioneered by Nationwide BS in December 2013.

15. Another positive from the EU process is on the leverage ratio, where at the insistence of the European Parliament, the text of CRR explicitly calls for a differentiation by riskiness of business model in any final leverage ratio requirement, to cater for models based on a low risk asset class such as building societies and their equivalents across the EU. On this issue, we regard the EU approach as wiser and likely to provide better outcomes than the UK-only initiative undertaken by the FPC.

The implications for the UK

16. The UK's difficulty is that while its financial sector is far and away the most important in the EU, its formal decision-making power, being related to member-state population, and constrained by qualified majority voting, is quite weak. With its advanced regulatory culture, the UK has undoubtedly exercised a lot of soft power, but we suspect this is waning. In future, and notwithstanding the formal safeguards in place, the UK risks being further marginalised in the Council and within the EBA by the emergence of the Eurozone plus banking union bloc. The UK's influence in the EP - again, where previous examples of soft power (chairmanship of the key ECON committee) can be cited – is also on the wane. To set against this, however, is the extremely welcome recent development that a UK Commissioner has been designated to take charge of the new financial services directorate-general split off from the old DG – Internal Market. We look forward to this change helping to remedy some of the problems identified above.

17. The practicalities for UK firms and trade associations in influencing EU legislation are also more challenging – advocacy at EU level, mostly in Brussels, is less straightforward and more resource-intensive. It is almost essential for a UK trade association like the BSA to work through an EU-level trade body to obtain sufficient access, influence and leverage.

18. The BSA supports the Government's decision to stay out of the banking union, and opposition to any mutualisation of either deposit guarantee or resolution funds. Moreover, by staying out of the banking union and the SRM, the UK has preserved its freedom of manoeuvre to use alternative financing arrangements under BRRD. However, the development of the banking union, will, almost certainly, and notwithstanding the negotiated safeguards, contribute to further marginalisation of the UK in EU-28 financial services matters as the effective dominance of the Eurozone-based banking union caucus becomes clear.

17 September 2014

Lord Butler of Brockwell- Written evidence (FRF0027)

Submission to the Inquiry of the House of Lords European Union Sub-Committee on Economic and Financial Affairs into the EU Financial Regulatory Framework

Summary

The House of Lords Committee published in July 2012 a report titled "MiFID II: Getting it right for the City and EU Financial Services Industries", which highlighted that "MiFID II proposals [had] been rushed and [risked] creating confusion rather than providing clarity in terms of the regulatory framework for investment". Two and half years later, ESMA will issue its recommendations for level 2 regulation on MiFID II/ MiFIR to the European Commission. The current consultation process is very important to ensure this new important regulation is effective, while not harming the UK and EU financial services industry. In this context, a number of proposals require attention. In particular, dispositions relative to investment research could potentially be very damaging to the investment and capital markets industries. This paper outlines the serious consequences an application of the current proposals would have and suggest a workable, less disruptive alternative. I declare an interest as an Adviser to TT International, one of the London investment houses which would be adversely affected by the present proposals.

ESMA proposals to change the mechanism by which European Asset Managers can charge their clients for research purchased on their behalf would put EU asset management companies at a significant disadvantage with respect to their competitors in Switzerland and elsewhere in the world including the US.

In 2004, a similar proposal put forward by Lord Myners, which affected the UK alone, was largely withdrawn after the unintended negative impact on the UK asset management industry became appreciated. The mechanism that was introduced at the time to use commissions to pay for research has worked well since its introduction although the recent findings from the FCA suggest that some abuse has been occurring. Proposals detailed below would prevent such potential abuse and provide the right regulatory framework to control the use of dealing commissions.

Background

ESMA in its MiFID II consultation paper (dated 22 May 2014, responses received by 1 August) introduces severe restrictions on "inducements" an investment manager could receive from a broker, and includes research services in this framework. From this consultation, ESMA will draft its technical recommendation to the European Commission by the end of this year, for application in January 2017.

In addition, the FCA has published various papers since October 2013 that highlight a perceived potential conflict of interest in the joint provision of execution and research by brokers. In June 2014, it has clarified the rules for the Commission Sharing Arrangements (CSA) mechanism in place in the UK. CSA arrangements allow asset managers to allocate part of the commissions they pay on trading to pay for research. Then, in July 2014, it launched its own consultation (responses to be received by 10 October), which refers to ESMA's proposal to suggest a full "unbundling" of execution and research services at a Pan-European level.

Trade bodies, law firms and professional associations have responded to the ESMA consultation, which collectively counter ESMA/FCA's argument that research is an "inducement". They also point out the competition distortion these measures would create. Similar responses have been provided to the FCA paper.

ESMA's Position

ESMA believes that for the protection of European investors, it is its role to ensure investment managers comply with best execution, and are not subject to undue influence and inducements from brokers. To implement its inducement ban, ESMA states investment managers should only be allowed to accept "minor non-monetary benefits" of which it proposes an exhaustive (but short) list including product marketing collateral, product training and "hospitality of a reasonable de minimis value". Provision of research services is considered a non-minor non-monetary benefit and is therefore deemed banned.

FCA Position

The FCA has expressed several times its concerns that the current CSA system creates a risk of excessive proximity between investment managers and brokers, "scratching each other's back" at the client's expense. In particular, it fears investment managers will be less diligent in their control of research spending since it is not their own money that is used. ESMA's drafting of MiFID II regulation offers the opportunity to go for full unbundling on a Pan-European basis, which the FCA sees as the purest way to avoid the above conflict of interest.

The FCA has correctly identified the risk of commission being spent in a profligate way but provides a disproportionate answer. A tightened application of the current Commission Sharing Agreements ("CSA") system would provide an adequate answer while the suggested unbundling option would have dramatic consequences for the UK investment management industry and would create major distortions of competition.

Research is not an inducement. It is a product the investment manager requires in order to make informed investment decisions in the management of client portfolios. It is to the ultimate benefit of clients (unlike hospitality which curiously is not deprecated). It should therefore be dropped from the list of banned inducements.

ESMA's own "Securities and Markets Stakeholder Group" states that this intended ban is "typical of the kind of rules whose consequences cannot be foreseen but which clearly will destabilise the economics of the asset management industry without bringing any benefit to the final investors" and "urges ESMA to reconsider their stance by deleting the paragraph relating to investment research". Similarly, the IMA "does not support ESMA's proposals. Research associated with the use of dealing commissions is not an inducement. Rather, it raises conflicts of interest, which need to be managed". Similar positions have been taken by all professional organisations, such as AIMA, Euro IRP, AFME or SIFMA.

In financial markets, playing fields have to be level to avoid severe distortions. The banking industry worked this out decades ago. Know-how, labour and access to markets are all that is needed to run an asset management business and each is highly portable. For European

businesses that are bound by the new rules and which compete against other non-European organisations, there will be a substantial cost disadvantage, which they will be unable to bear. Even worse, many multinational asset managers will be able to buy knowledge in jurisdictions where they can use client commissions and use the information generally across their client base including those in Europe. Indeed it would not only be impossible to trace but also would be totally against the principles of treating clients fairly if a large multi-national asset management firm were to obtain valuable research in the US or Asia but be unable to use it for their European clients.

Furthermore, it is not a realistic option for European fund managers to spend their own money on research and then bill the underlying clients arguing that the clients have benefitted from lower dealing commissions. Trustees and plan sponsors will not understand in sufficient numbers to prevent this becoming a major barrier to retaining or winning clients. In addition, to treat clients fairly all clients would have to agree as otherwise some would benefit from research paid for by others.

The immediate impact of the proposed rules is that European asset managers who do not have non-European subsidiaries will heavily reduce or cease altogether the payment for third party, independent research. As well as disadvantaging them and their clients, this will be highly damaging for independent providers and concentrate the demand back on the sell side investment banks.

It is clear that the proposals will impose a significant marginal cost of doing business for European asset managers, which will in time make it less attractive to start businesses in this region. Start-ups are the most portable of all businesses, as they will tend to be created in regimes that are financially friendly and fairly regulated. If start-ups are discouraged and legacy businesses are disadvantaged there will be a long-term decline in the activity. It could be that the regulator takes the ‘crated veal’ position and determines that it does not want a morally abhorrent activity to take place in its jurisdiction even if it means that the activity is carried out entirely overseas. We think this unlikely and that the negative impact of the new rules will be seen as an unintended consequence. But we would argue that the very high level of transparency that means that all clients can see the sums that are being spent on their behalf through CSAs and are each able to come to an informed decision as to whether

this or the market turnover which makes it possible is reasonable. There will be some pools of money where the oversight is poor quality but this is more of a reason to impose better oversight than to damage the competitive position of a whole industry.

In 2004, Lord Myners forecast that any period with a non-level playing field would be very brief as regulators around the world would rapidly move onto his proposed morally higher ground. There has been no such move and there continue to be significant costs suffered by asset managers in the UK as a result of his proposals, which are not borne in other jurisdictions.

To illustrate the impact of such unilateral move, one can take the example of a small to mid-size institutional asset manager, who would struggle to pass on the costs of research to its clients. The estimated cost of the current specificities of the UK regime in restricting the use of dealing commissions represents ca. 5% additional costs, while imposing a full unbundling of research could represent up to a 50% increase[26], threatening the very existence such businesses or at least driving them away from the UK.

Below is the published summary of the views of Robert van Brugge, CEO of Sanford C Bernstein. Significantly, this organisation is part of an asset manager with offices in Europe as well as all over the world and is therefore a potential heavy beneficiary of the proposals:

> *We believe these proposals could have an adverse impact on the European investment industry, independent research providers, and ultimately on investors in the following ways:*
>
> 1. *It would create **a less competitive European asset management industry.** If these proposals were enacted, the European investment industry would be disadvantaged relative to the U.S. and Asia where research can still be paid for with dealing commission. There is no indication that U.S. and Asian regulators are likely to follow ESMA's proposals any time soon.*
> 2. *It would create **higher barriers to entry.** Smaller asset managers would be disadvantaged as they are less able to defray the fixed costs of both external and internal research compared to larger competitors. Their access to research may also be curtailed.*

[26] Source: 2013 accounts of a sample UK investment firm managing ca. £5bn of primarily institutional money.

3. ***The volume and scope of research provision would shrink**. Provision of research by independent research houses -- which are unable to cross-subsidize the cost of research with other business activities -- is likely to fall.*
4. ***Research coverage of small and mid cap European names would come under pressure**. This would make raising capital more difficult and reduce trading liquidity; hampering both economic growth and investor returns.*
5. ***The cost of research would increase**. The internalization of research across many asset managers will cause duplicated efforts compared to the economies of scale provided by the sellside. In addition, unbundled research would likely attract VAT which may not be recoverable by asset managers.*

We believe the interests of the end-investors are best served by the ability of all asset managers to access a wide variety of research and differentiated points of view. If asset managers are forced to reduce their sources of research or are drastically limited in their selection of research providers, it could translate into poorer results for the very clients ESMA is seeking to protect. Instead of prohibiting the use of dealing commissions to pay for most parts of research, we would advocate strengthening the use of CSA programs coupled with increased disclosure and transparency on the amount paid for research.

Indeed, rather than creating this un-level playing field and facing the issues listed above, regulators could achieve the same objective of limiting the risks of conflict of interest, by implementing a number of measures to more broadly impose a model based on a strictly regulated use of CSA arrangements.

While research is not an inducement, there remains a risk of conflict of interest if overspending is possible on research. A CSA model, which clearly identifies research spend limits this risk if it is implemented within a strict control framework imposing the following features:

- Pricing: Contractual pre-defined pricing for research services. Similarly to any other provision of service, asset manager and research provider should contractually agree terms and pricing for research provided.
- Governance: Proper internal governance for CSA pool administration. This should include a transparent evaluation process of research quality and an internal oversight independent from portfolio managers over research spend. It should also ensure

research providers are paid from CSA pools controlled by brokerage firms independent from the provider paid. Finally, it should impose that brokerage reverts to execution only tariff when research spend budget is covered.

- Transparency: Disclosure to end clients of research spend. This should ensure clients know what amount has been spent on research on their behalf for managing their assets. This should include disclosure to end-clients rather than only fund boards in the case of fund-holding clients;
- Awareness: Training of clients on how to control research spend. Example of pension trustees is often given as not having the necessary level of awareness and understanding of such issues. Training would ensure this system become properly controlled through scrutiny by clients over the reasonableness of research spend.

Over the last ten years, the CSA system in the UK has proven its efficiency, allowing asset managers to pay for independent research, but all must recognise its current application still leaves room for excesses. A relatively simple tightening of the CSA system, as suggested above, would suffice to ensure its proper functioning. This would ensure investment managers only buy the research they need at the right price and it would make them accountable on these expenses.

Conclusion

The ESMA and FCA proposals are damaging to the European asset management industry and will disproportionately hit the UK as London is the largest financial service centre in the EU. They are also anti-competitive and will lead to a decline in independent research, especially on Mid and Small Cap names, inhibiting their access to capital. They must be altered.

The disproportionate presence of asset managers in the UK means that London will be the most affected and therefore efforts to prevent Europe becoming uncompetitive in this important industry should begin in this country.

Lord Butler of Brockwell

11TH November 2014

Centre for International Governance Innovation–Written evidence (FRF0013)

1. In the aftermath of the 2007 global financial crisis, the EU and the G20 began coordinating efforts with the intention of restoring and sustaining financial stability. The proposed and ongoing regulatory reforms seek to clarify and, in some cases, consolidate numerous stakeholders and develop tools in an attempt to tackle the intricate task of achieving a sustainably resilient, transparent, and efficient financial system. One of the many shortcomings that contributed to the financial meltdown was the uncontested buildup of systemic risk stemming from the lack of transparency, coupled with ineffective supervision of the banking sector which exposed its lack of resilience to shocks. This pre-crisis state of financial resiliency, or lack thereof, can be attributed to the (almost) exclusively micro-prudential – concerned with individual banks' risk profiles – mindset of the implicated actors. For this reason, macro-prudential – namely the collective mitigation of risk to the financial system as a whole – regulation has been pushed to the forefront of financial sector reforms.

2. The search for resilience, transparency, and the efficiency of the financial system is being pursued through the use of a Single Rulebook. The Single Rulebook allows for financial regulation and directives to be applied to the entire European Union in a consistent fashion. Nevertheless, the importance of consistency across countries cannot be stressed enough. Without it potential negative spillovers, such as those experienced in 2007 and then again in 2010, across national boundaries will resurface.

3. The European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) - two key players in the Single Rulebook framework – were created for the purpose of maintaining EU-wide consistency in regulation across different jurisdictions. These independent EU authorities play a large role in the overarching mandates of the Single Rulebook and regulatory reform through their supervisory roles of the banking sector. The Single Rulebook framework is crucial for financial stability in Europe. However, it is likely not sufficient. There is sufficient variety in the composition and governance of financial sectors across Europe to create certain obstacles that are best handled by national authorities. Others may require some form of international participation. Put differently, even if a 'level playing field' is seen as desirable, any set of regulations must be sufficiently flexible to recognize, for example, some national idiosyncrasies in levels of financial system capacity and maturity. For this reason, the ESRB recommends that nations designate their own macro-prudential authority, either in the form of a board of relevant entities, or as a single institution. Not surprisingly, central banks are often, if not always, members of macro-prudential policy boards. Perhaps even less surprising is that countries opting for a single institution have exclusively chosen the central bank to do all of the heavy lifting, as in the case of the United Kingdom.

4. Decisions taken to date have promoted a successful and promising balance of supervisory and regulatory powers between member states and the EU. It is important to acknowledge, however, that considerable distance still needs to be covered, as future

regulations are scheduled to be phased in. Another critical concern is the difficulty of quantifying progress made, at a national or international level.

5. The concept of international systemic risk prevention, and hence, internationally-coordinated macro-prudential policy is important for all countries. The collapse of the European banking system had an immensely negative effect on international economies, including the United Kingdom. The extensive degree of interconnectedness among financial systems cannot be overlooked, and neither can the degree of global policy coordination necessary to mitigate international spillovers. The post-crisis responses of central banks, and more specifically their financial stability mandates, have been studied to a considerably lesser extent.

6. The United Kingdom has entrusted the Bank of England with full macro-prudential authority. Included in the mandate are micro and macro-prudential supervisory responsibilities. However, the "single entity" approach has not been taken in all countries, and certainly not in any of the world's other large economies (e.g., the US, the Eurozone, China). In many cases, there is somewhat of an obscure and opaque division of responsibilities between micro and macro-prudential regulatory responsibilities within central banks. This is, in part, because there remains no consensus expression of what financial stability means, except that "we know it when we see it". The inclusion of financial stability mandates alongside traditional monetary operations leaves potential either for policy synergies or undesirable overlapping tasks and conflicting interests to emerge. Understanding the effects of varying degrees macro-prudential regulation and supervision within banks and across the financial system more widely may very well contribute to the ongoing construction of a resilient, transparent, and efficient financial system.

7. The paper we are preparing creates an index that measures the scope of macro-prudential responsibilities of central banks on a global scale. The metric will help highlight the clarity of the burden-sharing of micro and macro-prudential responsibilities (based on indicators derived from legislation, bank level data, and other sources). Given considerable variations in approaches countries are taking to improve the resilience of financial systems, an indicator of the quality and effectiveness of macroprudential policies will provide a means of generating international comparisons that existing casual evidence or case studies cannot. Just as, more than two decades ago, indexes of central bank independence helped focus policy makers' attention on the benefits (and costs) of providing autonomy to the monetary authorities it is hoped that indicators of macroprudential responsibilities shouldered by central banks will do the same. In this instance, however, the outcome may lead the authorities to circumscribe the responsibilities given to some central banks while clarifying their overall role in the maintenance of financial system stability.

29 September 2014

City of London Office in Brussels- Oral evidence (QQ 116-139)

Evidence Session No. 7 *Heard in Public* *Questions 116 – 139*

WEDNESDAY 24 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witnesses

Mike Vercnocke, Head of Office, City of London Office in Brussels, and **Elizabeth Gillam**, Deputy Head of Office, City of London Office in Brussels

Q116 The Chairman: Mike Vercnocke and Elizabeth Gillam, thank you. I would be grateful if you could describe the work of the City of London office here and what you are trying to achieve. Over all the files in which we have had a live interest in the Committee, it would be interesting to know whether other cities are involved, given the pre-eminence of the finance industry in the City of London, which is so much more. Certainly, in the past I have been met by and welcomed Lord Mayors of London, and have been pleased to do so. I recognise the very important work they do not just here in Brussels but around the world in recognition of the central position of London. It is not just Europe's financial centre but it is one of the big competing two or three. Please introduce yourselves and give us a feel for the work that you do. You do not have to answer any more questions about Scotland.

Mike Vercnocke: I was with the current Lord Mayor in Riga over the weekend up until Tuesday, visiting the central bank, amongst others, and it was fortunate that the Scottish vote had been in favour of staying together because otherwise every single question would have been about Scotland. I head up the European affairs team in the City of London office here. Despite my name, I am British. My father's family were Belgian and my mother's come from Leeds in Yorkshire, so I am a true European. I started my career at the Bank of England and was seconded to the European Commission in the mid 1990s to work on the construction of the euro of all things. I stayed in Brussels, working at the FSA for a while, then for the European Banking Federation and later as a consultant. For the past seven years I have been working in the City office in Brussels. My background is in the prudential supervision of banks. My last job in the Bank of England was implementing European directives in London. This is my deputy, who is also based here.

Elizabeth Gillam: My name sounds very English but I grew up in France, so we both have international backgrounds. I have been at City of London for three years as deputy head of the office. I started my career as a civil servant in the Treasury, working primarily in the tax department. I led the Government's work on tax evasion and the G20 push against tax havens, as well as other areas of business taxation.

Q117 Lord Hamilton of Epsom: May we press a little more and ask what you actually do every day?

Mike Vercnocke: Certainly. I run the City of London's EU team. In Brussels we have a team of two and a half people—we share one person with Scotland Europa—and there are another four people in London in the European team. We are the eyes and ears for the City in Brussels, so we spend a lot of time talking to people, going to the European Parliament, seeing people in the other permanent representations, and seeing people in the Council and the Commission. We transfer information back to London, where we have a lot of working

groups. You may be aware of the International Regulatory Strategy Group, which is currently chaired by Rachel Lomax, former deputy governor of the Bank of England. That brings together in London the CEOs or very senior people from all the firms based in the UK. It is a cross-sectoral group, so not just banks but asset managers, accountants and so on. You name it. Beneath that, we have a series of working groups looking at individual proposals and dossiers. Our role is to support these workstreams with information and analysis. The other part of our job is lobbying, to be frank. We form the policy positions in London and come back to Brussels and indeed, other capital cities and argue our case with the right person at the right time.

Lord Hamilton of Epsom: Is this the European Parliament, the Commission or both?

Mike Vercnocke: It depends. Elizabeth does a lot of our engagement with Parliament but the thing with the European legislative codecision process is that we have to talk to the right people at the right time. When a proposal has just been thought up, you need to contact the people in the various capitals who have put it forward, but equally the person in the European Commission—it is usually one person, or two people—who is drafting the new proposal. We contact them and deal with them directly to try to influence the drafting process at the start. Once the Commission adopts its proposal, our focus tends to be on the European Parliament, because that is where it will be discussed, and then the Council. It depends on how it goes. There are trilogues and last minute discussions with the MEP who is dealing with the report and the chair of the relevant committee. It depends on the time of the process.

Elizabeth Gillam: I completely agree with that. It also depends on the issue. You might get more traction on one particular issue in the Parliament versus another issue that might be better suited to the Council. The Parliament is much better on those issues that relate back to their constituents, compared with the much more technical issues that the Council might

be better suited to dealing with. Again, there are different competences. I think the FTT was one of your items to discuss. The Parliament can issue opinions but it has no legislative role in tax, so in that regard we would focus on the Council.

Q118 The Chairman: Before we explore that role, building on Lord Hamilton's question and your reply, can you give a view on the esteem or otherwise in which the City of London and the UK are held here in this big European village of Brussels? We will then perhaps learn more from you about how we can be effective.

Mike Vercnocke: The main point is that it is not black and white. It depends on to whom you are speaking. If you are speaking to somebody very left-wing at the European Parliament, we are likely to be viewed as a despicable lot and they will say that it would be much better without us and that we are less socially useful than gambling.

Equally, if you are speaking to a Member of the European Parliament who focuses on financial services there is likely to be a very different take on it. They understand the issues and the importance of financial services to the economy. I think the idea that everyone has got it in for the City of London or for the UK is slightly misguided. What is true is that a lot of people have it in for the industry as a whole. If you talk to a lot of people, they say that the industry has not learnt its lessons. We bear the brunt of that because the majority of the industry in the wholesale market is in London. That is just how it is. It is not about them having it in for us because we are British.

The Chairman: I understand the distinction. Elizabeth, perhaps you can say what you think is true about the City of London. We as a Committee have always suggested that the City of London, as a financial services centre, is the premier European financial centre. We have tried to intimate that in our reports and have tried to make people gather around that view. It shows it in a different light and does not mean that we are always defending. Can you just add to what Mike said?

Elizabeth Gillam: It depends on who you speak to. There is a clear distinction between the more political elements of Brussels versus the more technocratic elements. In terms of financial services, both the industry and the Government in the UK are seen as expert in this field. If you are speaking on a technical level, the UK voice still carries weight in that regard. Obviously, there are bigger political things in play, which is why the European Parliament is sometimes more difficult. The one thing that we have been hearing increasingly is about the bigger debate about the UK's membership of the EU and some of the messaging around that having an impact on the way the UK is viewed in Brussels. The way it has been characterised to me is, "You seem to be saying that if regulation comes from Brussels it is bad, if it comes from Westminster, it is good". That plays into the way that they respond to us when we are trying to talk to them in that they have this characterisation of the way the UK approaches Brussels, which is not helpful.

On London and its role as a European financial centre, that is well understood. We are very conscious that it should not be to the detriment of other financial centres. In particular, we work very closely with Paris Europlace. We have a joint industry committee with Paris Europlace, and we do a lot of work together. We are also members of the EU financial centres roundtable, which includes a number of European financial centres, and we work together to show that although London is the biggest, there are other European financial centres and issues with regard to financial regulation are shared regardless of whether you are in London, Paris or anywhere else.

Q119 The Chairman: You have set another very interesting hare running with that distinction about if it comes from Brussels, it is bad, and if it comes from Westminster, it is good, but you have had superadded gold-plating, which is what we always get told and the complementary element of that is we obey the rules and they do not. Please reflect on that. We are very interested in what is clearly recognisable as a number of spokespersons for the

City of London. I know that Lord Kerr is particularly interested in that aspect. If you would like to answer that first point, about gold-plating and the distinction between the two, I will ask Lord Kerr to come in on that.

Mike Vercnocke: One thing is that legislation is sometimes misrepresented as coming out of Brussels but is really coming out of the G20 or the Basel Committee on Banking Supervision and then through Brussels. It is not just coming out of the blue from nowhere. Gold-plating is an issue that the industry has concerns about. In part, it is because UK authorities have been particularly diligent at implementing things and some member states have not. For example, the Spanish are only now getting around to fully implementing MiFID 1, and we now have MiFID II coming online in 2017. On the other hand, sometimes gold-plating is probably justifiable in the UK context because quite often the legislation that comes out of Brussels is insufficiently developed for the highly developed markets in London. Some countries can literally cut and paste the directive into their national legislation because none of that business is being done in their country, so there is no actual need, whereas sometimes for us the regulation or directive is insufficient because we have a much more sophisticated market. While I am not trying to defend gold-plating, it is not such a black-and-white situation.

The Chairman: At the end of our report on MiFID II, we quoted one witness who said there would be a MiFID III, IV and V. Lord Kerr, please pick up that other point.

Q120 Lord Kerr of Kinlochard: I am worried about the waters becoming muddied by too many organisations. In London, you guys put out serious research. Thank you. Please keep it up. There is also TheCityUK, which seems to be a good platform, well run by good people, but not trying to rival you in the serious heavyweight research stakes. There is now a third entrant which is trying to rival you, I think, with Gerard Lyons, apparently with the imprimatur of the Mayor of London, publishing this very strange research piece on Brexit

which one cannot get to grips with because the economics are not explained. There are various numbers, but the workings are not shown. Lyons, speaking as chief economic adviser to the Mayor of London, is publishing a Bruges Group pamphlet today. Gerard Lyons is a very good economist on China, but I am not sure that he knows much about the European Union. However, he is the mayor's man. There is Open Europe and CER, in which I declare an interest as chairman, which have a wide range of people. CER does not actually get on to your topic at all. We probably should do more, but we publish very little on prudential regulation. Open Europe does a little bit more. We have TheCityUK and we have you. Please tell us whether this muddying of the waters is damaging to the ability to get across a clear UK view in Brussels.

Mike Vercnocke: Clearly there is potential for confused messaging and there is some confusion out there, even occasionally between us and TheCityUK about what we are doing. The area my team works on is very closely linked with TheCityUK because the International Regulatory Strategy Group is a shared body with TheCityUK. We work in close cooperation with TheCityUK in a joint secretariat for the IRSG. We have regular joint secretariat meetings where we divide up the workload. For example, we are working on the benchmarks proposal and TheCityUK is dealing with capital markets union. We know each other's views and generally share common concerns. We have a slightly different role because TheCityUK is a private-sector funded-by-industry membership organisation and is clearly there to promote the industry, which we also do to a degree, but in addition we are here also to represent the City of London as a whole, all sectors, and as a local authority though technically we are not a local authority. Explaining what the City of London is would take all day. So we have a slightly different role, and therefore we have slightly different access to people. In the European Parliament, for example we are registered as a local authority, not as a lobbyist, so are viewed slightly differently.

On Dr Lyons and the GLA, we have quite a close relationship with the GLA office here in Brussels. We meet regularly. Its role is slightly different from ours. It is focused more on things like transportation, environment and funding. Generally, the division is that we do the financial services bit, and it does not. The only area where—I would not say "we have had conflict"—things overlap a bit is on the question that Elizabeth was leading on to about Europe. There is no doubt that our position as expressed by our chairman Mark Boleat is very clear, but having done wide-ranging soundings in the City, the vast majority of City operations want us to stay in the European Union.

Elizabeth Gillam: The only thing to add in terms of branding is about the number of things with "London" or "City" in the name and those who are uninitiated about London can find this confusing. When I say, "I work for the City of London", they say, "Oh, you must work for Boris then", and I have to explain that actually I have very little to do with Boris Johnson. Similarly, with TheCityUK, when they see it, they think of the City of London and they assume we are the same body. On messaging, I do not think we are that far apart, apart from on the one issue about Europe as Mike mentioned, but there is confusion with multiple bodies with similar-sounding names all here with slightly different stakeholders involved.

Q121 Earl of Caithness: Mike, you said that the benefit of the City to Europe was well understood. I would question that. A lot of the evidence we have received points in a totally different direction: the City is this mystical thing out there in the UK, on the fringe of Europe, where a lot of people make a lot of money and say they are whiter than white, then up come the LIBOR problems. I think you have a lot of spadework to do in telling people what are the actual benefits to the rest of Europe in having the City. Are you doing anything on that front?

Mike Vercnocke: Absolutely, I would not disagree with that at all. It depends on who you speak to. Of course, you are right: to the general public in, say, Romania, there is very little

understanding of what the City does. Probably what they see in the press is negative because they read the popular press. Yes, we try to do a lot of work on this but it is an uphill battle. You are right: in the past every time we think we are going forward, another development arrives like LIBOR, forex or whatever. There is a constant need to justify ourselves. We certainly get the message across to the European Parliament here in Brussels. When MEPs ask why we are coming to see them, we try to explain: "Okay, you do not see the direct benefits of the City of London but they are there. Your little local company wants to have insurance against fluctuations in the currency markets, and you go to your local bank for a product for that company. But that local bank will do the deal in London through a bigger bank. You might have a pension fund it will undertake many of its transactions in London even if indirectly". We try to explain that. The difficulty we face is that the explanations are technical, not emotional. You are right: it is difficult. We try to do a certain amount of work with the general population and MEPs. But of course we tend to target more the people who make decisions, to ensure that people working on dossiers understand the importance of what is happening in London so that when they come up with legislation they understand the consequences of what they are proposing. The consequences are not just that people in London will not make as much money, but that the MEPs' electors will suffer. The financial transaction tax is very much a good example; we commissioned detailed research on the effect on household wealth of bringing in the financial transaction tax. We even convinced a member of a trade union in Rome that it might be a bad idea.

Elizabeth Gillam: We are conscious that financial services are not popular and therefore our arguments need to be much more geared to the end user and what the impact is on the wider economy if we are to have an effect. The FTT has been one area where all our research has been focused on that dimension. The first research report we did was on the impact of the FTT on corporate and sovereign bonds: what is this going to do to your

companies and your Government's bottom line in terms of being able to sell your own sovereign debt? This year, we did a report focusing on household savings in different European countries, saying that, given what we know about saving patterns in your country, this is potentially the impact. The report found that up to 15% of overall savings portfolios might be wiped out by the FTT. We went to Berlin and Rome to present those findings to policymakers and said, "You might not have considered this angle". A lot of the work, as Mike said, is focused less on the general population and the reputation of the City and much more on policymakers. We have done a lot of work over the past couple of years with Paris Europlace. We also work with the CBI and its French counterpart, MEDEF. Together, we produced a series of papers on what are wholesale financial markets, what are international centres, and what are the benefits to the wider economy. Obviously, having a link to the corporates and therefore the wider economy was quite useful in that work. There is often this distinction drawn between the so-called "financial" economy and the "real" economy. We try to refer to the "wider" economy rather than "real" economy to emphasis that the two are not separate as some people think, but we are trying to show that they are interconnected. Therefore something you do in financial regulation will ultimately have a broader impact. We have found that a much more fruitful avenue to explore than purely what might happen to the industry itself.

The Chairman: That episode was extremely helpful and we have learnt more about you and your position. You will have absorbed and read our two reports but I want Lord Shutt to open up a question about a new and interesting field.

Q122 Lord Shutt of Greetland: What is your reaction to Mr Juncker's appointment and to our colleague Lord Hill—Jonathan Hill—as Commissioner for Financial Stability, Financial Services and the Capital Markets Union? What will be the biggest issues for him? How much of an issue is it that he, from the UK, has oversight of things like a banking union when, on

the other side, he might get involved in more and more regulation? What is your overall feel for that?

Mike Vercnocke: The appointment to that portfolio certainly came as a surprise because generally Brussels leaks this kind of information but nobody here knew until the day before. There had been talk for a while that there was a possibility that the UK would be given that portfolio but it was disregarded or put off. I think it is a very bold and imaginative step by Mr Juncker. Clearly it serves his purposes because it potentially answers some of the UK's concerns. Certainly, within the whole composition of Mr Juncker's new Commission, it looks quite positive. Frans Timmermans is there to keep control of subsidiarity, in a sense, and is looking at whether we really need legislation at the European level or whether it would be best left at the level of the member states. Lord Hill's portfolio is going to be a difficult one. First, on 1 October he has to get through the hearing in the European Parliament. That will be quite difficult but my hunch is that he will get through. I do not see any fundamental reason why he should not. Certainly some German politicians we have spoken to were surprised that his portfolio included banking union in the eurozone area. But again I think that that is quite a good signal: with this Commission we are not looking at a Balkanisation at least in terms of jobs, where if you are not from a eurozone country you cannot have a role in it. Obviously there are two lots of things Lord Hill will have to deal with. One, that just has to be sorted out, is the tail end of Mr Barnier's programme: benchmarks, banking structure and a few other things. They are likely to be completed. The more interesting area is the future agenda. We know when we spoke to some Commission officials last week that it has a list of what it wants to do in terms of capital markets union. Lord Hill will now have the job of prioritising that. That is very useful because one major criticism we have had in the past is that there has been a lack of prioritisation of what should be done when, with no critical path of what you do first and what logically follows on. I have

never met Lord Hill but my understanding is that he is rather good at that sort of thing. I hope he will have a much more structured approach. The big topics will be the capital markets union and what that comprises. We understand that it will include issues like private placement, making more of a securitisation market in Europe, increasing access for SMEs to capital markets—which raises a number of issues, including cultural ones—and the whole issue of long-term infrastructure finance. That will be a major part of the portfolio. It is potentially very positive for the City of London because obviously this is an area where the City is the main place where this business is done and the expertise resides. The only caveat—this is more a personal view; though we have a working group on this we have not got very far yet because the proposals are not out—is to what degree this might, as with banking union, require some sort of European-level oversight. That is an area we would have to watch very carefully. Will there be some sort of European body with greater oversight of how capital markets are operated?

The Chairman: Elizabeth, do you want to say more about the choice of Lord Hill and his hearing on 1 October?

Elizabeth Gillam: The hearings will be a big test for him. We have heard the S&D already making comments about his appointment. The sense I am getting from speaking to people is that although he will be given a rough ride when he gets to his hearing on 1 October, ultimately they will not look to block it, particularly not the main parties. Obviously, it is difficult that there is no centre-right majority any more in the Parliament so if the S&D does decide to follow through its current thinking of blocking it, just getting the numbers might be difficult. However, they can only vote for and against the entire Commission, not individual candidates. It will be a finely balanced decision for them. We know the Italians were very pleased at getting the External Action Service and the French were very happy at being given the monetary affairs portfolio. I guess those issues all come into play when deciding how to

vote on the Commission as a whole. How strong a message do they want to send? Equally, it would be a strange message to send that his nationality should bar him from having the financial services portfolio. Again, we have not met Lord Hill but everybody I have spoken to says he is a very competent person. If they come out of the hearing saying that the only reason he cannot have the job is because he is British, that would send a very worrying signal that any one member state is de facto excluded from holding any of the Commission portfolios.

Q123 Lord Shutt of Greetland: We have mentioned Lord Hill, who we have talked up because we know him and think he is a decent sort. He has been collegiate in the House of Lords. We wanted to make that clear. However, of the various people we have spoken to, no one has said that there seems to be any organised plot against him. You are suggesting that a political group is very doubtful about him.

Elizabeth Gillam: The head of the S&D group, Gianni Pittella, made some comments about Hill's appointment. The Greens equally queried this. They have also picked up on the fact that he used to be a lobbyist and there is lots of anti-lobbying sentiment in the European Parliament. I am sure you will have seen that Sharon Bowles came under attack for joining the London Stock Exchange shortly after leaving as Chair of the Economic and Monetary Affairs Committee. Based purely on competence, he should not have a problem. Equally, the new structure should help him in terms of the fact that, yes, it is a Brit in charge of financial services but the vice-presidents will oversee the work. His main direct report will be to Jyrki Katainen, from Finland, which is inside the eurozone. There are concerns about exactly what Lord Hill's portfolio will be but there are now more checks and balances and less siloed work within the Commission.

The Chairman: Before I bring in Lord Kerr, does Elizabeth want to say more about the capital markets union?

Elizabeth Gillam: No. As Mike said, our position is still developing on that, so I do not have too much to say.

Q124 Lord Kerr of Kinlochard: On bank bonus rules, Barnier's parting shot was to write to the EBA. What is going to happen? How big a row is this? Is it going to go stratospheric?

Mike Vercnocke: Obviously, there is a legal case in hand on bank bonuses and we will see where it goes. It is a difficult political issue, and certainly the more left-wing parties in the European Parliament are focused on it as a serious issue. I am not sure it will ultimately be such a big problem. One thing we have highlighted is that some of the banks might be slightly less vocal in their claims about getting around it, even if they are. It has been agreed. We certainly argued against it. We thought it was a mistake, not so much on moral grounds but more on prudential ones. Under Basel III and CRD IV, we have already brought forward a lot of very sensible claw-back arrangements on bonuses which are now fairly meaningless because of the new rules. We think it was counterprudential. However, those are the rules as they stand at the moment, so firms should abide by them. It is certainly a question on which Lord Hill will be asked his position and whether he will do anything about it, but I think the answer is that the rule exists. The rules are there at the European level and it is up to member states to impose them. I cannot see more legislation being proposed. I cannot see that there is much appetite in the Commission to pursue anyone on it.

Lord Kerr of Kinlochard: The EBA will have to make some sort of report.

Mike Vercnocke: A slightly more worrying development is that, at the moment, the bank bonus rules apply to a relatively small number of people in the City of London. We understand that the EBA's approach to this could result in more people being captured by the definition, so they would expand the definition of the rules to a responsible person in an organisation. That could be more difficult because it would greatly expand the number of

people who are captured. Of course, most of these bonuses are paid in London because most of the bonus-driven jobs are in London. For example, I understand that people like Deutsche Bank pay most of their bonuses in London.

Q125 Lord Hamilton of Epsom: Do you get the impression that more bonuses are paid to investment bankers than are paid to clearing bankers?

Mike Vercnocke: My personal view would be yes.

Lord Hamilton of Epsom: If we split the banks would this be less of a problem?

Mike Vercnocke: Potentially. When different groups of people get paid large bonuses, they are obviously very senior people, such as global heads of business. The other group which could potentially be more troublesome if they were captured by the EBA are people who work more in dealing rooms and are paid relatively modest salaries and who potentially can earn large bonuses if they do well. Equally, that means you can shrink your trading floor quite quickly if necessary because severance costs are linked to salary not bonuses.

Q126 Earl of Caithness: Looking back to 2008, do you think that the EU financial sector is better able to withstand shocks and crises than it was? Do you think that, given all the new rules, regulations and directives, there is the flexibility to adapt and respond quickly in the event of such a crisis?

Mike Vercnocke: The short answer is yes. The financial sector is more robust and resilient to shocks than it was. Clearly, conceivably, the asset quality review of the ECB will show that banks are much more highly capitalised than they were. The quality of the capital they hold has also gone up. They are also much more liquid. In that sense, clearly, they are more resilient to potential shocks. We would, in general, support much of what was done as having been necessary. The downside is a question that is coming up more and more: whether we have gone too far in terms of regulation. Is this actually stifling growth because banks are unable to lend as much? The proof of the pudding will be in the eating. It is not

clear yet because we have not got economic growth, and therefore the current demand for credit is relatively supressed.

What the Commission did in terms of M Barnier's package was overall pretty correct. We had some doubts about the timing of some proposals. Coming out with the alternative investment fund managers directive first seems a slightly strange choice. One might think that a lot of the things which have recently occurred which have shored up the banking sector, such as the recovery and resolution directive and the creation of banking union, might have been done rather earlier; they are probably the first things one might have done. However, we have sort of got there. It is not perfect by any means, but we have a much more defensible structure. My only doubt would be that while we have the banking sector all nice and safe now, who knows where another crisis will come from?

Elizabeth Gillam: I share that view. The issue is guarding against where the next crisis will come from. What are the potential new risks, and what new risk might be inadvertently created with this new regulation? One area is central counterparties, where we are now concentrating risk. Everybody agrees that this was the right move, but there is now a question mark over whether subsequent legislation needs to be brought forward in terms of recovery and resolution of CCPs and CSDs. The Commission is currently working on that and we would support it as a potential new area. Obviously shadow banking is an evolving area as well, on which the FSB has taken the right view: that it is something we need to monitor. We are not sure exactly what risks might emerge. Obviously the FSB has its five workstreams looking at that and the EU is responding appropriately. I think we are now in a much better place than we were before the crisis. It is now just a question of monitoring where the new crunch points might be.

Q127 Earl of Caithness: Given that general welcome, what were the two best bits of reform, and what were the two worst bits?

Mike Vercnocke: It is hard to say that one particular directive in its entirety was bad.

Earl of Caithness: Okay, I will qualify it for you. What part was good or bad?

Mike Vercnocke: Obviously in the capital requirements directive, many of the proposals were good. We would obviously say that the bankers' bonus proposals were a bad move. But there was a good move in what the Commission did on capital requirements for trade finance. The Basel Committee came up with a far too high capital charge for that, so that was good. I guess one problem that we have seen in the regulations, because they have become more detailed, is that there is less coherence internationally. That is not just the European Union's fault. Another piece of legislation that has turned out well is MiFIDII/MiFIR. There remains a lot of work on implementation but the third-country regime, which started off being very restrictive and potentially damaging to the City, has been amended to provide a very good workable solution, which allows third-country firms to continue operating until such time as their home jurisdiction is deemed equivalent. Even with things such as the alternative investment fund managers directive, we understand that some aspects are actually looking quite beneficial. So it is hard to identify exactly what is good and bad; it is a bit of a curate's egg. Generally, what we have tended to find is that the initial proposal has often been rushed and therefore poorly drafted. For instance, the AIFMD was drafted in something like six weeks, whereas the UCITS directive, which worked very well, took about six years. Just the sheer speed of drafting has meant that the quality of the initial proposal has often been sadly lacking—but the ultimate product, because of a lot of hard work, has ended up being basically quite okay.

Elizabeth Gillam: It is difficult to say which two have been the best. The EU, unlike the US, which just has one massive Dodd-Frank Act, does things incrementally, and it is very difficult to pinpoint which two might ultimately work out the best. It is slightly easier to identify the

worst. The FTT is a clear one, in that everyone felt that it was unnecessary and not helpful. So one worst one I can pinpoint quite easily.

Q128 The Chairman: Commissioner Barnier told us that MiFID II might have gone a bit quicker—or done more on transparency.

Mike Vercnocke: Frankly, we were looking at a less granular level. We looked at third-country aspects. In terms of transparency, the real concern was that some of the proposals to extend transparency requirements from equities to non-equities were misguided in certain areas. If you have a bond that is traded once every five years, what level of transparency do you need? The cost of implementing would be very high for something that is meaningless. He may have wanted more on transparency, but from an industry point of view we think that there is quite a good balance.

The Chairman: I thought that he included both free trade and post trade. We in our report say post trade by all means but not free trade, because it was anti-competitive.

Q129 Lord Hamilton of Epsom: You said that you thought problems might come out in the wash. You did not think that it had been tested whether there was too much regulation and said that it could not really be tested until there was economic growth. I think that we would claim in the United Kingdom that there is economic growth. Do you think that the financial system in the UK is responding properly, or do you think that it is reacting to too much regulation?

Mike Vercnocke: Some of my colleagues deal with the domestic side, so I am not really entirely au fait with what is happening exactly in the financial sector in the UK. The Commission agreed that there should be a retrospective assessment of the impact of the regulations and directives. The problem is that some of them are only just coming into effect, and some, such as MiFID, in 2017, with parts of the CRD coming in in 2019. So choosing the moment when you actually assess these things is quite difficult. You are right

that UK economic growth is picking up, and we will see shortly whether the industry can provide the finance to maintain that growth. In a lot of continental Europe, it has not really happened yet, because there has not been that level of growth. For example, our French colleagues in Paris Europlace feel that while France is not doing very well economically the financial sector can provide the credit required, because there is not much demand, but if economic growth in France starts to get ahead the industry will not be able to respond because of all the regulations.

Q130 Lord Hamilton of Epsom: With all this regulation gone through, how do you think the institutions of the EU have held up? What do you think about the Council and the European Parliament? Have you had a lot to do with Sharon Bowles? How about her successor?

Mike Vercnocke: Yes, we had a lot of dealings with Sharon, but at a certain arm's length. One of her greatest strengths was that she managed to demonstrate that she was a very independent chair of her committee, which has not always been the case with some previous chairs. We had a good working relationship with Sharon Bowles and a good relationship with the Parliament, which Elizabeth may want to talk about because it is her area. We have a pretty good relationship with the Commission, with regular meetings with Commission officials at all levels—not just at the senior levels, but at working levels. They are very open to our arguments. We are going back a bit to where we were before the crisis; when I first started in Brussels, if you went to talk to a Commission official and said, "If you go ahead with this proposal it will be damaging economically", they would take that on board and say, "Right, what would you suggest we can do to get the same result without the damage?". With the crisis, the attitude was more, "We do not really care about that—we are willing to trade market efficiency for safety. You'll have to come up with a better argument". The pendulum has swung back a bit. We are getting more traction with the Commission. It is a

reflection of the fact that even the Commission thinks that it had gone too far, although it is not going to row back from what it has done. But new proposals will be assessed in terms of whether they will support growth or not.

Lord Shutt of Greetland: May I come in on this? Although it seems a couple of weeks ago, it was only yesterday afternoon that we had a witness who told us about the amount of regulation that a new bank would have and having to hire 20 or 30 staff just to cope with regulation. When Lloyds floated off TSB, did TSB come to you and say, "Good heavens, we're going to have to hire 30 staff"? I just wondered about that. We are talking about new entrants to banking—that there have been too many banks in the UK, and so forth. But these people have not been saying, "If you're reckoning to represent us, can you not make some inquiries here?" They just accept it and think it is part of the job of setting a bank up.

Q131 The Chairman: Elizabeth, do you want to answer that and also supplement Mike's earlier replies.

Elizabeth Gillam: All the institutions have played their role. As Mike said, it is done on a case-by-case basis; each institution has different strengths and so at times will give with one hand and take away with the other. The capital requirements directive is a case in point. As we were saying earlier about CRD IV, on the one hand, the European Parliament was very instrumental in getting through the revised proposals on trade finance, of which the industry was very supportive; on the other hand, they did the bank bonus cap. They all play their role. We have by and large been happy with the result, which shows that although the system may not be perfect we are ending up in roughly the right place—and, therefore, they are each playing their own part to achieve that. Barriers to entry and the competition aspect is a part that has not really been analysed. Again, the focus has been heavily on stability as the number one priority. The new Commission and new Parliament provide an opportunity to address this, as they are likely to be more receptive to those messages about the impact

of regulation not only on growth but on competition. One big lesson of the financial crisis was not to have too concentrated a financial sector. We have done the exact opposite of that. When banks have failed, the first port of call was finding a bigger competitor to absorb them. In lots of cases, we have ended up with an even more concentrated banking sector than we had before the crisis. This competition element needs to be reflected, and regulation is one of the big barriers to entry, particularly for smaller players.

Lord Hamilton of Epsom: Having said that, I am sure the banks will have said that the cost of compliance is becoming a much more significant element than it ever was before. All this means is that bank charges are going up and we all pay more. Are we actually safer? I suspect not.

Mike Vercnocke: There is that and the knock-on effect that is probably driven more by American regulations: for example certain types of business are just not being done because money-laundering rules are so tough. Some banks have decided that certain individuals in certain countries are too risky to justify the potential fines if they get it wrong.

Q132 Lord Hamilton of Epsom: My next question is on the growth agenda. We have heard a lot about how the EU budget has been linked to stimulate growth, jobs and all those sorts of things. Let us start at the beginning. Probably the reason why the United Kingdom has seen quite a bounce in economic growth is because of previous reforms that took place in the job market generally—making it easier to employ people and all that sort of thing. Many of the eurozone countries have hardly started down this road. There is a mentality of, "Well, if we spend a bit of money here it will make all the difference". Do you sign up to this? Do you think this makes any sense at all, or do we really have to wait for reform to come through to make the marketplace a pleasant place to do business?

Mike Vercnocke: I would agree. People in the Commission agree with that point. We had a meeting in June with people in DG ECFIN, coming up with proposals on how to get supply-

side improvements and how to get credit flowing. They all agreed these were important supply-side replacements—the usual things. They were however very concerned that in continental Europe in some countries there are structural problems. Even if you had less or better regulation and the floodgates were opened in terms of credit, you would not necessarily get that much growth because there would be limited demand for credit. We think the real problem for the Commission's growth agenda is that they do not control many of the levers to sort out things like labour market structures. Structural reform is mainly a national level issue.

Lord Hamilton of Epsom: On top of that is trade union reform.

Mike Vercnocke: There are all these areas where the Commission has no locus. There is a concern that you could have a fantastic new structure and programme on the supply side and still have very slow growth rates.

The Chairman: Hollande has come round and Renzi understands that there needs to be reform. I think you are right about that.

Mike Vercnocke: Germany is doing quite well.

Lord Hamilton of Epsom: Germany is going backwards as we speak.

Elizabeth Gillam: The latest growth figures for the eurozone show that very clearly. The countries with programmes and that have done lots of these reforms are now doing quite well. The latest growth figures show that Portugal, Spain and Ireland are all doing very well. Others have dragged their feet a little in terms of reform—the French talk a lot about reform, but have done relatively little compared with, say, Ireland. The Italians have also struggled for political reasons to get reforms through, even when Mario Monti was there. They had all these ideas and they know what needs to be done, but politically they found it very difficult to do these sorts of reforms. That shows in the growth figures.

Q133 Lord Kerr of Kinlochard: I am afraid I disagree on the AIFMD. I think it is a net minus. It has imposed a lot more costs on a much wider group than was required. It probably has done some good, but overall it has done a bit of harm. Miles above it, though, in the list of bad measures is the financial transaction tax, which after all was designed to do deliberate harm and punish evil people like Lord Hamilton. Could you, looking back on the financial transaction tax, comment on whether we, the UK, got it wrong? It is my contention that we all did, including this Committee. We were quite slow to wake up to the fact that it would apply to the UK, even if done in enhanced co-operation. The Treasury's reply to us was, "Don't be silly". At the time, the Mayor of London, Boris, was rolling out the red carpet and wishing FTT to ahead because all the business would come to London. He reversed himself in due course and decided that FTT was a deliberate plot to kill the City of London. I do not know why the Treasury was slow and why it did not try to block the procedural decision on enhanced co-operation, which in my view would have been easy to do. The council should have waited until it saw the proposal. It should be an established rule that those who want enhanced co-operation must put their substantive proposal on the table, showing precisely what it is they want, before the procedural decision is taken. So we all made lots of mistakes. How does it look from here? Were you guys alert to it from the word go, saying, even if it is an enhanced co-operation, it will be operated in the City and therefore damage our markets?

Elizabeth Gillam: We were aware of the third country deeming provisions. When we first started looking at FTT we were obviously very conscious that it would have a harmful effect on London because so much trading is international. We were very much aware that, if they had followed that model for enhanced co-operation, it would still impact on the UK. I think the UK Treasury was also aware of the case. I think the decision to proceed with enhanced co-operation—even though the UK did not vote for it—was difficult to block. The political

situation was such that lots of member states did not feel that they could stand in the way of member states. I agree that the procedure for enhanced co-operation is far from perfect and we equally had concerns about the Commission impact assessment which said that the enhanced cooperation would not impact on non-participating member states. What was unsatisfactory was there was no hard data. They just said they could not do an assessment because they did not know what the tax would look like. We argued hard and had support from the Treasury in terms of saying, “We need another impact assessment once you’ve come up with a proposal because you can’t say, in very general ways in the way you have done, that it will have no impact on the UK, given we do not know what the text will look like.”

The FTT was designed to make the sector pay and was very political in nature. The only saving grace is that it has been three years and they still have not managed to agree among themselves what they need to do. We are still very much monitoring and lobbying on this issue, particularly the latest position, which is that they would include some derivatives. We do not yet know what these “some derivatives” might include. We are still looking at this very carefully. While it could be the worst piece of legislation to emerge, it has not happened yet. While the original Commission proposal was very broad, it looks likely that participating member states have scaled back their ambitions considerably. If they manage to agree something I do not think it will be nearly as bad as we first thought.

Mike Vercnocke: One of the big problems at the start was that people would come to have different views of what the tax was for. Several thought it was needed to stop people doing things like high-frequency trading. That has now been addressed, from a prudential point of view, by MiFID, so that has gone away. Other people, such as the French, saw it as a way of milking the industry. We have made it very clear and they now accept that it is not, it is actually pension funds and end users who will pay the tax, not the industry. Wherever we go

around Europe, either with the Lord Mayor or with our chairman, we lobby quite strongly on the FTT. It is interesting that even those countries that are nominally in support, when you actually talk to people in the finance industry, by and large they think it is a very bad idea. Just now I was with the Lord Mayor in Riga and both the finance ministry and the central bank agreed they thought it was a bad idea. Elizabeth is right. We are still waiting to see if we can get an agreement. All the countries that support the FTT have different things they want to have carved out. If they carve everything out this is probably going to be driven to a halt. It might end up with domestic equities being the only securities covered.

Q134 Lord Hamilton of Epsom: We have always had difficulty trying to understand how this thing would be administered? It was yesterday, I think, when someone came up with a ruse so that if you are trading in Volkswagen shares on Wall Street, that actually has to come through the German stock exchange. It is to be registered with that exchange and a fee is paid at that point. Tax would then be added on to that fee, so it would not matter where you traded the Volkswagen shares around the world; they could pick up the fee in the stock exchange.

The Chairman: I do not think that is quite right.

Lord Hamilton of Epsom: Is that not the case?

The Chairman: I think it is the case within the EU, but perhaps Lord Kerr can clarify the point. That would not apply if the deal was made in, say, New York.

Lord Kerr of Kinlochard: I thought that if it was cleared through a clearing house in Europe, a fee would be payable.

Elizabeth Gillam: The collection mechanism remains one of the big unanswered questions. They have not decided yet whether it is going to be an issuance-based tax on the UK model or a residence-based tax. The latest we heard was that it may be a mix of the two, and obviously that has big implications for how difficult it will be to collect. It is one of those

strange things in Europe. You decide first what you are going to tax and only as a second step do you decide how you might go about collecting it, whereas in the UK when we did stamp duty, we rightly said that we can tax only something that we know we can collect. The CREST system was designed specifically to enable that. The Commission has been working with various infrastructure providers, whether they be the exchanges, the CCPs or the CSDs in terms of trying to find some way of collecting the tax, but as yet we have no clarity as to what they might do. Obviously, there is an issue around going for an issuance-based tax and having foreign shares traded on Wall Street. How do you force the Americans to pay this tax when they said very clearly when the FTT started that they would not force US institutions to pay the tax by making it a legal requirement, given that it is extraterritorial. I think it is one of the big unanswered questions of the FTT: how exactly can they go about doing this?

Lord Hamilton of Epsom: We raised this as well with an official who came before our Committee. We asked, "How are you going to persuade the Americans to pay this tax?" He said, "Oh, I have a wonderful ruse. What we are going to do is this. The Americans will be allowed to collect the money and keep the interest for six months, and this will postpone its collection". When I hear that sort of thing, I wonder whether I am in a lunatic asylum.

Q135 The Chairman: Picking up on that, what is your view of HMT in terms of its alacrity and flexibility of response? For what it is worth, my overview—which you might reflect upon—is that they have so much else on their minds. I can give an example. The official line of the Government was that they were for the FTT provided that it could be done on a global basis. That was a fraud in the sense that it was never, as was mentioned a moment ago, going to be achieved. But in a way it allowed them the cachet of saying, "Oh yes, we are all for this, but oh dear, we will not be able to get it past our American friends". Then of course there is the other element of the domestic political agenda that at times sits

like a sparrow hawk on their shoulders and pecks away. I will lose myself in that metaphor, but I am sure that you get the general drift. However, I have asked for your opinion, not mine.

Elizabeth Gillam: All Governments have to appear to be willing, and the UK was not the only country to take that view. The Dutch said on FTT, "We are willing to join in with enhanced co-operation provided that you can meet certain criteria." There was a sense that the criteria were designed in such a way that they could never be met. In order to be guaranteed a seat at the table in Brussels, you have to appear willing to do something. I think that the Danish took a similar view with banking union. They said that they might consider joining once they had seen the details. There were some who were sceptical about the true desire of the Danes to join the banking union and felt more that they wanted to be kept involved in the discussions. At the working level we work well with the Treasury. Again, a lot of legislation went through in the last 5 years and sometimes the broader strategy can seem to be missing.

The Chairman: I cannot believe that someone would create criteria in order for something to be prevented without acknowledging the role of Chancellor Gordon Brown many years ago—on 27 October 1997.

Q136 Lord Hamilton of Epsom: Let us come back on this point because I think that you are letting the City of London off here. I am not actually sure that the institutions in the City of London did not sign up to the BoJo line that this is a wonderful ruse that will bring endless business to the City of London and fed that into the Treasury, which had many other things to think about. They simply thought, "Let it go".

The Chairman: Is BoJo by any chance your friend Boris Johnson?

Lord Hamilton of Epsom: Yes, it is Boris Johnson.

Mike Vercnocke: We certainly did not do so in Brussels.

Lord Hamilton of Epsom: But it would not have come from Brussels, it would have come from the City of London.

Elizabeth Gillam: All these things depend on the fine details. There was definitely some thinking about whether there was a way that London would benefit. However, we found that among all the stakeholders we worked with on FTT, the view was that it was never going to happen. Even the principle of having an FTT was a bad thing and therefore no one I know is actively lobbying the Treasury saying that it is potentially a good idea. I cannot speak for everyone else, but I will admit that we had that conversation with our stakeholders and came out very clearly on the side of no, that an FTT would not benefit London.

Q137 Lord Kerr of Kinlochard: The other question I want to ask is not quite the one you expect. Something is going to happen on "Capital Markets Union". We can be quite sure that by the end of this Commission, something will have happened. We are getting the sense on this visit that it will not be a giant capital markets union directive, but that the chapeau will cover a range of things. What single thing would it be most advantageous for the City to see included under the chapeau? On the whole, we have been gloomy old pessimists in danger of approaching such things defensively and wondering where there might be some damage done. But let us suppose that we were as we used to be, back in the 1980s, looking at the single market programme as a way of opening up European markets and overriding protectionists in other countries. Where would the British financial services industry benefit most from any specific liberalisation of everyone's capital market inside the European Union?

Mike Vercnocke: I think that we can look at a number of areas. One obvious one would be the securitisation market. If you could get securitisation working, that would be very good. At the moment, a lot of European houses use the American ones. So, again, the development of a European one might well benefit London. The difficult one is the idea of getting greater access for SMEs to capital markets. It is politically an attractive idea, but it is

much more difficult to see how that is actually achieved; there are a lot of factors. I would say that securitisation is the right place to achieve T+2 rather than just two plus one.

Lord Hamilton of Epsom: Hold on, surely one of the problems of the single market is that we have not been able to sell financial services into, say, Germany, because it has a closed market. Is it not possible that it would be opened up or is that just my giddy optimism?

Mike Vercnocke: That is why we are focusing on the importance of getting private sector and market solutions to how all this actually operates. You will need some EU legislation to knock down barriers. These markets must be clear on this.

Q138 Lord Shutt of Greetland: We are not in the eurozone. With the regulatory reform agenda, are there specific challenges for the UK? How does it compare to other places, such as Poland and Sweden, that are not in the eurozone? Then there is the whole business of the regulatory framework applying at an EU 28 level. Does that mean that there is a danger of a two-speed Europe?

The Chairman: On that question, you might like to know that we met UKREP's Polish and Swedish equivalents because we as a Committee wanted to get a feel for the outs and the pre-ins.

Mike Vercnocke: The frank answer is yes, there must be some dangers to the UK and the City, and there must be some potential for some two-speed-Europe issues to develop. On the other hand, there are certain safeguards in the system, certainly in the banking sector with the double majority voting in the EBA. There is also potential for the Bank of England and the ECB to be the two dominant players in the market and therefore, with regard to how that relationship works, the UK is not in such a bad position. In terms of the euro, you are right that there are different categories. Countries like Poland are clearly going to join the euro eventually—we can discuss how long that will take, but they will almost certainly

join—whereas Sweden and Denmark, like the UK, are potentially not joiners. As long as we are not alone as the only non-euro country in the EU, policymakers in the EU will have to take into account the fact that we have a single market with multiple currencies. And even if everyone was in the euro, we would still have a multicurrency single market in a sense because a lot of business in the eurozone is international. You will always have to deal with multiple currencies and indeed the dollar is still the primary currency, despite what some people might like to do about that. We should not underestimate that there are some risks, but equally we should not be too pessimistic. In reality it is almost the other way around: in the eurozone there is concern that a large chunk of the eurozone wholesale markets are in London, not in the eurozone. The more that we can have a structure that reassures everyone, it is fine that we have a single market but it does not matter if we are in or out of the euro from a prudential or regulatory point of view.

Lord Kerr of Kinlochard: I agree, but it is still the case that that there is a eurozone qualified majority, thanks to the great British Thatcher triumph of getting all this stuff put on a qualified majority basis. Given that the eurozone meets the day before ECOFIN, there is a strong probability, even if everyone says that caucusing is a terrible thing and must never happen, that there will be deals. What do we think they are going to talk about at dinner the night before? We will find that, when the Chancellor of the Exchequer explains clearly what we want, they will all listen, because they are very intelligent people, and they will then say, "Very interesting. Shall we now vote?" That is the danger of the road that we are now going down.

Mike Vercnocke: You are absolutely right, there is that potential. Certainly on the supervision side, if the ECB develops a more coherent approach in the eurozone area to supervision, there is potential there for us to be outvoted. On the other hand, why would a group come up with a proposal that was bad, in a sense? Good supervision is good for

everyone. I agree, there is clearly a risk, but at the moment it does not seem to happen that much because a lot of countries in the eurozone still do not agree on a lot of issues—perhaps less so at the moment than in the past. Clearly the Club Med countries of the eurozone and those from the north—the Germans, the Dutch and the Finns—have very different views on quite a lot of issues. In the long term, though, this could indeed be an issue for us.

Q139 The Chairman: Elizabeth, would you like a last word?

Elizabeth Gillam: As Mike said, there is definitely a potential for risk but I do not think we have seen that manifest itself in any way. It is useful to underline that on most of these issues they go for a much more consensual approach to policy-making than I guess is true of Westminster, and it is very rare that they would agree something without the UK—I think there has been one example in recent years when George Osborne was outvoted, which was on bankers' bonuses. Other than that, they always try to get the UK on board. As Mike said, lots of the things that differentiate the eurozone countries are less to do with being in or out of the eurozone than with—on banking, for example—whether you are a home regulator or a host regulator. In security for regulation, the question is: do you have capital markets or not? I accompanied the chairman to Spain earlier in the year, and one of their complaints was that the UK had been doing deals with countries with little capital markets, such as Estonia, rather than working with member states with significant capital markets such as Spain. The eurozone is not a cohesive bloc at the moment. Whether that develops further down the line is another matter, but at the moment they are not cohesive. While there is a threat of caucusing, we do not have that much evidence at the moment that they are doing it.

The Chairman: In thanking you both, I remind you that we will send a transcript and ask you to correct it in the usual way. If you have any further ideas, we would be very grateful

for them because it is a moving target. I shall say this parting piece. This really has been an excellent hour and a half. I am sorry that we have pummelled you, but with good intent and indeed with good ends, because you have been so helpful on the range of interests that we have had over this visit. Believe you me, we will have a really good look at what you have said; I feel that we will incorporate much of it. We run up to 4 November when we will have the Bank of England on the block on these issues and then Andrea Leadsom that afternoon, which will finish off our inquiry and we will write up what we have to say. At that point, I thank you both.

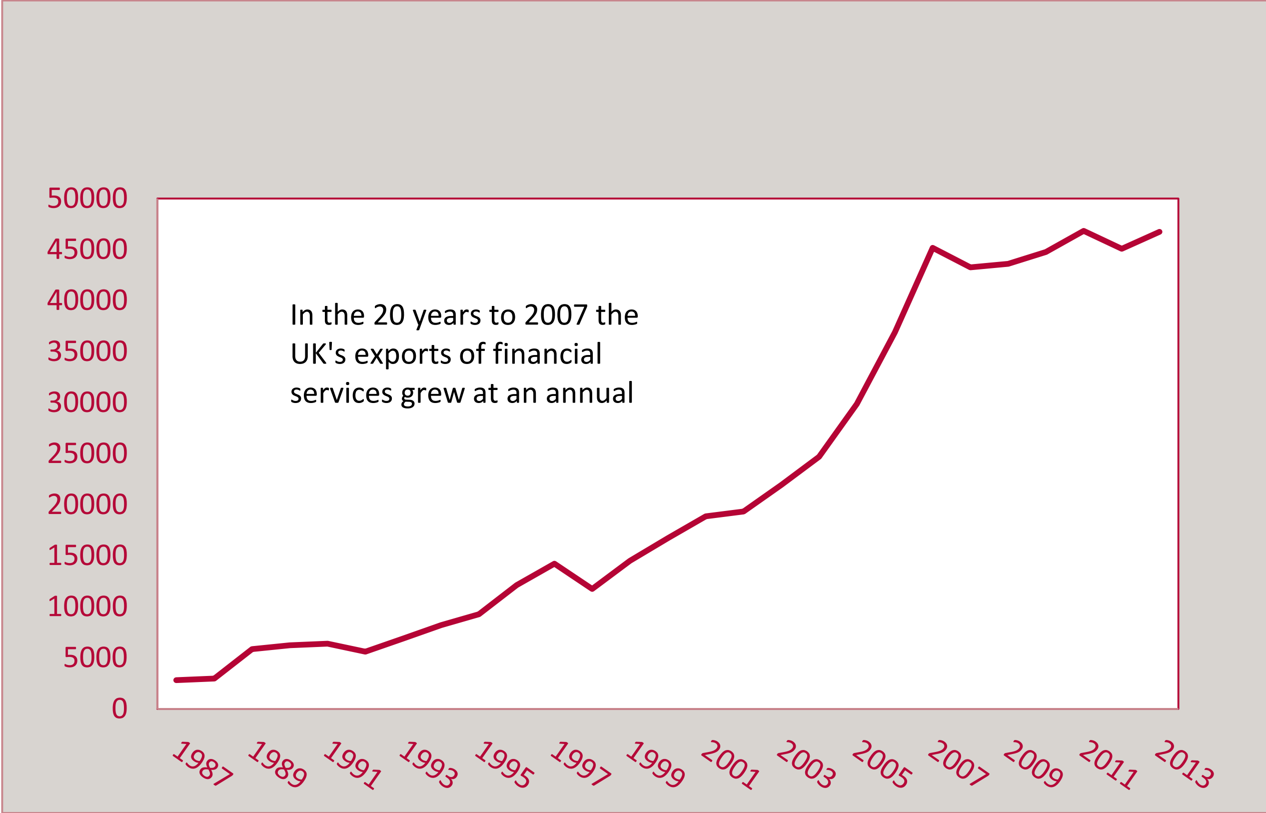
Tim Congdon–Written evidence (FRF0021)

Note on London and Singapore as centres of excellence for financial and business services

Halt to growth of UK's financial services exports

In the 20 years to 2007 the UK's exports of financial services (excluding insurance) rose explosively from £2.8 billion to £45.2 billion, with a compound annual growth rate of 14.9 per cent. In the following six years to 2013 they rose fractionally, from £45.2 billion to £46.7 billion, with the annual growth rate down to 0.6 per cent. London was undoubtedly the location for the overwhelming majority of the international financial services activity, with "the Square Mile" of "the City of London" as the focus.

The boom in the UK's exports of financial services to 2007, and the halt afterwards



The change from boom to stagnation was part of a larger growth setback for the UK economy, as the Great Recession and its aftermath took their toll. It is instructive and perhaps sobering to realize that, if the pre-2007 growth rate of these activities had continued until today, the UK's exports of financial services would be more than double their current level and would exceed £100 billion. To talk of "the missing fifty billion pounds" may be a simplification, but it is not silly. The halt to the growth of the UK's exports of financial services has been a major reversal for the British economy and needs to be explained.

Two main explanations come quickly to mind,

1. the check to growth due to the Great Recession and the wider global slowdown, and
2. the impact of increased financial regulation, much of it international in origin or specifically the result of decisions by European Union institutions.

In this note my argument will be that, while the first of these clearly had some force in accounting for the outright declines in financial service exports in 2009 and 2010, developments in the world economy cannot be the only influence on the halt to growth. I will show, first, that the growth of the world economy has resumed from 2010, and, secondly, that financial services activity (and indeed business services more generally) have kept on booming in a major non-EU centre, Singapore, for which reasonably good data are available.

Continued growth of the world economy since 2007

The boom in UK financial service exports in the decades leading up to the Great Recession reflected two underlying drivers,

1. the tendency for financial services to grow faster than output in general in the course of economic development, and
2. the tendency for international trade in financial services to grow faster than home-market, domestically-consumed financial services in the post-1945 world, due to the increase in economic integration between nations made possible by, first, the multilateral and non-discriminatory institutions created in the immediate post-war years, mostly by the USA and the UK (i.e., the International Monetary Fund, the General Agreement on Tariffs and Trade/World Trade Organization, and so on), and, secondly, major technological advances in telecommunications, computers and transport.

The severity of the Great Recession must not be downplayed. According to IMF data, world output grew in every year from 1945 to 2008, even though the mid-1970s and early 1980s saw marked dips as the USA, then with by far the largest single economy in the world, tried to combat inflation. But world output did drop in 2009, for the first time since the 1930s, and by no less than 2 per cent. It is not surprising that the UK's financial services exports, which exhibit pronounced cyclical instability, should have fallen in 2009 and 2010. (The data show that they had also gone down in 1998, by no less than 20 per cent.)

Table 1: The growth rate of world output in three periods

Table is of average annual growth rate of world output, at market exchange rates

	Growth, %
1984 - 2007	3.2
2008 - 2009, 'The Great Recession'	-0.3 *
2010 - 2013	3.0

* World output fell in 2009 itself by 2.1%.

Source: IMF and author's estimates

But global growth resumed in 2010 and in the four years to 2013 inclusive ran at a rate not that different from “the golden age” (as it now seems, in retrospect) in the two decades to 2007. (See the table above.) But the UK’s exports of financial services did not resume their earlier growth path. Arguably, the contrast between the dynamism of the pre-2007 period and the sluggishness of the post-2009 period is particularly disappointing, as the last few years have seen spectacular gains in Internet-related technologies and applications (Google, Facebook, LinkedIn). These gains ought to have facilitated international trade in services, including financial services.

Table 2: Growth of Singapore's economy, 2006 - 13

% annual rates of change of output and gross value added,

according to Statistics Singapore

	Total GDP	Finance and insurance	Business services
2006	8.9	11.9	12.0
2007	9.1	21.0	19.3
2008	1.8	0.1	17.4
2009	-0.6	1.1	3.8
2010	15.2	12.3	9.0
2011	6.1	9.1	5.5
2012	2.5	1.8	5.5
2013	3.9	10.8	4.3

Continued boom since 2007 in Singapore's output and exports of financial services

Some city hubs of financial and business service activity are outside the EU, and are therefore not subject to EU regulation. The most obvious is of course New York, but the USA has been involved in the tightening of international financial regulation since 2008 and has indeed imposed on itself the restrictive Dodd-Frank Act. Other well-known centres are Hong Kong, Singapore and Dubai, although Dubai's role as a financial service location remains embryonic. (The Swiss cities – Zurich and Geneva – need to be mentioned, but in practice their business regulation has less autonomy from the EU than their citizens might like in an

ideal world.) Hong Kong has flourished since the Great Recession, with an average growth rate of GDP in the four years to 2013 inclusive of over 4 per cent. Nevertheless, as a “special administrative region” of China, it has serious issues grappling with its uncertain long-run geopolitical status. With New York taken out of the picture, the world’s leading non-EU financial and business service centre is increasingly Singapore. Singapore’s GDP in 2013 was just over Singapore $370 billion, equivalent to about £180 billion at the exchange rate of just over two Singapore dollars to the pound which prevailed for most of the year. Its population was 5.4 million. These numbers compared with a London region GDP in 2013 of over £300 billion and a population of 8.3 million. Singapore has a larger manufacturing sector than London, but – in terms of income per head and economic structure – Singapore and London are very similar cities.

The table above shows the rates of change of Singapore GDP, and of gross value added in its financial services and business services sectors, since 2005. As might have been expected, the Great Recession resulted in a pronounced slowdown in 2008 and 2009. However, it is apparent that a significant rebound has occurred subsequently. This is true of both financial services as such and “business services” more generally. Whereas the international financial sector in the UK (i.e., “the City”) has stagnated since 2007, Singapore’s financial services’ output in 2013 was 40 per cent higher than in 2007 and has continued growing steadily so far in 2014.

Figures are also published on financial service exports from Singapore. Unfortunately, the information depend on surveys which are carried out with a lag, and where the data need time to be collated and organized. (The 2013 results will not be available until early next year.) At any rate, in 2012 Singapore’s financial service exports are estimated to have been Singapore $20 billion, or about £10 billion. (If financial services exports last year grew is line with total output, the 2013 figure would have been about Singapore $22 billion and £11 billion.) Although on this basis Singapore has only about a quarter of London’s importance in the financial arena, the figures confirm that it has enjoyed strong growth since the Great Recession. The divergence from London’s experience is clear and obvious.

Table 3: Composition and growth of Singapore's service exports

Figures are of exports, annual totals in billions of Singapore dollars

	Financial	Other business	Other services	Total
2003	5.6	10.6	37.9	54.1
2004	6.3	14.4	47.4	68.1
2005	7.5	15.4	54.1	77.0
2006	10.5	22.3	60.9	93.7
2007	15.5	23.7	72.1	111.3
2008	15.3	26.3	84.8	126.4
2009	15.1	25.9	77.8	118.8
2010	16.2	26.6	94.0	136.8
2011	18.6	29.4	98.1	146.1
2012	20.0	33.6	102.4	156.0

Source: Statistics Singapore

More regulation could be to blame for the halt to growth

This note does not prove that increased EU regulation has been to blame for the halt to the growth of the UK's exports of financial services. Far more detailed work, with attempts to measure the impact of regulation on particular sub-sectors of financial activity, would be needed to move closer to a rigorous demonstration of the claim. (See my two pamphlets for

the Bruges Group – my 2009 *The City of London under Threat: the EU and its attack on Britain's most successful industry* and my 2014 *The City of London in Retreat: the EU's attack on Britain's most successful industry* – for a more detailed discussion.) However, the evidence presented is not inconsistent with the argument that extra regulation played a part – possibly a dominant part – in restraining growth.

First, since 2009 the world economy has been expanding at rates not that different from those seen in the 20 years to 2007. Exports are of course sold to the world market and their growth performance should be related to that of the world economy, not just the economy of the UK or even the EU. It is evident that the UK's financial service exports have not responded to the return to the growth in the way that might have been envisaged if pre-2007 patterns had re-emerged. Something has gone wrong, with extra regulation being one potential culprit. There is no doubt that in these years the main sources of extra regulation have been from outside the UK. These sources have been mostly EU-related, particularly the European Commission itself and the new EU financial sector regulatory bodies that have been created under the terms of the 2009 Lisbon Treaty.

Secondly, Singapore has been less affected by the new international regulatory initiatives, although it does belong to the Bank for International Settlements, and its banks have to comply with the various Basel rules. Crucially, Singapore is not part of the EU, and is unaffected by EU directives and regulations. The design of new regulations, arrangements for corporate authorization, and the procedures for new product approvals and infrastructure development, are matters for the Singapore authorities themselves. Whereas Singapore's exports and output of financial services have risen by over a third since the Great Recession, the UK's exports and output of such services have stagnated. One difference between the UK and Singapore – perhaps the key difference – is that the UK belongs to the EU whereas Singapore does not.

16 October, 2014

Richard Corbett MEP- Oral evidence (QQ 157- 174)

Evidence Session No. 9 *Heard in Public* *Questions 157-174*

THURSDAY 25 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witness

Richard Corbett MEP, Labour/S&D MEP for Yorkshire and the Humber

Q157 The Chairman: It is a great pleasure for me to welcome Richard Corbett. We have known each other over so many years in different ways. Richard, we will pick your brains, if I may say so, not only on your immediate experience with Herman Van Rompuy. We thank you for helping us gain access to him. Those who went to see Herman Van Rompuy enormously benefited from that meeting. We will also speak to you a little beyond the range of the questions about Lord Hill, as that will be an important choice for the United Kingdom and we would like you to say one or two things about that. Ostensibly, we are here for the financial regulatory framework. Just to put in the background, yesterday we met a whole number of MEPs and the City of London. It was very good just to distinguish all the strands representing London, which helped clarify matters in our minds. That was useful

because we met many of their friends and colleagues elsewhere in finance associations and what have you. Two other innovations we have practised are that, having been to UKREP, we met the Polish and Swedish UKREP equivalents. Given the outs and pre-ins and so on, we ought to do that. I hope that colleagues think that that was beneficial. I ask Lord Caithness to consider the Commission in particular. We will do our best to get from Richard answers to some of the thoughts we have been having.

Earl of Caithness: Richard, what do you think about the appointment of Lord Hill as a prospective Commissioner, particularly for a dossier that is relevant to the UK but where a lot of the work will be outside the UK because we have not signed up to things like the banking union? Is this a clever move by Juncker or a deliberate ploy for a more devious tactic?

Richard Corbett: I think that his whole Commission has been put together quite cleverly in many ways. I do not think it was a devious manoeuvre to propose Lord Hill for this portfolio. It was an attempt to reach out to Britain with its concerns about financial sector regulation and other aspects of economic and financial matters at EU level. He has of course to come before the European Parliament Economic and Monetary Affairs Committee for a public hearing, as do all prospective Commissioners for their portfolios. That will be a tough three hours of public questioning. I would love to see British Ministers do that when they take office. There are always rumours that the European Parliament is gunning for one or two victims to pick off, which I think is inaccurate. It is true that the last two or three times, one or more prospective Commissioners have come a cropper and been replaced, but that very much depends on their performance. If there are questions that need to be answered, they must be prepared to answer them properly. There are three or four prospective Commissioners where you can hear questions being asked in the corridors: "We will have to really cross-examine this one on that, or that one on this". Lord Hill is not someone in

the first firing line, but one does hear colleagues in certain quarters say, "Is it appropriate to put in charge of the financial sector someone perceived as being close to the City of London, formerly lobbying in that field, close to the British Conservative Government?" and so on. Those questions will arise. I am sure that he will be able to defend himself. That will convince some of them but maybe not others. There will be an interesting and lively discussion.

Earl of Caithness: How much depends on his performance in front of ECON? Have people already taken sides?

Richard Corbett: I have just been party to a discussion in our group, the Socialists and Democrats group, where everyone was at pains to say that we cannot and indeed must not make up our minds about any Commissioner—not particularly about Lord Hill, by the way—before we have had a hearing. We can discuss our concerns, the questions we want to pursue and the reservations we might have before the hearing, but that is in order to raise them vigorously at the hearing. We should not prejudice the outcome.

Q158 Lord Hamilton of Epsom: What are the mechanics of this? Is there a vote when that has happened?

Richard Corbett: No. After the meeting there is a meeting of the committee chair with the co-ordinators or spokesmen of each political group to discuss the evaluation in order to write a letter to the President of the Parliament. That is then considered in a conference of the committee chairs and a conference with the President of the Parliament. Only if the co-ordinators are in deadlock do you then convene the whole committee to have a discussion and, if necessary, a vote. The idea is not normally to have a vote on each Commissioner because Parliament's vote of confidence at the end of the day is a collective vote of confidence on the College of Commissioners as a whole. But those meetings are crucial for shaping the climate of opinion on individual Commissioners. I would just like to say that if

the Parliament feels strongly that one or other Commissioner is unacceptable, it has to feel strongly enough to say with some credibility that we might consider voting against the Commission as a whole unless you change that Commissioner or change the portfolios. You need quite a broad level of political consensus to be able to do that with credibility.

Q159 Earl of Caithness: Let us assume that Lord Hill gets through. What is the biggest thing on his desk and what are the prime issues that he will need to tackle?

Richard Corbett: The immediate task is a reorganisation of the services so as, in a sense, to create a DG that will cover his remit. He will then have to pick up on where we are on European financial sector legislation and, as you mentioned earlier, the pursuit of banking union among the eurozone-plus.

Earl of Caithness: Looking at the restructuring that Juncker has proposed, would you be happier to serve under the system that Juncker has put forward or under the system that you have been working in? What was wrong with your system which meant that Juncker has had to make the proposals he has?

Richard Corbett: When you refer to my system, do you mean the previous Commission?

Earl of Caithness: Yes, the system under which you have been working.

Richard Corbett: I have not worked in the Commission. I worked for President Van Rompuy in the European Council. The Commission under the treaty is a college with the President as the primus inter pares and having a few extra powers. As it has grown with the successive enlargements of the European Union, it has become a little bit unwieldy. For some time now many voices have called for some structure, if not a hierarchy, to be brought in to the Commission. Prospective President Juncker is addressing that issue. There was a suggestion to have clusters of Commissioners, but he has not actually done that. He has proposed a sort of matrix system which is more complex but quite clever. The various Vice-

Presidents will be charged with particular priority subjects and will deal with different Commissioners according to their subject.

Q160 Earl of Caithness: Is that going to depend much more on personalities and people working together than was the case for people working in the old system, which was a much more vertical one?

Richard Corbett: You could say that the old system ended up being much too horizontal. There was a trainload of Commissioners and there was the President. This creates Vice-Presidents who in a sense will fit in between. Technically, Juncker is delegating some of his prerogatives as President to the Vice-Presidents. I draw attention, for instance, to the role of the prospective first Vice-President, who I think you know very well: Frans Timmermans. Part of his remit is to say no when he thinks that the Commission services are being too enthusiastic in, for instance, bringing forward new legislative proposals.

The case of Pierre Moscovici is now the subject of some debate in the Parliament because it is a very important portfolio. Does he have to have the agreement of the Vice-Presidents that he works through to go further, or is there a hierarchy? In one sense there is, but not in the sense that the Vice-President can take his proposals and say, "No, I don't like them", and change them. The Vice-Presidents are charged with making a joint proposal with him to the College of Commissioners, but there is always a safeguard in the sense that if you cannot reach agreement, any Commissioner is entitled to request that an item be discussed in the College of Commissioners as a whole. The trick would be to avoid that happening all the time, of course.

The Chairman: So Timmermans is a kind of early longstop in the sense of looking at legislation which may or may not be permitted under ideas of subsidiarity and proportionality. The Vice-Presidents then have their important roles. We have calculated that Lord Hill may have to report to as many as three. But in his favour, of course, is that he

does have a developed civil service behind him, as indeed Moscovici will have. That lends quite a bit of weight to how things are brought forward under the financial rules and regulations. So that is a fair reading of it and you seem to be fairly satisfied that it may work. It may work, but there are always personalities which can intervene.

Richard Corbett: I am satisfied that it may work out, although it may not. However, I think that it is worth trying.

Q161 Lord Kerr of Kinlochard: One of the effects is likely to be, taking the long view, a strengthening of the central secretariat-general inside the Commission. That is because it will be servicing the Vice-Presidents and will be the counterweight to the directorates-general all servicing the individual Commissioners. In a way you could say that you are going back to Émile Noël. The central secretariat has become weaker over the past couple of decades, in my judgment. Is that right when seen from your perspective?

Richard Corbett: Possibly, but of course it is not all done at the level of the services. The personalities of the Commissioners can be very important. Also, given that the Commission is so large nowadays means that you often use the written procedure to sign off on decisions. Under the internal rules you can use the written procedure only if the various services involved, not just the central secretariat but the different parties, have all reached agreement. That is a guarantee that you use the written procedure only if it is pretty consensual, otherwise it would need a discussion. So there are safeguards against it being overly centralised.

Lord Kerr of Kinlochard: From your unique perspective over the past few years, can I ask you how, when standing back, you would mark the way the institutions reacted to the financial crisis? By that I mean the Commission, the Council—which you were particularly close to—and the Parliament. Who rose to the challenge and who rose less well? Do not tell us that they performed equally well and were all totally splendid.

Richard Corbett: Almost everyone in the western world was taken aback by the magnitude of the crisis. Many academic writers and others have noted that the European Council played a central role and some have said that it was a sort of power grab by the European Council vis-à-vis the other institutions. I would say that it played a central role not because it was grabbing power from the other institutions but because of the nature of the issues that had to be grappled with, which included at crucial points in the crisis the issue of sovereign debt. On that matter, it is a crisis of national government debt; that and it brings up the whole debate about national debts and deficits. (The EU budget is irrelevant in this as it is small and balanced by law.) So we were talking about co-ordinating national policies, where member states are in the driving seat, and their representatives at the highest level were bound to take a key role in those discussions.

Secondly, the EU lacked instruments for dealing with a crisis of this magnitude. There was no lending facility, for instance; that and other instruments had to be created. If you are creating new instruments that do not exist already in the Union framework, you need member states to agree to do that, which sometimes involves treaty change or new treaties and sometimes not. If you need that, it has to be agreed, almost inevitably at the level of heads of state in government. So for both those reasons, the European Council was in the immediate primacy. That does not mean that the other institutions have not played a role, especially when it comes to financial sector legislation or implementing measures that the European Council has agreed. Then the full institutional triangle comes into play in the normal way. The initial reaction and conceptualisation of what needed to be done and how we could move forward was described by President Van Rompuy as being like building a life raft when you are already in the storm and your boat is about to sink. That had to be done at the European Council level.

Q162 Lord Kerr of Kinlochard: We were thinking about this during an internal debate in this Committee, and it struck us that the role of the President of the European Council was particularly important in two ways. First, he and his advisers produced an overarching programme which in our view was rather more impressive than the comparable exercise from the President of the Commission, and actually had more effect on the way in which the world moved. If you consider that the Commission in its present structure is a bit silo-minded, it was very important that this should be an overarching concept. We should congratulate you, as you played a part in that. Secondly, perhaps for the British it was a very good thing that the European Council was the forum in which the heads of Governments met to take some crucially important decisions. If it had not been there, it would have been at a eurozone summit, which would probably not have been very good news for the United Kingdom. You might have thought that it would be more convenient for it to happen at a eurozone summit, because there would not be so much bad-boy behaviour going on in the classroom; but, in the historical context, it is very good that we had for the first time a full-time President of the European Council, with the Council developing its role as agenda-setting for the institutions as a whole. I am interested in your comments on that, Richard, but please also come back to looking at the Parliament and the Commission, as well as the European Council, as separate institutions. Mark our card. How did they perform?

Richard Corbett: Would you like my comments on the first question? The European Council's role under the treaty is agenda-setting and setting the main priorities. Most EU business comes nowhere near the European Council; it is the ordinary Council, Commission and the Parliament that deal with it. But that which does tends to be pretty important, either because it is system change or because it is about matters on which there are deep divisions within the ordinary Council, or because it is to do with setting priorities for the medium to long term for the EU. There is one advantage and one disadvantage in dealing with

something in the European Council. The advantage is that, if you get agreement at that level, with the most powerful political figure in every member state and the President of the Commission, it has political momentum behind it that usually carries through whatever has to be done afterwards at European or national level. The disadvantage is that it needs unanimity on policy questions, out of 28 people who do not work together day in or day out and meet only five or six times a year, most of whom are used to getting their own way nationally. I have sometimes said—although perhaps I should not do so before Members of the House of Lords—that there are 28 prima donnas, and you have to knock their heads together. Suddenly they are in a meeting room where none can have their way unless everyone else around the table agrees, and they are not used to that.

So the development arising from this in having a full-time, longer-term President has been absolutely crucial, because of course the European Council has become more and more unwieldy as it has enlarged. You need time to prepare the meetings, talk to everyone, put a text on the table and adjust it and to explain, persuade and knock heads together. All of President Van Rompuy's predecessors under the old system had a national Government to run, which naturally took up 90% of their time. Nowadays you need that time and the longer term of office. Fortuitously, the first President also knew a thing or two about economics; he had been a professor of economics and the Belgian Budget Minister, at a time when Belgium's debt-to-GDP ratio was about 130%. He had had the experience of how to turn around that sort of thing and go on a different trajectory. He was very familiar with many of the issues that were coming up, more familiar than some members of the European Council. That helped, and we were lucky to have Herman Van Rompuy, and not just because he is very skilful because he has come out of the Belgian tradition, whereby Prime Ministers do not always get their own way without squaring it with all kinds of people in more than one

language. He was good at the consensus-building role, but he also knew a thing or two about the subject.

The third thing we were lucky with were the eurozone summits, which France pressed for under President Sarkozy. Others were reluctant to, but then they were set up and they are now enshrined in the Stability Treaty. President Van Rompuy always sought to organise these things in conjunction with a European Council meeting, except when there is an emergency, which has normally happened only once or twice. So it is tagged on to the end of a European Council meeting, and has usually been a very quick thing. Furthermore, because it comes at the end of a European Council meeting, all the other members can see what is on the agenda and raise it in the wider circle beforehand, if they feel the need to do so.

Finally, he ensured that the president of the eurozone summit is the President of the European Council. It does not have to be, legally, but it was agreed while he was there because of his expertise. Now, despite the next President of the European Council being from outside the eurozone, it has been agreed that he will continue the tradition of chairing both summits. That is a reassurance for those who are not otherwise at the eurozone summit.

Q163 The Chairman: Do you want to pick up on Lord Kerr's marking of the card of the Commission, Parliament and Council?

Richard Corbett: The Commission, the Parliament and the Council? That is harder for me to judge. You can give a good or a better score depending on the subject. Many Governments acknowledge that a lot of the legislation was improved by dealing with the Parliament, although sometimes that can be frustrating from a ministerial point of view, but many people think that the six-pack and the two-pack were considerably improved by the Parliament.

What does the European Parliament bring to the system? If the European Parliament were not there, it would all be dealt with by eminent diplomats, bureaucrats, technocrats, loosely supervised by Ministers flying in periodically to Brussels to try to keep track of it. The fact that you also have in Brussels a body of full-time Members coming not just from governing parties but opposition parties in each country, not just from the capital city but from the regions, brings a lot more pluralism into the system as a whole. The dividing lines in Parliament tend to be political, not national, otherwise it would duplicate the Council. It is very unusual in the Parliament to find all the Members from one country voting this way and all the Members from another country voting another way; it divides politically.

For most European legislation, if you think about it, that is quite logical. Do you want stronger rules on consumer protection or to leave it to the market? There are people on both sides of the argument in every country. Do you want higher environmental standards, but at greater cost, or not? There will be people on both sides of the argument in each country. Do you want tighter regulation of financial markets or a lighter touch? In most countries, there will be people on different sides of that argument. That comes out in the Parliament, whereas in the Council the Minister comes along and says, "My country thinks this", as if everybody back home agrees with him or her, which is not always the case.

Q164 Lord Kerr of Kinlochard: This is only a half point, so it is not really cheating. On the sequencing point that you made about the order about the European Council meeting, then the Euro summit, the heads of government, meeting, on which I agree with everything you said, is it not of general application? Is it conceivable that the order of Eurogroup and ECOFIN meetings could be switched for precisely the reason that you give, so that there is a general discussion of the issue in which all are involved and then those for whom the issue may bite particularly because they are in the eurozone will proceed to reach their decisions

afterwards? It seems to me that, although a lot of the worrying talk about caucuses would not go away, psychologically it would be less of a worry if the sequence was reversed.

Richard Corbett: I agree that that is a good idea. There is one other thing to watch out for with the eurozone at the level of Finance Ministers—the Eurogroup, as it is called. It elects its own chairman, its president, for a two-year period, currently Mr Dijsselbloem. It is often envisaged to give it a full-time president who relinquishes any other posts that he or she has. That would create yet another president in the system, yet another cabinet and possibly a secretariat, which would be an intergovernmental eurozone secretariat and a eurozone cabinet. An alternative to that, if they decide to move to a full-time president, would be to ask the relevant Commissioner to chair it in a double-hatted way, similar to what Cathy Ashton does for foreign affairs—the advantage being that you do not create yet another president and yet another cabinet, and so on, in the system and that it would be someone coming from an institution that belongs to all of us and is accountable to all of us. That would avoid that problem.

Lord Kerr of Kinlochard: But it would have other downsides.

Richard Corbett: Minor things.

Q165 Lord Hamilton of Epsom: Can we come back to Timmermanns's role to restrict legislation? Do you see that as being pre-emptive or reactive? Will he have a remit to go around to different Commissioners and shoot newborn babies at birth, or will he be waiting for these proposals to mature and then say that there is not enough space in the legislative programme to take them on?

Richard Corbett: The bottom line is that it is reactive, but I am sure that someone with Frans' ability will try to do it more pre-emptively if he can. That being said, there is a danger that his role is perceived as being the answer to concerns about subsidiarity and an overactive Commission, whereas of course it is part of the Commission's role to be

proactive, to come up with ideas and proposals. At the end of the day, they do not become law unless the Parliament and the Council have agreed to them. In the Council, that requires a hefty majority—74% of the votes at the moment—of national Ministers, who are members of national Governments and accountable to national Parliaments. The idea that the Commission can foist things on hapless member states of which they are blissfully unaware needs to be taken with a pinch of salt. The true safeguard for subsidiarity will not be Frans Timmermans, yellow cards or other things, it will be the fact that no legislation can be adopted unless a very large majority of national Ministers say, "Yes, okay, we do need a common rule on this at European level and this is one that we can sign off on". A minority can block in the Council; it has a red card.

Lord Hamilton of Epsom: But might there then be a situation where Timmermans says to the Council of Ministers: "This proposal has come from this Commissioner, but I think it is unnecessary and you should block it"?

Richard Corbett: No, in principle he should have sorted that out within the Commission, because the Commission collectively formally proposes—

Lord Hamilton of Epsom: Before it ever got that far.

Richard Corbett: You may have situations where the Council gets frustrated at not receiving a proposal it was expecting and the answer will be, "Ah, because Frans Timmermans killed it off in the Commission".

Lord Kerr of Kinlochard: Does he not also have a quality control function, not just in stopping a crazy brainwave but trying to raise the overall standard of legislation?

Richard Corbett: One would like to think that that was happening anyway, but I think that Frans Timmermans's role will help in that respect.

Q166 Lord Shutt of Greetland: We met Michel Barnier. He wrote to the EBA to express concern about alleged attempts to circumvent the bonus rules with the use of

allowances. He stated: "It is important to show a collective proactive stance on this important matter and address the claims made that the spirit—if not the letter—of EU law is being disregarded". Will there be a lot of tension about that in the coming months?

Richard Corbett: I do not know how much tension there will be, but it will certainly be the focus of attention. If you have legislation limiting bankers' bonuses—as you know, that is currently being challenged in the courts by the British Government—obviously you do not want it to be circumvented.

Lord Shutt of Greetland: That is clear. Mr Juncker has promoted the concept of a capital market union. We are having great difficulty picking up from anyone what that means. What do you think it means, or what does the Commission think it means? Have you got a clue? Is there anything that the UK can add to it as it develops?

Richard Corbett: This no doubt will be one of the questions we will be asking Lord Hill in his hearing.

Earl of Caithness: If I was Lord Hill, what would you be whispering in my ear now?

Richard Corbett: On that point?

Earl of Caithness: Yes.

Richard Corbett: I do not know the detail of what is proposed. It sounds good superficially and it sounds like something that would be in Britain's interest, given that the City of London is Britain's—indeed, Europe's—main financial centre. If you have an enhanced single market in financial services, surely London is well placed to take full advantage, if we get the detail right. As with all these things, the devil will be in the detail and getting it right.

Lord Shutt of Greetland: Although Jonathan Hill has got to respond to this in this great hearing, the issue is in the gift of Juncker. It is not his invention, is it?

Richard Corbett: No, but he would be the portfolio Commissioner. There is the caveat that it is Juncker's idea and a second caveat is that all Commission proposals have to get the

approval of the college of Commissioners and then make their way through the Council and the Parliament.

The Chairman: Given that we have fallen on to the United Kingdom, perhaps you could help us Lord Hamilton.

Q167 Lord Hamilton of Epsom: Can you give us your read-out on the row over the Juncker appointment as President of the Commission? Has the dust settled on that? Has the fact that we now have Tusk and Hill in quite significant positions been accepted by everybody?

Richard Corbett: For most of Europe, there was not a row and it was 26-2. There is a feeling of a lack of comprehension about the vehemence of the British Government's opposition to Mr Juncker. It was fair enough to say that he was a candidate that Britain did not particularly like, but the vehemence and the degree to which that opposition was taken surprised people. After all, Mr Juncker was one of the candidates for President of the Commission who had already said in the election campaign that one of his priorities was to address British concerns. He is also representative of a segment of political opinion in Europe, the traditional Christian Democratic centre or centre-right view, which is precisely the segment that Mr Cameron would need to try to get on board if he goes down his proposed route, should he win the next general election, of starting negotiations on reform. He is the sort of person, the segment of opinion, that he would need to do a deal with.

Q168 Lord Hamilton of Epsom: I rather enjoyed Charles Moore's comment in the *Spectator*. He said that in his experience whenever Conservative Prime Ministers objected to an appointment in the EU, they invariably got rid of that one and got somebody even more Europhile instead. I do not think we really want to talk about the Scottish referendum, although it presumably caused a certain amount of concern for countries such as Spain. How about the British referendum? What is your feeling about the "in or out" referendum? Do

you think it is going to happen? Do you think that in the end Labour will have to support having an "in or out" referendum in 2017? Can it get through an election campaign without matching that promise?

Richard Corbett: I think that Ed Miliband was very clear. Labour is not going to match that promise.

Lord Hamilton of Epsom: Tricky.

Richard Corbett: Possibly it is tricky. There are indeed some people in the Labour Party who say that in the election campaign he would be almost obliged to match that pledge. Others would say, "Hang on, this subject comes 12th, or something like that, in people's lists of concerns if you ask them in opinion polls. Those people who do feel strongly that you need a referendum have probably long since stopped voting Labour and are not likely to swing back just because we have also proposed a referendum". Above all, if Labour pledged a referendum, it would have to deliver, so the first year or so of the Labour Government would be totally overshadowed by the need to organise and win such a referendum. We saw in Scotland that, yes, you can win tricky referendums, but at the cost of all hands on deck, drop everything else you want to do and make all kinds of pledges. That would overshadow everything else that Labour wants to do. It would be a massive distraction. Then, if you lost it, you would have an economic catastrophe on your hands. You would spend the rest of your term of office negotiating the terms of exit from the EU and simultaneously trying to negotiate new trade agreements with every other country in the world to replace the ones we currently have via the EU and negotiating as just little Britain without the clout of the rest of Europe behind us. It would be a nightmare. I do not think that anybody who is ambitious to see a Labour Government wants to see that as what it is elected to do. There are other priorities.

Q169 Earl of Caithness: Can I pick up on Juncker's point 5 about this being a British concern. Is that not the wrong phrase to use? There is a concern that Europe is going in the wrong direction. That is not just in Britain but across Europe. Labelling this as a British concern misrepresents the seriousness for the future. The current direction of Europe has to change to accommodate a changing population with a different view.

Richard Corbett: It is not unreasonable to talk of a particular British dimension to this because Britain is the only member state whose Government—or, at least, one of whose governing parties—is envisaging a strategy of putting a set of changes on the table in 2015, negotiating and agreeing them in 2016 and then having a referendum and possibly leaving the EU in 2017. No other member state is envisaging anything like that. It is true that there is a widespread constituency wanting reform, although there are different ideas of what those reforms should be, but the EU in many ways, if you are not talking about treaty change, is a non-stop negotiation of reform. It is 28 countries around the table managing their interdependence in various fields, and it is a non-stop process of reform, all the more so in that nowadays, unlike 20 years ago, most new EU legislative proposals are about revisiting existing EU legislation to adapt it to technical progress, to change it because it did not work very well, to repeal it or to revise it. It is not about legislating in new fields. In other words, it is about reform, and that is what we do day in, day out, year after year. It is not a one-off to say, "Let us propose it in 2015, do it all in 2016 and sign off on it in 2017". It is non-stop.

Q170 Lord Kerr of Kinlochard: I agree with both of you. I agree with the Earl of Caithness that it is an extremely unhelpful label to call it "the British problem", as in point 5 of the Juncker text. I agree with you that keeping our Union competitive in a world in which the Chinese economy is growing as fast as it is and making these necessary changes acceptable to domestic public opinion in our country is a non-stop task. I do not see anything in the first part of the Prime Minister's Bloomberg speech which would not achieve

quite a wide degree of agreement. What seems to me to be involved is for the Commission to present the need to do something about some of that, because that is a way of keeping the British in. I think it is far better that the Commission should be presenting, as the European Council did in its summer conclusions, an agenda which is precisely in line with the first bit of the Bloomberg speech. If I were the British Prime Minister, I would be starting to declare victory and saying that the agenda of the European Union for the next five years is laid down on very much the lines that we in Britain were talking about. You are both right, but I am sure that the Earl of Caithness is even more right that it will be much harder to get such changes—and further changes are required as laid down in that agenda—if they are presented as things to keep the British in the boat, because there are some people who think the British are pushing their luck a bit and need to make up their mind on whether they want to be in the boat or not.

Richard Corbett: I think that Mr Juncker's flagging that up as a particular point was infelicitous in that way, but I think it was intended as a signal to Britain to say, "I'm not saying no to discussion; I am open to it". And, yes, it is true that the issues are of wider concern, though with this particular British dimension of possibly exiting the EU, which nobody else is threatening. I also agree with you about the proposed European Council conclusions, which were very helpful, although the devil is in the detail. They were very broad-brush and there will be quite divergent views on a lot of the detail. In general, if I were to advise Mr Cameron on his proposals in the event of his being re-elected—not a hypothesis I am planning on—I would say, first, that treaty change is much more difficult than policy change. Secondly, proposals in the general interest of the Union are much more likely to garner support than demands for unilateral opt-outs. If he moves in that more constructive direction, he is more likely to find a degree of support.

The Chairman: Let us hear from Lord Hamilton. I have a couple of questions for Richard that I want to finish on, but if there are any other thoughts lying unpresented from colleagues, please share them.

Q171 Lord Hamilton of Epsom: Richard, if I shared your enthusiasm for the EU, I would be lying awake at night worrying about the economic performance of the eurozone. We have been advised—there is something of a consensus on this, although that does not mean anything because there has regularly been economic consensus on things that turned out to be wrong—that the eurozone will flatline for another five years. That would be 10 years in a row of virtually no growth in the eurozone, with record high levels of unemployment and the emergence of parties that basically reject the views of the main parties in many countries in Europe. How long can this go on for? It is all very well sitting there saying that the way the EU does things is by incremental change. Something pretty dramatic has to happen quite fast or we will all be in terrible schtuck. I do not believe that the EU can survive the collapse of the eurozone, or that the eurozone can survive 10 years of flat growth.

Richard Corbett: I am curious that you put it all on the eurozone because other countries in Europe have also faced challenges of slow growth or flatlining for a long period. It is a common challenge, whether you are in the eurozone or not.

Lord Hamilton of Epsom: Not quite because the European Central Bank can do something about it.

Richard Corbett: I was about to say that there are some aspects, though, where it is different for the eurozone, not least with the role of the Central Bank. In a situation where you have already used many other tools of economic policy, can the bank do more? One criticism I have of the Central Bank is that it seems to get around to taking the right

decisions but very slowly. You could say it is always six months too late, but that is another discussion.

Lord Hamilton of Epsom: That is a fundamental point because central banks should almost pre-empt, not react.

Richard Corbett: One can think of other central banks that also act in this way. On your central point of economic stagnation, people are aware of the danger. They look at what happened in Japan and for ways of avoiding that here.

Lord Hamilton of Epsom: Bear in mind that unemployment levels in Japan were much lower at the start so they did not have the same problem.

Richard Corbett: People are aware of that and policymakers are addressing that with the tools at their disposal. Very few of our countries—a few, not none—are in a position to have a great fiscal stimulus. Germany arguably is. On the monetary side, classical monetary policy does not have much left in it either so you have to move towards extraordinary measures. Then there are the structural measures, which are vital, though politically often much more difficult. The situation we are in has focused attention much more on structural measures. Then there are trade agreements which can also help, not on a month-by-month basis but more in the medium term. The importance of some of the prospective trade agreements coming before the EU also has to be part of the answer.

The Chairman: Let me come in on that as we are beginning to wind up. On the trade agreements, did Lord Kerr want to explore the financial services in the TTIP?

Q172 Lord Kerr of Kinlochard: Not really, no. I am perfectly prepared to do so—I am the dog in the HMV poster. On your free route, it seems to me that you are a little hard on the Central Bank being six months late and so on. The process is grandmother's footsteps, and grandmother lives in Berlin. You need to move at a pace that does not cause trouble with the Germans. Perhaps the German role is clearer now that the British have retired to

the wings a bit and the French economy is in the state that it currently is. I think that Mr Draghi manages his relationship with Berlin rather well—perhaps better than his predecessor—and so far he has moved quite a long way while maintaining a grandmother's footsteps position and nothing is changing. Do you think that the advent of coalition in Germany has made this game easier or more difficult to play?

On structural reforms, of course you are 100% right, but everyone knows structural reform is a slow-burner: you have to do it, but you do not get the return in terms of growth for a considerable period. That is not a reason for ducking it, although it is even more difficult in times of recession than at a time when you have growth. Nevertheless, you have to do it.

The third one is trade. I admit that I am a little pessimistic about the prospect of a brave new TTIP world. I cannot see the next ambassador from Washington or the United States regulators and financial services industry agreeing to a single transatlantic market in financial services. The Americans are much more protectionist in lots of areas of services, such as aviation or shipping as well as financial services, than the Europeans. My expectations are rather low, and I worry about the extent to which people build up TTIP expectations. I think they might be dashed.

The Chairman: Do you want to answer those, and then I will come in with my relatively short points? We can then conclude this session.

Richard Corbett: We are not necessarily in disagreement on the Central Bank. You offered an explanation of why it is six months late. If you think I was exaggerating, I will concede that maybe it is only five months late.

Lord Kerr of Kinlochard: And on coalition?

Richard Corbett: The coalition will change it only at the margins. That is the initial assessment. Structural change is slow, you are right. You said that is no reason not to do it, but let us not forget that it is not starting now. Structural change has been going on for

some time now, more vigorously in the programme countries, where you are beginning to see some results from structural change—Spain springs to mind. Spain also springs to mind in the context of the unanswered part of your earlier question about extremist parties. The correlation of where extremist parties have risen and the degree of economic crisis is not a match.

Lord Hamilton of Epsom: No, but Alternative für Deutschland is doing all right.

Richard Corbett: Whether you count them as extreme in the same sense is debatable.

Lord Hamilton of Epsom: The Nazis have all joined.

Richard Corbett: The Alternative für Deutschland did not get into the Bundestag in the past elections. There are some extremist parties in other countries whose rise preceded the crisis, like the Netherlands and Belgium. But I digress from the structural change question.

The third question was on trade. TTIP might not see the light of day in its fully fledged form. I expect something will come out of it, but it is not the only game in town. We have already concluded some and we are negotiating other trade agreements with countries across the world.

Q173 The Chairman: Let me ask you a concluding question about the European Central Bank and the United Kingdom central bank—the Bank of England—which we are seeing on 4 November. Do you think they share a common challenge, especially in terms of the review of the banks and the asset quality review, which of course is being done in conjunction with the EBA? We are also seeing Mr Enria shortly. Can you talk about the relationship between the ECB and the UK, who see themselves as the big two overseers? Do you think there is a lot of harmony and understanding between the two?

Richard Corbett: I do not know well enough to give a sound view on that. They talk to each other a lot and face many of the same challenges. There are some peculiar challenges that one has and the other does not, both ways round—the volatility of the British housing

market, for instance. They are the two biggest central banks in Europe and they both know that they have to get their relationship right. They are run by grown-ups who will appreciate that.

Q174 The Chairman: I will make a concluding point, but just to refer to Mr Van Rompuy and the help that you gave him, we as a Committee recognise the very strong, in many ways behind-the-scenes role that he played. Is it fortuitous, since his challenges were so much in the financial services, that he was a former Finance Minister and professor of economics? We have the newly named President of the Council; is that something that is essential to any President of the Council? It is always going to be an important thing.

Richard Corbett: It was fortuitous because that was not at the forefront of people's minds when he was chosen. But who knows the future? It may be fortuitous that we have Mr Tusk when foreign-policy relations with countries to the east are now to the fore. I saw a very good tweet the other day, which said the years of the last European Parliament but one—therefore the last Commission but one—were focused on constitutional change; the last one was focused on economic crisis; is the next one going to be on foreign policy?

Lord Kerr of Kinlochard: As long as it stays foreign, that is all right.

The Chairman: My final point is that it has come to the fore from this Committee that financial services are taking such a central role. We are interested—indeed, concerned—that Lord Hill should have been nominated for that. We realise back in our own country how crucial the hearing that is coming up will be. For my part, coming from the same place on the political spectrum as you, I have recognised that many of the qualities that Cathy Ashton had in the House of Lords, where she was so clearly a collegiate player, can be found in Lord Hill. I believe, if he does get in, he will demonstrate that in spades. He could be very successful. I have been at pains to say that, as have my other colleagues to the various other colleagues we have met in the European Parliament.

For my part I recognise that, were Lord Hill to be rejected in some unsubtle way, opportunities for the 2017 referendum could be very difficult indeed in terms of the sensible way it will be reported in our press, which is perhaps not always the keenest of reporters from the viewpoint some of us round this table share. I do not know whether you want to respond to that, but I hope to see Roberto Gualtieri on Monday in Rome when we finance chairs meet. I will take the opportunity to speak to him there. I was interested to hear your own report from the group I used to be in that there has been a self-fulfilling desire that they look at the candidate and test the will of the candidates in the process.

In the mean time, you are our concluding witness on this visit, which has been interesting and fascinating. You have rounded it off by bringing a whole number of other perspectives, from not just your parliamentary career but your sojourn with Herman Van Rompuy and your unparalleled experience writing books with some very good colleagues and friends on the whole structures of the Parliament. A number of Committee members were particularly interested to learn more about the internal workings of the Parliament. We will send you a transcript of what has taken place here today. Please correct and add to it, as ever. You are a frequent flyer with this Committee. We are always open to hearing your other thoughts as they develop in trying to sort out this business. We hope to conclude the text by Christmas time and publish in the new year. Finally, we hope to have a look at the European Central Bank as a concluding task of the Committee before the Committee reconstitutes itself after the general election in May. In the mean time, my very warm thanks to you for coming on a Thursday afternoon to speak to us.

Peter Cosmetatos–Written evidence (FRF009)

Introduction

1. I am providing this evidence in an individual capacity, but would like to explain the reasons and the specific, if limited, extent of my experience and knowledge of this subject.

    a. I am the chief executive of the Commercial Real Estate Finance Council Europe (**CREFC Europe**), a trade association that represents those who provide, or invest in, debt to commercial property businesses across Europe. Two particular areas of financial regulatory policy that I have focused on in this role are the Solvency II capital rules (and how they treat different forms of exposure to commercial property and different kinds of debt); and the rehabilitation of securitisation (in particular, the evolving approach to asset backed securities (**ABS**) and especially "high quality" securitisation (**HQS**) under Solvency II and more generally).

    b. Before taking up my current role a year ago, I spent five years or so as the director of finance policy at the British Property Federation (**BPF**), a trade association that represents businesses developing and investing in property in the UK. In that role, I was especially concerned with how the Alternative Investment Fund Managers Directive (**AIFMD**) and the European Market Infrastructure Regulation (**EMIR**) would affect the diverse commercial property investment universe.

    c. In parallel, over the last couple of years, I have been a member of an independent UK property industry group, the Real Estate Finance Group (**REFG**), which published a report in May 2014 entitled *A Vision for Real Estate Finance in the UK* (the **Report**).[27] The Report (of which I was the principal author on behalf of the group) makes a number of recommendations aimed at weakening the feedback loops between the property cycle, the credit cycle and the regulatory cycle, so that the financial system is better able to weather the next commercial property crash. The REFG's premise was that, given the importance of commercial property investment to the real economy and the impact its cycle can have on the financial system, it merited a strategic and holistic review – something neither government nor financial regulators had attempted.

2. Numerous post-crisis regulatory initiatives have been of interest to the UK property industry and the property lending and debt investing industry at the national, European and broader international levels. It has been a common feature of many of those initiatives that they have significant impacts on the flow of capital to property without being specifically concerned with it. The lack of any specific (or holistic)

[27] The report is available at https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx.

policy interest in property markets has generally meant that those impacts are poorly understood and, as a result, largely a matter of accident rather than design.

3. I am not able to judge whether that problem, which is the sole focus of my evidence, also affects other 'non-core' – but potentially important – financial markets or economic sectors. However, I believe it is significant even if it is limited to commercial property, because commercial property is both an important enabling part of the real economy, and systemically important to financial stability.

4. I would single out the new focus on macro-prudential regulation and the introduction of measures and powers specifically designed to be used in a counter-cyclical way as positive achievements of the post-crisis financial regulatory response (Question 3). In the absence of a move to a more automated, 'governor' (rather than 'switch') based regulatory system, such as is advocated in *A Vision for Real Estate Finance in the UK*, I remain doubtful as to how lasting and impactful those positive developments will prove. Subject to that one point, I apologise that my submissions do not cross refer to specific questions in the Call for Evidence – I hope it will not be difficult to pick out the key points and relate them to the Sub-Committee's inquiry.

General remarks about commercial property and financial regulation

5. Commercial property is not an obvious or central target for financial regulation – but its contribution to the delivery, maintenance and management of the UK's capital stock and built environment is highly capital intensive. That means that financial regulation affecting the sources of capital has an impact on the sources, types, amount and cost of capital finding its way into the commercial property sector. This matters for two reasons.

    a. First, the indirect ramifications of financial regulatory reform for the real economy are largely a matter of chance, because financial regulators lack expertise about, and fail to give adequate attention to, the operation of the commercial property industry.

    b. Secondly, the implications of financial regulatory reform for financial system resilience and stability are also a matter of chance. This is because of the fragmentation of financial regulatory policymaking across different financial sectors (banks, insurers, investment funds, etc.), with minimal horizontal perspective across affected customer bases of those sectors.

6. UK commercial property will always attract both equity capital investment and debt. The distribution of equity and debt varies, not only across the cycle, but also geographically and across sectors (e.g. large, prime central London assets may attract cash buyers, whereas riskier, smaller, transitional or regional assets are more likely to require cheaper debt alongside more expensive equity). Commercial property and its potential for stable, long-term rental income and (for equity investors) capital growth offer a very broad range of direct and indirect investment options for investors in terms of risk/return profile, the degree of active involvement required, liquidity, diversification and control. Financial regulation affects different types of investor and different types of investment increasingly, and in different ways – but there is little

sign that financial regulators are conscious of the cumulative impacts of their various interventions.

7. During the last boom, burgeoning commercial property risk accumulating in certain UK banks was barely noticed by regulators who were, unfortunately, asleep at the wheel when they should really have made a difference. After the bust, the echo of US sub-prime also contributed to property being seen as part of the problem, and financial regulators have generally tended to try to discourage property exposure wherever they see it.

8. I believe it is their lack of expertise and knowledge about commercial property that causes regulators to regard commercial property as simply and inherently risky for lenders and investors of all kinds. That approach might have some, partial justification in relation to systemically important financial institutions such as banks and possibly insurers. It is very difficult to justify in relation to sophisticated institutional investors in commercial mortgage backed securities (**CMBS**) and alternative investment funds (**AIF**).

Observations about post-crisis EU financial regulatory reform

9. I do not believe the EU has done a particularly good job of reforming the financial regulatory framework insofar as it relates to commercial property and commercial property debt since the crisis. The main problems, briefly illustrated, are set out below.

    a. ***The commercial property debt 'knowledge gap'*** Given the importance of commercial property debt to the real economy and to financial stability, there is a quite extraordinary lack of meaningful information available for financial regulators about the structure, composition and characteristics of the commercial property debt market. For example, European Central Bank data showing the contribution of property to economic growth and employment in the Eurozone provide no breakdown between owner-occupied residential property and commercially owned investment property. Another problem emerged when a senior official at a European financial regulator expressed great surprise when I told him that commercial property investment (both debt and equity) is a highly globalised activity. He said that regulatory orthodoxy holds that property investment is principally a domestic activity, in which cross-border capital flows play no more than a small part.

Another extraordinary blind spot is the extent to which ordinary commercial lending by Europe's banks is based on the value of commercial property collateral, rather than on a credit assessment of the borrower business. This is undoubtedly the case, and it means that banks' exposure to commercial property markets is far greater than the size of their formal commercial property loan books would suggest. Information and understanding should be key to good policymaking, yet nothing has been done since the crisis to address huge

weaknesses in this area – indeed, my impression is that regulators' ignorance about commercial property is an 'unknown unknown'.[28]

b. ***Politics and the regulatory pendulum*** Financial regulators (in the UK as well as the EU and elsewhere) have shown themselves to be as susceptible to the cycle as the firms they supervise. Their failure to act in the boom was followed by an inevitable backlash in the bust, reflecting understandable public hostility towards bankers and the world of finance. Eventually, policymakers remembered that, for all its sins, the finance industry had to be part of the solution in getting the economy moving again. Financial regulators found themselves trying to balance their reawakened instincts for focusing narrowly on risk not only against their new awareness of a broader need for macro-prudential supervision, but also against political imperatives to support the 'real economy'.

The continuing rehabilitation of securitisation illustrates these tensions, as well as regulators' failure to understand the role of different ABS asset classes in supporting the real economy. SME lending is a relatively risky business, commonly made a little easier by the presence of commercial property collateral – yet regulators are bending over backwards to encourage it. Conversely as few regulators understand the vital role played by the commercial property investment industry in (among other things) allowing SMEs to rent suitable premises flexibly, the flow of credit to property businesses continues to be seen simply as problematic and risky.

c. ***Regulatory silos and lack of coordination*** One of the main drivers behind the REFG and *A Vision for Real Estate Finance in the UK* was the sense that, from the point of view of the commercial property industry, there was no sign of any coherent plan or strategic vision behind the various regulatory initiatives affecting the sector. When all financial regulators think commercial property risk is bad and seek to protect investors or the firms they regulate from it, what implications does that have for the capital that wants commercial property returns, and for the property businesses seeking capital? The likely result is reduced capital supply, with more of it taking unregulated or more complex routes.

I can illustrate the problem by referring to a disturbing conversation I had in early 2014 with an official at a European financial regulator. I was arguing that the approach that regulator was adopting towards the relative treatments of different types of commercial property exposure by regulated firms seemed certain to create arbitrage risks, negatively impacting overall financial system resilience and stability. He replied that he was only concerned with the firms he regulates, and actually said: "financial stability is not our concern".

Similar problems arose when the European Commission and ESMA were developing the EMIR and used still-evolving definitions in a different piece of European legislation (the AIMD) in drawing the line between financial and non-financial counterparties. It was

[28] In this context, I refer you to first recommendation in *A Vision for Real Estate Finance in the UK*, referenced in footnote 1 above, which argues for the creation of a comprehensive CRE loan database. The Bank of England is to be commended for taking an interest in this proposal.

impossible to have a sensible conversation with European officials about the problems that approach might create in the context of property investment funds, partly because of poor communication between the separate teams working on the two legislative proposals.

d. ***Lack of transparency and effective consultation*** Silo effects are further entrenched because consultation in many complex areas has been conducted informally with regulated firms, with information and participation denied to other interested parties who might bring a broader perspective. The worst example of this that I came across was the development of Solvency II by EIOPA. Insurance firms are significant investors in commercial property in various different ways, but the regulator had no interest in engaging with the commercial property industry – either to explain its proposals, or to listen to what their impacts might be on the commercial property industry. Successive drafts of regulations have been circulated informally only, sometimes leaked to the media, but rarely shared with stakeholders outside the insurance industry itself.

Conclusion

10. To be clear, I would like to see better regulation. I am not advocating less regulation or a closer relationship between regulators and businesses. The risk of regulatory capture for regulators is a real one – but it is cyclical, principally affecting the boom phase of the cycle. This inquiry focuses on the post-crisis period, in which regulators over-compensated for their failings in the boom. The issue is how well regulators understand the firms they are regulating, the market in which those firms operate, and the investment and economic sectors affected by regulation of those firms. Based on the interactions I have had with them and what I have seen of their performance over the last few years, I do not feel confident that European regulators have the understanding required for them to do their job effectively.

29 September 2014

European Banking Authority- Oral evidence (QQ 175-186)

Evidence Session No. 10 *Heard in Public* *Questions 175 – 186*

TUESDAY 14 OCTOBER 2014

Members present

Lord Harrison (Chairman)
Lord Balfe
Earl of Caithness
Lord Carter of Coles
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witness

Andrea Enria, Chairperson, European Banking Authority

Q175 The Chairman: Mr Andrea Enria, it is my pleasure to welcome you for the third time here before the Committee and to thank you for coming to help us on this, our latest session on the EU financial regulatory framework. As you will recall from past interviews that we have done, we will send you the transcript of what takes place here this morning. We ask you to look at it, correct it and indeed, if you have further ideas, let the Committee know about them. We are in session and are being broadcast on the network, and I ask colleagues to keep any sotto voce comments to a minimum; or at least to make them amusing, which is of benefit to the Committee.

Perhaps you would begin by saying what role you have, but I will then ask you this question, Mr Enria: what is your assessment of the reforms that we are looking at, retrospectively but also prospectively, which have taken place since 2008 and which are designed to improve the functioning of the financial sector in Europe? Will the new regulatory framework allow the European Union to have the flexibility to respond to changes but also to withstand, were there to be one, another asymmetric shock? Does it have the tools in place now to be able to resist that? Perhaps you would like to introduce yourself first of all. Thank you very much.

Andrea Enria: Thank you very much, Lord Harrison and honourable members of the Committee. It is a great pleasure for me to be here again. I must say that I enjoyed and learnt a lot from our previous conversations, and I have very much appreciated your reports on European matters. I am Andrea Enria. I have been the chairman of the European Banking Authority since 2011, so have been there through these difficult times of the crisis and the European Union's attempt to introduce the financial reforms that are at the core of your question. My assessment of the reforms is generally very positive. The G20 in 2009 had already identified the right drivers for reforming the financial sector: having more and better quality capital at banking institutions; introducing liquidity standards to ensure that banks have more readily available buffers of liquid assets to withstand shocks without the need for public support; and better matching between the maturity of assets and liabilities to avoid, let us say, the excessive reliance on wholesale funding to finance long-term investments. All these are coupled with governance issues, including dealing for instance with the incentives in the remuneration packages and in general introducing new risk-weighted measures such as the leverage ratio. The suite of reforms that have been designed by the G20 and implemented through European legislation are the right ones. I believe that the way in which the process has been managed has been relatively effective and efficient.

As you know, the European Banking Authority is, together with the other European supervisory authorities, now going through a process of review. I think ECOFIN will possibly come to conclusions today on the performance of the three authorities and the European Systemic Risk Board during the three years since they were established.

In general, in terms of the functioning of the financial sector, we now have banks that are better capitalised, and the process of repairing balance sheets has come a long way. As you know, we were criticised at the beginning for the stress test that we did in 2011, but through that stress test and the recapitalisation exercise that we managed shortly afterwards we pushed a significant strengthening of the capital position of European banks. We enhanced the transparency and comparability of banks' data quite significantly. This might not have been sufficient of course, but it was necessary to bring back confidence to the European banking sector. Now the banks are funding in the markets again at relatively reasonable prices and are in a much better position to lend. Having said that, this is the part of the glass that is half full; we are still grappling with some difficult issues.

There are three main points that link to your question on the prospective ability to manage future shocks. The first point is the functioning of macroprudential tools. We have introduced macroprudential supervision, for which the European Systemic Risk Board in particular has responsibility. That will be essential to maintain the flexibility of the framework to enable it to adapt and cover for new potential sources of risk. In this respect, I am quite positive about the tools that are being developed. I am a bit concerned about the fact that a lot of flexibility is left, both in the legislation and in actual practices, to national authorities to define these macroprudential tools. We need to achieve some degree of co-ordination in the way in which these tools are designed and deployed at the European level.

The second problem that I see is the segmentation of the single market. The crisis unfortunately brought a massive retrenchment in cross-border banking, and the single market, to a large extent, stopped working for a while. This was to a significant extent linked to the shortcomings in the design of monetary union, which led to this perverse link between sovereigns and banks. Banking union should provide an answer to that, but we are still seeing the market having difficulty recovering, and difficulties with cross-border flows and integration of markets. That is a major concern for me of course, because the single market is my remit.

The Chairman: Shall we pursue some of those issues in depth? I ask Lord Kerr to come in.

Q176 Lord Kerr of Kinlochard: Chairman Enria, can you tell us how you see the effectiveness of the legislative process, starting upstream? How should the EBA, which you chair, be engaged in the legislative process in Brussels? If you were talking to Lord Hill now, what would your pitch be to him in order to ensure that the technical expertise that resides in the EBA is better embedded in the legislative process? It could not be at the start, of course, because the EBA did not exist, but now that it does, should there be some mechanism for drawing in that expertise?

Andrea Enria: Thank you very much for this question, Lord Kerr. Indeed, I think there is still some way to go to for the EBA to be engaged in the legislative process at a European level on a similar footing to the one which national authorities have at the national level with national parliaments and national Governments. We are still far away from that. In a sense, the process is very much top-down now. Basically, the primary legislation defines mandates for us to accomplish and we enter into the picture in general once those mandates are defined. In my view, this has some shortcomings because we have the impression that our expertise is not entirely used when producing primary legislation.

First of all, there is an issue with the definition of our mandates. In terms of content and timelines, it is important to have good engagement with the Brussels authorities—the Commission, the Parliament and the Council. Frequently in the past, mandates have been attributed to us at the very last minute, with very unreasonable timetables that have not allowed us to pursue the process of consultation and engagement with the stakeholders. It is important to have this type of engagement, at least for the definition of our mandates.

On primary legislation, sometimes it is important to exploit our expertise. There have been some good examples. For instance, we have done a couple of reports—one on the calibration of the liquidity coverage ratio and one on the regulatory treatment of covered bonds—in which we have identified and provided advice to the lawmakers on how we view the developments in the markets, and suggested that European legislation should be adjusted to reflect those changes in the markets. But the relationship is still not at its best. I even thought that having a sort of legislative adjustment that recognised our advisory role in the legislative process could help. I will give you an example. Much European legislation goes through Council working groups, which are composed of member states and the Commission. Member states usually bring their national authorities as back-benchers in those meetings. The national supervisory authorities are well involved in the production of European rules, while, because of an interpretation of the treaty—a rather restrictive interpretation, in my view—we are not allowed in the room; we are not allowed even to see the documents that are produced in those discussions. Honestly, sometimes banks know about the developments in the legislative debates before we do. That is something that is still far from satisfactory.

Lord Kerr of Kinlochard: Is there a particular role for the EBA in impact assessment? When the Commission produces a legislative proposal, it is now required to include an impact

assessment. Sometimes these are rather general. In the case of banking regulation, we have the expertise of the EBA. Would it be a good idea for you to be associated with the preparation of the impact assessment, or, if you are not associated by the Commission, for you to write your own?

Andrea Enria: Of course, first of all, we are supposed to and do conduct an impact assessment of our own products. In some cases we have also supported the Commission with our own analysis, but you are right: there is no structured involvement of the EBA. That would be a good idea, because from last month we started to receive for the first time data from the single reporting that we have just implemented in Europe. Now all banks are using the same supervisory reporting and we collect, at the European level, all the reporting for the main 170 banks. We have also gathered information on a wider range of banks in order to cater for different business models, such as savings banks, co-operative banks and the like. So we have a wealth of data that can help in conducting the impact assessment.

I said before that the first requirement for me would be to have involvement in the process of consultation on our mandates. The second point is that whenever a task is assigned to us, we should have a clear legal basis and, especially, sufficient resources to conduct the task. If we were requested to do this work on an impact assessment, which I would view very favourably, we would also need the resources to do it, otherwise it would be very difficult with the current staff.

Q177 Lord Kerr of Kinlochard: Going downstream now, under your chairmanship the EBA comes up with a piece of delegated regulation. Under the present system, as I understand it, that is submitted to the Commission, which is entitled to make changes to it. Is that a problem? Does it impose delay? Are some of the changes easily understood, or do they cause problems for the members of the EBA?

Andrea Enria: That is a difficult question. We have developed a good working arrangement with the Commission. To be completely honest, the EBA founding regulation says that when the Commission wants to amend our standards, it should send that back to us for comments and there should be an interaction, unless the changes are non-material. So in general we have had some agreements on non-material changes. That has worked rather well. The process has been slower than expected. I think the Commission underestimated our production capacity because it had quite a lot of standards coming to its table and it had difficulties in the translation, the legal review and the like, so sometimes it took much longer than the three months that are allowed by the legislation. I think for the reporting requirements it took eight months, which led to problems in the first implementation. Indeed, the process is not the easiest that you could envisage. Now, together with the other ESAs and on the basis of the first experience that we had, we have an exchange of letters under way with the Commission in which we are trying to set out the working arrangements—how these interactions could work—and we are trying to find an agreement on a best-effort basis to make sure that this goes as smoothly as possible.

Lord Kerr of Kinlochard: Is there any common frame to the sort of objections that you get from the Commission—the amendments that it wants to make to the standards that you have drafted, approved and put on its table? Is there any theme in the Commission's reactions?

Andrea Enria: It is difficult to say. In general, it is a question of the legal basis. That is the main point. The point is that the tradition of the Commission is that the legal services of the Commission enter into the analysis of the legal text rather late in the process. We involve our legal services very early so that when we go to our board we have something that we think is sound from the legal point of view. The Commission enters the process rather late,

so sometimes it is concerned that we might not have covered part of the mandate or might have exceeded the mandate in some areas. These are the types of discussions. But in general it is more the legal business.

Lord Kerr of Kinlochard: There is no appeal procedure in such a dispute. The Commission rules, and if it has an objection it is the prosecutor, the judge and the jury.

Andrea Enria: First, there is a process by which the Council and the Parliament are also involved. When we send standards to the Commission, we send them to the Parliament and the Council at the same time. The Parliament and the Council have a certain timetable for calling back these standards, intervening and providing comments. The process of commenting and making changes, especially if there are changes, is transparent. When the Commission sends a request for changes back to us—I cannot remember whether it has happened once or has never happened—they are also sent to the Council and the Parliament, so the process should be transparent. The problem is these less transparent discussions that we are having on the legal basis. We are discussing with the Commission whether to have earlier engagement by their legal services so that we do not start discussing these issues at a very late stage.

The Chairman: Lord Flight, briefly please, come in before the Earl of Caithness.

Lord Flight: Please excuse my ignorance, but I am not entirely clear what the role or purpose of the EBA is, particularly versus the ECB. What are its powers, if any, and where is it accountable?

Andrea Enria: Thank you very much for that relevant question. In the standard-setting process, the drafting of standards is delegated to the EBA by primary legislation—by directives or regulations of the Union. This delegation gives us a certain timeline to draft these standards and submit them to the Commission. The Commission then has an

endorsement process, and they are implemented as secondary, delegated legislation. I was trying to describe a sort of process that limits the possibility of the Commission changing our standards without our involvement. That is our main role in the standard-setting process. Once these standards are adopted, they become legally binding on the 28 member states of the Union. Then we have less legally binding tools: guidelines and recommendations, which are addressed to competent authorities or financial institutions and that are "comply or explain". The addressee should say that it intends to comply with our guidelines or recommendations, or explain why it does not. We have a mediation role in the case of conflicts between competent authorities, for instance for cross-border banking groups, in the joint decisions that they have to take in certain areas. We have a role in the conduct of stress tests, which is very material currently, because the new stress test is supposed to be completed by the end of this month. We also have a responsibility in terms of a breach of the law: if some authorities are applying European legislation in a way that is not correct or is in actual breach, we can open investigations and recommend that they amend their acts. If they do not, the Commission could take action.

Q178 Earl of Caithness: We have received evidence from various people making the criticism that, so far, the decision-making process in the EU has been too silo-based with regard to regulation and that there has been quite a lack of joined-up thinking in preparing matters for financial services. First, do you agree? Has that been a problem?

My second question follows on from that. Decisions are made not just at the EU level but at the international level, and those made by the Financial Stability Board or the Basel committee inevitably impinge on EU regulation. What role can you play to make that as consistent and as even as possible, given that you are part of the glue that is holding the single market together and trying to keep an overall group rather than just a Euro group?

Andrea Enria: Thank you for that question. I recognise that there is some truth in the concern that you have reflected there, but we have made a lot of effort to try to join up with our sister organisations in the securities market and insurance—ESMA and EIOPA—and have tried to provide a more cross-sectoral approach in the area of regulation. The relationship between the three agencies is excellent, both personally and in terms of technical working relationships. We have a joint committee that brings the three authorities together, which we chair in rotation—this year it is my turn. We have been doing a lot of work in a number of areas, especially during the crisis. In the worst moments of the crisis, we did a lot of practical work together, for instance in trying to assess the potential impact of malfunctioning credit risk transfer mechanisms. We did a lot of cross-sectoral data collection, liaising data from the CFTC in the US, securities repositories and information that we had from the banking sector. We made serious efforts in that respect.

In the regulatory field, there are areas where we are given joint mandates, for instance in the conglomerates directive and now in PRIIPS - the packaged retail investment and insurance-based products: products that are similar in function but can be packaged as insurance, securities or banking products – to harmonise a transparency document for customers. We have done joint work on complaints handling and on institutions that are issuing their own liabilities to their own retail customers. So we have done a lot of work together but, to be honest, European legislation does work in silos. Solvency II, the CRD IV/CRR and MiFID/MiFIR all have their own processes, and it is not always easy to bring them together. Despite our willingness to work together, it is not easy. You know that we do not have very easy governance, in the sense that our board tables are composed of 28 voting members, one from each member state. When you have to approve a joint product for the three ESAs,

you have to go through three complex, parallel processes, so it is complexity cubed to some extent. It is not easy, to be entirely honest with you.

The best way to move forward here would be to acknowledge this sort of interaction at the legislative level. There are areas where this is the case, such as the interaction between EMIR and CRD IV/CRR on the treatment of bilateral margins, for instance for derivatives, where we have a mandate to develop joint standards and we are doing something that is very harmonised between the two types of legislation. ESMA has a responsibility for rating agencies, whose products we use in regulating banks, and we are mandated by legislation to develop joint work. That is the right way forward: where there are already these connections, to put these into legislation.

On the second part of your question, on international borders and European legislation, you are absolutely right. We have important work on standard-setting at the international level with the Financial Stability Board and the Basel committee.

Let me say something that is very painful for me, but I want to be completely honest with you. As you know, I am a strong supporter of the single rulebook—having exactly the same rules across countries in the single market. That is very important. However, in the past it worked in this way: you had international standards, then directives, and then the directives left enough room to national authorities to, let us say, deviate from the international standards in a minimal way to adjust for specificities in their domestic markets or to favour their domestic banks. Now that we have the single rulebook, each country brings its own national issues into the European legislation, which means that you sum up together all the deviations from the international standards in the European rules, and the risk is that the European legislation deviates from the international standards. In banking, this is a serious risk, which means that you need a strong commitment at the European level. I understand

that there is a parliamentary process that we must be extremely respectful of. The Council has a strong role, so we need to respect our own institutions. But it is important to find ways to make sure that this legislation develops in line with international standards. I do not think that we have got that balance right yet.

The Chairman: Lord Caithness, do you have a follow-up to that?

Earl of Caithness: My only comment is that it sounds as though we have made the situation worse.

Andrea Enria: That would probably be going too far. We managed to implement the standards in an effective way, very quickly and in a much more harmonised fashion. The problem is that you need to keep in line with the quality of international standards. It is positive that we are now undergoing a review by the international authorities—by the Basel committee, for instance—on the implementation of Basel III. So the European institutions will be faced with areas where they might not be in line with international standards and they will have an opportunity to remedy that situation. I am a strong supporter of maintaining the European legislation as much as possible in line with international standards.

Q179 Lord Carter of Coles: Mr Enria, is it your view that the EBA enjoys sufficient powers and resources to enable it to highlight and address overlaps and interconnections between regulations? As an example, what do you think of the range of unintended consequences, such as regulatory arbitrage and, of course, transferring risk off-balance sheet? Perhaps you could also outline how the rules prescribed within the CRD IV package, including the use of definitions, exemptions and access provisions, interact and, indeed, overlap with other regulatory dossiers such as the recovery and resolution directive and the European markets infrastructure regulations?

Andrea Enria: Thank you. You must understand that we are very short of resources, to be honest. By the end of this year, we will have 110 permanent staff. Being a European agency, a good chunk of that is absorbed by people doing all the internal administration, procurement and budgets, because we have to comply with very complex rules, as the Commission does. So the number of staff is kept very low. For reasons that are difficult to understand, the Council and Commission in particular are keeping us even tighter going forward, notwithstanding the increasing number of tasks coming to us. It is already difficult for us to meet the direct requirements that we are requested to fulfil. I must be honest: we do not always have the time to look into the neighbour's garden and check how the regulations that are being developed in, say, securities or insurance, could interact with banking rules and cover all the interconnections, although, as I mentioned, in the joint committee we try to make efforts in that direction.

For instance, we are now working quite a lot together on securitisation. Securitisation is definitely an issue that cuts across sectors. We have established a joint taskforce, with which we are trying to address all the rules that impact on securitisation, such as Solvency II, CRD, AIFMD and the rules concerning credit rating agencies. So we try to do it in a joined-up fashion. There are areas where we manage to do that, and I am glad that we do. As I mentioned before, with EMIR and CRR, we are trying to look at interconnection and to work together, but it is not easy. There is indeed a risk that while you tighten the rules for banks in particular— let us say, a number of risks are shifting to other intermediaries—that process is not to be seen only negatively. In Europe we have what is probably an oversized banking sector and perhaps too shallow capital markets. As long as this process leads to a rebalancing of these and there is genuine investment in fixed income that substitutes for bank credit, that is not a bad process. Also, cleaning up the banks' balance sheets—for

instance, non-performing loans being moved to specialised funds—is a good way to complete the process. In general, the ESRB—the European Systemic Risk Board—should also play an important role in understanding the development of systemic risk and how risks are being shifted between sectors and from the regulated sector to the non-regulated sector. That is something that it is doing more and more.

On your more specific question of the CRD IV/CRR and the recovery and resolution framework, you are right: there are important interconnections, because you have capital requirements for going-concern situations and then you have requirements that are linked to the ability of banks to absorb losses and to make sure that that you do not need to deploy taxpayers' money to support banks in a crisis again. We have mandates under both the CRR and the BRRD to develop standards for these requirements and we are making sure that there is a strong alignment in methodologies between the two. I will give you an example. You have all the triggers for early interventions by supervisors under the capital requirements regulation and then you have the triggers for recovery and resolution under the bank recovery and resolution directive. What we are trying to do is link all these triggers to the same indicators and to make sure that supervisors and resolution authorities share this information so that they act on the same information.

Q180 Lord Balfe: We understand that there are overlapping responsibilities between the EBA and the ESAs. That has been widely acknowledged. But at present, what are the main obstacles to achieving a more comprehensive and transparent single market for consumer financial products and services? How do you regard the EBA's role with respect to consumer protection, particularly given the demands imposed by the financial stability agenda?

Andrea Enria: Thank you very much, Lord Balfe. I have always been quite outspoken and honest in saying that in the first couple of years of our life we did not deliver much in the area of consumer protection. We were totally absorbed with firefighting the crisis and the

amount of standards that we had to deliver around the implementation of Basel III. We have now increased our efforts in the area of consumer protection quite a lot: for instance, we are working on product oversight and governance mechanisms within the banking institutions to make sure that when a product is designed, the target market and the process to make sure that consumers are sold products that they actually need are clearly identified. We are working not only on the compensation for high-profile traders, board members and the like but the remuneration of sales staff and which type of incentives are put in place there. We have worked a lot on virtual currencies. We issued a report and we have taken the leadership role at a global level in the debate on whether or not we should regulate virtual currencies. So there is a lot of work that we have been doing.

Let me say quite frankly that in the prudential field after the banking crisis, with the De Larosière report, there was a strong commitment to strengthening the underpinning of the single market. The idea was a single rulebook and convergence in supervisory practices, basically. We have not seen the same urgency and the same development in European legislation on consumer protection. All the legislation that has been issued, even recently, consists of directives. We do not have any regulation there. Most of those directives did not give the EBA any mandate. The first mandate that we received was in February this year in the mortgage credit directive. Now more is coming, with the payments account directive and the payment services directive II—PSD II—which are still being discussed, there will be more mandates for us and more standards to be developed by the EBA. But the legal basis that we have for the work on consumer protection is not as strong as the one that we have in the prudential field.

Lord Balfe: Will you be pressing for it to be strengthened?

Andrea Enria: The founding regulation of the EBA has an article that lists the pieces of European legislation that fall into our remit, so in those areas we can issue guidelines, give recommendations, do breach-of-law investigations. No consumer directive has been brought under our remit in that article. That would be an important adjustment.

Another point is that some directives have given us mandates, such as the mortgage credit directive, which gives us a role that we could expand by developing our own products, as we are doing, for example by developing guidance, such as guidelines on responsible mortgage lending. Still, our remit is limited to institutions that are mentioned in the regulation, which means that they are basically credit institutions and investment firms. That means, for instance, that mortgage brokers or other entities that are still under that directive are not within our remit, so we face some legal loopholes there.

Q181 Lord Hamilton of Epsom: I think you have answered my question about the single market and the single rulebook, so I would like to ask you a completely different question. It strikes me that the elephant in the room at the moment in the EU generally is growth. Does the EBA discuss growth? Does it make recommendations as to what should happen to produce growth, or does it just say that because the French and the Germans are at loggerheads on this and cannot agree, we will not even talk about it?

Andrea Enria: That is an important question. First, let me give you my personal opinion. I think that we are coming out of a massive balance-sheet recession. This is not a normal recession; it is a recession that has left us with a major debt hangover, in the public sector as well as in the private sector. Sometimes the banking industry makes the point that the lack of growth is related mainly to the excessive stringency of the regulatory requirements, in particular capital requirements. I do not agree with this argument. I think that the banks that have strengthened their capital the most are the banks that are lending more, so I do not

accept that argument. The point that we still have to deal with is how to manage and come out of this situation of excessive debt. We are seeing a lot of initiatives being taken at national level on, for instance, favouring the conversion of non-performing loans into equity and rebalancing debt into equity. That would be an important contribution to restarting growth, because if corporates are still focused on rebuilding equity and are highly leveraged, they are not focusing as much as they should on capital expenditures and investments. That, in my view, is a key point.

In terms of the EBA, I am not a fan of the Tinbergen rule that you should have one tool or one objective, but there is some truth in that. Bending the prudential rules, the rules for the safety of financial institutions, to growth objectives can be risky. It must be done with great care. There are areas in which we are working, such as high-quality securitisation—a discussion paper will be published today, I think, on high-quality securitisation—where we are trying to create a differentiated treatment for securitisation products to favour the development of a high-quality segment of the market that could also support even small and medium-sized enterprises to access the markets better and to overcome financial constraints. So we do have this type of discussion at our table, but I think it would be excessive to describe growth as our main objective. That is not what the legislation gives to us as a main mandate.

Lord Hamilton of Epsom: Does the EBA have the role of getting rid of regulation as well as imposing new regulation?

Andrea Enria: We do not have a specific role like that, but we do have a review obligation. Three years after certain standards or guidelines have been issued, we should review whether they remain necessary, and if not we should repeal them. So in a sense we do have

built into the process the idea that we should always review whether the rules are still necessary.

Lord Hamilton of Epsom: Have you repealed any regulation?

Andrea Enria: We are currently trying to do so with one regulation but we are meeting a legal obstacle. We issued reporting requirements for the calibration of the liquidity standards, but now that we are issuing new reporting standards we are repealing the old one. We are meeting legal difficulties, but we hope to be able to overcome them.

Q182 The Chairman: Mr Enria, would it strengthen the EBA and ensure greater representation of the EU approach and interests, as opposed simply to that of national supervisors, if we added more non-regulator representation to the Board of Supervisors?

If you could hold that question in your head, I am anxious to press on and try to recognise the difference between the work of the ECB and the EBA. Have you identified a possible duplication of standards and supervisory guidance with respect to the EBA's single supervisory handbook and the SSM supervisory manual? Is there a potential clash there?

Andrea Enria: I thank you a lot for this question, Lord Harrison. In theory, the division of tasks and responsibilities between the EBA and the ECB/SSM—the single supervisory mechanism—should be clear. We should be doing the rule-making task for the whole of the EU, including the euro area under the remit of the ECB, plus we should have a supervisory convergence task that provides a sort of common umbrella for the supervisory practices which the ECB is developing for euro-area banks and the supervisory practices of authorities that are outside the euro area or that in any case are not participating in the banking union.

One of the ideas that I floated when the single supervisory mechanism was introduced was the idea of the single supervisory handbook. Originally the idea was to have some chapters of the manual of the competent authorities that would actually be the same for the whole

EU, as in the US: in the US you have the Federal Financial Institutions Examination Council, which brings together the Fed, the OCC and the FDIC and basically develops some common practice for the examiners who go to the banks and have to assess their risk. That was our idea. The way in which this was introduced in the legislation was not exactly according to the original plan, shall we say, because now the legislation defines the single supervisory handbook as a collection of best practices. It does not substitute for national manuals or ECB manuals but is an additional layer. We are being confronted by the question of what to do there, because the last thing we want is an additional layer of rules adding to the complexity of a framework that is already complex enough. This is still in the experimental phase, but we have identified two or three areas in which we try to develop common, very practical guidance, with case studies. We have a chapter on business models, for instance, which is a new area that all supervisors had to enter, and we tried to bring together the experiences of different European supervisors, such as the UK supervisors on Northern Rock or the continental supervisors on the cajas in Spain, of what did not work in certain business models and how we can factor that into the practical review by supervisors. This does not substitute for the manuals, so you still have an ECB manual and a Bank of England manual, but hopefully it can provide something useful. If it does not, I will be the first to stop the train and say that we should do nothing in this area.

Q183 Lord Shutt of Greetland: Do you foresee the differentiated treatment of banks operating in the banking union undermining the integrity of the EU-wide single market? How can frictions be avoided? Are there any additional powers that the EBA needs to support it in this regard?

Andrea Enria: The first point is that the fragmentation of the single market that I referred to before was driven by the shortcomings of the monetary union—the fact that the monetary

union did not include common supervision and a common safety net. So to some extent, the banking union is a contribution to restoring the integrity of the single market. But you are absolutely right: at the same time it introduces a new level of complexity and potential segmentation and polarisation between the ins and the outs—countries that participate in the banking union and countries that do not. I have always argued that in order to maintain the integrity of the single market, some elements need to be preserved and maybe strengthened.

The first one is the single rulebook. In this area I am always positive about the progress made, but still there is not a single week in which we do not discover areas of flexibility left to national authorities that have led to major differences in the interpretation of the common standards. For example, with the implementation of the capital requirements legislation, there is a calendar for the phasing-in of the new requirements that has a lot of discretion for national authorities on how to phase in the new requirements. This is leading—for instance, with the stress test that we will publish at the end of this month—to a lot of challenges in making sure that you publish data that are truly comparable, because the national interpretations of the same rules are different. That is indeed a remaining challenge. So the first point is to have a role for the EBA in identifying those practical problems and escalating them to the table of the legislators and bringing to their attention the fact that there are still differences that are impairing the correct functioning of the single market.

In the supervisory field, we are still in a sort of existential search for what our value-added could be to make sure that we have a level playing field and a common layer of practices between the ECB and the other authorities. I still think that two key areas are important. One is the stress test, because through that we try to provide a lot of common information

on how banks under different jurisdictions would be affected by a consistent shock under a common methodology. That is very important. Having full transparency, common definitions and common aggregates is also extremely important. So strengthening our powers there would be welcome.

Secondly, I do not want to get too technical here but the regulation now leaves the banks to calculate the regulatory requirements with their internal models. That leads to a lot of potential inconsistencies between banks and between countries. So we are doing a lot of work to try to fix this issue, which emerged as a major one during the crisis. Having a strong basis to do that would be very important.

The Chairman: Our final two questions. First of all, Lord Kerr.

Q184 Lord Kerr of Kinlochard: Chairman Enria, has the scope for rulemaking been overdefined? Do you have sufficient flexibility if a problem turns out to be bigger than expected? If a new problem arises, can you adjust the rulebook sufficiently quickly? Have you got that flexibility built in? Secondly, if you were talking to Lord Hill now, is it in that area that you would ask him to look, or is it in the area that we were talking about before—the legislative process itself and the need to ensure that the rules you draft or that the banking authorities draft are not delayed unnecessarily or changed undesirably?

Andrea Enria: In an ideal world, I would like to have a situation in which authorities such as ours had a strong accountability framework and were trusted by the European legislators. That would allow for a much lower degree of detail in the primary legislation than is the case today and much more delegation to the technical authorities—but of course with more resources because otherwise it would be difficult. At the moment there are indeed some cases in which we do not have sufficient flexibility because of that imbalance between the primary legislation and the delegated legislation, but also because, for reasons that I

completely understand—we are experimenting with a very important and relevant institutional change so it is clear that there is some caution in moving to the new territory—there has been a rather strict interpretation of the so-called Meroni doctrine, which constrains the possibility of delegating tasks to authorities such as ours.

I will give you a couple of examples. The reporting framework, all the data that banks need to report regularly to their supervisors, with all the technical specifications, even the IT specifications such as the XBRL formats and IT platforms that they should use to send this information to the authorities, the validation of rules that we as authorities use in order to check that the information is correct—all this is in the official journal. Honestly, that is impossible. As a supervisor, in the day-to-day interaction with the banks you realise that there are small mistakes and you need to adjust. There is a new technology, and you need to change. So changing the primary legislation or even changing the standards every day and going to the official journal is not possible. Some of those things could be easily delegated, even within the current legislative framework. That is definitely an issue. But I think that as long as the balance remains tilted towards the primary legislation—and in my view it will remain so for a while—the most important thing is to engage the technical authorities more in the production of primary legislation.

Q185 Lord Hamilton of Epsom: As long as the UK and indeed other countries do not join the eurozone, we will have a two-track Europe, in effect. The people who are outside the eurozone very much look to the EBA to protect their interests. I do not have to tell you that the United Kingdom in particular has a completely dominant position through the City of London in the provision of banking services and financial services. How do you think these countries are going to be affected by the fact that you are going to have a eurozone that is really going to be making up its own rules as it goes along? Indeed, it would be sensible that

the ECB did so when it is dealing with bank crises and so forth. How do you think that is going to affect the City of London in particular?

Andrea Enria: The UK has taken an attitude in the debate on banking union which, in my view—I may be overstepping my role here but I say this in a personal capacity—is very defensive. There is this concern that banking union could give stronger power to the ECB in defining the European rules, so the approach that is understandably being followed is one of defending the possibility of the UK blocking rules that it disagrees with. For instance, the governance of the EBA has been changed, introducing the double simple majority rule, according to which in order to pass our standards we have to have not only a qualified majority but also a majority of countries that are both inside and outside the banking union. It is understandable. That is fine. But honestly, the UK is a big global financial centre. It has a very high ratio of financial assets to GDP. In my view, there is a strong interest to have very strong rules, both prudential and conduct of business rules, to make sure that you have integrity and resilience in the domestic market. In my view, it is in the interests of the UK to make sure that this is the standard of the EU as a whole and that there is a truly level playing field with the whole of the European Union. In my view, it is also in the interests of the ECB now as a new regulator to make sure that the whole single market is set on the basis of strong standards for every bank: that are truly common for every bank. I really think that instead of looking for, let us say, potential tensions, we should look at the common interest of strengthening the single market and repairing its function.

Lord Hamilton of Epsom: Do you think there is a danger of the United Kingdom getting out of step with the EU over this? I thought that some of our regulations were actually rather stronger than those of the EU.

Andrea Enria: The risk that I see is that both the UK and the ECB focus on their domestic jurisdictions too much and try to move to the setting where the European rules are lucent and more flexible in order to be able to adjust for different approaches. If this is the future, we will have a polarisation in the single market between different marketplaces, and this will not benefit the single market. That is my main point.

Q186 The Chairman: Mr Enria, I wonder if you will forgive me if I ask about the draft recommendations from the EBA about bankers' bonuses. Can you give us an update? I am very conscious that we have some witnesses sitting behind you who are eager to hear your answer.

Andrea Enria: It is not a very comfortable position for me because we have a conference call in a couple of hours in which we will vote and finalise this piece of work. If the board approves the report, we will probably publish it today, which makes me a little uncomfortable in anticipating the content of the report already. What I can say is that we have done a very thorough work of collecting from national authorities the remuneration policies that have been developed by different firms following the introduction of the cap in the European legislation, and we have seen the increased reliance on different types of allowances. Some allowances, which we define as market-value allowances, include a flexibility in the remuneration that is linked to market conditions in specific jurisdictions: for instance, you have a subsidiary and you want to adjust the salary of all the staff in that jurisdiction to local market conditions. These allowances are non-discretionary and the same for everybody, so for us they are indeed fixed allowances. We found some problems with the formulation of so-called role-based allowances, because they are very discretionary and can be changed at the discretion of the firm. In our view and the view of the technical groups that have looked at the issue so far, they are considered by some of these firms to be

qualified as fixed. We are now coming out with a report that should define criteria to classify remuneration as fixed or variable, and this should be used by authorities to classify the remuneration correctly and apply the cap correctly going forward.

The Chairman: Mr Enria, we must close there. When you came before us in summer 2011, when we did the report on the burgeoning ESAs, you mentioned to us the small numbers of those who had joined the EBA. I believe you have repeated that this morning by identifying some 110 people who are working for you. I am sure they are all of the top quality, but it must be difficult for you. Once again, we thank you for your attendance before this Committee and for the clarity of your answers in dealing with some difficult subjects. We will send the transcript to you and ask you to correct it. As ever, if some even better ideas tumble out of your head when you look at the answers again, please do write to us. We hope to be publishing early in the new year. We are most grateful and we are sure you will have a good engagement with Lord Hill, one of our number, as he takes on some very interesting responsibilities. Forze tanti grazie ancora. Alla prossima riunione.

Andrea Enria: Thank you very much. Thank you for your attention and your questions.

European Banking Federation and Finance Watch – Oral Evidence (QQ 80-100)

Evidence Session No. 5 *Heard in Public* *Questions 80 - 100*

TUESDAY 23 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witnesses

Benoit Lallemand, Acting Secretary-General, Finance Watch, and **Wim Mijs**, Chief Executive, European Banking Federation

Q80 The Chairman: Welcome both. My name is Lyndon Harrison and I chair the Committee. We are on a mission to try to find out a little bit about the EU's financial regulatory framework. In a way it is looking back at what has happened in the past few years, but also looking forward and trying to give advice in the House of Lords and beyond about what might be done to introduce further stability to the financial sector.

As neither of you have been before the Committee before, you may like to know that we take a transcript of the conversation that passes between us. We would be very grateful if you would look at it and correct when we send it to you. Indeed, if further good ideas suddenly occur to you, please write to us and let us know those ideas. We will not write up until the end of November, which always ends with our interviewing a Minister of the Crown

of the United Kingdom. As I say, we are very grateful to you, not only for coming but for speaking English. Our witnesses often have better English than we speak ourselves.

I will ask the two of you an opening question. Looking back at the years stretching back to 2007 and 2008, when we started to change things in terms of financial stability and the regulatory framework, do you think it is true that we have stabilised to the extent that we could now withstand an asymmetric shock to the system? Is it also true that we have done that and retained sufficient flexibility in the framework so that we could still respond, if we need to, in a positive way? If I ask Wim Mijs first, could you tell us a little about your background before you go into the question? We would be very grateful if you did the same, Benoit.

Wim Mijs: I am chief executive of the European Banking Federation and I am as fresh as you can get: this is my fourth week on the new job. You might think that that is an interesting question to ask me, but I have been involved in financial services for the past 21 years and not only on the European regulatory side. For the past seven years during the crisis I was the chief executive of the Dutch Banking Association, so involved in everything from ABN AMRO and Icesave and all the dreadful things that happened in the Netherlands. Before that I worked at ABN AMRO.

If you passed honest judgment on European institutions, some remarkable things have happened since 2008. In my view it is too early to say whether we would be able to withstand an asymmetrical shock, but there have been 40 regulatory measures. I would say that industry generally across Europe would agree that they were necessary: we needed to recalibrate the financial system and learn lessons from the crisis. If you look at the ratios from the Basel Committee, the introduction of the capital requirements directive and the capital requirements regulation were quite important, including the deleveraging of bank

balances, through which the public EU authorities have managed—together with the national supervisors, of course—to stabilise bank balances.

The eurozone crisis was an important shock. One of the things that happened was that it was forgotten that a monetary union should have in time become a fiscal union and a banking union. The banking union was put in place with remarkable speed. The reaction on the whole has been quite good, but we will still now have to see how it works. Everything that was decided will have to be implemented. If you look at the calibration and the level 2 measures that still need to be taken, you still come to the question—if we are now stable enough for a new shock—of the calibration. The newly organised union will have to prove that it is flexible enough to adapt to new circumstances.

Q81 The Chairman: That is helpful. I notice in your CV that you were president of Euribor. Some of my colleagues might like to ask you questions on that. I turn to Benoit. Wim has gone some way to say that much has been done concerning the 40 pieces of legislation; Monsieur Barnier will no doubt tell us that it is 41 piece of legislation. Could you tell us not just about the asymmetric shock and so on, but, if there have been the successes as outlined by Wim, what some of the failures of that process may have been?

Benoit Lallemand: As a brief introduction, my boss, the previous Secretary-General, testified to this Committee on MiFID a few months ago. I have been with Finance Watch from the beginning and I have spent more than 10 years in the financial industry in clearing and settlement, so mainly market infrastructure. We exist to look after European financial regulation from the public interest point of view. Part of the reason why we were created was to bring balance to the debates. You will allow me to be provocative or bring some different perspectives to the discussion.

The Chairman: We encourage people to be provocative.

Benoit Lallemand: That said, we engage with industry on a daily basis. We are the best advocates of the financial system when it does serve the needs of society and the economy. Journalists love to ask us if we are converts, because we come from the industry and they tell us we have moved to the positive side of the force. We do not see things that way.

That said, on the G20 agenda and the way it is being implemented in Europe, before we get into the discussion, I think the way you framed the question was whether we can make sure that the financial system will not harm the economy or society again: is it safe, is it stable? That is a very noble purpose, but I am afraid it is only now, six years later, that we ask the current question, which we think is even more important: how do we make sure this financial system serves the needs of society in a much more positive manner? That approaches financial regulation not just from a negative or prudential perspective, asking how we can make sure it does not harm citizens again using taxpayers' money and so on. It is a limitation in scope that was there from the beginning, which we were disappointed by. We are now entering this debate about the need for the financial system to support the growth agenda, which comes back to the forefront these days. We would have preferred it had it been embedded in the discussion from the beginning.

A lot has been done in terms of quantity of regulation. We have been labelled as pro-regulation, but I argue that, in terms of size, there has possibly been too much—certainly too much for us to handle. At times we would have preferred a simple and more effective approach. There has been great momentum, which was needed to address some of the failures of a system that had built up over the past 20 years. I understand that the context of this discussion is the demand of the industry to have some sort of a cumulative impact assessment of the 41 different pieces of legislation you mentioned, which is legitimate. The

Commission came out with the economic review—we do not call it a cumulative impact assessment.

I am keen to ensure that the burden of proof is not on the supervisory regulator. Most of these pieces have not yet come to the implementation phase. Very little has been implemented and we are already hearing many voices saying, "We must not have too much. We need to be careful". Of course we need to be careful. As I said at the beginning, the financial system is indispensable for the economy and society. However, we have gone through a period of 20 years, leading up to the crisis, where some mistakes were made. Very high-level officials, including in the US, recognised that some of the theory underlying the policy choices could cause deregulation to a certain extent and were mistakes—you could qualify that further. It would be interesting to take a step back for a moment and identify the mistakes that had been made, to look at the fundamentals of that and look at the approach we took. We needed to act quickly and urgently, hence the big package on the table now.

I would be keen that we take a wider perspective to ensure, for example, that we do not go back to the idea that the less regulation, the more efficient the financial system is going to be in serving society, which is a reaction you could have these days. For good reasons, politicians in Brussels have been obsessed with growth: you need employment, you need to build the economy. But you do not want to take a simplistic view that regulation on stability that we have built for the past five years is necessarily in a position with the banks and the financial markets to do their jobs properly. On the contrary, for long periods before the 1970s and 1980s you had a very tight and strict environment for the financial system, for banks and markets, which supported growth as we have never seen, although there were macroeconomic factors linked to that as well. You can show that a strong, efficient regulatory framework enables the system to focus on serving the needs of the economy.

Q82 The Chairman: Those of us who were in at the dawn of the euro of course hoped that we would have a stability and growth pact. Some of us tried to describe it as the growth and stability pact in order to give some weight to the concerns that you have just articulated. However, I would like to draw you out on some of the criticisms. Although you have mentioned consumer protection as being important, I turn to Wim to ask whether he would like to comment on the aspect of consumer protection. Has that been well noticed and taken care of in all those 41 Acts, in terms of making the market more efficient than it has been? Has that, too, been prioritised and given its head, all leading to greater financial stability? Perhaps if you come back on that, then I will turn to Benoit to see if he would like to say a little more about the deficiencies of what has been done over the past few years. Your Finance Watch paper was a terrific read—thank you very much for that.

Wim Mijs: I would say that the first direct reaction after the crisis was a complete focus on stability. If you look at the period 2008-2010, yes, arguably there was less interest in consumer protection because the system needed to be stabilised. So it is correct that that is very important. However, one important part of consumer protection was the deposit guarantee throughout the EU of €100,000 for savers. That served both purposes: it served to stabilise on the one hand, but on the other it was about consumer protection. Nevertheless, going forward, there will be more attention given to consumer protection, notably in MiFID II. In my opinion, MiFID has two main aims, unifying the European capital markets, which is all very nice, but on the other hand harmonising consumer protection. I must say that again, steps forward were made. MiFID I did a good job at harmonising consumer protection, and MiFID II makes it more modern, also introducing a different way of looking at inducements, making costs more transparent. Again, that is still to be implemented. Then there are the bank account measures. On the one hand I understand that the idea of having a universal

bank account serves a purpose and ensures access, but on the other hand it is also a question of subsidiarity. If you look at the reasoning why, you see that it is to give everyone access to a bank account, which is sometimes part of social policy, which again should be member states rather than the EU.

In short, there is no doubt if you looked at the financial services action plan when real attention was given to consumer protection because it was one of the three pillars there, then looked at the crisis of 2008, there was certainly a lapse in the time that they needed to stabilise the system. However, now, since 2011, in these 40 or 41—perhaps I am forgetting structural reform, which is one measure I would like to forget—if you look at the latest package since 2011 there is revamped attention for consumer protection, and rightly so.

Q83 The Chairman: Before I come back to Lord Kerr, Benoit, perhaps you would like to come back on some of those other elements I have highlighted—some of the problems on the way.

Benoit Lallemand: Staying on consumer protection, as Wim has just pointed out, MiFID II is a big consumer protection issue at stake. To be honest, it is an ongoing battle. Also, to be completely transparent on this topic, we have been extremely in line with UK policy and people at the FCA. Let us be completely transparent on MiFID II, because a discussion is going on. At level 1 you have certain elements related to inducements, and there is a way to interpret that into the implementation and the level 2 that ESMA and the Commission are willing to take very seriously and push, and there is a strong push-back from other sides, basically to give a different interpretation to level 1. So that is pretty interesting.

The Chairman: You have sung a similar song to others who we have been talking to today about the important of MiFID II.

Q84 Lord Kerr of Kinlochard: How do you think the legislative process worked during all this great drama? Who comes well out of it and who comes out badly? Our witnesses both have been involved in the pre-proposal process of consultation with the Commission, and then will have been involved in the processes of the Council and the Parliament. How much were these institutions moved by serious considerations which arose from the crisis and how much were they moved by the desire to punish banks? How much were they driven by one or other reason to end up with something that is too heavy and does not include enough flexibility?

Wim Mijs: I was surprised by the way some of the institutions worked together on stability. Certainly the trilogues went very well and led to something. If I looked at the national parliaments—my experience goes back to the Dutch Parliament, but I also followed the UK—the desire to punish banks and let heads roll and burn things down, the public anger directed at persons and institutions, was much more raw and direct than what I felt at the same time here in the European Union, where everybody felt this feeling of stabilisation. You could not really miss it if you say that in 2008 we had a banking crisis and arguably in 2011 we had a monetary crisis. Therefore there was no time to make it too political. Yes, there were huge interests and I saw them being played out, but I have deep respect for the way in which finally an outcome was found. This is quite impressive.

Benoit Lallemand: Yes, but I will not repeat what has been said. To add to that: in general, we might say that the Commission has come out with a pretty balanced text with what we would call the right level of ambition. There is only one thing that could bother me. Unusually, Parliament took this ambition seriously and sometimes pushed it forward in a complex manner. I am also impressed at how it managed that. The number of amendments it proposed is pretty scary. But then, in some instances you see that there are national

interests that play out on top of that. It is all pretty obvious but what bothers me is that, especially in the run-up to the European elections, there was a tendency on specific pieces for the Council to actually weaken some of the provisions desired by the Commission and Parliament—is was the Council playing that role in some instances. Then, some politicians went back to their capitals saying, "What do you want? This is Europe and you have to compromise". Unfortunately, that feeds into the Eurosceptic mindset when in fact, in this specific instance—I only know about financial regulation and not the rest—you had European bodies that were in effect more ambitious than the member states. The way it played out is a pity. I am not naive and I understand that there are important financial interests and so on. It is more the way that that was reported.

The Chairman: Before I ask Lord Hamilton to come in with his very important question, I want Lord Kerr to continue the analysis of the financial work that has been done.

Q85 Lord Kerr of Kinlochard: The theme of the Finance Watch paper looking at the product of all this is that the weaknesses derive from lack of ambition, the resolution fund not being big enough, capital adequacy terms not being as stringent as they should have been and the fund taking a long time to come in. You even suggest that there is a danger of having created a façade that would inspire confidence when the reality behind it is not big enough to match the scale of the crisis that could happen. Is that a fair summary of Finance Watch's review of the product? We have talked about the process and you have both been rather polite about that. You suggested that the problems arose more in member states' capitals than in the institutional structure, but what about the product?

Benoit Lallemand: I think you are referring to a paper on banking structure, a recent policy brief. Anyway, I recognise some of what you said. If you talk about banking union and stabilising the whole system, which was the aim starting at the G20 level, then yes, it is a

great ambition. It should restore confidence and if it does then that is perfect. Of course, we, like many other observers, look at the content and want to make sure that it will be effective, is solid enough and so on. Our analysis could lead us to banking structure and the fact that we would like to make sure we do not forget about this part. I will take a metaphor: the crisis of 2008 was a tsunami of banking losses. Unfortunately, it hit a coastline composed of citizens, who had to absorb the loss. Then the approach was very much prudential, saying "Let us build on the existing embankments and maybe add some more to stop the tsunami". You had three embankments to make it really simple. Of course, this metaphor has limits, but the first embankment should be the shareholders' own capital brakes, such as Basel III and CRD IV. Banks have raised substantial capital over the past few years and fresh equity. There are two weaknesses there. First, it is not enough capital. The second weakness is the way that you calculate it, relying on internal banking models. This has been documented by the Basel Committee. You want a more standard approach as to how to calculate the risk rate. I will not go into details now.

The second embankment is creditors. That is bail-in powers, banking resolutions and so on. The main weakness of this wall is the interconnectedness of the system. As a politician, you may want to say at some point, "I will activate bail-in now so creditors will take losses". However, wholesale funding and the interconnectedness of funding between the major banks in Europe might make you think twice before pressing the button because there might be a domino effect. There is still some work to be done on the level of complexity and interconnectedness on the second embankment. The third and last-resort embankment is, of course, the resolution fund of €55 billion. That is a great idea but to put it in perspective, €1.6 trillion of public money had to be made available in 2008-09. Of course, that was not all direct capital but also guarantees and so on but it was still a burden on the budgets of states

to save the system. Again, that is €1.6 trillion versus €55 billion. That brings us to the question that when you have tsunamis, in the real world you can only build embankments or run away. In this financial world—I am pushing the metaphor too far—underwater volcanoes create these tsunamis. If you can make the volcanoes simpler, less interconnected and possibly smaller then your embankments might be sufficient, even with the weaknesses I mentioned. As long as you have these giant volcanoes that are interconnected, I am not sure about the idea that the embankments will protect us from the tsunamis. Personally, I would run. I would not count on them. On the concept, you need to address the root cause—which you cannot do in the natural world. That is a discussion to have. These embankments are necessary, the basis is there but we need to work on them to strengthen them. But we also need to look at the root cause.

The Chairman: Would you like to respond, Wim?

Wim Mijs: Certainly, I am Dutch so I know about water management. I am being polite about European institutions because I think they really deserve it. I would certainly not be polite if I thought otherwise. Yes, there has been national interest and hard negotiations, but all in all they have done a lot in a short time. That is true. On the discussion of Finance Watch, we both agree on the framework but not the calibration. I think that is very clear. Then you come to the dykes and the question is what buffers you need. To start with, one of the discussions we have is the leverage ratio. A lot of academics would like to raise it to 20%. We would argue that if you have a concrete floor in your kitchen and you raise it through the ceiling it is hard to live in the kitchen. My point is that the leverage ratio is all agreed as a backstop. You can set it at 3% as now or say that is too low and set it at 4%. We argue that you should do this across Europe with no national discretions there, but it is the concrete floor on which you build your buffers. The buffers are supposed to take the first hit and then

the concrete floor is the final protection. That is what the discussion is about. But it is not ready because it is in the implementation phase, so this is one of the discussions we have. I would argue that Basel III and CRD IV give us a very good basis where you can calibrate a little, say moving the leverage ratio from 3% to 4%, and look at the buffers. Basically, the healthiness of the bank balances has risen considerably but that is part of the discussion. The other part is interconnectedness. That is the bail-in tool, and I go back to water management. One reason why the funds can be smaller than the actual damage of the crisis is that we put in a lot of dykes that were not there in 2008. There are two problems with the resolution fund. First, you have to think how big it should be. After all the other measures were taken to make banks healthier or possible to break up; what should your end resolution fund be? The second point is that you need some time to fill it. Unfortunately, due to the damage that was done, the economy needs to be restored and that fund will take some time to fill because it is still a huge amount of money. Again, that is part of the discussion of the whole water management system rather than every measure in itself.

On interconnectedness, I very much believe in bail-in as a tool. Bail-in is the way forward: the reassurance that the taxpayer will not ultimately have to pay for future crises and/or mismanagement. Something I do not yet know but which needs to be looked at is how it works and whether we really dare to bail in senior debt, for instance. That is one of the discussions that, again, I must honestly say that I do not know about yet. If you asked me about BRRD, I would say that it is pretty good legislation and we have this MREL capacity, which everyone now tells me does not work and that is why the Americans have not tabled it for the G20, because they want to construct GLAC. I translate the Gone-concern loss-absorbing capacity as how far you dare to go in the case of a bail-in, which is apparently not clear yet. We thought we had agreed it at the European level, but apparently that is not

enough at an international level. So this comes back, and is where the question of interconnectedness arises. It is still an open question and more work needs to be done.

Lord Kerr of Kinlochard: That is absolutely fascinating. I did not pick up the point about the Americans.

Wim Mijs: Their concern with the bail-in is about the loss-absorbing capacity. I do not know as exactly as I would like, but I have been wondering why there is this incredible push on the G20 to discuss GLAC in Brisbane in the next few months. Part of it, I understand, is that they are daring us to bail in senior debt; this is seen as questionable. Consequently, they are working on a concept which is similar but not the same, GLAC, at G20 level. As Benoit also mentioned, it has been shown that we are not yet completely sure about the international bail-in system. Due to the interconnectedness of banks, not only within but also outside the EU, it is important that we make this visible and do some more work.

The Chairman: If you do some more work and you feel that you have developed your ideas, please write to us.

Wim Mijs: I will.

Lord Kerr of Kinlochard: Thank you, that was fascinating.

Wim Mijs: I am slightly worried if that was fascinating.

Q86 Lord Kerr of Kinlochard: I am catching up. You have been incredibly polite. Please now be rude. Please tell us which of this great raft of legislation, 41 measures, was the most useless.

Wim Mijs: Number 41. Absolutely. We had Vickers, Volcker and Liikanen and now, for all sorts of reasons which have a little to do with the political opportunities of Michel Barnier, we have structural reform. We have both talked about water management, the framework, with all the dams in it. However, if you do not let this work and you have new ratios, new

balance management, the recovery and resolution directive and everything, and then before you let these things take you come up with a proposed regulation to break up the universal banks we have in Europe as a kind of afterthought, I would worry about that. Then there is another one, my "rude-free" one: the financial transaction tax.

The Chairman: Hurrah.

Earl of Caithness: Hurrah.

Lord Hamilton of Epsom: Hurrah.

Lord Kerr of Kinlochard: Hurrah.

Lord Shutt of Greetland: Hurrah.

Wim Mijs: That is not a good idea. I saw my colleagues in BUSINESSEUROPE and the federation of the Netherlands looking at me and thinking, "Ah, it is just another banking tax", but it is actually not: it is a tax on the economy. I said, "Guys, it is a tax on you". We have seen where the FTT has been implemented, in France and Italy, that the trading book is getting smaller. So you are making your capital market, which you need for growth, undeep. I will not go further. I hope that has been impolite enough.

Q87 Lord Kerr of Kinlochard: I liked that very much. Could you please consider the merits and demerits of AIFMD, which would be my other candidate for the prize for useless legislation?

The Chairman: Will you ask Benoit whether he would like to respond to that?

Benoit Lallemand: On this one I cannot; I would not comment. Obviously that makes a discussion—

The Chairman: What about FTT?

Benoit Lallemand: You will notice that we do not comment on the FTT, so I will let you draw a conclusion.

The Chairman: What about AIFMD?

Benoit Lallemand: I guess it is not a priority.

Wim Mijs: I am sorry, AIFMD?

Benoit Lallemand: Investment fund managers.

Wim Mijs: Oh God, yes. I am slightly more distanced. I do not know that acronym directly, but it is about asset management.

Lord Kerr of Kinlochard: Well, it applies to all sorts of things, like investment trusts.

Wim Mijs: I know. I am not comfortable commenting on it because I do not know the exact arguments.

The Chairman: The good news is that we are seeing Monsieur Barnier tomorrow afternoon. The other good news is that Lord Hamilton is coming in.

Wim Mijs: I need to look for another job. I met this chap from the European Central Bank who had some interesting comments on your structural reform and your own political ambitions. Excellent.

Q88 Lord Hamilton of Epsom: You have mentioned the growth agenda. As we stand today, the economy of the United Kingdom is growing pretty robustly and that of the eurozone is not growing at all. Why do you think this is?

Wim Mijs: This is a difficult question which goes to public policy in the eurozone. I will be more personal than representing European banks. The consequences of the crisis has unearthed underlying economic problems which have not been solved. There have been problems with education, balance mismanagement by countries and maybe industries that were protected which are not protected any more. Consequently, continental Europe is going through a phase of restructuring its economy caused by the two shocks that happened to it. This means that the economy is adjusting more slowly than outside Europe, where

there is more flexibility in the economy. If you refer to the United Kingdom, the City of London is very connected to the rest of the world and perhaps more able to pick up quickly, whereas continental Europe is still restructuring.

The Chairman: Benoit, to answer Lord Hamilton's question about growth, is that to do with member states' failure to embark upon structural reform, of which we have just heard some of the elements outlined by Wim?

Benoit Lallemand: That goes way beyond my capacity to comment. I agree with what has been said. Our position is focused more on the fact that measures that have been put in place and the cheap liquidity idea are not working in a way. We are lacking some sort of connection between these specific liquidity facilities and productive investments.

Q89 Lord Hamilton of Epsom: Until recently the Bank of England has been pumping liquidity into the British economy but of course the ECB under German direction would be extremely reluctant to do that. Is that a salient factor in the lack of growth in the eurozone and more of it in the UK?

Wim Mijs: I find it very hard to say to say that. I think that the ECB has gone to the absolute limits of its mandate in stabilising the economy. I very much agree with Benoit when he says that the liquidity is there but the growth is not. What I said was not criticising Governments for not doing structural reform—I do not think that that is my position to say—but I note that while you have the SMEs, it is still hard for SMEs and industry to get the money and there is also a lack of demand. If we look at banks across Europe, the liquidity is there; yes, maybe we should worry about a new growth spurt where we may not have enough liquidity, but right now there is certainly enough liquidity in banks. The problem for SMEs is equity. All the measures that we are looking at collectively are about getting equity to SMEs. Of course we are trying the high-quality securitisation that everyone agrees on, but then you need to

interest institutional investors. If you want to attract them, you have to find a way to bundle SME loans in such a way that they are both transparent and of high quality, but the different rules in different member states make it very hard to compare SME balances and to bundle them in chunks that are large and interesting enough for institutional investors. I hope to illustrate by this example that things are waiting for each other: SMEs will not invest because they do not see the economy growing, and the economy will not grow because SMEs are not investing.

The Chairman: Benoit, would you like to respond to Lord Hamilton's question? I wonder whether I could attach another one to it. After this investigation by the Committee, we are going to look at the European Central Bank, its role, what it has been doing and whether indeed it has overstepped its own rules. I do not know whether you have anything you might want to add to that and to the point about quantitative easing.

Benoit Lallemand: For lack of a defined position or expertise, I cannot answer on whether the ECB is going beyond its role; it is at its limit now and doing everything that it can. Again, unfortunately the connection is not working with the economy picking up. It is also a problem of demand, not just from SMEs but from households. We need to work on that as well, not just the supply side.

Q90 Earl of Caithness: You have rightly said that a lot has been done in a short time. You have also reminded us that a lot is still to be implemented and indeed a lot is still under discussion. When this begins to settle down, some very serious errors will come to light because you have done a lot of legislation in a short time. Given how difficult it is to alter directives and regulations, how do you think the EU will cope with this and maintain financial stability at the same time?

Wim Mijs: That goes back to the Lamfalussy discussion that we had 14 years ago. The essence of the EU 28—the Council, the Commission and the Parliament—has a certain time in which to pass laws, so level 2 and the three European supervisory authorities will become more important. If you have done the right thing and it is a framework with enough flexibility to adjust, the Lamfalussy doctrine should work. That means, though, that we put a lot of weight on the supervisory authorities, and there is a question there: they call themselves authorities, but are they yet? By which I mean, do they have the procedure, the possibility, the power and the resources to adapt? As I said in my introduction, as did Benoit, the framework itself seems to be solid. The problems will be in the calibration, and that should be dealt with at level 2.

Earl of Caithness: But can level 2 deal with the overlap between the EBA and the ECB?

Wim Mijs: No. You are absolutely correct. The basic decision to set up the banking union, and the fact that no one was ready or had the time to renegotiate the treaty to put banking union in a different place, meant that de facto we used an article to build this around the ECB. Yes, that is structurally a very dangerous route to take. For me, the ECB will have to deal first with direct supervision of the 128 largest eurozone banks, and that will create a supervisory culture. But the EBA in London is essential for keeping the single market and the single rule book there. We constantly need to revisit the distribution of power within the EBA. For me, the banking union and the supervisory powers are just for the eurozone and can be dealt with, but the importance of the single rule book is extremely important for the whole union. That would suggest strengthening the EBA as a kind of guardian of the single market. I am using the wrong phrase here, by the way—the Commission is the guardian of the treaty, of course—but you understand what I am saying.

Benoit Lallemand: I will make two points. You touched on the autonomy of the agencies, as they call it in the US—ESMA and the EBA. There is a lack of flexibility because they lack autonomy. I will touch on how you define an error, but if an error comes up you might have to go back to level 1 and, as you know, that is three years minimum, which would be crazy. This is a big problem and it is embedded in the institutions as we have them. I see ESMA because I follow MiFID very closely. It is now interpreting level 1 and putting it into tactical details to become effective, but then if it detects anything it has only a small margin for improvement or new guidelines and it will not be able to change much. You are making a very good point about the lack of flexibility for improvements.

My second point is that I am curious to see how you define an error. I shall give an example that goes back to MiFID I but is very current because everyone in Brussels talks about a capital markets union; after all it was initially the goal of MiFID I to say, "We need capital markets for Europe to become the primary economy in 2010"—that was the Lisbon agenda—"and we need them to complement banking funds". We saw a lot more about it being the primary economy in the world in 2010, but it did not quite work out that way. I am giving this example because I would have measured an error in the strategy, as the key indicator for success should basically be primary markets. What you want with capital markets is to develop the access of SMEs and so on to finance, so your key indicator should be primary markets—how many companies are able to go to markets and raise fresh funds. But in fact the whole idea was that to get there you need more liquidity, the cost of transactions on the Continent was too high and so on. In order to work on the costs of transactions, you need to bring forward more competition between trading venues and so on. Before MiFID II, everyone in Brussels would have agreed that MiFID I was a success because the costs of transactions came down and competition was introduced between

trading venues. I heard no one taking the indicator that was the purpose of the regulation and saying, “Yes, corporations in Europe have better access to capital markets”—which was actually not true, for other reasons as well. It is really important, and this is a key point that we make on every piece of regulation, to have the right indicators from the beginning, saying, “This is exactly what we want to achieve and this is the indicator by which we are going to assess its success or otherwise, year after year”. Then of course you need the flexibility in your analysis of these often complex topics to say, “Okay, we need to go back to calibration, or maybe there is a fundamental flaw in the design of our regulation”. It is key to keep in mind the goal of what you are doing. With MiFID, you want to bring your fresh capital to corporations. You do not want to reduce the cost of trading for the sake of it. That is not the goal; that is the medicine.

Q91 Earl of Caithness: My second question picks up on part of your reply to me. You mentioned calibration and the importance of the work of the ESAs, but we have in front of us a letter from Mr Juncker to Lord Hill, asking for a review of the functioning of the operation of the European Systemic Risk Board and the three supervisory ESAs, particularly paying attention to the governance and finance of these agencies. Here you have these agencies, which you say have to be twiddling around with calibration, at the same time as the traces are being kicked over by Lord Hill. How is that going to work?

Wim Mijs: I define it slightly differently. I think that Mr Juncker is making the same point. I know him from his time in Luxembourg and I know that he has the same worry about the autonomy and resources of these authorities. We have seen that the authorities—certainly EBA—have been overwhelmed with work with a small staff and an incredible amount of political pressure. Certainly this needs to be reviewed. If we want the ESAs to play the role that we envisaged at level 2, in flexibility and in calibration, we need to revisit the design.

Either they need more resources, more autonomy and perhaps different leadership, or you may need to redefine their tasks to avoid them being put under such political pressure that they cannot do their work any more. That is the agencies.

As for the European Systemic Risk Board, I remember thinking at the time that it made absolute sense that one should also look at the macroprudential rather than only the microprudential, but still it is interesting now, after a few years, to review it. Does it play its role? I hear many supervisors talk about macroprudential as the solution to everything, but I do not know whether that completely works. An example I hear a lot about is whether there is a housing bubble in the UK. There is a suggestion of one in the south-east but certainly not in the north-east. Is there a macroprudential indicator for this? We have been noting that the ESRB has been awfully silent. I do not know for certain, but it seems that this has not developed any further. Again, I think that Mr Juncker wants to review what has been done and how the European Systemic Risk Board has developed since we set it up. We still believe in macroprudential overviews. We have certainly discussed the need for a review of the authorities.

Q92 The Chairman: Benoit, I should like you to respond to Lord Caithness's questions on the European Systemic Risk Board and the ESAs. Wim might like to know that we have interviewed Mr Enria twice. This Committee has been very concerned that he has been understaffed in the job that he has taken on. We said so way back in 2011, when the board was first set up. Could I ask you to respond to the Earl of Caithness, particularly on ESMA, as you have great knowledge of it, and say whether you think that there needs to be a review? Did ESMA in part overstep the mark when it fulfilled its function on the short-selling directive and stepped into the market? There was surprise at that. I think that it was within its rights to do that, as I recall.

Benoit Lallemand: I would think so. ESMA is one good example, but I think the same applies to EBA, which has been overwhelmed. I think also that the review of the responsibilities is positive. I see it as something that is needed, because the resources are needed. More critically, it is a question of how much sovereignty you want to keep as a member state. As you know, the authorities are understaffed, so they rely on the competent authorities in different member states—these are very competent people indeed. To give them more autonomy and flexibility in terms of going back to the calibration and making sure that regulation is efficient is a question of how much you are willing to delegate these sorts of powers to a European authority. I think that that should be a matter for discussion in the future.

Q93 Lord Hamilton of Epsom: Since the financial crisis, the Americans and Basel have been issuing regulation. The EU has been doing what it can to produce regulation that is in line with these other bodies. Has that been working well? Has it been working in the interests of the EU and Britain in particular?

Wim Mijs: Yes, I think that the work of the G20 and the FSB has been good. A number of international standards have been set, such as those by IOSCO, which has done good work. The IAS board has also done good work in setting standards. This relates to the difference between 'equal' and 'equivalent'. The Americans take a slightly different approach to regulation. They are moving in the same direction than the global standards, but in an American way. Although I think that there is a good dialogue, the political dialogue and the political outcome are sometimes different. This is what a transatlantic dialogue should be about. I referred to GLAC, which is another example of this, as is the discussion on IFRS. You see these things moving little by little on some issues, whereas on others they do not, because the Americans just say, "This is our way and we won't budge". Certainly in view of

the interconnectedness and the importance of the American economy and the American financial sector, with its presence in the City of London, it is not great if the differences are too big. Yes, every country has its own culture and political system, so I can understand when there are differences, but when these are fundamental, the economies are too close together to endure it. That is certainly something that we should look at. I am also chairman of the International Banking Federation, which has its secretariat in London. It was set up to deal exactly with these kinds of things. We felt that we saw all the regulators organise themselves globally on the need for standards, so we thought that it would be important also to unite the banking associations of the different continents in such a way that we could respond broadly. We have been doing that either by ourselves or together with the IBFed. It is a very important discussion.

Q94 The Chairman: Benoit, would you like to respond to Lord Hamilton's question?

Benoit Lallemand: My answer is along the same lines. My view is that the momentum might be slowing down. When you look at financial regulation and the pressure from the G20 on the FSB and the different bodies, that would be a pity. Again, the credibility of the FSB and the level of authority and autonomy that it has are pretty weak—it is more of a co-ordination body or secretariat. It would be welcome, to ensure coherence at the international level, if bodies such as the FSB had more staff, more authority and more autonomy, completely in line with the various standards-setting agencies. We mentioned IOSCO and the Basel Committee. It comes back to different national interests playing differently and making sure that they maintain the expression of this specific interest versus sitting around the table. Of course, the US has a different regulatory culture, I think for good reasons. In some reports, you read that the huge efforts that the Americans put into the banks in terms of public money, notably AIG, went to some European banks that were

exposed to AIG. The figures are enormous. That is a pretty bad memory for them, which makes them eager to ensure that the American consumer will never again be exposed, including to the risks in London, for example. I think that they had the feeling that they had to find out some of the problems which were happening to banks in London and which came back to the US. Again, that does not explain what you could call the bluntness of their attitude or their arrogance in some ways to impose what they do at home all over the world, but I think that there are almost psychological reasons for that. Let us see how it plays out. I have not read a thousand papers that confirm that it would be a huge problem if we have discrepancies at different levels. I am not for regulatory diversity and so on, but it is not always the case that it is a huge problem. You could argue, in terms of interconnectedness and the containment of a specific risk, that it might in some circumstances be good to have different regulatory approaches adapted to different areas.

Lord Hamilton of Epsom: Are you saying that the international impetus for regulation is lagging and that the Americans and the FSB are responsible for that?

Benoit Lallemand: I would not go that far. My perception—and unfortunately I am not involved on a daily basis with the work of the FSB or the G20—is that the momentum on financial regulation is slowly going down.

Lord Hamilton of Epsom: But you do not blame that on the Americans.

Benoit Lallemand: Not specifically. On the contrary, if we go back to the FSB, I do not think that it has the mandate to drive that agenda. Unfortunately, many parties do not want it to drive the agenda. It should rather follow up—

Lord Hamilton of Epsom: If it does not drive the agenda, who does?

Benoit Lallemand: Basically it is more the heads of states represented at the G20, the ministries of finance or whatever you want to call them. It is in their hands.

Lord Hamilton of Epsom: So Basel is more important than the FSB.

Benoit Lallemand: I would think so.

Lord Kerr of Kinlochard: It does not sound terribly promising for the role of financial services in TTIP.

Wim Mijs: No, it does not.

Q95 The Chairman: Quite. Before I bring Lord Kerr back in for a fresh subject, let me ask you this, which relates to what Lord Hamilton has been pursuing. What is your assessment of the impact of the new rulebook on the third-country actor access to the EU and the approach taken to equivalence? What risks do you see from rules arising from multiple jurisdiction, and multiple jeopardy in terms of a multiplicity of regulatory regimes across the EU and beyond, which locks into that earlier discussion?

Wim Mijs: In principle, third-country access is good, and that goes back to the equal versus equivalent issue; if you have equivalent rules there should be access, but on the basis of mutual recognition. That is the basic thinking. I am slightly repeating myself here. If the disparity in the rules is too great or the regulator, the treatment, or the prosecution is too different, problems arise. For me, third-party access to the EU should be welcomed on the basis of equivalent rules, equivalent stability, and negotiated on the basis of mutual recognition. That is my base answer.

Benoit Lallemand: Your question really relates to that put by Lord Kerr, because in TTIP we talk about regulatory convergence. That is a big issue, and where the discussion is now. We do not have any commercial interests, so in the third-country element we do not look into that perspective. Our concern, as it would be of most people around the table, although we would certainly frame it differently, is that if there needs to be convergence at an international level, first the key is that this becomes a race to the top, not to the bottom, so

that the denominator should not be the lowest common denominator in terms of the rule that is the least stringent. That is the whole discussion about TTIP. This is the broader question of convergence. Our view would be: is a free-trade agreement the right place to have this discussion? I am talking only about regulatory convergence, not about ISDS or market access. For regulatory convergence, would you not want to strengthen the FSB and similar organisations? I understand that this is not working, which is why the dialogue between the US and the EU on financial regulation is not smooth; it is proving difficult, specifically with some figures and heads of some agencies in the US. Therefore I understand the political opportunity to say, "We'll use TTIP to create this forum where we can discuss regulatory convergence", but I also understand the reluctance of some people who say, "Maybe this is not the place where we need to do it".

Lord Kerr of Kinlochard: To be honest, it seems to me that it takes some sort of political impetus from outside. The regulators from the other side of the Atlantic and our side are never actually going to converge, or certainly no faster than the accountants have on the IFRS issue. If we leave these people to themselves, they get entrenched. Somehow we need to bring in an external impetus, which TTIP might have done—although I do not think it will happen.

Wim Mijs: I agree that basically some political impetus might work—maybe to have TTIP as a basis, but certainly not as the only place. With IBFed we strive for standard-setting everywhere. We go to IOSCO and try to set standards there. At the political level—the FSB, the Basel Committee, everywhere—we try to use standard-setting. Our membership has a number of emerging countries like India and Japan, for instance, and sometimes getting them to the forefront can break through the entrenched positions on both sides of the Atlantic. Therefore I would agree that TTIP is not the only place for getting regulatory

convergence of financial services; maybe it can only give a political push, but it needs to be at many more levels at the same time.

Q96 Lord Kerr of Kinlochard: Looking internally now, just at the Union and the member states—and I think that I deduce the answer to the question—do you think that the balance between the centre and the member states is now about right in the regulatory and supervisory area? The subset to that question is: am I right to be so surprised that so much of the Barnier programme was done by regulation rather than by directive? If you think back to the original first wave of such directives—the Arthur Cockfield period—we were doing big directives: the banking directive, and all that stuff. Now an awful lot of it seems to be regulation. Does that matter? Is it a good thing or a bad thing?

Wim Mijs: Too much regulation is a bad thing in whatever form you make it. That is an interesting question, which you should ask the other Dutchman, Frans Timmermans, who may want to deal with it. That is politically very important in the Netherlands. EBF does not have a clear position on it. Basically, there is a good side and a bad side to use regulations versus directives. All those matters that are clearly aimed at stability and the basics where national discretions do not work well are suited for regulation. Part of the reason why so many are being done by regulation is just that—because they are seen as basically important for the whole of the European Union, derogations are not wished for. For the rest, one has to be very clear about subsidiarity and what needs to be dealt with at the central level and what can be a directive. I would hope that this Commission—and the nomination of Mr Timmermans points in this direction—would look very strictly at those things. As I said about the bank accounts directive that is now being set, yes, you can say that it is excellent to have access to an account throughout the Union, but you can also say that that may be social policy that belongs to member states. I am not choosing sides on this debate, but it is a clear

example where one can ask if it should be done by Brussels or by the member states. All in all, I can understand that a number of regulations have been used because they were used for stability and derogations were not wished for. However, I agree that subsidiarity is essential if one wants to keep social cohesion in the Union. I would expect this new Commission to take good note of that.

The Chairman: Certainly, in Mr Juncker's letter to new Commission members, that point about subsidiarity, proportionality and the role of Mr Timmermans has been emphasised.

Wim Mijs: I noted that. I agree to that. Again, EBF does not have a fully-fledged view, but generally EBF members agree to this.

The Chairman: Benoit, have you anything further to say on this?

Benoit Lallemand: On subsidiarity in the area of financial regulation, I am not sure that that is where the main focus should be. It makes a lot of sense if you want a single market for finance and a single rulebook, in that there is a need for strong harmonisation at the European level. That is a good idea. It is also a reason why you need European harmonisation of the banking structure rules that you have now in Germany, in France and through Vickers in the UK. You need to make sure at some point that you do not have regulatory arbitrage and you have some sort of agreement. That will be painful to get at the European level. I am not sure that financial regulation as such is the main focus of excessive zeal from Brussels. It made a lot of sense specifically after the crisis.

Q97 Lord Kerr of Kinlochard: I agree with you. Subsidiarity does not apply with most of this stuff. It is the heaviness of the instrument you use, which is a different question from whether there should be European legislation at all. We all buy that this should be European legislation but, when we take our friend the AIFMD, it is extraordinarily detailed, imposing requirements on bits of the financial sector that are not actually very risky, bits where no

problem arose. Worse, if you take a regulation and negotiate in as much detail, as has been done—very well, our witnesses said—you are bound to force some people somewhere in the Union into a template that does not quite fit them.

Benoit Lallemand: That is true to a degree. One of the balancing factors is that, if you take ESMA again—I am pretty sure it is the same for EBA—you really have a strong representation of competing authorities. Basically, I agree that it is too detailed and too heavy, but at the same time take MiFID, where the FCA is really involved in the nitty-gritty of setting these rules. That is fair enough because everyone is there to make sure that you have in the end rules that fit the specificities of different markets. Yes, you could make it more simple and efficient from the start, but member states carry quite a weight on the design and calibration of the technical details. For me, that brings balance.

Wim Mijs: I agree with you. There is a difficulty with the levels and in the cascade of detail. It is almost human. In the negotiation of level 1, the framework directive becomes less and less of a framework because the devil is in the detail. They negotiated in detail and level 1 is finished. We had this with MiFID I and MiFID II. When you look at it, you think, "This could be good but it is certainly no framework". Then level 2 comes with its own level of detail, and then level 3 requires implementation. This danger is absolutely present. It would be good to have a mechanism for a kind of evaluation at the end to see if we are not overly detailed, a kind of counterweight to the human nature to get to the compromise in detail.

The Chairman: We come to our final two questions. Benoit, you offered to be provocative and, Wim, we invite you to be provocative now as our questioner, Lord Shutt, comes from the independent county of Yorkshire. He will ask a very testing question.

Q98 Lord Shutt of Greetland: We have not had a referendum, but who knows. You will have spotted that we have come from the UK. We are a non-eurozone member state. What are

the specific challenges of the regulatory reform agenda for the UK? How does its approach to regulatory reform compare to that of other non-eurozone member states such as Poland and Sweden? Does this lead on to a two-speed Europe?

Wim Mijs: These are the questions that I thought about the longest. A number of things are very much national politics. But generally for me it starts that the UK is a prominent member of the EU and the City of London is the most important financial centre of Europe—at least of Europe. The British Bankers' Association is a very important member of the EBF. We need both the country and the member state on board and playing the game, however strongly they want to play. I need to hear their voices. So the first part of my answer is, "Let the voices be heard, and ensure that the UK has the strongest possible representation in the EU and its voice is clearly heard in the Commission, Parliament and Council". I always invite my colleague from the BBA to be as loud as possible in the EBF. That is the first point.

The second is aimed more directly at your question of a two-speed Europe. The eurozone needed to deal with what it did not deal with 12 years ago. It needed to get banking union to go with its monetary union. It is as if you built the attic but forgot to build the rest of the house, and suddenly you notice that it falls down. That banking union needed to be done, but it has to do with direct supervision of banks in the eurozone. What is important is the single market and to ensure, for the UK and the rest of Europe, that emphasis is not put on supervision. Supervision will not give us an economy or growth, but it will give us stability and equality. It is very necessary but the attention should be on the single market, in which non-eurozone countries play an essential role—certainly those with strong economies like yours.

That would be my advice. It is not provocative but very pushy on looking to revisit the single market again, and re-evaluating what has been done. One of the bad things of the crisis is

that after it, logically but regrettably, all countries have withdrawn within their own borders. We took tremendous steps away from the single market. It is now harder to sell across borders. Indeed, the European capital market, if it was there at all, is certainly not there now. That is what I would concentrate on for the UK. Then you do not have a two-speed Europe because there is only a single market. You have a one-speed Europe. Indeed, part of it has its own supervision.

The Chairman: Would you ask your second question, then I will invite Benoit to answer both?

Q99 Lord Shutt of Greetland: Do you think that the UK has been promoting a protectionist agenda? Have its interests been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?

Benoit Lallemand: Yes, I would think so. My answer to your first question would be in the negative. The UK has not promoted a protectionist agenda. But we would need to go file by file, because it is difficult to have a general approach. From our perspective, which is that of public interest and these markets serving the man on the street, on some areas we disagree with the UK approach. On others, on consumer protection and MiFID II, we are completely hand in hand with the UK. We need to make sure that we do not agree too much, but on Vickers the UK needs to be applauded for being the first to this law. I know that people always say that it is only to be implemented later and so on, but in that regard I should think that the UK should be a strong proponent of the Barnier proposal. I shall just finish being provocative. There is a legitimate argument that Vickers would qualify as some sort of equivalent to the Barnier proposal. I would hope that, for the UK banks to enjoy a level playing field, the UK should be a strong advocate and supporter of the Barnier proposal. That is just to make sure that we have an animated discussion.

The Chairman: We have one final question, unless Wim wants to answer on the protectionist issue.

Wim Mijs: I will not grant you your provocation, because I personally think that Vickers is much smarter than the structural reform. So I think that you are calling for Mr Barnier to withdraw his idea and look more at the Liikanen and Vickers ideas, which he should have done in the first place.

Benoit Lallemand: Do you prefer Liikanen to Barnier?

***Wim Mijs*:** From a personal perspective, I prefer Vickers to Barnier.

Lord Hamilton of Epsom: There was an opportunity, which has now gone, to split the banks completely and give shareholder value as well as protecting depositors. We ducked that completely. I can tell you now what they are doing in the City of London. They are trying to find ways in which to use depositors' money in the casino bank, and the Chinese walls are not working. So it is going to end in disaster at some stage. Why you think it is such a good thing, I cannot imagine.

Q100 The Chairman: I have a final provocative question to Benoit. What advice would you give to the new Commissioner, Lord Hill, as he takes on his responsibilities for financial regulation?

Benoit Lallemand: He should take a wide perspective, looking at not just the past five years but the past 25 years, so that he looks at finance in particular with that perspective, making sure not just that the system does not harm society—that is of course the minimum that you should expect from a specific market—but that the design of the financial system, the size of it and the nature of its activities can feed the real economy, versus the casino. My advice would be to take the necessary time before engaging in saying, "We should promote capital markets and investment banking, because boring banking is dead—and because of

deleveraging banks, which cannot lend any more”. These assumptions are way too light; we need to take a step back and look at the quality and specifics of lending, or traditional bank lending, before going to the agenda of saying, “The only solution for growth is to go into more capital markets and revive securitisation”. But I am afraid that it is a bit too late for that. Those are extremely useful tools as a complement, but it is a bit early to say that we should forget about traditional banking. He needs to take a wide-scope perspective before setting the agenda.

Wim Mijs: This is a fantastic opportunity. One thing that I worry about is that you have a Commissioner for Financial Services with an empty desk—so probably it is an idle thought to say that there should be no more regulation. So I will not say that, but I can make his agenda interesting. The first thing is that we have been talking about implementation and calibration for the past hour. I agree that the most important role is to see if it all works. This was done quickly, and the structure is there, but we have both argued that now the implementation is essential—getting it implemented well and getting it working, including looking at the stakeholders whom Benoit talked about, and the health of the economy at large. That is essential. My second piece of advice would be to pick up from Mr Juncker and review the institutions. My third is a passionate plea to look again at the single market and make a new financial services action plan, which includes not regulation but certainly implementation and calibration, to see whether it works—and, indeed, making banks work for society, about which I agree.

The Chairman: Lord Kerr reminds me that Lord Arthur Cockfield was a distinguished Member of the House of Lords, who had that responsibility for fashioning and developing the single market. Many of us think that he did a very great thing in that. Benoit Lallemand and Wim Mijs, we will send you the transcript of what has transpired today. I know that our Members

are inspired by it, and by the clarity of your answers, as well as your brevity in getting to the point. It is often said of the Irish that they put English, a foreign language, to its most effective use, and you have both demonstrated that today. We would be grateful if you could correct that transcript and add any further ideas. After all, you are only four weeks in your honoured position.

Wim Mijs: It is worrying that we have been very clear; we may have to strike out everything.

The Chairman: I will comfort you with the fact that tomorrow I will not mention that we met you two, or anything that was said here, but I shall mention you next time I see Anthony Browne, an esteemed member of your organisation. We thank you for that comment. You have both been terrific and really helpful in our better understanding of a very difficult and complex subject.

European Commission- Oral evidence (QQ 101-115)

E*vidence Session No. 6* *Heard in Public* *Questions 101 - 115*

WEDNESDAY 24 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witness

Michel Barnier, Commissioner for Internal Market and Services

Q101 The Chairman: Monsieur le Commissaire, pour le deuxième fois c'est un grand plaisir pour moi de vous remercier pour recevoir ici la commission dont je suis président. We thank you for receiving us today. I would like also to turn to your companion, Jonathan Faull. On behalf of the Committee and, if I may say so, the United Kingdom, we thank you for all the work you have done, especially in supporting Monsieur Barnier in what has been acknowledged—not only today and yesterday while we have been in Brussels—as a wonderful mandate that you have accomplished for the Commissioner. You have had the support of your Secretary-General and many others within the Commission.

We are here because we are looking at the financial regulatory framework. I understand that you are going to speak principally in French. If I get lost for a word, sometimes I resort to speaking in French—but that may not be necessary. We have decided to do this important

piece of work. We will be interviewing the Minister, Andrea Leadsom, the afternoon after we interview three senior members of the Bank of England. Our report is retrospective in that it looks across at what you have been doing, and to some degree prospective as well. Although I understand that you are leaving, we think that you are the very best man to speak to in terms of assessing what has been done with the regulatory framework—the 41 pieces of work you have produced. We hope also that you will give us some of your thoughts and ideas as they have developed, especially with the advent of President Juncker into the post of President of the Commission.

Perhaps I may first invite you to reflect on your four or five years of busy activity. Do you think it is true that what is now in place in terms of the regulatory framework offers a defence that will withstand any future asymmetric shocks and that we have built in the flexibility needed to withstand any such challenges? This is the important one. Please do speak about what you think have been the successes of your mandate, but perhaps there are some things still left to be done or gaps that it might be appropriate for the future Commissioner to attend to. Again, we are most grateful to you for being here and helping us both today. You have helped us in the past and we are all grateful for that.

Michel Barnier: Thank you very much, Chairman. Welcome, all of you, and I am delighted to have this opportunity to speak to you. It is always a pleasure to see the Committees of the House of Lords. I am not sure that my English has improved, but I am sure that my French has improved. I am with my deputy Head of Cabinet, Paulina Dejmek Hack. I have with me this brochure and if you look carefully at the picture on the front, you will see that there are around 500 people who have done a tremendous amount of work over the past five years. For the past five years, I have been in charge of the financial regulatory agenda for the Commission. It has been a huge job and very hard work, but it is necessary work. As I say, all

the work has been done by just 500 people and I have had the privilege to lead this team, together with my Cabinet.

Also, as I said during our first meeting with you in London, the road map was, is and will remain the G20 road map, with the new decisions taken, including the last agreements reached a few days ago in Australia. My first duty was to deliver what the G20 decided in London, Pittsburgh and Washington in 2009 and 2010, at the very beginning of the crisis. As you will remember, what happened at the time was that we were at the heart of the crisis and not far from an explosion of the eurozone. At the time I went to Washington and Beijing and many other places, and the only question I had to answer was, "Are you sure you can get to the end of the year with the eurozone?" The timing of your visit is perfect because after five years I am now ready to pass the baton. It is the right time to take stock of the financial reform agenda and what we have achieved together. I insist on the word "together" because this financial reform exercise is a collective effort. It started with proposals presented by the Commission and subsequently, discussed by Ministers and the European Parliament, which represents the citizens. And it has always been my wish to take into account the national Parliaments.

Since February 2010 I have presented more than 40 legal proposals, ranging from banks to insurance, the securities market and consumer issues. Most of these texts have been unanimously agreed by the European Parliament and the Council, who together need to agree on all proposals. Many of the measures are already in force. I would like to add here that in almost all cases they have been made with the agreement of your country. That was not by chance. It was my clear wish and my will to build the financial regulation agenda never against the City of London and the UK Government—that is, never without them. We succeeded in doing that on almost all of the proposals.

Of course, this is not the end of the road. The next Commission will have to focus first on enforcement and implementation. That is the case for almost all of these proposals. In one, two or three years we will have to focus on a review exercise in order to evaluate and perhaps to change, complete or improve the texts. As you know, the financial markets can change quickly. Time in these markets passes much more rapidly than does "democratic" time, as we know. Therefore we need to make sure that our rules evolve as well. Please look at this short document. I have tried to produce a legacy document, and a very objective one. If you turn to the end, you will see that there are clear, simple and intelligible tables.

The first is what we have done for the single market, the other represents the work on financial services. I think that the two tables go together. There is no possibility for any kind of initiative for growth and competitiveness and thus jobs without financial stability. The first precondition was to implement these new rules and to regain financial stability. In the single market, we have worked for the stability of the eurozone through the banking union, which has been the main part of my job for the last two years.

The second precondition for any kind of initiative for growth and competitiveness is to have a single market that works efficiently. It should be coherent, solid and should not suffer from too many fragmentations. This is the second part of my agenda and I have tried to deal with these matters through the so called Single Market Act 1 and 2. We have done much for the single market by implementing very concrete measures to help businesses and investors. There are measures for consumers, for instance, and on the European patent, which has finally been agreed after 35 years. The European patent will have a competitive cost, comparable to the costs in the United States. We have also simplified the public procurement rules, notably for SMEs through the digitisation of public procurements. You can see in this table very concrete operational measures and proposals. As I say, the two

tables go together. I am now ready to go into the detail of what we have done and perhaps what needs to be done as far as financial markets are concerned over the next few months.

The Chairman: Many thanks for that. If I were to pick up the British press and show you a photo of Members of the House of Lords, they would all be dressed in ermine and facing in the opposite direction. It is lovely to see 500 smiling faces who are all clearly very content under your leadership. You mentioned Lord Hill, and we note—given the man sitting next to you—how popular the name Jonathan has become here in Brussels.

Michel Barnier: We have two Jonathans.

The Chairman: Perhaps I may say, as Chair of this Committee and as a Member of the Labour Party, that we have admired Jonathan Hill's leadership of the House of Lords over recent years in much the same way as we admired Cathy Ashton's leadership. It was no surprise to us that she did well in her position, and it will be no surprise to us to learn in a couple of years' time that Jonathan Hill has ensured his place in the Commission by taking up many of the dossiers that you have brought forward and would hope to see through to the end.

I am going to ask my colleagues to put questions to you that look at some of those dossiers, and I have the great pleasure of inviting Lord Shutt to start. He is from the independent county of Yorkshire, which welcomed the start of the Tour de France earlier this year. He will put the first couple of questions to you.

Q102 Lord Shutt of Greetland: Thank you. As the Chairman indicated, I am from Yorkshire, but we are not that independent—yet. However, not only did we start the Tour de France but it passed through my village on the second day, so I was able to share what many people have experienced in your country.

Coming to our work, we see this list, and of course all of it ultimately becomes legislation. How do you assess the effectiveness of the legislative process over the course of the

financial crisis, including the role of the Council and the European Parliament? Is there any way that that could be improved?

Michel Barnier: I am glad that Lord Shutt enjoyed the Tour de France, because sport has played a very important part in my life. From 1981 to 1992, I organised the Winter Olympic Games in France, which were held in 1992. I was the chairman of the organising committee. I remain very involved with sport. Perhaps I may now speak in French in order to be more precise and concrete.

(Interpretation) First, I have tried to carry out my work in line with the commitments made by the UK Prime Minister, the President of France, the German Chancellor and all the other G20 leaders. Almost all of these texts are linked to the requests and recommendations made by the G20, co-signed by the Prime Minister of the UK, the President of France, the German Chancellor and all the other G20 leaders. So my first duty—and this was the Commission's role, really—was to come up with proposals implementing the G20 commitments.

Now, I mentioned the other signatories. The second thing I had to do—and perhaps we will speak about this later—was to explain to other regions of the world, and to the Americans in particular, what we were doing and check that they were doing the same thing, too. Afterwards, a third thing was to work on interoperability and to ensure that there was equivalence between the rules on the two sides of the Atlantic.

Coming back to the agenda, I worked on each of the subjects which the G20 had clearly identified. Basically, the G20 said that there had to be regulation of rating agencies, that derivatives had to be dealt with and that it was important to capitalise banks as foreseen by the Basel rules. There are many other examples I could give. If you look at the G20's decisions in 2009-10, they go into a lot of detail; it is very clear. In all the G20 documents, there is one thing which is not there—and I say this because it is interesting particularly, but

not exclusively, for the UK. You will not find anything at all in the G20 documents about the risk of manipulation of benchmarks. No one, apart from one American newspaper at the start of the crisis, mentioned the possibility of manipulation of benchmarks and the fact that it might be a problem. Yet, two or three years later, we saw that scandalous things had in fact been taking place with LIBOR and other benchmarks as well.

That aside, I did what we were going to do: we had public consultations, impact assessments were carried out and basically we tried to produce as intelligent a balance as possible in the documents and decisions. This process could certainly be improved now that all of these texts have been adopted and are coming into force this year or next year. Most of them in fact came into force last year. We will be able to carry out comprehensive assessments of these texts. Each text includes review clauses. For example, the directive on alternative investment funds and private equity may need to be reviewed. We also need to work on the implementing measures to the different texts. As you may now, the Commission works as a College with the 28 Commissioners. If you asked Cathy Ashton, she would tell you that she was very active and worked hard with her Cabinet on all the texts I have come up with. I was happy to see that. For my part, I followed with great interest the issues she was working on. These matters interest me, having been the French Minister for foreign affairs. She did good work. There really is co-operation. Once the College has adopted a text, the legislative process in the Council and the Parliament usually takes 1 to 2 years. Texts are often amended. Sometimes they are weakened through the legislative process, sometimes they are improved. That is the method we use.

Q103 Lord Shutt of Greetland: Thank you. Lord Hill has stated that there is much work to do to build on the important legacy of Michel Barnier to ensure that we have stable and well regulated financial markets. I am glad that you referred to what we would call post-

legislative scrutiny because it is important that we look at what has been put into legislation and check that it is appropriate. Apart from that, what do you believe should be his priorities? Have you sent him a couple of postcards saying, "If I were you, this is what I would take on next"? In particular, how can the growth agenda and the support of alternative financing sources be best promoted by the European Union with respect to regulation?

Michel Barnier: *(Interpretation)* I will say between ourselves what I have said publicly; it will be Lord Hill who takes over some of my portfolio. The new Commission that will come into force on 1 November will have three commissioners to do the work that I am doing at present.

Lord Shutt of Greetland: Irreplaceable.

Michel Barnier: *(Interpretation)* Actually I am replaceable; we have proof of that. Three commissioners are being appointed: a UK commissioner for financial services, and there is plenty of work there; a commissioner from Poland for the internal market; and a German commissioner for the part of my portfolio dealing with intellectual property and so on. I have met Lord Hill, and Jonathan Faull is helping him with his preparatory work ahead of his parliamentary hearing. Personally, I was struck five years back by the prejudgment that I received in the UK press because I was French. I did not feel that that was very fair, and at the time I said, "Judge me on what I say and do". That is what I am expecting now. I do not think that it was fair of commentators to criticise me ahead of time simply because I was French, and therefore I do not think it would be fair to criticise someone because they are British. I think Lord Hill should be judged on what he does.

With regard to what remains to be done, we need to ensure that all the texts that have been voted through are applied correctly. That is the responsibility of the European Commission

as a guardian of the treaties and legislation. Secondly, we must fully implement the projects that are in the legislative pipeline and bring those home. I spoke earlier about benchmarks and another pending proposal concerns the structural reform of the banks—the major banks in particular, the 30 largest banks—taking into account the Vickers report in the UK and existing national legislation. I have presented a text for a European framework to prevent risk in the major banks and also a text on shadow banking; I tabled a text on money market funds that is still under debate; I presented a text on combating money-laundering; and, lastly, there is the package on payment services. So those are five texts that have not as yet been voted on.

Then there is the key matter of stability in the eurozone, which is of interest. As George Osborne has rightly said on a number of occasions, the stability of the eurozone is a precondition for the stability of the whole single market, and vice versa. For stability there is the revolution that is banking union, with centralised supervision and resolution for banks within the eurozone. That has been the main area of my work for two years now. If we achieve all that, ladies and gentlemen, I think that we will have consolidated financial stability, which is a prerequisite for launching initiatives on growth. I have prepared the transition for Lord Hill and the other commissioners with a Communication on long-term investment and financing, including measures that could be taken relating to the governance of companies, share ownership and issues regarding taxation, and fiscal measures for the financing of companies and long-term investment. That is what I have to say about the many areas that my successor will have to work in.

Q104 The Chairman: Commissioner, before I move on to Lord Kerr, can I take you back to Lord Shutt's point about working with the European Parliament, and how successful that was? The first person the Committee interviewed on this subject was Sharon Bowles, with

whom you struck up a strong relationship. I would also like to ask about the role of the Council of Ministers. What was that relationship like and is there room for improvement in those important areas for your successor, Lord Hill?

Michel Barnier: *(Interpretation)* I said last week to Lord Hill that a lot of time would have to be given to the Parliament and the Council of Ministers. I was a member of the Council myself on four occasions—I attended summits as Minister for Foreign Affairs—and I was an MEP. You cannot have European legislation in my area without agreement between the co-legislators. These negotiations are called trialogues. We should not wait until the last moment and get a clash of differing views. It should be a process where issues are debated and solved. We need overall consistency and coherence throughout the process, with participation of Ministers, or their experts, and MEPs. In the Parliament, you are dealing with very able individuals who follow the files, sometimes in even more detail than the Ministers. They are very able, and indeed that was the case with Sharon Bowles. The same holds true for another ex-MEP, Malcolm Harbour, who did very good work regarding the internal market—so two of the key Members whom I was dealing with were your compatriots. As I said, the MEPs are very able in this particular area and very specialised. Lord Hill, as was the case with me, has to be available to them. In parliamentary sessions in Strasbourg, as Jonathan will tell you, I would spend three days there. Every 45 minutes I would meet an MEP, a rapporteur, a co-rapporteur or a co-ordinator, to discuss and try to progress with the legal texts. The commissioner, male or female, is a politician. They are in dialogue with Ministers and MEPs, and that is work that a commissioner needs to do; officials cannot do it in their stead.

Q105 Lord Kerr of Kinlochard: Monsieur le Vice-President, you will remember the last line of the film, “Some Like It Hot”. It is a great film. It is clear that you did like it hot. The last line

is, "Ah well, nobody's perfect". You have spoken about the things that remain to be done. Which of the things on this agenda do you wish you had not done, which of them were mistakes, which of them came out less well than you wanted, and were any of them the result of the political process you described, with the Parliament taking you in directions you did not really want to go, or taking you further, leading to add-ons in texts that you would have preferred not to have?

Michel Barnier: *(Interpretation)* As you say, no one is perfect—certainly not me. I do not think that one has time to be self-satisfied or rest on one's laurels. The crisis affected many countries and populist feeling is mounting across Europe. The financial markets in Europe are operating on a more solid and healthier basis than five years ago and, as I said, I think that there will be a competitive advantage for the financial industry in Europe. I have had pleasant surprises as well as disappointments. When we put together the text on alternative investment funds and private equity, I read expert commentaries that said that it would lead to a flight of capital to Asia and that the City would empty out—but that did not come about. Five years on, the text has been applied; it has to be reviewed, but it did not prove as costly or as much of a burden as some experts, lobbyists and market participants said it would.

In summary, I have no regrets but there has been some disappointment. As regards the banking union, there are two pillars: supervision, which will be effective from 1 November next, and resolution, where we are in the process of putting in place the Single Resolution Board. I think that the system we have achieved, which is a compromise between Ministers and Parliament, is still quite complicated. I had hoped for a banking union of 28, not 18. But anyway, what is important is that we have a single market with only one rulebook and one market. We could have gone further in another area that is important to the financial markets—the MiFID II reform. The final text could have been more ambitious on

transparency requirements. For some transactions, post-trade and pre-trade, I would have liked to see more transparency. A third example is the text that I tabled on audit. It changed a lot during the legislative process, and the scope and the ambition have been stepped down compared with my earlier proposals. I do not feel regret or remorse because I am not nostalgic by nature, but those would be some points where further assessment may be required. As I say, though, the review clauses are there; they are programmed in. Jonathan will tell you that almost annually now on each of the texts we have a review clause that allows for correction or amendment, should the need arise.

Q106 Lord Kerr of Kinlochard: We in Britain would certainly say that we agree that you did extremely well in preserving the integrity of the single market. Perhaps we in Britain ought particularly to put that on the record because it is important to us. We ought to thank you for that. You mentioned AIFMD: in a way the trouble with it is that you were covering a wide range of different vehicles. To someone very old-fashioned like me, as a director of old-fashioned investment trusts, the extra elaboration of the depository arrangements and so on that were introduced looked a bit unnecessary, although I can imagine that there are more exciting vehicles in the financial sector where introducing these extra assurances was required. I wonder whether AIFMD did not cover too much of the course. My last point is on CRD IV and bankers and their bonuses. Was that an example of an area where the Union did not really need to legislate in the view of the Commission, but the Parliament took a different view?

Michel Barnier: *(Interpretation)* I have a couple of brief replies. On the alternative investment funds, I acknowledge that it was a very broad definition, because we had to include all the actors in the fund markets, to avoid loopholes. That proposal was prepared shortly before my arrival, very quickly and perhaps too quickly. There were a lot of difficult

negotiations with the Parliament and the Council. The definitions are very broad, which I can understand may cause concerns, but it was necessary to avoid loopholes. We will see with the review clause whether further clarification or amendments are needed. The Parliament tabled almost 2,000 amendments, my colleagues remind me. I have never seen that for other texts.

On bonuses, many of the ideas came from Parliament. I supported it, not from any ideological perspective of a managed economy; the idea was not to deal with payments and the paying of wages in general, even if in many companies the wage range between the lowest-paid worker and upper management cannot be justified. That was not our aim. The idea was to deal with something picked up by the G20 on the attitude of risk-takers—people who in finance companies, took risks on behalf of their companies and for whom the more risks they took, the higher their bonuses were, without any limits. You have seen in your country and others that those risks fuelled crises the costs of which were borne by the taxpayer. The idea was to limit excessive risk-taking through bonuses. That was the idea that was voted on. And as is always the case with the law, it has to be applied without anybody trying to get around the legislation.

Q107 Lord Kerr of Kinlochard: What happens now? You have written your letter to the EBA. What response do you expect? Do you think that this matter will go through any further developments before you leave the stage, or is this one a dossier that will be sitting in the other Jonathan's tray, glowing radioactively?

Michel Barnier: *(Interpretation)* I wrote to the EBA because I am the guardian of the treaty and its sound application. EBA is the first point of call, it has the ability and expertise to analyse the transposition of the European legislation into the law of the UK and other countries. All financial institutions had to respect the law fully. I am waiting until the middle

of October for the EBA’s analysis. It is up to each country to ensure that European legislation is respected. If it is not, it will be possible for the Commission to initiate infringement proceedings and ultimately bring a country that does not respect European legislation before the Court of Justice; that is a process that can be followed. I should clarify that it will not be Lord Hill dealing with that in the next Commission. It will fall under the remit of the Czech Commissioner, Věra Jourová.

Q108 Earl of Caithness: Commissioner, perhaps I can take you on to a different subject. In fact, I have three different subjects on which to pose questions for you. They are the recently published review of the ESAs and ESRB. The President-elect of the Commission has written to Lord Hill saying that he should pay particular attention to the review of the governance and financing of these agencies. As the architecture currently stands, are there sufficient mechanisms to fine-tune legislation, whether that be at the Commission or the ESA level?

Michel Barnier: *(Interpretation)* A few weeks ago we published the first evaluation report on the three European authorities set up in 2010-11: EIOPA for insurance, ESMA for the markets and the EBA for the banks. Our analysis—Jonathan Faull can correct me—is that those three authorities are doing very well but they are still young institutions. They are to be more than a club of national supervisors. There were already such clubs, but they were not enough. We need an authority that is more than a club and has its own authority. ESMA in Paris supervises all rating agencies, including the big four or the big three, that want to work in Europe. If you are an American or a Chinese agency, you have to register with ESMA and it will check your operating methods, transparency and confirm that there is no conflict of interest. That is the authority of ESMA. I think that the three agencies have worked correctly. Despite their youth, they have contributed well to the level 2 legislation. Looking

ahead, there are some 200 delegated Acts or standards to be elaborated to ensure that the new legislation can be fully applied. That requires solid technical expertise. In terms of how the authorities operate, 40% of their budget comes from the EU and 60% from member states. I think that it would be logical for the European authorities if over time you had full financing of those three authorities by the institutions that they supervise, by the banks themselves or the institutions that they supervise. That is something that Lord Hill will have to deal with in his work.

Q109 Earl of Caithness: Thank you. I should like to move on to a different subject. Some people have said that there was a lack of joined-up thinking in the Commission with regard to some of the proposals, saying that it was due to the amount of legislation that you were trying to take through, while others commented that it was due to a more silo-based approach. Could you comment on that and would you also comment on whether you would have preferred to serve under the current Commission structure or the structure that is proposed by the President-elect?

Michel Barnier: *(Interpretation)* By definition, when you have one single Commissioner there are no silos at all. In the work that I have done—which is the main subject covered by your visit to Brussels today, of course; this is the main aim of the visit—there is no compartmentalisation and there are no silos. I worked jointly with others, and Jonathan Faull can bear witness to that, which is not always the case when it comes to the various services and cabinets of the Commissioners. We worked together transparently, with lots of trust. In our cabinet there are eight people, including the spokesperson. I had people of five different nationalities in my cabinet, including a spokesperson from the UK. There are also five people aged under 35, so it is very dynamic. They have worked very closely with the services. However, what you have said is true, if I am quite honest: here there is too much of

the old way of thinking regarding working vertically, so everyone works independently, if you like. Monsieur Juncker's idea that it should be compulsory to bring together Commissioners working in a given sphere, with a co-ordinator or Vice-President responsible for moderating that work, is a good one. We would need to see how it worked in practice; it would depend on the competences and powers of the various Commissioners, because in principle they are all on an equal footing. At the end of the collegial process, in a room like this one, a bit higher up or next door—you can see the names around the table here—if a decision has to be taken by vote rather than by compromise, it is one vote per Commissioner, so everyone is on an equal footing. So we would have to see how it worked in practice, but the idea is a good one.

I have had experience of this in two areas. First, on the internal market, in all the work that was done on *Together for New Growth*, there are 50 proposals that have been implemented, many of them stemming from Mario Monti's 2010 report on the functioning of the internal market. You can see the names of all the Commissioners concerned; on each line you have a different name. This work was done by 12 Commissioners and I moderated it, although I was not Vice-President of the Commission at the time. Everyone worked on it together and the idea was to break down the silos. We set that agenda at the outset and then we all worked together. I have also done that work in another, more sensitive and tricky area, the defence industries. It is something that I have been interested in for a long time. You may remember that in the context of the European Convention, I was responsible for moderating the work on defence matters. While respecting the limits of the Commission's competences, we had about a dozen DGs working together. The idea was that they would work together and propose to heads of state and government and to Ministers concrete ideas to consolidate the single market for defence industries in terms of certification, research, trade, calls for

tender and energy. So for the first time all these DGs—actually, it was 10 of them—worked together, not just at the end of the process. We did not ask them all to work independently; rather, we said, “You are going to work together on a given topic”, and that was something quite new—here, anyway. I hope that that can continue.

Q110 Earl of Caithness: Could you enlarge on the reply that you gave to Lord Shutt when you said that the Commission could improve the effectiveness and quality of its impact assessments? Can you briefly give us an idea of how that might be done? Also, could you lift the lid a little on what advice you have given to Lord Hill as to what capital markets union means?

Michel Barnier: *(Interpretation)* In the future European Commission, President Juncker said that Frans Timmermans, who will be the first Vice-President, will deal with the important issue of better regulation. There is a lot of work to be done on that. Here in Brussels, we need more policy and less regulation. That is possible. I was interested in the initiative launched by your Prime Minister. He looked at British national interests and then looked at European competences through that prism. That gave me an idea, which I have spoken of publicly. You could have a screening, as you did in the UK, which would be done here. You would not start by looking at national interests, or not just the position of national interests; rather, you would look at European added value of competences and policies. You would have a screening of European competences and policies from the perspective of their European added value.

There is work for the next Commission to do on this. The new Commission will have to consolidate the work that we have done and apply it. As Mr Juncker said, it will have to continue to build this single capital market, which has been fragmented by the crisis. We have seen fragmentation and renationalisation of the banking market and the capital

markets. On the basis of what we have done and what we have constructed, more work needs to be done towards this idea of a capital markets union. That will be done through, for example, MiFID II, new rules on securitisation, other measures in the context of long-term financing and securities markets and certainly more diversification of funding for small and medium-sized enterprises. Companies are too dependent on funding by banks, but funding could come from markets as well. All of the measures mentioned will contribute towards reducing fragmentation in capital markets.

My dream, which can be inherited by my successor, is that we will have a real European capital market. Projects could be funded anywhere in Europe fairly, taking into account the risk that they pose, rather than the country where the project is to be carried out. If in the single market we can make sure that we fund projects under the same conditions wherever they are, solely looking at the risk linked to the project rather than at where it is based—whether it is Germany, Greece or Ireland—we will have managed to create a capital markets union.

Q111 Earl of Caithness: Yes, as long as it is not so regulated that it stops in its tracks to begin with. My third and last question to you is this. You started by saying that what had been implemented was the result of what the G20 had done. What have been the economic and political challenges for the EU and which of those remain when you are dealing with a global situation? Perhaps you could let us know how difficult it was to agree a fair balance and understanding with other countries, such as the USA.

Michel Barnier: *(Interpretation)* Almost all the texts have come from requests from the G20. We presented texts that we needed for Europe. For example, I presented a new tool to create a European venture capital passport. I also presented a tool to make sure that you could have business social entrepreneurship in the same way throughout Europe. I looked at

what has been done in the UK in that context. That is something which I have always been very interested in. I presented a text on basic bank accounts for all citizens as well. So there were various texts in this agenda which were not requested by the G20 but which stem from Europe's needs.

To come back to the G20, I think, as you do, that it is one thing coming up with texts in Europe to ensure solid financial markets, but that will not be all that helpful if there are not the same laws or efforts being made elsewhere in the world. For the past four years, I have spent a lot of time explaining to others what we do. I have been to Moscow, Beijing, Tokyo and, most of all, Washington—I have been to Washington eight times in four years to meet the Treasury Secretary, the President of the Federal Reserve and the other American regulatory authorities. To be quite honest, I was more interested in this consultation than were the Americans. The former President of the CFTC came here on a number of occasions, as did others, but usually it was me going to Washington. In the negotiations on the transatlantic agreement, for example, we were the ones who said that the financial regulation process—the process not the substance—should be included in the negotiations. The Americans are a bit reticent about that at the moment. But we worked a lot and well with the Americans.

Jonathan, perhaps I can give to the House of Lords the table that I gave to the Ministers last week. Basically, last week at the informal ECOFIN meeting, I gave the Ministers a very clear note of where we are in terms of G20 regulation, comparing the European side with the American side on the regulation agenda. There are parallel approaches. If you look at the two sets of rules, on the American and European sides, it is important that they are interoperable. At the G20 in Cannes a few days ago, with the support of a lot of countries we defended the idea of equivalence and deference—our texts need to be equivalent and

supervisors should defer to each other. There are still some difficulties when it comes to the Americans, in particular when it comes to derivatives markets. I hope that we will be able to find solutions to those problems over the next few weeks. When it comes to other regions of the world, it is important to explain to people, as you can when you make international trips, that there are things that are specific to Europe. European laws have to be applied when multilateral decisions are implemented. In Europe, we find that much of the funding—75% for the SMEs, for example—is from banks, whereas the figure is much lower elsewhere. It is 25% in the US, for example, so it is the inverse. We have 8,300 banks in Europe, to which we apply the Basel rules. The US applies the Basel rules, when it does apply them, to 30 banks. So Europe is different.

Q112 Lord Hamilton of Epsom: Commissioner, can we turn to the single rulebook and the single market? Do we think that the right balance has been struck between regulation and supervision of the financial sector?

Michel Barnier: *(Interpretation)* When we speak about financial markets, we are speaking about markets that are no longer national. The financial institutions in London, for example, are very lucky to have the City as the main financial centre and the main gateway for international investment in Europe. But sometimes there are risks that need to be addressed. The framework for all this is the Treaty and there are policies and articles in the treaty that lead us as Europeans to take action in terms of the financial regulation of the internal market. Common rules enable us to speak with a single voice when we speak to others. When I go to the US, and this is very interesting, I am the only person there as a European regulator for insurance, financial markets, ratings agencies, banks and derivatives, and there are five or six people on the other side of the table. My answer is, yes, when it comes to financial markets I believe that we currently have a good balance within the

European approach regarding what should be dealt with at the European level and what can be dealt with by subsidiarity. We also use the national authorities as a support, if you like. In the eurozone, when the ECB supervises 6,000 banks there is direct supervision for the largest 140 banks in the eurozone area, but that is done with cooperation by national supervisors. That is true for the three European authorities that have been created as well; it is not just a club of national supervisors. However, the national supervisors participate in the work being done by the three European authorities, so I think that we have struck the right balance.

Q113 Lord Hamilton of Epsom: Thank you very much. You have made reference to equivalence and I want to know what you think will be the impact of the new rulebook on third-country actor access to the EU. We have heard about regulatory arbitrage, but are there risks arising from multiple jurisdictions on those people who are trying to trade in this business?

Michel Barnier: *(Interpretation)* Much of Lord Hill's work, and much of the work that I have done, has consisted or will consist of ensuring that there is equivalence and keeping an eye on that. We have European rules, most of which directly stem from the G20. There are third countries or non-G20 jurisdictions but there is no reason why there should be special treatment for them. We are not trying to establish extraterritoriality here, just as we do not accept extraterritorial measures that the Americans sometimes implement. What we want are common standards, interoperability of rules and equivalence when it comes to supervision in particular. That is what we are working on. The Americans are quite reticent about the issue of equivalence, but we have to stick to our guns and impose it to ensure that we are not subjected to the rules and supervision of others. Europe needs to keep its autonomy and sovereignty in this area. This point on equivalence has another advantage for

investors in business and financial institutions. It makes it possible to avoid twofold supervision or regulation because we are speaking about working efficiently and effectively. That is why I want us to work together on TTIP. We need a dynamic process to ensure this interoperability because you cannot have synergy between the American and European markets if you have a risk of dual supervision or of things being imposed from two different sides.

The Chairman: Commissioner, we are coming towards the end so I will turn to our final subject, which is the United Kingdom. We are looking forward to hearing from you about its role.

Q114 Lord Shutt of Greetland: You will appreciate the implications for the UK. What are the challenges of the regulatory reform agenda for the non-eurozone member states? In particular, which specific challenges does the UK face? How has its approach to the regulatory reform agenda compared with that of other non-eurozone states, such as Poland and Sweden? In light of the fact that some of the regulatory framework applies at the EU 28 level and some only at the level of the eurozone, is there any danger of a two-speed or inconsistent approach to regulation?

Michel Barnier: *(Interpretation)* I just want to make it clear and ensure that there is no misunderstanding about this, as it is important for you. There are no different rules in the single market. This was something that I was really concerned about. There is only one rulebook for the 28 EU member states. The rules are the same for everyone. All the European financial laws in this brochure apply in the same way, with the same content and requirements, to all financial actors in the single market, whether or not they are in the eurozone. Where differences arise is in how these rules are implemented. The banking union has been put in place because in the eurozone there was a link between banks and states—

systemic links between banks and their countries. We saw what happened with Greece. We wanted to make sure that the common rules for the single market would be implemented consistently, effectively and in an integrated manner—federally, some might say, because there is one single currency. But the same rules apply everywhere. For example, the Basel rules for banks have been implemented in European laws that apply throughout the EU. Within the eurozone, in the banking union, it's the European Central Bank that applies them. In London, it would be the British supervisor and the Bank of England, for example. The place where possible conflicts would be resolved between the eurozone and those not in the eurozone would be the European Banking Authority in the area of banking, but there would be one single rule-book.

Q115 The Chairman: Commissioner, some 2,000 years ago Julius Caesar wrote, "Gallia est divisa in partes tres"—Gaul is divided into three parts. We have learnt today how your job has been divided into three parts. However, I want to congratulate you once again on achieving much of what Julius Caesar achieved in his own special way in developing Europe. We would like to leave you with an open invitation, and indeed to your two lieutenants, especially Jonathan Faull. In fact, we would make you an honourable Member of the House of Lords if we were able to do that. I have been asked by my colleagues, who have been vigorously practising their smiles, whether it would be possible to replicate the wonderful photograph that you have shown us and whether you will give us the benefit of your presence. We will give our United Kingdom—English and Scottish—smiles in support of you and all that you have done over the past five years.

Michel Barnier: *(Interpretation)* Lord Chairman, I thank you for your kind words. I would be very honoured to be a Member of the House of Lords. I was a Member of the French Senate and the European Parliament, so I have a lot of experience as an MP and a lot of respect for

national parliaments. When it comes to Lord Hill, given the very sensitive political situation in Europe, one thing that I will stress to him is the need to focus on what is done by national parliaments as well as by the European Parliament. We are not going to speak about Gaul and what was written 2,000 years ago, but I published a book a few months ago when the European elections took place. I would have been interested in being the President of the Commission if my party, the EPP, had put me forward. My book was called *To rest or to be free*. This comes from Pericles, who said to the Athenians in the Peloponnesian War, “To rest or to be free, you have to choose”. In that book, I look at subjects in which Europeans would put their freedom at stake if they would not work together. If the UK, France or Germany are alone, for example, we no longer have the strength individually and separately to be free in some areas vis-à-vis the rest of the world—for example, financial markets, industry, migration and digital issues. I tried to look at these issues through the prism of freedom. That is why I think that it is very important that in the financial area Europeans can act independently and autonomously, with our partners in the G20. Thank you for your kind words, which mean a lot to me. I will be in London next Monday for my last official visit in the City. When I am there, I will repeat a few of the things that I have said today. Thank you very much for your visit.

European Securities and Markets Authority (ESMA)- Oral evidence (QQ 241-251)

Evidence Session No. 15 *Heard in Public* *Questions 241 - 251*

TUESDAY 28 OCTOBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Shutt of Greetland

Examination of Witness

Verena Ross, Executive Director, European Securities and Markets Authority (ESMA)

Q241 The Chairman: Verena Ross, it is a great pleasure to welcome you for the first time, I think, to the Committee from ESMA. I would be very grateful if you would perhaps in your introduction say a little about the work of ESMA, which would be very helpful to the Committee. I will ask you, too, the same question that I asked the previous witnesses. In casting your eye over the period from 2007-08 and the financial crisis, do you think we in the European Union are putting in place the wherewithal to withstand the challenges that are liable to happen in the future? Could we withstand future asymmetric shocks of one kind or another and, indeed, have we retained the flexibility to respond in a healthy and active way

to the challenges which will inevitably happen as time develops? Welcome to the Committee, and perhaps you could just introduce yourself first.

Verena Ross: Thank you very much, my Lord. My name is Verena Ross. I am the Executive Director of the European Securities and Markets Authority, or ESMA in short, which was created about three years ago as one of the three European Supervisory Authorities and is based in Paris. I have been working at ESMA now for three and a half years. We have been focusing over the last three years mainly on building the single rulebook for Europe. That has really been the main focus of our work. I think evidence has already been given to you about that, both by the EBA Chairman Andrea Enria and just now by David and Christopher, but a lot of the rulebook-building is now also leading into the implementation challenge, where a key objective of ours is to make sure that there is ultimately supervisory convergence and common implementation. On top of that, we have significantly built up the ability to look at risks across the financial sector, both as the securities markets regulator, looking specifically at securities market risk, and in the context of the European System of Financial Supervision, together with the other two ESAs and with the European Systemic Risk Board. All that ultimately supports our core objectives as a regulator: investor protection; financial stability; and ensuring orderly and effective markets. That is a bit of an introduction to ESMA. Thank you very much for giving me the opportunity to be here today.

On the question of how I see where we have got to, clearly we started with a situation in 2007-08 which was extremely worrying in terms of the crisis that we experienced and the impact that we saw percolating from that; not only in 2007-08 but the further problems, particularly in Europe, over the following years. There was clearly a need for a strong regulatory response at the global level, which was driven partly by the G20, but also at the European level. I very much support what has been said by others about there having been a

very significant, effective response by the European legislators in particular. The 41 different measures you mentioned represent a very impressive workload, which both the Commission and the two co-legislators, the European Parliament and the Council, have worked on over the last few years. Significant progress has been made. I would mention two or three specific measures there. The European market infrastructure regulation, EMIR, looking at the derivatives markets and making sure that they become more transparent is a key one. The current revision of MiFID as a cornerstone to the securities markets is another one I would emphasise, but there are many others that we might want to get back to in a bit more detail. A lot of progress has been made, but obviously the proof will be in the eating of the pudding in the end. When we face further crises, which we no doubt will, we are overall better placed than we were before the crisis, but none the less challenges will remain in spotting the risks early enough and finding the right regulatory response as we go along.

Q242 The Chairman: You mention the two co-legislators; many of our witnesses have commented on the efficiency and effectiveness of the co-legislators and, indeed, of the Commission. I am not going to ask you to comment on that particularly, but to what degree do you think that the technical expertise that you have within ESMA was well used and mobilised by the Parliament, the Commission or the Council when they were co-legislating and forming the legislation?

Verena Ross: Clearly, as an organisation, we are not directly or formally involved in the legislative process. That is absolutely right: there are two co-legislators that take those decisions. We have at times, but quite sparingly so far, tried to provide some technical input where we were asked to—mainly informally, to be fair, by the respective co-legislative bodies. Most of our focus has been on taking on what has been decided at the level 1, legislative level and looking at how we make it work at level 2, when it comes to more

detailed implementation. We have worked very hard there at trying to bring our technical expertise to bear to then make sure that the legislation that was decided on is actually made workable. However, of course we are constrained in that, as what has been decided at level 1 is our exact mandate. Speaking personally, I would say that sometimes there would be benefits from us being more involved in the level 1 process. It sometimes happens that level 1 provides certain mandates or provisions which do not really give us the ability to deliver, either in terms of timing or in terms of the remit or scope, the right quality technical input in the level 2 drafting that we would like. On top of that, there is an issue about making sure that the information flow works properly and that we fully understand what the co-legislators really intended when they drafted a certain piece of legislation. For that, it would certainly be helpful for us to be a bit more closely associated with some of the debates, at least in terms of understanding what the drivers were for coming up with certain legal texts.

The Chairman: So very understandably, you were from time to time informally asked for a review of or insight into the construction of the legislation? Perhaps it might form part of our report to say that you would indeed be open to giving your technical expertise, if and when required. There must be times when you have thought, “We could improve that” or “we could have said something about it”. Lord Shutt.

Q243 Lord Shutt of Greetland: We understand that you plan to spend more time next year, 2015, monitoring financial innovation. How concerned should we be about the current range of unintended consequences which may arise, such as: technical incidents and failures of systems to handle ever larger amounts of complex sets of data, giving rise to operational risk; trading market developments and their effect on market liquidity and price formation; and increasing market fragmentation and greater reliance on arbitrage strategies?

Verena Ross: Thank you for that question, which is obviously very broad. I will start with our overall look at financial innovation and then get into a couple of the areas that you specifically mentioned. The continuous innovation in financial markets is not only a reality but something that we need to have a balanced view of. It can be beneficial and it is important, both for consumers and the wholesale market, to see the right products coming to the market and the right way of developing the financial system further. At the same time, we need to realise that innovation can also entail risk. It is about getting the balance right in terms of understanding the new developments. Here, as regulators, we always risk being a bit behind, because the innovation takes place in the financial markets. As regulators or legislators, you need to make sure that you are on the front foot and able to understand it and deal with it. In ESMA, we try to work collectively with the national competent authorities from the different member states to make sure that we gather market intelligence and understand, where there are new developments happening in one country, what the implications might be and how that might expand cross-border. From that, we then try to make sure that we find ways of looking at whether that needs a regulatory response or not. We need to be nuanced there because not everything necessarily needs a regulatory solution. Recently, we have looked specifically at issues such as crowdfunding, which came up earlier this morning, and self-placement, where banks have basically sold some of their quite complex capital-raising instruments to retail depositors and investors, which has led to quite difficult situations for some of those people and where we have worked collectively with the EBA. There are a number of specific areas that we are looking at. Structured retail products is another area.

More generally, to come to the areas where you said there might be innovations and developments that could pose a risk, key market infrastructure is clearly an important part

of the overall functioning of the market in terms of financial stability and also, ultimately, of the protection of the investors in those markets. We have seen a number of incidents, certainly in stock exchanges, for example, and in other trading platforms, where operational incidents have led to the suspension of trading or other problems. It is difficult to say that there is a common theme to the causes of those kind of incidents, but we are very conscious that the more you create important infrastructure, the more you need to make sure that that infrastructure is also able to deal with operational risk and to make sure that the standards of regulation are sufficiently stringent. I would just use the example of central counterparties, the CCPs. Through the centralisation of some of the clearing of OTC derivatives in these counterparties, they have clearly become even more core to the financial system. It is very important that we not only raise the standards of what they should be able to do to ensure operational risk is properly covered but look, for example, in the future to recovery and resolution issues—not just for banks but also for these key market infrastructures that underpin what we do.

The other broad area I wanted to touch on is the whole question that you talked about of data and information, and the issues around fragmentation and liquidity. One of the areas that we have looked at in quite some detail, and are continuing to look at, is the question of automated trading, in particular the high-frequency trading phenomena. That has clearly led to some changes in how markets work and to how liquidity in some markets actually operates. We have started work on guidelines for automated trading—making sure that not only exchanges but market participants are able to properly understand the flows that are coming in, are able to control them and are able to manage the operational risks that come with such trading. We are also undertaking some research looking specifically at the liquidity implications around the risk of ghost liquidity, a term that you use when you think about

high-frequency traders putting orders into the order book—to what extent they are actually there when it comes to the crisis moment when the orders actually need to be executed or whether they have, in the mean time, been withdrawn through the automatic processes that are there. So we are doing some research on how much liquidity in the market is real liquidity and how much is ghost liquidity. It is not easy to do, but we felt it was a very important area of potential risk, exactly in the areas that you mentioned.

The Chairman: I sometimes think that when we talk about the vocabulary of financial regulation—ghost liquidity, shadow banking, dark pools—we have a return to the Gothic. Lord Carter.

Q244 Lord Carter of Coles: I have a couple of questions. The first is on transparency. Do you think EU financial regulations designed to meet requirements set by the G20 provide a sufficient level of transparency on off-exchange markets? Do you believe those markets are sufficiently lit—I think that is the word—for wholesale and consumer markets? Is the transparency there, are there loopholes that should be addressed and is there a risk of impact on market liquidity? As part of that question, can ESMA learn from other international jurisdictions, particularly the US?

Verena Ross: Indeed, this is an area that the G20 has clearly been very keen on, but making sure that we increase transparency in the markets has also been a big theme in Europe. The core proposal delivering that is MiFID. That has been agreed at level 1, and we are now in the middle of consulting on what level 2 should say. In particular, there is a significant extension of transparency in terms of the type of venues to which it applies—so it is not just for regulated market exchanges but for other trading venues—and for some of the systematic internalisers; to go back again to the trading which happens more bilaterally but where there are key price developments that need to be reflected in the overall market to

make the market work. At the same time as that scope extension from exchanges to other trading venues, there is also the extension from pure equity transparency—around shares—to bonds, derivatives and other equity-like instruments. That is a huge change and a huge challenge, and we are very much in the middle of specifying, now that we know what level 1 says, some of the requirements at level 2 to try to create a consistent transparency regime across Europe. That is not easy. There are a lot of interplays between how you make sure that there is sufficient transparency but at the same time ensure that the markets still function and that there is liquidity in those markets. Making everything transparent in a nanosecond to everyone could also harm some of the functioning of the markets. Getting that balance right is extremely difficult.

You asked specifically about whether that will create more lit markets. Yes, I think it definitely will. Will it also potentially create some loopholes? That is something we will need to see. We will obviously do our best to try to ensure that there is consistency, not only in the whole way the system works but across countries and how it is implemented. But the fact is that there are a lot of different exemptions and waivers that will have to work together. I am sure that some market players will also be quite intelligent about how to look at exploiting those potential different workings. So we will need to remain nimble and able to react to those market developments. That is a general challenge when you have effectively legislative measures to deal with quite technical, specific, market-related issues. Something that we have said to our European legislators is, “Do look at whether there are more flexible instruments that you could put into the regime to make it able to work effectively and enable regulators to react flexibly to some of those market developments, to make sure that we can deal with the changing liquidity and the changing market structures effectively”.

Lord Carter of Coles: Can I just stop you there? Given that you are probably always going to be behind the market, because it is very innovative, do you think, as it stands, that you have not got that flexibility to react?

Verena Ross: The fact that we now have two measures which are clearly more flexible than the primary legislation already helps us a lot. It also helps that we have some other tools, such as guidelines and Q&As, to react quickly to market questions and market developments. Having said that, with the clearing obligation for example, we will basically say, "All these instruments need to be centrally cleared from a certain date". However, if you see significant changes in market liquidity or structure, you might need to react quite quickly to abandon the clearing obligation to make sure that the market continues to work and that excessive risks are not being put into the system. Given that it is a legislative instrument—even if it is a level 2 instrument—that is something that, at the moment, would take probably about six or nine months to do, which is quite a long period of time in markets. That is one area you referred to where we think we could have a look and learn lessons from other jurisdictions. Personally, I think that this is a key area.

The other area that the US has done quite well in, and where I think we also need to learn lessons, is the phasing in of certain requirements. It has been a bit more flexible in saying, "Not everything has to come in with a big bang on date X, but there will be some phasing-in; let's see how it works in some asset classes and then expand". Because we generally have a big bang approach in Europe, we in ESMA will need to be quite careful that what we propose initially is what we believe is workable in the first step, although we might then have to amend it over time to further increase some of the requirements.

The Chairman: Just before Lord Carter goes on, could you give us an example of where it might have been useful to phase in a development? I am thinking of the financial transaction

tax; if it ever sees the light of day, they are proposing that it will be phased in for various assets. Perhaps you have a more ready example.

Verena Ross: The example I would use is the transparency requirements under the EMIR regulation. We had the big bang in February with the reporting of trade reports to trade repositories, and we argued at the time that it might be beneficial to start with genuine OTC trades being reported, rather than trying to do exchange traded contracts at the same time, which were already in the transparent environment, through MiFID I. We felt that the risk of trying to do both together would be too big, both for the market and for us as regulators to cope with. With the big bang, we had to do it all together. I think that we succeeded reasonably well, but there is a lot of cleaning up to do now because we did not have a phasing-in approach. As a result, you then need to sweep up afterwards to try to clear up some of the data quality issues that have arisen.

The Chairman: That is really helpful.

Q245 Lord Carter of Coles: This is really on the relationship between the three ESAs. I think that next year you will be chairing the Joint Committee of the European Supervisory Authorities. What is the nature of that relationship at the moment? How do you see that and what concerns should we have? Where are there gaps, how does it all fit together and how does it feel to you at the moment?

Verena Ross: The relationship between the three ESAs is excellent at all levels, whether at the level of the Chairmen, the Executive Directors or the staff as a whole. We work very well together and benefit from each other’s experience, as well as from the constant exchange of information. Clearly, financial markets are broad and include players—banks, insurance companies, brokers and fund managers—which all work together, so we need to work very closely together to deal with understanding risks as they move from one sector to the other

and how they interlink. From my perspective, the three ESAs work very well together. We do that informally through exchanging views and talking to each other but also formally through the Joint Committee, which is the committee that brings the three ESAs together and the relevant chairmen of sub-committees that work across different areas.

Lord Davies of Stamford: How often does that meet?

Verena Ross: The Joint Committee meets every two to two and a half months. But that does not mean that we are not in constant touch. Those are the formal meetings, but in between we talk very regularly. I talk to my counterparts pretty much at least weekly, if not daily, about one thing or another. So there is a lot of exchange.

Lord Carter of Coles: Are you able to share with us a couple of examples of when issues have come up and you have had to work together in the area of demarcation of rights and so on?

Verena Ross: I will give a couple of examples. One example that has been and will continue to be a key focus for us is the whole area of consumer protection. As others have already said, if you are a consumer faced with certain financial products, some of those products might in theory fall into a particular sector, but in effect you have the choice as a consumer whether to go for an insurance product or an investment product. It is very important that we work closely together there. There are a number of areas, whether it is complaints handling or product governance, where we have worked together to set common standards, which we then each take forward in our individual areas. We have started work on the PRIIPS Regulation and will work very intensively on it over the next year. That will be a key output for the thee ESAs, as it will set a standard under which every consumer in Europe will get a Key Information Document that will be the same across the three sectors. Consistency there is very important and something that we are very focused on.

But there are other areas where we work on trying to find common ways forward: securitisation is another important area, where we are finding that the requirements in different sectoral legislation could potentially cause contradictions. It is certainly creating some confusion, so we are looking at how we can be more consistent across the three different areas. I have already mentioned the work that we have done on self-placements which, again, is effectively about banks raising capital and the distribution of those products to clients of those banks. That also cuts across the different parts of the banking and securities markets.

Lord Carter of Coles: So we should be very comfortable about the frictionless nature of your relationships?

Verena Ross: Yes, I would definitely say so. That does not mean that we do not sometimes come from different perspectives as we look at issues, but I am very comfortable that we work very well together.

Q246 The Chairman: I have two questions before I bring in the Earl of Caithness. There are presumably benefits in the three ESAs being in the financial centres of Europe, but are there disbenefits in not being co-located? Could you also just elaborate on the question you heard earlier about the EBA and the resources that are apportioned to it? Would you like to make a plea for ESMA or are you pretty satisfied with what you have?

Verena Ross: I will perhaps start with your second question, since you invited me to comment. All three ESAs face very similar issues on resources generally. We have grown significantly, which was necessary to enable us to even make a start at fulfilling the objectives that we have been set by our parliamentary masters, but resources are still a big issue, in particular the timeliness of getting the right amount and type of resource into the organisation to be able to fulfil the tasks and obligations that have been put on us. That is a

constant struggle for all three ESAs, and we are no different from the EBA in that regard. I would fully subscribe to what Mr Enria said and would make the same plea, which we have been very public in making. We have said very clearly that, for example, the Commission's current proposal for 2015—no increase in resources and, indeed, an effective budget reduction, given some in-built cost increases—will make the continuing growth of the task and our responsibilities very difficult to manage. With that, I will leave that topic to one side.

On how we operate, you talked earlier about the question of separation. Clearly, there are different regulatory systems: some are separated by sectors and others by conduct and prudential, while other countries have a single supervisory system. There are benefits and risks to all of those. They can be made to work or they can be not as effective as they could be. Having three European Supervisory Authorities that concentrate on their respective areas makes sense in a way. The fact that we are based in three different cities was clearly a political choice at the time. It would not really be for me to comment on whether that would be the right political choice going forward or not.

Earl of Caithness: I will briefly follow up Lord Harrison's question. How many staff do you have in ESMA and what proportion come from the UK?

Verena Ross: Overall staff numbers include not only people on contract with ESMA but some seconded national experts. We are currently at a resourcing level of about 165. I would need to double check the exact number[29], but out of those, about eight to 10 people[30] are from the UK, which is reasonably proportional to the other big countries. We have a good representation, both on the ESMA staff and in the working groups that we have with national competent authorities, which David and Chris mentioned.

[29] Note from witness: Currently there are 12 British nationals on a contract with ESMA (so called "Temporary Agents") as well as 5 British nationals seconded to ESMA by the FCA as Seconded National Experts.

[30] Note from witness: The intention was to refer to the number of Temporary Agents from the UK, see footnote 1.

Earl of Caithness: So you are about 5% of the size of the FCA?

Verena Ross: That is about right. I do not know what the FCA is these days.

Earl of Caithness: It is just over 3,000. Given that, do you have the powers to enable you to produce the single rulebook in the fashion that you would like and to make it sufficiently adaptable so that when inconsistencies are found they can be ironed out quickly and in a sensible timescale?

Verena Ross: With all humility, I think that we have been reasonably good at fulfilling the objective of the single rulebook drafting, often against very tight timetables and with very complex issues to deal with. We have managed to add to the single rulebook over the last three years significantly in a lot of different areas. I am more concerned about our ability to do the other important part of the job, which is to make sure that there is also consistent implementation and supervision of those provisions. One part is getting the rulebook on the block and the other is making sure that that is implemented consistently across Europe. Our resources have not really been sufficient to do both. We have very much concentrated on the immediate legislative requirements of the single rulebook. We have done much less in the supervisory convergence field.

I wanted to point out the other area where we are a bit unique. We have direct supervisory responsibilities for a small number of EU financial services entities. So we are a bit of a front-runner of the banking union in a way, in so far as we supervise credit rating agencies and trade repositories. That is where there is no national competence any more; all the supervision is done at a European level. Building up that supervisory capacity and becoming a credible supervisor at European level for those entities has been another big emphasis of our work and resources over the last three years. It includes on-site inspections, getting data, and making sure that we authorise, register and properly enforce the regulation.

Q247 Earl of Caithness: To go back to the question of staff, we have had evidence that says that you are very easy to approach and that you are very receptive. We have also had evidence that says that you are very difficult to get through to and very unreceptive to any ideas that people come to you with. Perhaps I can follow that up later.

Lord Carter talked about your relationship with the other authorities. What about your relationship with the national supervisory authorities? Are you happy with that?

Verena Ross: Yes. The national supervisory authorities are for us a cornerstone of the whole system. The European System of Financial Supervision is built on having European institutions such as the three ESAs and the ESRB, but also on having national competent authorities which do the supervision on the ground and which implement the measures agreed at European level. From that perspective, they are core to the whole system.

Secondly, the national authorities such as the FCA sit on our board, so they are part of the core decision-making body. All the key policy decisions are made through the board, so the national competent authorities have a big role to play in making sure that what we do works for the whole of Europe.

Thirdly, and very importantly, we have a lot of technical working groups where the national competent authorities bring very valuable expertise to the work that we do. It is essential for us that we are not just sitting in an ivory tower centrally in Europe but that we understand how different markets work, and how the regulation that we are devising at European level will affect different market structures. That exchange and working together is absolutely key. The UK is very active in that and is a very strong contributor, which is extremely important for us, as it is such an important part of the European financial market.

The Chairman: Before Lord Caithness goes on to his next topic, could the timescales for ESMA's level 2 work be enhanced? For example, an earlier witness noted the very short

deadline for the short selling rule. Is ESMA seeking to extend these deadlines and how might the co-legislators be encouraged to do so?

Verena Ross: Indeed, I was very heartened by David's comments on this point because this is and has been a big concern for us over the last three and a half years. The Short Selling Regulation was probably the low point in that experience, in terms of the shortness of the period that we had to finalise the level 2 and to implement the whole thing. There have been other instances where the legislative debate has lasted longer than originally expected and there was a firm date in the legislation that then meant that the level 2 process was significantly squeezed. That is an issue for ESMA and for national competent authorities participating in the process. It also has implications for our interaction with stakeholders because often we cannot fulfil what we generally try to do in terms of holding at least two rounds of consultation, having open hearings, and giving sufficient time for responses. We are squeezed to timetables that are very unfortunate for everyone and we run the risk of not getting things right, which is a big issue.

What has happened is that we have made this point very strongly. Currently, the Parliament and the Council are a lot more conscious of this issue. Normally, now, they try to provide us with nine to 12 months; we always say that we need at least 12 months for the process to work properly. We are also arguing for more flexible deadlines which move with the finalisation of the legislation, rather than being a fixed date in the legislation, which then squeezes the process.

The Chairman: If you were to write to us, I think the Committee would be grateful for the other examples that you have alluded to, other than the Short Selling Rule, where a little more flexibility would have been helpful.

Q248 Earl of Caithness: I would like to explore a little more the consumer protection agenda. What is ESMA's view on that? Obviously, and up until the recent past, financial stability was the key issue, and now one can take a broader view. What is your role on consumer protection and how do you see your role in being able to influence greater transparency and greater consumer protection for financial products?

Verena Ross: Thank you very much. That is a very important issue. We saw with the experience of the crisis that first, creating some stability in the system was absolutely key. That was important and was the right priority choice that needed to be made. Having said that, we have learnt some lessons about consumer protection from the crisis. We have focused firmly on trying to make sure that we do not forget the very important other part, which is rebuilding trust of investors and consumers in the financial services markets and its players. Without rebuilding that trust and making sure that investors and consumers are properly protected, we will not get back to a well functioning and proper financial system. It is very important that stability and consumer protection go hand in hand.

Consumer protection is core to what ESMA is about; I mentioned it as one of our core underlying objectives. All that we do, whether it is single rulebook, whether it is the supervisory convergence, whether it is direct supervision, is ultimately grounded in the fact that ESMA is there to protect investors and consumers in the end, but also protects investors and consumers by having a properly functioning and stable market. There is a very important interlinkage between those different objectives.

So from my perspective, investor and consumer protection is core. The specific areas where we are currently working under MiFID will be key to delivering that on the ground. That is about enhancing the consumer protection requirements in MiFID and also about ensuring that we extend the regulatory remit from the pure sales process of transparency and

disclosure into more on product governance, including how products are designed at the start, what the responsibilities of firms are for the products that are going into the market, and how the process to deal with complaints and issues afterwards works.

Lord Flight: Is there any conflict between your responsibility in proposing equivalence situations to be accepted by the Commission with your responsibility to ensure that the EU markets remain open and competitive? Quite a lot of this stuff is seen from outside as protectionist. ESMA has done rather well in terms of equivalence but is that not slightly in conflict with the whole underlying intent here?

Verena Ross: As David Lawton pointed out earlier, there is the issue of how to ensure, when you build a European regime that you believe provides the right regulatory regime, that there are not financial market participants competing in that market from other jurisdictions in an unfair way. You need to make sure that there is some way of creating a playing field in Europe that is on the one hand open to players from outside Europe, but at the same time that those players have similar—not exactly the same, but similar—regulatory requirements and therefore that there is a genuinely common protection of investors and a common way of looking at regulatory issues.

We have indeed provided advice to the Commission on some specific equivalence decisions. We have always seen ourselves very much as the technical adviser, where we provide the intelligence and understanding of how different regulatory regimes work in different parts of the world. We go through them and try to understand not only what the law says but how the supervision might work in practice. We have always argued for an objective-based comparison as well as a proportionate approach that recognises that there are different ways of getting to the same aim. The ultimate decision on equivalence is for the Commission

and that is clearly enshrined in the legislation concerned. We are there to provide that technical expertise to help understand how different regimes work.

Q249 Lord Dear: I would like to develop the issue of conflicts with you and discuss potential competition, if I may, and ask a really simple question. We have not talked much about banking union and the reform that is going on in banking markets. I wonder whether you think that banking union poses any challenges to ESMA, particularly when one looks at the way the single rulebook would need to be supported and the development of the single market generally? Do you see a potential conflict between ESMA and banking union, or is it something that one can handle?

Verena Ross: Certainly, we have built up a very good working relationship with the Single Supervisory Mechanism that comes into play formally from 4 November. We have worked with them on some of the issues around disclosure of comprehensive assessment results that were just released on Sunday. I personally do not see it as a tension or a problem. The fact is that there is now a single banking supervisor for the eurozone and some other countries. There are also some other countries that are not part of the banking union where the banks are not supervised by the SSM. We as ESMA have to have good contacts with the banking supervisors, whoever they are. Therefore we very much see the world, particularly from the securities markets perspective, very logically as the world of the 28—of the European Union. Therefore we work closely with the EBA to ensure that we also look at any interaction between banking and securities markets from that perspective. Of course we are also talking directly to the ECB on certain issues where there are overlaps between securities markets and banking issues, such as accounts, disclosure and some of the market abuse legislation that impinges on the obligations that banks have. We deal with them as another key banking supervisor.

Lord Dear: It is not so much the overlaps, although one would hope that there were not too many, or none at all, of those. It is the gaps. Do you see any gaps that need to be filled, or could develop, that are irreconcilable?

Verena Ross: I am not sure that I see immediate gaps emerging, because the EBA is the body that will continue to look at the European Union angle across the board. That is really our key counterpart, as ESMA was set up on the same basis. From that perspective, to my mind, this can work and I cannot see any particular reason why it should not work. But it is clearly key that the information flows and that the co-operation of regulators and supervisors across different parts of that varying geography works well.

The Chairman: Given that the EBA is working with the ECB on the survey of the viability of Europe's banks—you may like to comment on that—is that a good example of the ESAs working with the European Central Bank? You just alluded to ESMA's own engagement.

Verena Ross: Indeed. We saw a big, significant project being jointly undertaken by the EBA and the ECB, with results published on a European Union-wide basis. That at least provided some significant similarity in terms of the data that were provided, the timing of the release and how it was handled, while also looking at common stresses and ways of testing the resilience of different banking systems. From our perspective, we have worked closely with the EBA and the ECB, looking at the interactions there with the securities markets legislation and the potential issues that could arise.

The Chairman: Unless other colleagues indicate that they want to say something, I am going to ask Lord Hamilton for our final question.

Q250 Lord Hamilton of Epsom: The City of London probably operates internationally more than any other financial centre in the EU. Are you happy with the EU regulations not making life more difficult for people in the UK operating in these international markets?

Verena Ross: The City clearly has a very international outlook and, having worked here as the national supervisor for many years, I am very aware of that international linkage between the UK markets and the rest of the world. At the same time, one of the key benefits that the UK financial market has is the background of having a lot of other parts of Europe, being part of that general single market. I believe that the European approach to looking at whether we can find a common way of interlinking the European market with the global market is a very important one from which everyone can benefit. Increasingly, the financial markets are no longer either national or regional but genuinely global. Europe as a whole is stronger than its independent parts and therefore it is very important that we have that strong interlinkage, but also that the UK plays that very strong role in Europe to try to inform and influence how the international aspects of the financial market regulation need to play into the European regime.

Lord Hamilton of Epsom: Your experience of the City of London will have told you that it acts as a magnet for many of the brightest and best from all over the United Kingdom. There is an argument that the City of London has done more perhaps than any other industry to harbour computers, with the result that everything happens more and more quickly—so you have dark pools, high-frequency trading and so on. Do you not worry that any regulator is going to be some way behind the curve on the constant innovation that will be coming into the way that business is conducted in financial institutions such as the City of London?

Verena Ross: As I said earlier, it is a genuine challenge for any regulator to make sure that you stay on top of how the market develops and that you have the right tools to monitor where potential risks are building up and how markets function, so that you can understand how that works and find regulatory and supervisory ways to deal with the risks that might come from that. That is the same challenge for all regulators whether they are at national

level—in the UK or somewhere else—or at the European or global level. This is a common challenge that we all face. I believe that some of the measures that have been adopted over the last few years, and are still in the process of being adopted, will help us get a better grip on that. It still will not be perfect but I think it is a significant step forward, whether it is the trade reporting into trade repositories and the access that regulators and public authorities will therefore have to the derivatives trading and the risks arising from it, or whether it is the transparency that MiFID will bring on a cross-European basis for all kinds of different instruments. There are a lot of different areas where we can see progress genuinely happening, which is to the benefit of all the markets, whether in the UK or beyond.

Lord Hamilton of Epsom: As a lot of this will emanate from the City of London, do you think that the national regulators in the UK are better equipped to deal with this than ESMA?

Verena Ross: It is not a question of either/or but about being in this together. The role of ESMA is not to take over detailed day-to-day supervision of all kinds of financial services players that are in the City of London. That is not what is on the cards and it is not anyone’s aim. The key thing is that we are trying to find the right regulatory tools that work across the European level, and we are working with the UK authorities to make sure that that is then implemented and working properly in the UK system. There needs to be co-operation and working together.

Q251 The Chairman: One final question, if I may. This Thursday, our parent Committee, the European Union Select Committee, is interviewing Lord Hill in his new incarnation for the first time. What would you like Lord Hill to do or to be aware of in respect of the ESAs? Then there is a very last question. We have been stopping people in the street and asking them what is meant by capital markets union, but we still do not have a very clear answer. Could you help us with that one as well?

Verena Ross: Lord Hill has a very interesting and challenging role for the next five years. One of the challenges that he faces is what the next phase will be. We have seen significant legislative proposals on the table that are getting to the end of being implemented and put across. What now is the next step in trying to take the European single market for financial services forward? Also, what do we need to do to make sure that we change the structure of the financial markets to genuinely support the economies of Europe in creating growth and employment? That is where the interlinkages are very important.

Capital markets union and the whole idea behind it are clearly part of that. If you ask 10 people, they will give you 10 different answers as to what capital markets union means. To my mind, it is about looking at the capital markets as a solution for ensuring there is a common single market for raising capital and that properly informed and protected investors find trust in those markets. There is still a lot to do to make that happen, and from that perspective, Lord Hill—Commissioner Hill, perhaps I should now say—has a challenging task ahead of him. From an ESA perspective, we have been set up to enable the European Union to deliver that greater single market rulebook and consistent supervision and implementation across Europe. We will be able to play a very important role in that next phase, particularly as we go from the single rulebook into convergence and implementation. We will come to the fore to try to bring that together and it is very important that we can play that role effectively in the overall context of the next five years.

The Chairman: Verena Ross, we will send you a transcript of the exchange that we have had this morning. We would be grateful if you could examine it and correct it, but also add to it. I think you are going to write to us about some of the points raised by Lord Flight and Lord Carter, which we would find very useful indeed. Again, if there are further thoughts which you think would help the Committee come to some substantive thoughts and reasons in its

report, we would be most grateful. In the mean time, we are extremely grateful to you for coming over to see us and particularly for the clarity of your answers, which we will look at, and the way in which you have fielded all the questions that we have thrown at you. It has been a very good session; thank you very much indeed from the Committee. I close this public.

European Securities and Markets Authority (ESMA) – Written evidence (FRF0031)

There were two points, one where I was asked to provide further examples and one where the discussion moved on and I did not get a chance to respond at the hearing.

Firstly I was asked by the Chairman to write to the Committee as "… the Committee would be grateful for other examples that you have alluded to, other than the Short Selling Rule, where a little more flexibility would have been helpful". (see end of my answer to Q247) Other examples besides the Short Selling Regulation, where more flexibility in legislative acts in respect of timing given to ESMA for delivery of Technical Advice or Technical Standards would have been helpful, from an ESMA staff perspective, are: EMIR, MiFID2/MiFIR and CSDR.

Secondly, also in relation to Q247, Earl of Caithness spoke about the differing evidence you have received as to whether ESMA is easy to approach and receptive or not. On this point, I would like to clarify that ESMA is committed to being a transparent and open regulator. We consult extensively on our policy proposals (for example we aim to have at least two rounds of consultation on important Technical Standards, with an early Discussion Paper and a subsequent Consultation Paper that outlines the draft legal text) and hold regularly open hearings. Moreover, we work closely with the Securities and Markets Stakeholder Group, a statutory group that brings together 30 experts from a wide range of backgrounds (consumer and investor representatives, market participants, academics, etc), and have set up more specialised technical consultative groups in relation to some of the work of our Standing Committees. In addition, we hold many bilateral and multilateral meetings with stakeholders whether on specific topics and in relation to particular consultations or whether for a more general exchange of views.
It should be noted that, given our nature as a cross-European authority, we aim to provide fair and balanced access to all our stakeholders – which might mean that, given limited resources, we are not always able to meet all the demands for direct contact and meetings that we receive and need to, at particularly busy periods, prioritise such requests. We believe that it is essential that we are an open and transparent authority that explains clearly to the wider public and all stakeholders what we do – as such we publish all of our work on our website.

Verena Ross,
ESMA
5 January 2015

Financial Conduct Authority (FCA)- Oral evidence (QQ 229-240)

Evidence Session No. 14 *Heard in Public* *Questions 229 - 240*

TUESDAY 28 OCTOBER 2014

MEMBERS PRESENT

Lord Harrison (Chairman)
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Flight
Lord Hamilton of Epsom
Lord Shutt of Greetland

Examination of Witnesses

David Lawton, Director of Markets, Financial Conduct Authority (FCA), and **Christopher Woolard**, Director of Policy, Financial Conduct Authority (FCA)

Q229 The Chairman: Colleagues, I warmly welcome David Lawton and Christopher Woolard—and indeed Verena Ross, who comes before us in the second session—to our penultimate evidence-taking in our examination of the new financial regulatory framework with the European Union. Perhaps the two of you would like to say a brief word about the work that you do currently when you start. We will make a transcript of the examination and send that to you. As I say to all witnesses, please correct the transcript but also add ideas as you think further on some of the questions that we have posed. We are always taking evidence, even at a very late stage. This session is being webcast. We hope that we find it

useful and that you as witnesses can do your best to pass on to us the burden of the knowledge and expertise that you have developed.

Perhaps I could begin with you, David Lawton, and ask you and Christopher, when you have just told us a bit about the work that you do, what your overall assessment is of the reforms that have been brought forward since 2008, which have aimed to stabilise and improve the functioning of the financial sector in Europe. A broad-sweep view, perhaps, would be extremely helpful to the Committee as we set out. David Lawton.

David Lawton: Good morning, Lord Chairman, and thank you very much for inviting us to be witnesses for your inquiry. I am the director of markets at the FCA, which among other things encompasses the FCA’s interest in markets and broader wholesale policy matters. I am also the FCA’s alternate member on the ESMA board of supervisors and am therefore heavily involved in a significant chunk of the ESMA agenda.

On your opening question about our overall assessment, I would say that it has been a mammoth undertaking on the part of the European Union to bring forward, I think, more than 40 pieces of legislation since 2008. It has been a significant response to what has clearly been a significant global crisis. Overall, our assessment is that it has been a very thorough and effective response. The downside, of course, is that with 40 pieces of legislation developed at such breakneck speed, there have inevitably been a number of rough edges, some of which we may get on to talking about as we go through this. There is still a significant implementation challenge to come: we are moving into the most significant implementation period, both for us as regulatory authorities and for the firms affected, and very intensive work is going to continue for the next two or three years. Finally, the European response has been set in the context of a global response, co-ordinated by the Financial Stability Board. For the most part, that has been broadly consistent with the global

response, which has obviously been a good thing, although there have been one or two places where there have been some inconsistencies.

The Chairman: I think Mr Barnier would correct you and say that 41 pieces of legislation have been brought forward under his reign. Christopher Woolard, perhaps you could say a bit about yourself in your response to the first question.

Christopher Woolard: Thank you Lord Chairman. My name is Chris Woolard. I am director of policy, risk and research at the FCA. That means I have responsibility for our overall approach to conduct policy, while David obviously does a lot on the market side of the house. I also chair our policy steering committee, which tries to keep an overview of everything that we are doing. I very much echo what David has just said. The agenda that we have seen is obviously very ambitious and has operated at speed and pace. It is worth saying that, overall, from our perspective as the FCA, it is the right agenda in broad terms. There are specific pieces where we may have disagreements or rough edges but overall it has sought to correct and protect against a series of problems. We very much see those issues as being global as well as on a European level. It is worth adding—we may come to this at some point—the extent to which we in the FCA engage quite deeply in the European debate. We have a very large number of people seconded into either the Commission or the European supervisory authorities. We also engage directly at scale—probably around a quarter of the ESMA working groups have an FCA member of staff chairing them or working with them very closely.

It is also worth underscoring that we do that very much from a technical perspective. We are not here to run a political agenda, but in that context we try to bring as pragmatic and practical solutions as we can to the problems in front of us.

The Chairman: I and some of my colleagues forgot to bring our ear trumpets this morning, so if you two gentlemen could speak up a little, I would be most grateful. Lord Davies.

Q230 Lord Davies of Stamford: Thank you, Chairman. Mr Lawton, you came from the FSA before you joined the FCA. Like many of your colleagues in the FCA, from Mr Sants downwards, you have found yourself taking over responsibility for the current supervisory and regulatory regime. How much comfort do you think the British public can take from the fact that there has been such a continuity with the FSA, which presided over the undercapitalisation of the British banking system? It seemed to have ignored altogether the fact that Northern Rock was in danger through excessive dependence on the wholesale markets in its funding. It paid no attention to the risks of CDOs, which were the fastest-growing asset category in the banking system at the time. It permitted RBS to bid for and buy ABN Amro, with disastrous consequences, et cetera—as you know, there are many et ceteras in this long story. How much comfort do you think the British public can take from that continuity of responsibility?

David Lawton: I do not think there has been continuity of responsibility. The financial crisis has led to a fundamental reassessment of the regulatory frameworks for the UK and for Europe. Parliament has created a new regulatory system with responsibilities split between the new Prudential Regulatory Authority and the Financial Conduct Authority. There is a new, enhanced Financial Policy Committee, with a remit to look at these macroprudential and financial stability questions and which has new powers. While in some cases there has clearly been some continuity of personnel, there has been a fundamental change to the regulatory landscape, with new regulatory authorities, new objectives and new powers. There has also been a thoroughgoing set of reassessments of the lessons of the financial

crisis, which of course are not peculiar to the UK—this was a global financial crisis and a number of other jurisdictions have been doing similar reassessments.

Q231 Lord Davies of Stamford: We had the worst outcomes in terms of the banking system of course. If you take those scandals that I have just referred to—and others such as the LIBOR scandal—along with the fact that our continental partners are getting the impression these days that it is quite likely that we are going to leave the European Union fairly soon, do you think the combination of those two things has seriously reduced our influence and credibility in financial regulatory matters in the EU at present? Do you think those two things have slightly reduced our influence and credibility, not affected it at all or enhanced it?

David Lawton: It is really important, when things have gone wrong, that we look to learn the lessons. In my discussions with regulatory counterparts in Europe, one of the things those counterparts are respectful towards us about is that we have taken active steps to try to learn the lessons and to publish analyses of what went wrong and what needs to be done differently in the future.

You are absolutely right that the financial crisis delivered a knock to the financial sector as a whole—both the participants and the regulatory authorities. I have talked about how the UK is looking to strengthen the regulatory regime since the crisis. In the European context, we continue to be very respected because of our technical expertise. In my discussions with ESMA colleagues and in the ESMA environment, I certainly sense no loss of influence because of broader strategic or political concerns about the UK's longer-term place in Europe.

Lord Davies of Stamford: That is reassuring. I hope that continues to be the case.

The Chairman: Before I bring in Lord Shutt, Christopher Woolard, and indeed David Lawton, would you elaborate on your first answer? What do you think have been the achievements

of the regulatory agenda as developed and what are some of the obvious mistakes? Were there underlying problems that were not to do specifically with the financial crisis but which were there and needed to be addressed? Have those been addressed or have they not been addressed? Christopher Woolard.

Christopher Woolard: It is a mixed package that we see. Some of the 41 measures are very much designed to tackle the crisis, while others are far more orientated towards single market issues that may well have been on the Commission's agenda anyway. Of those that have particularly worked, the programme to create the ESAs should be regarded as quite a success. That is working pretty well from our perspective. The programme around MiFID, in terms of the consumer protections board, very much mirrors and takes forward, at a European level, the UK agenda.

In terms of some of the things that could perhaps have gone better, if you want to put it like that, we would definitely look at questions such as AIFMD, where there was a high degree of prescription within the directive. Although I was not there at the time, from talking to colleagues who were involved in the negotiations, it appears that that was one of the more difficult negotiations that we have been engaged in. There are other small examples elsewhere, where even though the overall thrust of particular legislation is the right one—something like the mortgage credit directive, for example—there can be aspects, particularly where maximum harmonisation is involved, where you can end up with slightly odd outcomes from a UK perspective.

The Chairman: That is very useful. David, do you want to add to Christopher's comments?

David Lawton: In terms of the big achievements, and looking at the really big picture, there are the measures to strengthen the capital liquidity position of banks and steps to try to deal with the recovery and resolution and "too big to fail" questions—all that sort of area which

is more the province of our PRA colleagues. The steps to strengthen the largely disaggregated derivatives trading landscape and bring more centralised reporting and clearing of those instruments are clearly important achievements. Then there are the structural changes that Christopher talked about in terms of the ESAs and, at the global level, the Financial Stability Board. One gloss I would add, going back to your 2008 starting point, is that I do not think that anybody in that year had a comprehensive blueprint of the 41 measures. They have in part emerged not quite piecemeal but in response to issues as they have developed. For example, the banking union and the single supervisory mechanism were not on the agenda in 2008; they came on to the table subsequently.

As for what could have been done differently, the breakneck speed at which these measures have been introduced will inevitably mean that, as we get into the detailed implementation and as we look back, we will find some inconsistencies and challenges that we will want to revisit.

The Chairman: An appropriate moment for Lord Shutt.

Q232 Lord Shutt of Greetland: Good morning. You said, compositely, that the regulatory framework that has been put together is "mammoth, ambitious, right, thorough but effective". What about overlaps, contradictions, inconsistencies and gaps? Have you identified any of these in either the retail and wholesale investment markets? We are talking about these 40 to 41 sets of regulations, and you have already indicated that there might be or might not be. Is there anything that you can put your finger on? If it is all very detailed, we do not mind some notes afterwards, but it is important to say whether there are things here which you really would like to highlight.

David Lawton: There are probably three particular examples on the markets side. The first is that, as I mentioned, the European response has been developed as part of a global package,

and there are certainly still some issues to iron out, for example in relation to the consistency of the European and the US implementation, particularly around the derivatives agenda. There is still work to be done to avoid having dual regulation of the same firms doing the same activity to similar standards. That is one inconsistency that still needs to be worked on.

A second example relates to liquidity, particularly in bond markets. We have seen three major drivers of change: first, changing the capital rules for banks and investment firms that are active in these markets, which, in Europe, is being delivered through CRD IV; secondly, we are just about to introduce, through a revised MiFID, wholesale transparency requirements for these markets; and thirdly, banks and investment banks themselves are changing their business models. Those three things taken together are pretty big drivers of change. There is certainly quite a bit of market uncertainty and worry about what it will all add up to in terms of liquidity provision in those markets going forward. That is not an inconsistency, but it is an area where different elements of the package are going to be brought to bear on a really important part of the financial system.

A third example—really getting into the weeds now—is that some of the timings have been quite aggressive, which has led to legislative conclusions that, from a technical perspective, might be flawed. I will give you two examples in that space. First, a hard date was baked into the legislation for when the short-selling regulation would take effect, but when the level 1 negotiations slipped that hard date was not changed, which meant that the regulatory detail had to be developed in a very short space of time. ESMA had a consultation on some of the really important technical detail that only lasted five weeks, which is not the best way to develop effective legislation. I will give a second example in the context of MiFID. One of the concerns in the level 1 discussion was around the amount of what is called dark trading in

shares—the amount of trading that takes place without any public dissemination of the prices and sizes that are available to trade before trades happen. That was a difficult part of the discussion. It was settled at the last moment with a pretty clunky aggregate cap mechanism, which many market participants and some regulators think is not the best way to deal with the challenge.

The Chairman: Christopher, did you want to add anything to what David said or in response to Lord Shutt?

Christopher Woolard: Can I add two comments more from a retail perspective? In terms of overlaps and the question of different directives potentially either contradicting each other or setting up unintended consequences, one of the things that we have to be particularly careful about is the interplay of the MiFID regime, PRIIPs and the forthcoming insurance directive, IMD. We perceive that there is a danger there, largely based on the fact that, in a number of other European countries, the domestic markets are very different, such that we could end up creating different treatments simply because something is sold with an insurance wrapper around it even though, fundamentally, the underlying product is still the same. We need to make sure that we do not run into those kinds of risks, although we are not quite there yet.

There are places where, for perfectly good reasons, disclosure is chosen as the principal tool in a number of directives. The problem that we can run into there is that those disclosures could potentially be either contradictory or quite burdensome. One of the things that we are very keen to do, and have spent quite a lot of effort on, is to try to ensure that the Commission and others thinking about these kinds of disclosures try to make them as behaviourally informed as possible. In other words, let us not just give people more and more information but try to give information that really matters and can influence choices.

On occasion we see examples, such as with the mortgage credit directive, of disclosures that we think are probably going to have very little impact on individual consumers' choices. For example, there is a maximum harmonised requirement to provide people a 20-year view of interest rates when they take out a mortgage. When you translate that into the UK system, the numbers involved become almost meaningless for someone making a rational decision about the mortgage that they are about to take up.

The Chairman: This Committee highlighted one of the problems of pre-trade disclosure in MiFID in its report a couple of years ago. Already we have come on to the ground that the Earl of Caithness is interested in.

Q233 Earl of Caithness: You mentioned some of the problems with MiFID II, PRIIPs and IMD. Your chairman stressed that one of the major issues is policy clarity. Given these overlaps and lack of consistency, and given that your chairman says that he needs to sort all this out within two to three years, how easy is it going to be to correct these overlaps? Has consumer protection—and your ongoing efforts to address it—been influenced by these overlaps? Let us start with that.

Christopher Woolard: It is worth bearing in mind that a very significant amount of our existing rulebook is derived essentially from European directives. The majority of our existing rulebook is derived from European directives and frameworks. There is one way in which we can make that agenda consistent for UK consumers. Where we have discretion in the implementation of directives into UK laws, we can use that to try to make the system as consistent as we can.

The second way in which we can do that is by being alert to the dangers and risks of getting into conflicting systems. The example that I just gave you—that there might be a risk in relation to the IMD—is one that we are carrying into negotiations around that. Frankly, we

have to be on the front foot wherever we can, around being clear with people that even if the very best intentions sit behind requirements that are being placed at either level 1 or level 2 rules, when you translate those into a UK context they can have potentially perverse effects.

So far, the general picture is that we have been reasonably successful in making sure people understand that. For example, on the interaction between the Retail Distribution Review in the UK and MiFID, we are in a position where that works pretty well for consumers. Again, where we have discretion around where we implement something like the mortgage credit directive, we can make that make sense in a UK context rather than attempting to get a common denominator with a number of other countries that may do things in a very different way.

Earl of Caithness: In terms of product development, how confident can consumers and investors be that the risks generated by firm product governance/development processes and firm innovation will be addressed through the new regulator regime—or do you think that it is best done through a change in culture and behaviour by the firm producing the product?

The Chairman: Christopher again.

Christopher Woolard: I will start. On the whole, the UK system, and indeed much of the European system that sits behind it, bases the idea of responsibility on those who are providing products directly to consumers—often the intermediaries. The stress within that is on the intermediaries understanding the components of the products that they are selling at retail level. From an FCA perspective we do not see product innovation as necessarily a bad thing. Indeed, in many cases it is actually a good thing for consumers. That is one of the reasons we have put together a team with the title Project Innovate that is designed

specifically to encourage people to come forward with ideas that we think could be of long-term benefit to consumers, and to bring those into the market.

There is definitely a cultural question underpinning this. The test for us is: how far can you honestly say when you are bringing forward a product that it is treating your customers fairly or treating fairly the customers that it is going to be sold to—that it is genuinely in their interest rather than just happening to be an extra way of squeezing out a few more pence of profit per customer? That is very much culturally based. It is very hard for us to regulate every product on the market without having a stifling effect on change, innovation and competition in the market. At the end of the day it comes down to some quite big cultural shifts that might be needed.

The Chairman: David, do you want to add to that?

David Lawton: I entirely agree that the front line of responsibility for developing appropriate products that meet consumers' needs rests with firms. Firms' governance and culture are critical to getting a good outcome here. But the various rules, systems and controls that the regulatory system imposes play an important flanking role in that context.

Q234 Earl of Caithness: Like Lord Shutt, I will ask for some examples, please. This time I am looking at market efficiency and transparency with regard to the whole of the securities trading chain: pre-trading, trading and post-trading. Has this been enhanced or has it been made more difficult? Let us have some examples, please.

David Lawton: I am happy to supply some examples. One important piece of context is that in the European landscape, most of the framework legislation that deals with capital markets predated the crisis: it was part of the financial services action plan package that came into effect between 2005 and 2007. What we are seeing now are revisits and reviews of some of

that core legislation: looking again at the market abuse directive, at MiFID and so on. We have had a long run of years in which this capital markets package has taken effect.

I will give a number of positive examples. The first is, clearly, much greater competition in the trading of shares. That has brought down execution costs and enabled new entrants to come into the marketplace. Secondly, we have created a genuine passport for initial capital issues through the prospectus directive, which has enabled a broadening of previously national forms of capital.

A third key example that is often overlooked is the importance of measuring everything using the same set of variables through common accounting standards. Being able to compare firms' positions right across Europe using a single set of metrics is a very important contribution to the efficiency of capital markets.

Looking ahead at measures that have yet to take effect but which I think will have positive effects, we have the whole package around OTC derivatives that is bringing much better risk management to derivatives, whether they are centrally cleared or remain OTC. We have shortened the settlement cycle for securities trading from three days to two, removing a significant chunk of operational risk in the marketplace. MiFID II will also bring much greater control and transparency over the trading of financial instruments right across the spectrum: not just shares but bonds and derivative instruments. That will also contribute to the efficiency of the marketplace.

The Chairman: Christopher, do you want to add to that?

Earl of Caithness: I have one supplementary. Perhaps you could write to us on this. Given all of that, where are the extra costs and how much are they? If you could drop us a line on that, we can get on with other questions.

The Chairman: That would be very helpful indeed. The assessment of costs very much intrigues the Committee.

Q235 Lord Carter of Coles: I have two questions. The first is the importance of market-based funding in supporting growth. As you know, the prospectus directive is due to be reviewed in 2016. Is there any way, coming out of that review, that we could find a way of supporting growth and strengthening capital markets in the EU? Or, the reverse of that, do you think—this point was made earlier—that the regulatory burden will increase as a result of that? If we look at some of the more innovative means of funding, such as crowdfunding et cetera, should they be dealt with at European level or is there an argument that they could be dealt with at national level?

David Lawton: Perhaps I will start and Chris may pick up other aspects, particularly around crowdfunding. From a European perspective, encouraging the growth of capital market-based finance is critical. If you look at the comparison with the US, Europe is clearly much more dependent on bank finance than capital markets—two-thirds to one-third—and it is broadly the inverse in the US. Given that banks are, for various reasons, under pressure and retrenching, the opening up of capital market finance is clearly going to be critical to supporting the growth agenda going forward. It seems to me that the new European Commission has this very firmly in its sights with its capital markets union initiative. Within that context, a review of the prospectus directive can play an important part. The directive has already been reviewed once, so the challenge might be that some of the low-hanging fruit has already been picked—but the directive has within it exemptions for offers of a small monetary amount and exemptions for offers to fewer than 150 people. The opportunity in the context of the capital markets union is to see whether some of the disclosures could be more streamlined, particularly for small and medium-sized enterprises.

The technical challenge there is to address the liability regime. One reason prospectuses contain so much information is that the directors who sign them are liable for the content, so there is an interaction between the prospectus regime and the company liability regime. That is not harmonised in different member states, which makes it a particular challenge to deal with.

Lord Davies of Stamford: Is the regime regulated more or less on SEC lines?

David Lawton: I think that depends on the member state. Probably in the UK it is around about the same.

Lord Carter of Coles: Just going back to that point, which national Governments have the strongest and the weakest responsibilities for directors?

David Lawton: That is not something I can speak to off the top of my head. There is quite a complex set of interactions between securities regulation and company law and corporate governance. It goes beyond the FCA's remit.

The Chairman: But you are saying that there is more work to be done in that area, are you not?

David Lawton: In relation to the specific question about the opportunities of the prospectus directive review, it provides an opportunity to open up more opportunities to some more opportunities for capital market access, particularly among SMEs. One challenge is addressing the liability concerns.

The Chairman: Christopher, did you want to add to David's point?

Christopher Woolard: On the technical point about crowdfunding, in the UK we have introduced what we think is a proportionate regime to cover both equity-based and debt-based crowdfunding. What we have seen since the introduction of that regulation is a growth in that market, so it is very much a case of putting a framework around a relatively

young market that allows it to assure investors that there is something there. Clearly there are a number of different approaches to crowdfunding throughout Europe at this moment in time. The French have a very different version from us; the Dutch have a version that is reasonably similar to what we do.

If we think that this is going to be an important source of growth in the future, there is an argument for some basic minimum standards to operate at European level. At the moment you can have a situation where someone runs a crowdfunding website in Estonia to service the UK to then invest in Poland. The regulatory regime around that is pretty murky, frankly.

Lord Davies of Stamford: So there is no regulatory arbitrage?

Christopher Woolard: Very rarely. However, the question is if we think crowdfunding will become more of a mainstream activity; at the moment it is still relatively low in percentage terms in the UK. If the industry wants to think about growing on a European level, it will need to accept that there is need for some kind of minimum standards around that that allow those kinds of cross-border comparisons.

Q236 Lord Carter of Coles: Can we go on to silos? I think it was suggested that there has been a tendency towards silo-based regulation, with some people suggesting that there is a lack of joined-up thinking in the EU’s approach to financial services regulation. Would you agree with that? Is that fair?

David Lawton: This silo question has a number of dimensions to it. The first is the global versus the European; we have talked already about the importance for global wholesale markets of the European approach being consistent with global standards. I know that some are concerned about the fact that Europe has taken the Basel capital requirements, which were developed for internationally active banks, and translated them to apply to all banks and investment firms, suitably tailored of course for investment firms. The second silo

question is the sectoral one, between banking, insurance and securities markets. Obviously, having three different European supervisory authorities for those sectoral areas means that there is a need for co-ordination. One point I would note in that context is that most European domestic regulatory arrangements have some split, whether it is conduct-prudential or sectoral, and there are compartmentalised approaches across Europe as a matter of national approach. Thirdly, within the Commission—at the third level down—the different units talk to each other appropriately. Chris has already talked about some concerns around people developing some disclosure rules for investment products; are they talking to the people developing disclosure rules for insurance products?

Lord Carter of Coles: Do you think they are?

David Lawton: Not as much as we would like.

Lord Carter of Coles: What can you, the FCA, do about those things? What is your influence in that process and what is the mechanism for you to make that point?

David Lawton: Mechanisms such as this, of course. We give technical input, typically through the Treasury, but often talking with the Treasury to the Commission, making these points at the early stage of the gestation of legislative ideas. Secondly, as we are active in the ESAs, particularly in ESMA, in the ESAs providing technical advice and commentary on the legislation, we can make the points through those means. Thirdly, where we have discretion in our domestic implementation, we have the choice of trying to align measures that have come through different legislative channels where it makes sense to do so.

Lord Carter of Coles: Do you get the sense that you are being heard?

David Lawton: As with all debates of this sort, sometimes you are heard and sometimes you have less influence than you would have liked.

The Chairman: So are there times when the Commission could consult more effectively?

David Lawton: More generally, one of our concerns over the development of legislation, particularly looking back, is that because of the scale—which we have already talked about—and the timeframe over which it has been developed, some of the better regulation disciplines, which the UK has been trying to inculcate into the process for many years, have been squeezed, as well as the preconsultation development of impact assessments before legislation gets too far down the track—some of those disciplines have not been as fully developed as we would have liked.

Q237 The Chairman: Christopher, do you have anything to add? If not, before I bring in Lord Flight I have a few questions about the ESAs, which you have already identified as a plus as regards the response to the challenges that we have had. Do you think there is the maximum of consultation among the three ESAs with yourselves, and so on, and do you think that they have been given sufficient resources? The reason we ask that is because we had Mr Enria before us, on several occasions, who says that the resources are more slender than he would like to do the job that he would like to do.

David Lawton: I am smiling because I am sure that most bosses of regulatory authorities would say something similar about the scale of the resources relative to the challenge. I think the ESAs are playing an invaluable role in the current structure. They do three very important things. First, they provide the technical advice and drafting the technical standards to flesh out the politically agreed level 1 legislation. Secondly, they work to ensure a consistent interpretation and application of the legislation through developing guidelines and Q&As to make sure that we have a consistent approach across Europe; and thirdly, they are beginning to develop through things like peer review a greater supervisory convergence. So we are getting similar outcomes. The scale of their resources has increased significantly over the years; for example, ESMA has now grown up to about 160 or 170 staff. However,

the scale of the challenge that I have described in those three areas remains huge. From a UK perspective, we are very keen to see the ESAs be successful, and part of that is making sure that they do not bite off more than they can chew. In part, of course, the direct resources of the ESA staff are supplemented by the resources of the member regulators, so we as the FCA contribute a significant quantum of resource to the ESMA process through the various standing committees. Therefore it is important not just to look at the direct head-count of the ESAs when you think about the resources that are available to them.

The Chairman: I am going to bring in Lord Flight, but when you write to us about the costs it would be very useful to have some knowledge about the percentage that we send from our own national authorities to the ESAs. The Committee would find that insight very useful indeed.

Q238 Lord Flight: You have partially answered my first questions in being clear that you think that the ESAs play an invaluable role and we support them. However, would you agree that the level 2 administrative lawmaking process, including ESA engagement, has resulted in a single rulebook that is too detailed and inflexible? Secondly, do you not feel that the silo-based structure of ESAs risks the quality of regulation and how it impacts on major investors and consumers?

On consumers, I want to ask you very briefly, because your name is FCA: there are things coming through the FCA which are highly unattractive and silly for consumers. One is the strange rule on no mortgages to those over 70, which means that if people want to downsize and have a bridging loan, they cannot get it. I am trying to investigate where this nonsense comes from, because there is no banking justification for it.

The second is the interpretation of PRIIPs, as a result of which the children of many Peers are having bank accounts refused, and some have been sacked as clients because the whole cost

of verifying assets and monitoring bank accounts makes the business uneconomic. The whole requirement is ridiculous when Back-Bench Lords or MPs have no power to fiddle, even if they wanted to.

Thirdly, clients of private client stockbroker fund managers are mostly sophisticated, and it is impertinent to be requested to provide income on one's income, sources and assets and the rest of it, and it is unnecessary if they are to be treated as sophisticated investors. I might add that if you are left with the FCA's hierarchy of risk, you risk a disaster of people being put into gilts and then losing a fortune when inflation finally takes off and rates go through the roof, as always happens. Therefore, from where do these strange rules and requirements that come out from the FCA originate—are they from the ESAs or from FATCA? In addition, why are you not making sure that they end up with something sensible?

David Lawton: I will start with the single rulebook parts of the question. The European single rulebook will be detailed. In part you should compare that against what the domestic rulebooks that it is largely replacing would have looked like, so it is important to have the right counterfactual there. In part, some of that detail is part of the technique to deliver consistency. To be absolutely clear about what is to be applied, in part the technique is to be a little more detailed—so that is driving the harmonised application.

The idea behind the level 2 process is that it encapsulates the technical detail, so the level 1 discussions—Commission, Council and Parliament—set the policy direction; the level 2 is meant to be technical implementing detail, which is capable of being updated periodically to take account of market developments. We have not seen that technique being used sufficiently often yet to say whether it is has been a success in terms of the split between level 1 and level 2. There is clearly a risk that the level 2 technical detail never gets revisited because the process is too complicated. The jury is out on that, but it is designed to be

capable of being revisited reasonably often so as to be able to keep pace with market developments.

Earlier we talked about the question of the silo issue. Clearly, as you get down into more and more level 2 detail, the risk that you are, say, an ESMA getting a bit more divorced from similar things that are happening in the EBA or EIOPA, grows a bit. There are two ways of mitigating that risk. The first is that there is cross-membership of the respective boards of supervisors, so in ESMA there are observers from the EBA and EIOPA. The FCA is the UK member of ESMA and participates in the working committees in the EBA and EIOPA—we are not a member, but participate in the working committees—so we have the opportunity to do some joining-up there. The second way of mitigating it is that the three ESAs have a joint committee, which comprises ESA staff and selected members. That provides a clearing-house mechanism for dealing with some of these more challenging silo questions.

Christopher Woolard: Before I take some of the specifics, as regards the question of individuals over 75 not being able to get mortgages in a number of cases, the important thing to stress is that there is no rule from us that says that if you are over 70, you cannot get a mortgage. Various reforms have been introduced through the mortgage market review, which are intended to ensure that mortgage borrowing is affordable and sensible.

Lord Flight: That is the problem, because to make a mortgage for someone over 70, banks are required to have security other than the property in question. I do not see the logic of that.

Christopher Woolard: I will not go into individual cases, but I think that that is down to a number of firms that we have seen who have chosen to interpret the rules in a certain way.

I will come on to talk about the detail of your other questions, Lord Flight, but there is a bigger issue for us here on the question of de-risking. Most of the rules and frameworks,

whether they are at the European level or domestic, require firms, in particular in this case large banks and building societies, to manage risk. It is very much about managing risk; it is not about not taking any risk whatever. We have seen a number of cases where, by the time whatever it might be has been through a series of lawyers' compliance departments, you end up with a situation where some of the outcomes for consumers are not particularly good. Indeed they do not even fit with either the letter or the spirit of the original regulations that were put in place.

Lord Flight: Please could you therefore tell the banks to stop doing that? They do not need to.

Christopher Woolard: There have been cases, and certainly there is one specific example that I was involved in, where we talk to an individual firm and say, "We think you can probably follow the train of thought which got you to this particular position. Can you please explain to us how, starting from here, you managed to get there? Should you revisit that?"

On the question of PRIIPs, there are some international requirements that would flow into European requirements. We are aware of the small number of cases where there seem to be some slightly odd outcomes from that. That is something that we are talking directly to firms about. That is definitely on our radar.

Finally, on the question of sophistication, depending on the particular type of investment, there may be either tests or limits that either relate to sophistication—in other words, the experience of the investor having done this work before—or to their net worth. In many cases, clients have the ability to certify that they are sophisticated and that they have invested before, and to provide some evidence of that. That does not necessarily involve a massive degree of intrusion into their private affairs. What can arise is the question, depending on the individual broker or whoever it is you are dealing with, of the level of

evidence that they feel they might need to produce for us. Indeed, sometimes that conversation is in itself a marketing opportunity for them.

Lord Flight: What the private client stockbrokers are doing is obliging their clients to complete a 12-page form that asks for all this information and that substantiates that the risk strategy that they have chosen is appropriate to them. Their position is that they are not protected from your having a go at them, if for some reason the risk strategy turns out to be wrong. Moreover, if it turns out that the client is not that sophisticated, they are obliged to adopt a lower-risk strategy which is in line with the FCA hierarchy of risk assets, which is, as I point out, a dangerous long-term strategy. This is what has been created. It is not much good to say that it is not really necessary; that is how the market and the participants are reacting to the FCA's requirements to protect their own backsides, just like the case with PRIIPs. Fundamentally, it is not much good having regulation that has that effect.

The Chairman: I am anxious to bring this session to a close with questions from Lord Hamilton. Perhaps you would like to think about the more specific points raised by Lord Flight, and you could try to tackle those by letter.

Q239 Lord Hamilton of Epsom: I am anxious to look forward to how you see the relationship developing from here. First, on the single market, there have been serious problems with financial products being sold into Europe. Has that improved? Do you see that getting any better in the future?

Secondly, the whole economic model of the EU is one, it seems to me, where you have structures that impose regulation, and there is a tendency for them to impose more and more regulation. Nobody seems to be responsible for growth in either the eurozone or the EU, unless it is the nation states. People have rather overlooked the costs. We have already talked about costs. We had Douglas Flint here last week, saying what the structure of

separation of investment and clearing banks in HSBC will cost. Are you not worried that we will just go on imposing more and more costs to less and less effect?

Thirdly, and perhaps this is not totally in your remit, but, as an example, when we were in Brussels, we had a discussion with an MEP on what else she might get on to do and she thought that she should be getting on with harmonisation of insolvency laws. I do not think there were many people on this Committee who thought that that was a high priority for Europe to be concerning itself with.

David Lawton: I will start to pick up on some of those points. On the question about selling into Europe, there are two structural features of this package of reforms which help to address that point. The first is that most of the legislation passed since 2008 has some sort of third country equivalence provision. In other words, in order for a third country provider outside Europe to do business into Europe, it has to be done on a similar basis to the standards that would apply to a European provider. The idea that you could base yourself outside Europe and undercut European standards is addressed through the structural feature of the European legislation. That carries its own downside in that Europe has to do lots of equivalence assessments, but we can leave that to one side.

The second structural change that deals with that issue is the point we talked about earlier on the single rulebook and the role of the ESAs in promoting a consistent application of that rulebook, and supervisory convergence. What we will not see is regulatory arbitrage within Europe, where people move from one jurisdiction to another to try and reap the benefit of a weaker application of the legislation.

On the growth agenda, it seems to me that that is very much the buzzword of the moment. The new European Commission has it very much at the heart of what it wants to achieve in its five year programme. From a regulatory point of view, we have had five years of

measures trying to deliver stability and deal with the post-crisis agenda. We are now coming through that. From where we sit, the key thing over the next two or three years is a smooth and proportionate implementation of the 41 measures we have been talking about. We do not see a need for a new legislative agenda, quite the opposite. The best thing for growth is to allow firms and regulators to get on with completing the job that was started in the last five years.

Q240 The Chairman: Let me just conclude by asking you this. The FCA as the regulator has an important role of influence in the European Union which is marching very much towards a banking union. The rules and regulations may well cohere around that developing banking union. How able are you to intrude a voice there to ensure that the UK voice is heard and heard well?

Perhaps I can ask you, David, then I will turn to Christopher as well, what we have not touched on this morning that you think might be included and added to our report? What would be important to highlight in a parliamentary report of this nature?

David Lawton: On banking union very narrowly, that is primarily a matter for the Government. That is largely a prudential agenda. From our point of view, the important point there is that the conduct aspects of banking continue to be dealt with as single market measures, and the EBA is central, not the single supervisory mechanism.

On your final question, I come back to what we were discussing with Lord Hamilton. Over the next two or three years, our priority is going to be completing the technical standards on the legislation that has largely been agreed, and working with firms to deliver a smooth implementation. It is really important that space is provided by the legislative process for the resources to be properly devoted to that.

Christopher Woolard: I would stress three quick points. To some extent, there is a bit of an inflection point here. If we have the space to implement the agenda that has already been set out, then there could be some potentially positive outcomes. The alternative is that people would still keep loading more and more things on the wagon. That is quite an important point from the perspective of the wider good functioning of the markets. Secondly, to stress the points that have already been made a couple of times, maximum harmonisation and the degree to which that is seen as a tool to be deployed by the Commission and the Parliament need great care. It can be done with the very best of intentions, but the unintended consequences at national level always somewhat worry me.

The final piece is about consistency, which we discussed at length. It is important that we do not create frameworks that exist in their own worlds, for example, between ordinary user products and insurance products, simply because of the nature of the wrapper in which they are sold, or the fact that they are dealt with by a different directive. Getting that consistency is extremely important for the future agenda.

The Chairman: David Lawton and Christopher Woolard, the Committee is so grateful to you for coming this morning and giving us the benefit of your thoughts. We will send a transcript of this exchange and ask you to look at it, correct it, and indeed improve it. David, if you could, please pick up some of the points raised in relation to the costs and Lord Flight's questions. You mentioned right at the top of your response the transatlantic liaison, which we have not gone into this morning. If you have any further thoughts on that, we would be most grateful to hear them. Please do summarise those and respond to us.

We are particularly grateful for your labouring under the problem presented by a lovely room like this with a high ceiling, which was of course created for politicians with stentorian

voices, and doubtless stentorian ears as well. We are most grateful to you for surviving this and giving us the benefit of your thoughts.

With that, colleagues, I conclude this part of the session. I shall say goodbye to our witnesses and welcome Verena Ross. Thank you very much.

Financial Conduct Authority (FCA) – Written evidence (FRF0030)

The Lord Harrison
Chairman
EU Sub-Committee A
House of Lords
London
SW1A 0AA

25 November 2014

Thank you again for inviting David and myself to give evidence before the Committee last month.

During our appearance we committed to write to you with details on the cost of individual pieces of European legislation as well as figures on the FCA's financial contribution to the European Supervisory Authorities (ESAs). Lord Flight also asked a number of questions regarding the proportionality of certain regulations and their impact on consumers. I have provided some further details on those issues below.

<u>Cost of individual EU financial services legislation</u>

The European Commission is required to undertake an impact assessment for each of the individual legislative measures which it proposes, at the time when the proposal is made. These impact assessments are published alongside the proposal.

In addition, when individual pieces of agreed EU financial services legislation are to be implemented into UK law, the government (usually HM Treasury) will also undertake and publish a high level impact assessment of the changes being made. If the implementation of EU legislation requires changes to the FCA's Handbook of rules and guidance, the FCA undertakes a Cost Benefit Analysis (CBA) of the changes we propose to make. We publish this CBA for comment alongside the proposed Handbook rule changes themselves. FCA CBAs of changes driven by EU implementation tend to focus particularly on points where we are exercising permitted discretion as to how we implement, but also comment on the effects of changes which we have no option but to make.

As far as any overall assessment of the impact of EU legislation is concerned, the FCA has not to date carried out a quantification of the cumulative impact of the EU measures that

have required changes to our Handbook and regulatory processes. In May 2014, the European Commission did publish a communication and staff working document entitled *Economic Review of the Financial Regulation Agenda,* in which it reviewed available market, regulatory and academic evidence and economic literature to try to provide a high level assessment (across the EU) of the costs and benefits of the various measures comprising the post-crisis EU regulatory response. HM Treasury's July 2014 *Review of the Balance of Competences between the UK and EU* covering the 'Single Market' in financial services and the free movement of capital also sought to quantify the overall economic benefits of the EU Single Market to the UK, and to highlight some of the particular significant cost impacts. However, both the Commission and Treasury recognised in their reports the challenges of such overall quantification and assessment of costs and benefits.

FCA contributions to the ESAs

As we mentioned in our evidence to the Committee, the FCA plays a significant role in the work of the three ESAs. We are members of the Management Board and the Board of Supervisors of the European Securities and Markets Authority (ESMA) and are represented on every committee and work stream within ESMA involving ESMA members. In addition, we are significant participants in the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA) in respect of work that falls within the FCA's remit – notably relating to consumer protection, financial innovation and market trends.

Currently the ESAs' budgets are financed 40% from EU funds and 60% through contributions from Member States (made in accordance with the weighting of votes set out in Article 3(3) of the Protocol (No 36) on transitional provisions). The FCA's direct financial contribution to the ESAs in 2014 was:

a) An annual contribution to the budget of ESMA of £773,000.This represents the UK share of the ESMA budget.
b) Seven secondees (6 to ESMA and 1 to EBA) whose salaries are paid for by the FCA.

In addition, around 75 members of FCA staff participate in the ESAs at all levels, from the Board of Supervisors through to the various Committees, Sub-Committees and working groups.

Reported difficulties facing older people when looking to remortgage

There have been reports that older borrowers are finding it difficult to get a mortgage. It has been suggested that this is an unintended consequence of the new FCA rules brought in as part of the Mortgage Market Review (MMR).

The MMR was introduced in order to help consumers by ending irresponsible lending practices of the past and we believe it is helping to achieve that objective. The core focus of the rules is to ensure that lenders take proportionate measures to assess a borrower's ability to repay their loan. As such, the rules should not prevent creditworthy consumers, of whatever age, from being able to obtain mortgages.

Where a consumer takes out a mortgage which will extend into retirement, the FCA expects lenders to assess whether repayment is likely to be affordable over that period.

However lenders should take a proportionate and common sense approach when setting their own affordability criteria.

The FCA introduced some 'transitional arrangements' as part of the package of reforms, to help mitigate the impact of the new affordability rules on existing borrowers. This allows lenders to waive affordability requirements in certain circumstances where the borrower is not borrowing any more money. The FCA is encouraging firms to review their policy in this area to assess whether the transitional arrangements are being used effectively.

Politically Exposed Persons (PEPs) and the Anti-Money Laundering (AML) Regime

The definition of a Politically Exposed Person (PEP) is set by the Money Laundering Regulations 2007 (MLRs), and includes those entrusted with a prominent position by a state other than the UK, as well as their family members and known close associates.

We are aware that many firms apply higher standards and include some UK politicians within their definition. While this is a decision for the firm and not the FCA, we do expect firms to apply the MLRs and our Financial Crime Rules in a proportionate way. Our requirements permit discretion in the context that a firm's systems and controls must enable the firm to identify, assess, monitor and manage money laundering risk which are comprehensive and proportionate to the nature, scale and complexity of its activities, and this is an issue we have raised with firms during our ongoing supervision.

Private stock broking and sophistication requirements

FCA rules in this area relate to the type of information that is likely to be required in order to make a proper assessment of the suitability of particular investments for individual clients by private stockbrokers. These rules are directly copied from the EU Markets in Financial Instruments Directive (MiFID). However for the majority of clients, information about investment objectives, the attitude to the risk, the ability of the client to bear the financial risks, including their income and other assets, is likely to be necessary in order for firms to make that judgment.

MiFID (and FCA rules implementing MiFID) provides the option for a firm in particular cases to be able to treat an individual as an 'elective professional client' where the client meets certain prescribed criteria. This means that some of the elements of the suitability assessment can be more easily deemed to be satisfied. However, such clients would then need to receive a clear written warning setting out the protections that they would lose as a result of being treated this way; and they would need to confirm their acceptance of this.

I hope that this is helpful.

Yours sincerely

Christopher Woolard
Director of Policy, Risk and Research

25 November 2014

Financial Markets Law Committee (FMLC)–Written evidence (FRF0023)

Inquiry into the EU Financial Regulatory Framework

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

As highlighted by the Sub-Committee in its Call for Evidence published on 16 July 2014, the focus of regulators and law-makers, both in the U K and across the EU, is currently turning from agreeing the principles of new regulatory reforms to the detailed implementation and effective coordination of those reforms already agreed. The FMLC therefore considers this an opportune time to conduct a review of the changes to the regulatory framework that have occurred since the onset of the global financial crisis in 2007, and welcomes die present inquiry into the E U financial regulatory framework.

In response to the Call for Evidence, the FMLC wishes to draw to the attention of the Sub-Committee the issues of legal uncertainty highlighted in the papers and letters published[31] by the FMLC over the course of the current regulatory cycle. For convenience, a summary of those publications considered most relevant in the context of the present inquiry is set out in the annex to this letter. The issues identified therein may each broadly be categorised as follows:

1. Internal incoherence or inconsistency within a piece of E U legislation (including between Level 1 texts and Level 2 implementing measures);
2. Incoherence, inconsistency or overlap between different pieces of EU legislation;
3. Incoherent or inconsistent implementation in the UK of EU legislation; and/or
4. Incoherence with, or inconsistency between, EU and UK legislation.

While it makes no comment as to matters of policy, the FMLC remains highly supportive of the regulatory efforts undertaken by the institutions of the E U in pursuing the regulatory agenda which, as recognised in the Call for Evidence, is now "based largely on die ambitious G20 commitments set by international partners in Pittsburgh in 2009". While some degree of legal uncertainty is indissociable from any legislative process, and it is the ongoing remit and function of the FMLC to identify and address such uncertainty, the most significant instances of overlap, contradiction and inconsistency identified by the FMLC in the EU financial regulatory regime are frequently the product of insufficient consistency, coordination and cooperation amongst those who set and implement a now *global* agenda.

[31] The FMLC's publications are available on its website: http://www.fmlc.org/publications.html

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

ANNEX

HOUSE OF LORDS EUROPEAN UNION COMMITTEE (EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE) INQUIRY INTO THE EU FINANCIAL REGULATORY FRAMEWORK

INDEX OF DEFINED TERMS

"AIFM" means Alternative Investment Funds Manager, as such term is defined in the AIFMD

"AIFMD" means Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers

"AIFMD Level 2" means Commission Delegated Regulation EU No 231/2013 of 19 December 2012

"Banking Reform Act" means the Financial Services (Banking Reform) Act 2013

"Banking Reform Bill" means the Financial Services (Banking Reform) Bill

"BCBS" means the Basel Committee on Banking Supervision

"BRRD" means Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms

"Brussels I" means Regulation (EU) No 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast)

"CASS" means the Client Assets Sourcebook of the FCA Handbook

"CCP" means central counterparty

"CDS" means credit default swap

"CIS" means Collective Investment Scheme, as such term is defined in the FSMA

"Commission" means the European Commission

"CNAV" means constant net asset value

"COMI" means centre of main interest

"CRA3" means Regulation (EU) No 1060/2009 of 16 September 2009 on credit ratings agencies

"CRD IV" means Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

"CRR" means Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms

"CSD Regulation" means the proposal for a Regulation on improving securities settlement in the European Union and on central securities depositories

"Data Protection Proposals" means the Data Protection Regulation and the proposal for a Directive on the protection of individuals with regard to the processing of personal data by competent authorities

"Data Protection Regulation" means the proposal for a Regulation on the protection of individuals with regard to the processing of personal data and on the free movement of such data (General Data Protection Regulation)

"EBA" means the European Banking Authority

"EMIR" means Regulation (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

"EMIR RTS" means draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of the EMIR

"ESMA" means the European Securities and Markets Authority

"EU" means the European Union

"EUIR" means Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings

"Excluded Activities Order" means the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014

"FC" means financial counterparty, as such term is defined in the EMIR

"FCA" means the Financial Conduct Authority of the UK

"FMLC" means the Financial Markets Law Committee

"FSA" means Financial Services Authority

"FSMA" means the Financial Services and Markets Act 2000

"FTT" means financial transaction tax

"FX" means foreign exchange

"GMRA" means Global Master Repurchase Agreement

"HFT" means High Frequency Trading

"HM Government" means Her Majesty's Government "HMRC" means Her Majesty's Revenue and Customs "HM Treasury" means Her Majesty's Treasury

"Insolvency Regulation" means the proposal for a Regulation amending Council Regulation (EC) No 1346/2000 on insolvency proceedings

"ISDA" means the International Swaps and Derivatives Association "IOSCO" means the International Organisation of Securities Commissions "LMA" means the Loan Market Association

"Market Abuse Directive" means Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse)

"Market Abuse Regulation" means Regulation (EU) No 596/2014 of 16 April 2014 on market abuse (market abuse regulation)

"MiFID II" means Directive 2014/65/EU of 15 May 2014 on markets in financial instruments

"MiFIR" means Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments

"MMF" means money market fund

"MMF Regulation" means the proposal for a Regulation on Money Market Funds

"NAV" means net asset value

"NFC+s" means non-financial counterparties, as such term is defined in the EMIR, taking positions in OTC derivative contracts in excess of the clearing threshold specified in the EMIR

"OTC" means over-the-counter derivative

"PERG" means Perimeter Guidance Manual of the FCA Handbook

"PRA" means the Prudential Regulatory Authority of the UK

"Regulation on Benchmarks" means the proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts

"Rome I" means Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I)

"RRD" means the proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms

"SFR" means the Financial Markets and Insolvency (Settlement Finality) Regulations 1999

"Short Selling Regulation" means Regulation (EU) No 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps

"Solvency II" means Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

"Third-Country NFC-s" means third-country entities which would be classified as non-financial counterparties below the clearing threshold were they established in the EU

"TTCA" means title transfer collateral arrangements

"UCITS Directive" means Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

"UNIDROIT" means the International Institute for the Unification of Private Law

"UK" means the United Kingdom

3 October 2014

SUMMARY OF ISSUES OF LEGAL UNCERTAINTY IDENTIFIED BY THE FMLC

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
Banking Reform (Ring-Fencing)	Article 21 of the Commission proposal for a Regulation on structural measures improving the resilience of EU credit institutions provides that the Commission may grant a derogation from the ring-fencing requirements under the proposed Regulation, provided that equivalent national primary legislation was adopted in the Member State in question before 29 January 2014. The FMLC understands that the Commission legal service has expressed doubts as to the validity of the derogation under EU law, giving rise to the risk that certain banks may be required to comply with two differing regimes when the proposed Regulation takes direct effect. Differences in scope, application and interpretation of the regimes under the proposed Regulation and national legislation, respectively, give rise to considerable uncertainty for the entities potentially subject to them. In the case of the UK, such issues of uncertainty include the following: • The regime established under the Banking Reform Act exempts from the ring-fencing requirement UK institutions holding total core deposits inferior to *de minimis* amount, and excludes from the definition of "core deposits" those held by high net worth individuals. The proposed Regulation contains no such exemptions. • The proposed Regulation appears to grant national regulators significant discretion as to whether to require a core credit institution to separate out its trading activities, whereas for the UK regime under the Banking Reform Act there is no similar discretion. • National regulators are granted some discretion under the proposed Regulation as to the activities not to be undertaken by a ring-fenced entity, whereas the Excluded Activities Order prohibits a ring-fenced body from carrying out the regulated activities of "dealing in investments as principal" and "dealing in commodities".	*Letter to European Commission on legal uncertainties arising from the proposed Regulation on Structural Measures Improving the Resilience of EU Credit Institutions*, dated 18 August 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
MiFID II and MiFIR	The FMLC submitted a response to ESMA's consultation on the implementation of certain provisions of MiFID II and MiFIR. The response paper highlighted uncertainties regarding ESMA's proposals on investor protection. These uncertainties include: • That ESMA's advice on the recording obligation imposed by Article 16(7) of MiFID II is broad, with the implication that it would catch communications not intended to be caught within the meaning of Article 16(7) of MiFID II. • That ESMA's description of the term "manufacturer" of financial instruments differed from the meaning of the term in Article 16(3) of MiFID II, with the consequence that it is difficult to determine which firms are manufacturers of financial instruments and therefore subject to the further requirements on product governance. • That the introduction of an obligation to check the "fairness" of the price proposed by firms to buyers of bespoke over-the-counter derivatives (OTC) goes further than mandated by the legislative source for the proposed obligation i.e. Article 27 of MiFID II.	*Response to the European Securities and Markets Authority Consultation Paper on the Revised Markets in Financial Instruments Directive,* dated 14 August 2014
EMIR	On 14 April 2014, the European Supervisory Authorities published the EMIR RTS. The FMLC has identified the following issues of uncertainty arising under the EMIR RTS: • It is unclear whether the EMIR RTS permit initial margin to be transferred to the collateral taker pursuant to a TTCA. TTCAs are, however, viewed in many jurisdictions by market participants as particularly sound from a risk management perspective because of the opportunity they create for simplified enforcement or realisation of the collateral. • The EMIR RTS appear to stipulate that collateral must be collected by FCs and NFC+s in their dealings with, *inter alia*, Third-Country NFC-s. Such requirement is inconsistent with international standards as agreed by the BCBS and IOSCO.	*Report on legal uncertainties arising from the Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-derivative Contracts not cleared by a CCP under Article 11(5) of Regulation (EU) No 648/2012*, dated 14 August 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	• It is unclear whether the requirements of the EMIR RTS apply to collateral posted in excess of the regulatory minimum stipulated by the EMIR RTS.	
Audit Reforms	To improve the quality of statutory audit, Regulation (EU) 537/2014 on specific requirements regarding statutory audit of public-interest entities and Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts of all types of entities (including public-interest entities) were adopted and published in the Official Journal of the EU earlier this year. The Department for Business Innovation & Skills is expected to provide guidance for the application of the Regulation and consult on implementing the Directive in the UK in due course. The FMLC has identified the following two issues of legal uncertainty: • The transitional arrangements for mandatory rotation set out in Article 41(3) of the Regulation do not make clear when the maximum duration period should be deemed to begin, in particular whether the period begins on the date on which the Regulation enters into force or on the date on which the statutory auditor was first appointed. If the latter interpretation should apply, this would result in an unusual legislative outcome whereby those with the shortest audit tenor would be required to take action before those with the longest appointments. It could also lead to a "cliff-edge", i.e. a point in time at which a large number of systemically important institutions must secure the provisions of a new auditor, making it difficult for public-interest entities to obtain such services. The FMLC has recommended that public-interest entities be given an advance indication of when the period in respect of Article 41(3) is deemed to begin. • The FMLC has also noted that clarification would be desirable with regards to whether the definition of "public-interest entities" would include a branch of a non-EU credit institution or a branch of an insurance undertaking which is based in the EU, where the parent is based outside of the EU.	*Letter to Department for Business Innovation & Skills on Audit Reforms*, dated 11 August 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
Data Protection Proposals	The FMLC considers that the Data Protection Proposals give rise to issues of legal uncertainty. The Data Protection Proposals amend the existing regulatory approach introduced by Directive 95/46/EC (implemented in the UK through the Data Protection Act 1998). The FMLC welcomes the Data Protection Proposals' aim to build a more comprehensive and coherent framework than that which is currently in place, but observes that the following key issues of uncertainty should be addressed. • Uncertainty arises as to whether an independent safe-harbour is created from the restrictions under the Data Protection Proposals as to the transfer of personal data by virtue of Recital 79 in the proposed Data Protection Regulation in the case of transfers pursuant to international agreements. It is also unclear whether the application of this recital is restricted to agreements entered into between sovereign states or whether it instead applies more broadly, for example to international agreements entered into between national regulators. The FMLC has recommended that this recital be amended to clarify that it applies, in the interests of international comity, to international agreements entered into between governmental entities and agencies. • The provisions for a "right to be forgotten" in the Data Protection Proposals may lead to circumstances in which a data controller will not be entitled to resist a demand for erasure of personal data even where the retention of that data is a necessary and proportionate measure to safeguard public security and/or the prevention, investigation, detection and prosecution of criminal offences, let alone the retention of which would assist competent authorities in the performance of their regulatory functions. • For entities subject both to the obligations imposed by the Data Protection Proposals and to the obligation to cooperate with a competent authority in the exercise of its regulatory and investigative functions, a conflict may arise where the local regulator seeks disclosure of data which falls within the scope of the protections under of the Data Protection Proposals.	*Letter to the European Commission on EU Data Protection Reforms*, dated 8 July 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
Issues Relating to International Harmonisation of Law and Regulation	The Financial Stability Board Seventh Progress Report on Implementation of OTC Derivatives Market Reforms addresses the state of the implementation of OTC derivatives market reforms under the "Pittsburgh Commitments", which resulted from the meeting of G20 leaders in Pittsburgh in 2009. The FMLC notes that inadequate consistency and coordination in implementation is likely to give rise to issues of legal uncertainty, leading to a combination of, amongst other things, excessive compliance costs, inadvertent non-compliance, regulatory arbitrage and/or unwanted curtailment of business within specific jurisdictions.	*Letter to the Secretariat of the Financial Stability Board in response to the Seventh Progress Report on Implementation of OTC Derivatives Market Reforms of 8 April 2014*, dated 16 May 2014
FX and MiFID	On 10 April 2014, the Commission issued a consultation document on FX financial instruments. The ESMA had, in prior correspondence with the Commission, pointed out that "the different transpositions of [MiFID II] mean that there is no single commonly adopted definition of derivative […], thus preventing the convergent application of [EMIR]". In its letter to the Commission, the FMLC welcomed as a step towards legal certainty the possibility of adoption of a measure harmonising across the EU the application of the definition of financial instrument under MiFID.	*Letter to Jonathan Faull (Director General, Internal Market and Services) in response to the Consultation Document on FX Financial Instruments of 10 April 2014*, dated 16 May 2014
Money Market Funds	The Commission's proposed MMF Regulation gave rise to issues of legal uncertainty which were discussed in an FMLC paper published in May 2014: • Liability standards proposed in Article 6(4) of the proposed MMF Regulation differ from the liability standards in the UCITS Directive and the AIFMD. The UCITS Directive and the AIFMD apply to asset management and are intended to be co- extensive with the proposed MMF Regulation. In addition, Article 6(4) does not provide sufficient clarity to ensure a harmonious application of the article by courts in different Member States. • The requirement for certain MMFs to hold a three per cent. cash buffer at all times with a single credit institution raises the spectre of uncertainty as to	*Discussion of legal uncertainties arising from the proposal for a Regulation on Money Market Funds, dated* 12 May 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	whether the buffer would be protected from bail-in (one of the resolution tools under the BRRD) in the event that the institution were placed into resolution.	
Regulation of Credit Rating Agencies	In February 2014, ESMA published draft texts of three regulatory technical standards in a consultation paper concerning the implementation of CRA3. The FMLC responded to ESMA's consultation, but only in respect of the draft regulatory technical standards ("Draft RTS") on structured finance instruments ("SFIs"). The FMLC's concerns were: • That the scope of ESMA's Draft RTS was broader than the scope of CRA3 in at least two material aspects. First, ESMA's Draft RTS applies to privately rated and publicly rated structured finance instruments. Article 2(2) of CRA3, however, states that the regulation (CRA3) applies to publicly rated instruments. Secondly, the Draft RTS applies to SFIs that qualify as securities as well as other financial instruments such as money market instruments. The FMLC took the view that Article 8(b) of CRA3 confers a mandate to establish standards only in respect of SFIs that are "securities" subject to the obligation to publish a prospectus under the Prospectus Directive. • That the disclosure requirements in the Draft RTS overlap and conflict with disclosure requirements under framework legislation such as the CRR and the Market Abuse Directive.	*Response to the European Securities and Markets Authority: implementation of the third EU Regulation on Credit Rating Agencies*, dated 11 April 2014
Benchmark Reform	Following investigations into the attempted manipulation of the London Interbank Offered Rate and Euro Interbank Offered Rate, a number of measures were adopted and proposed by regulators and legislators both in the UK and in the EU. HM Government implemented the Wheatley Reforms and the Commission amended proposals for a Market Abuse Regulation and criminal sanctions for market abuse in order to tighten the administrative or criminal sanctions that apply to attempts to manipulate benchmarks.	*Discussion of legal uncertainty arising from the proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts,*

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	The Commission also published the Regulation on Benchmarks in 2013. The FMLC highlighted a number of uncertainties in a paper published earlier this year, a copy of which was sent to the Commission. The FMLC's concerns and the Commission's response to those concerns are summarised below. • Compulsory withdrawal of a benchmark may give rise to considerable legal risks associated with contractual discontinuity, including the risk that legacy contracts will be frustrated (further analysis of the risk of contractual discontinuity can be found in the FMLC's earlier paper on Benchmark Transition, dated December 2012). Such withdrawal is contemplated in the Regulation on Benchmarks in Article 39(4), in the event that the benchmark references no more than five per cent. of the value referenced at the time of the entry into force of the regulation. The FMLC recommended that the application of the five per cent. threshold was not clear, and that further guidance should be given. In its response to the FMLC, the Commission stipulated that, in its view, market participants will have sufficient time to prepare for the discontinuation of these benchmarks and "re-reference their contracts to benchmarks compliant with this Regulation". • The Regulation on Benchmarks also provides for restrictions on the use of certain benchmarks, owing to the equivalence regime set out in Article 20. In its paper, the FMLC considered that it was unclear whether complying with the IOSCO Principles for Financial Benchmarks is sufficient to generate a positive equivalence decision by the Commission. The Commission confirmed that the equivalence assessment for the Regulation on Benchmarks would take into consideration the implementation of the IOSCO Principles by third-country jurisdictions. • The FMLC raised concerns on the difficulties inherent in implementing certain requirements and particularly those requiring a clearer delimitation or measurement of an underlying interest (Articles 5(1)(a) and 7(1)(c) of the Regulation on Benchmarks). The Commission stipulated in its response to the	dated 18 March 2014

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	FMLC that further guidance on the appropriate implementation of these requirements could be desirable and is envisaged to be provided in future Level 2 measures. • The FMLC considers that key definitions, such as the definition of an “index” in Article 3(1)(1) and “benchmark” in Article 3(1)(2), of the Regulation on Benchmarks give rise to uncertainty as to their scope. The Commission’s response to the FMLC confirmed that some key definitions would likely be clarified during the negotiation process (between the EU Parliament and EU Council) but that some definitions were intentionally broad in order to ensure that all relevant benchmarks and their administrators/contributors are under the scope of the Regulation on Benchmarks.	
Recovery and Resolution	The FMLC’s paper, a sequel to its first paper on the Commission’s proposal for the BRRD (which entered into force on 2 July 2014), addressed residual uncertainties arising from the Council General Approach to the BRRD. These uncertainties included the following. • With respect to bail-in (i.e. conversion of debt to equity or debt write-down), legal uncertainty is likely to arise from the fact that contractual bail-in provisions may not operate in the same way as statutory bail-in provisions under the BRRD. • Article 36 of the BRRD requires a valuation of the assets and liabilities of the company or group before the application of a resolution tool; however, the resolution objectives (set out in Article 31) imply a need for resolution actions to be carried out with some urgency. The terms in Article 36 give rise to legal uncertainty as to the status of a resolution action which is taken when a valuation at the prescribed standard has not been carried out, owing to practical difficulty or impossibility. • Regarding the sale of business tool, whereas Article 38(3) of the BRRD requires a resolution authority to obtain commercial terms for a transfer in conformity with the relevant valuation, it is unclear how the terms of each sale could conform to	*Discussion of legal uncertainties arising from the Council General Approach to the Commission proposal for a Recovery and Resolution Directive*, dated 25 October 2013 *the draft Directive for a Financial Transaction Tax ("FTT") under ‘enhanced co o perat io n’*, dated 6 August 2013 and *Letter to Jonathan Faull of DG Markt, European Commission, regarding legal uncertainties arising from*

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	the single and definitive institutional business valuation required under Article 36. • With regard to third countries, it is unclear what action will be taken by a resolution authority in the event that the transfer of the property, rights and liabilities of a company are or may be ineffective under foreign law. • Having defined the meaning of "netting arrangement", the BRRD mentions the term "netting agreement", which is not defined therein.	*the draft Directive for a Financial Transaction Tax (" FT T") under 'enhanced co o perat io n'*, dated 6 August 2013
High Frequency Trading	In October 2013, the FMLC wrote to the Commission drawing its attention to, *inter alia*, the following points of ambiguity in the proposals for MiFID II and Market Abuse Regulation which relate specifically to algorithmic and high frequency trading. • The placing of orders (including by electronic means, such as algorithmic and high frequency trading strategies) and which, *inter alia*, "initiate or exacerbate a trend" is deemed under the Market Abuse Regulation to constitute market manipulation. This phrase may unintentionally cover a range of market activities which constitute normal market practice and established practices. • The process for establishing an "accepted market practice" under the Market Abuse Regulation gives rise to uncertainty, owing to its complexity. Article 8a of the Market Abuse Regulation sets out, amongst other things, seven criteria against which a market practice must be tested, rules for informing ESMA and a requirement that the relevant national authority officially accepts a practice before it becomes "accepted" in their Member State. This complexity may lead to difficulty in establishing accepted market practices on a majority of trading venues. • The definition of algorithmic trading in MiFID II uses terms which are imprecise (e.g."manag[ing] the order after its submission" and "limited or no human intervention").	*Letter with appendix: MiFID II and MAR – points covering algorithmic and high frequency trading*, dated 24 October 2013

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Financial Transaction Tax	The Commission has proposed a draft Directive for an FTT under "enhanced cooperation". The FMLC gathers that this draft is subject to further change; however, the FMLC's main areas of concern with the current draft are summarised below. First, the application of the FTT to different types of market transaction is uncertain and requires clarification, notably: • The treatment of movements of securities for the purposes of the management of financial collateral requires clarification, as there is material uncertainty as to whether such transactions should be treated as separately chargeable "financial transactions", for the purposes of the FTT. • Technical guidance published by DG Taxud suggests that CCPs will be subject to a "look-through" principle and exempt from primary liability; however, that principle is not reflected clearly in the draft Directive. • The scope of the exemption for "primary market transactions" may not include certain types of transaction which would be primary market activities protected by the Capital Duties Directive. Second, the provisions regarding the persons liable for, and the collection and enforcement of, the FTT raise uncertainty, notably: • Both the legal basis and also the mechanism for effective collection and enforcement of the FTT outside the participating Member States remain unclear. • The application of the definition of a financial institution to various types of entity requires further clarification. • Guidance is also required regarding the criteria to be taken into account in applying the "economic substance" exemption under Article 4(3).	*Letter to Heinz Zourek of DG Taxud, European Commission, regarding legal uncertainties arising from the draft Directive for a Financial Transaction Tax ("FTT") under 'enhanced co o perat io n'*, dated 6 August 2013 and *Letter to Jonathan Faull of DG Markt, European Commission, regarding legal uncertainties arising from the draft Directive for a (" FT T") under 'enhanced* August 2013

<table>
<tr><th>Topic</th><th>Summary of Issues of Legal Uncertainty Identified</th><th>FMLC Publication</th></tr>
<tr><td></td><td>Third, the anti-evasion and anti-abuse provisions in Articles 12 to 14 are uncertain in their scope and also raise various operational uncertainties, notably:

• Guidance and clarification regarding the implementation of these provisions by the participating Member States—as well as their application to common types of market transaction—would increase legal certainty. It is also unclear which tax authority or authorities will be responsible for determining these—and related—concepts (and whether there will be any appeal procedure).

• The "essential purpose" tests under Articles 13 and 14 may also result in legal uncertainty, particularly where the individual purpose of a party to a financial transaction is entirely commercial.

• In the absence of harmonising provisions, it is unclear how measures adopted by the participating Member States to prevent tax fraud and evasion under Article 12 will interact coherently with the other anti-evasion and anti-abuse provisions.

The FMLC is also concerned about the impact of the FTT on pre-existing—and future—market transactions. Uncertainty resulting from the FTT would be likely to result in advisory costs and disputes (and possibly litigation) which may be exacerbated by (i) the absence of "grandfathering" provisions and (ii) the "material modification" provisions, under which modification of an instrument may constitute a separately chargeable "financial transaction" for the purposes of the FTT.

The FTT will in fact have been an unforeseen risk in most—if not all—cases. Therefore, ascertaining how it should be treated under existing contractual provisions may be extremely difficult in practice. In particular, the FMLC considers the following examples of specific uncertainties which would arise from the FTT under the three sets of model documentation:

• The FTT may lead to uncertainties regarding the provisions of the ISDA Master

Agreement dealing with "Stamp Tax".</td><td></td></tr>
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	• The FTT may result in disputes under the "Tax Event" provisions of the GMRA, in the context of repos and similar transactions. • The FMLC has identified two key areas of the LMA model documents for use in the primary loan markets where the FTT may cause uncertainty: (i) "material adverse change" or "material adverse effect" provisions; and (ii) provisions allowing the lenders to recover certain "increased costs".	
Securitisation Risk Retention	The EU risk retention regime requires, first, that certain entities responsible for bringing instruments to market assume exposure to those same instruments and, second, that other specified entities invest exclusively in financial instruments which comply with the first requirement. The regime is split across a number of European Regulations and Directives. Rules for credit institutions are found in the CRR (Articles 404 to 410), which will also apply to investment firms. Rules for AIFMs are in the AIFMD and AIFMD Level 2. Rules for insurers and reinsurers are in Solvency II, whilst those for UCITS are in the UCITS Directive (as amended by the AIFMD). The FMLC considers that the risk retention requirements provide the following examples of inconsistency across EU legislation and also between the relevant Level 1 text and Level 2 implementing measures. 1. The CRR restricts the circumstances in which a party (an investment firm or credit institution) may be *exposed to the credit risk* of securitisation, whereas the other pieces of legislation listed above restrict the circumstances in which a party (e.g. an AIF, insurer or UCITS) may *invest* in a securitisation. 2. The CRR restrictions apply to "securitisation positions", whilst those under AIFMD and Solvency II apply to "securities or other financial instruments" and to "securities or instruments", respectively. Furthermore, the language of AIFMD Level 2 is inconsistent with the language of the AIFMD because it applies to the restriction to a "securitisation" whereas—as noted above—AIFMD refers to "securities or other financial instruments".	*Report entitled Response to the European Parliament Committee on Economic and Monetary Affairs' Public Consultation on enhancing the coherence of EU financial services legislation*, dated 30 June 2013

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	3. The AIFMD presents an "originator" as an alternative to the concept of a firm that repackages loans into tradable securities. By contrast, Solvency II and the UCITS Directive define an "originator" as a firm that repackages loans into tradable securities or other financial instruments (Article 135(2) of Solvency II and Article 50a of the UCITS Directive). The CRR definition of "originator" is different and refers to an entity involved in the creation or purchasing of the obligations underlying the securitisation. 4. Solvency II mandates the Commission to make rules implementing its risk retention provisions, which include a requirement that the originator retains a five per cent. interest. By contrast, the AIMFD and UCITS Directive each mandate that rules shall be made to include a requirement that the originator, the sponsor or the lender retain a five per cent. interest. The FMLC has raised the issues mentioned above with the European Parliament Committee on Economic and Monetary Affairs.	
Solvency II Directive	The FMLC published a paper in June 2013 drawing attention to, *inter alia*, the following concerns arising from the interpretation of Solvency II. • The criteria for the authorisation of third-country branches under Directive 2002/83/EC (the so-called "Recast Life Directive") and Solvency II are inconsistent. It is also unclear whether authorisation is the subject of minimum harmonisation and, if so, how "gold-platting" of authorisation requirements by individual Member States might operate in a cross-border context. • It is not clear whether the requirement for the third-country undertaking to cover the minimum capital requirement and the solvency capital requirement, as it appears in Article 162(2)(f) is to be met at the level of the branch or at the level of the undertaking. The same holds true for the governance criterion in Article 162(2)(i) of Solvency II. • It is not clear how rules in Solvency II which have been designed to be applied to	*Discussion of legal uncertainties arising from the Solvency II Directive*, dated 25 June 2013

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	solo undertakings should be interpreted in a group context. A number of the provisions in Solvency II which deal with the supervision of undertakings in groups apply rules for solo undertakings at the group level "*mutatis mutandis*".	
AIFMD	The FSA (now the FCA) published the first of two consultation papers on the implementation of the AIFMD in November 2012. The FMLC identified a number of areas of legal uncertainty arising from these proposals contained therein. These legal uncertainties fall into two categories: (i) transitional issues; and (ii) issues relating to depositaries. The issues relating to the transitional period (which expired on 21 July 2014) have not been summarised in this table. In its response to the FSA, the FMLC highlighted the following issues regarding depositaries. • As the AIFMD was drafted as an EU Directive, but the FSA rules take effect as regulatory requirements under the UK regulatory regime, there is uncertainty as to whether the AIFMD can be used to interpret the FSA rules and whether such rules can be considered as definitive in this respect. • There is uncertainty as to the steps needing to be taken to achieve "functional and hierarchical separation" of depositary and prime broker functions, and of the depositary function and potentially conflicting tasks. • Under Article 21(11)(b) of the AIFMD, "the depositary [must] demonstrate that there is an objective reason for the delegation" in order to delegate certain activities to third parties. There is uncertainty as to the criteria which will be taken into account when assessing whether there is an "objective reason" for delegation. • Article 21(11)(d)(iii) of the AIFMD provides that the depositary may delegate certain functions to a third party provided that "the third party segregates the assets of the depositary's clients from its own assets". It is not clear whether the	*The implementation of the Alternative Investment Fund Managers Directive: discussion of legal uncertainties arising from the FSA's proposals for the transitional period and depositaries*, dated 18 March 2013

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	FSA considers that this requirement will be met if the third party maintains separate records in its books. • The AIFMD and the AIFMD Level 2 provide that certain rules will apply "*mutatis mutandis*" to the relevant parties. There is uncertainty as to how these requirements will apply to the delegate and sub-delegate, for instance, whether this means that the relevant requirements are to be applied to the delegate and sub-delegate as if the delegate were in the position of the depositary, and the sub-delegate was in the position of the delegate. Equally, it is not clear how these obligations will apply where the delegate is not in the EU, for instance, whether a depositary would be required to impose contractual obligations in the same form. • It is not clear whether CCPs fall within the exemption from treatment as delegates of AIF depositaries as a category of securities settlement systems (for instance, because such entities are similar market infrastructures which may hold assets for AIF depositaries) or whether they may be treated as delegates of AIF depositaries. Further issues of legal uncertainty are set out in the 2013 FMLC paper, including in relation to (i) written contracts expressly transferring the liability of the depositary to a third party custodian in case of a loss of financial instruments held in custody; (ii) the obligations of a depositary to perform cash flow reconciliations; and (iii) the depositary's obligations with respect to custodial assets.	
Client Monies	The FSA (now, the FCA, as noted earlier) published CP/12/22 in September 2012 setting out certain changes to the client assets regime (1) required by EMIR; (2) in order to introducing multiple pools; and (3) seeking to improve the treatment of client assets in a firm's insolvency. The paper highlights the following issues of legal uncertainty, *inter alia*, identified by the	*Response to the FSA Consultation Paper entitled "Client assets regime: EMIR, multiple pools and the wider review" (CP12/22) Report*, dated 19

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	FMLC in its response to CP/12/22. • The establishment of multiple client money pools with the aim of facilitating the distribution of client money in the event of the firm's failure may lead to a lack of clarity in the event that a firm has misallocated money, leading to the risk of delay, uncertainty and litigation in the event of the failure of the firm. • Where clients have in effect opted out of the protections under CASS by agreeing to a TTCA, Article 48(7) of EMIR provides that such funds that cannot be ported must be returned either to the clients (if the CCP can identify them) or to the clearing member for the account of its clients (if the CCP cannot). The position is not clear, however, in relation to excess margin once it has been returned by a CCP to a clearing member as opposed to having been transferred directly to clients. • Excess margin transferred pursuant to a TTCA becomes the property of the clearing member and is not subject to any client money trust that would confer a beneficial entitlement on clients so as to justify a transfer to them. Article 48(7) of EMIR provides that, after the completion of the clearing member's default management process, such funds are to be returned by the CCP to the client or held by the clearing member (for the account of the client). It is unclear, however, whether EMIR can by itself alter property rights so as to produce a different outcome on insolvency than would otherwise be the case. • Pursuant to Article 296(5) of the CRR, a client subject to the own funds requirements under CRD IV may be able to benefit from advantageous capital treatment of its CCP- related transactions with the clearing member provided that certain conditions are met. The FMLC highlighted, however, that it was not clear whether a client that transfers cash collateral to a clearing member under a TTCA would be able to satisfy such requirements. • Some Member States interpreted Article 13(8) of MiFID as providing credit	February 2013

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	institutions with an absolute carve-out from the provisions concerning the protection of clients' funds notwithstanding the wording in Article 18(1) of MiFID Implementing Directive (2006/EC/72) that makes clear that the carve-out only applies to deposits within the meaning of the Banking Consolidation Directive (2006/48/EC). This can make the position relating to the branches of such banks less clear. For example, where a bank incorporated in another Member State holds segregated client positions at a CCP, those positions will benefit from the default protections in Article 48 of EMIR but it may not be clear that clients will benefit from the protections of the host state client monies rules implementing MiFID. It is important for Member States to ensure that such inconsistencies do not give rise to uncertainty over the regulatory, equitable or insolvency treatment of client balances held at CCPs and/or any conflicts of law issues which could undermine the client protections envisaged by both MiFID and EMIR. The FMLC also wishes to highlight that the FCA announced in PS 14/09 that it intends to consult further on the client money distribution rules towards the end of 2014.	
Banking Reform (Ring-Fencing)	The Banking Reform Act received Royal Assent on 18 December 2013. Prior to this, the FMLC considered areas of legal uncertainty arising from the proposed ring-fencing provisions in the draft Banking Reform Bill. The legal uncertainties highlighted in the FMLC letter fall into three categories: (i) the compatibility of the Banking Reform Bill with EU law; (ii) uncertainties within the text of the Banking Reform Bill; and (iii) the location and height of the ring-fence. Summarised below are the issues relating to the compatibility with EU law, which may still be of relevance in the context of the Banking Reform Act. • The Banking Reform Bill provided for a continuity objective in respect of ring-fencing, described as "protecting the continuity of the provision in the United Kingdom of core services". This continuity objective, by focusing on the provision of core services in the UK, may indirectly discriminate against nationals of other Member States in breach of Article 18 of the Treaty for the functioning of the European Union.	*Report entitled Banking Reform (Ring-Fencing)*, dated 5 February 2013

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	• The draft RRD provided for the possibility of “group financial support agreements” under which certain holding companies and certain of their subsidiaries may enter into agreements to provide financial support to any other party to the agreement that experiences financial difficulties. Such agreements could provide for support across the boundary of, and therefore be inconsistent with, the ring-fence set out in the Banking Reform Bill (and, now, the Banking Reform Act). The FMLC paper also noted that, under the Banking Reform Act, deposits covered by the Financial Services Compensation Scheme are preferential debts under Schedule 6 of the Insolvency Act 1986, whereas Article 99(2) of the RRD required Member States to ensure that deposit guarantee schemes rank *pari passu* with “unsecured non-preferred claims” under national law governing “normal insolvency proceedings”. The FMLC notes that the wording of the BRRD, now enacted, has been modified to allow for deposit guarantee schemes to benefit from a higher ranking upon insolvency than the claims of ordinary unsecured, non- preferred creditors: Article 108(b)(ii) of the BRRD.	
Short Selling	On 16 November 2012, the FMLC wrote to Verena Ross, Executive Director of ESMA,regarding the interpretation of Article 2(1)(k) (providing a definition of “market making activities”) of the Short Selling Regulation, concerning trading on a trading venue, in ESMA’s consultation paper on the exemption for market making activities and primary market operations under the Short Selling Regulation. The following issues of legal uncertainty, in relation to the consultation paper, were examined. • The letter highlights that, on a strict reading of Article 2(1)(k) of the Short Selling Regulation, there is no requirement for a link between the trading venue of which the market marker is a member, and the financial instruments in which that legal entity undertakes market making activities. ESMA’s consultation paper appears, however, to have interpreted the wording to mean that the person relying on the exemption must be a member of a trading venue on which it deals as principal in the financial instrument for which it is seeking to rely on the exemption.	*Letter to Verena Ross – Issue 170: The Short Selling Regulation: ESMA ’s consultation paper of 17 September 2012*, dated 16 November 2012

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	• Additionally, the FMLC highlights uncertainties arising in relation to Article 13(c) which allows third-country firms to rely on a market making exemption where it is a member of an equivalent third-country market, the legal supervisory framework of which has been declared equivalent by the Commission pursuant to Article 17(2) (which provides an exemption to Article 2). • The letter also draws out inconsistencies between Paragraph 13(c) of ESMA's consultation paper and Article 2(1)(k) or the Short Selling Regulation, which would have the effect of preventing a third-country firm from relying on the market making exemption where it is a member of a trading venue.	
Portingunder EMIR: Part VII and the SFR	The FMLC wrote to Mr Ola Ajadi of HM Treasury on 5 November 2012 to set out a number of issues of legal uncertainty relating to the legal efficacy of the segregation and porting requirements of EMIR. The letter highlighted, *inter alia*, the following issues. • The definition of "qualifying collateral arrangements" under Part VII of the Companies Act 1989 should be widened to include collateral arrangements created over any property or rights whether by way of title transfer or security. • A potential gap exists between the new definitions of "qualifying collateral arrangements" and "qualifying property transfers", and uncertainty as to whether the latter definition is wide enough to cover a transfer made under a porting procedure contained in a CCP's default rules. • The term "transfer" in section 190(3A) of Part VII (namely "in the case of a clearing member client contract or client trade"), might be misinterpreted as indicating that this was the only way of porting such contracts. • The definition of "default rules" in Part VII should be conformed with the wider definition of "default arrangements" in the SFR, so that the default arrangements	*Consultation on the implementation of EMIR - Segregation and Porting*, dated 5 November 2012

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	of a CCP are fully protected in order to confidently operate them in an emergency without fear of challenge.	
European Insolvency Regulation	The EUIR lays down rules on the court competent to open insolvency proceedings, recognition of judgments and the applicable law in cross-border insolvency proceedings. The objective of the EUIR is to facilitate the operation of efficient and effective cross-border insolvency proceedings within the scope of judicial cooperation. The FMLC examined uncertainties arising from the EUIR in a paper published in response to the Commission's review of the EUIR in 2012. The Commission has now adopted the proposed Insolvency Regulation which outlines amendments to the existing EUIR. This proposal has not yet been agreed. Key uncertainties and inconsistencies applicable to the provisions of the EUIR are highlighted in the paragraphs below. It is noted that some of these provisions have been amended by the Insolvency Regulation. • Article 1(2) of the EUIR expressly excludes insurance undertakings, credit institutions and investment undertakings from the EUIR's scope (the Insolvency Regulation also incorporates these exclusions and seeks to extend its scope). The fact that collective investment schemes do not fall within either a general or sectoral EU framework for insolvency proceedings represents a lacuna in European legislation which gives rise to legal uncertainty as to the treatment of these businesses on their insolvency. The FMLC supports the adoption of the BRRD, which brings investment firms within the scope of the winding up provisions of Directive 2001/24/EC on the reorganisation and winding up of credit institutions. The FMLC notes, however, that this proposal does not extend to collective investment schemes. Legal certainty would be promoted by an amendment of European legislation in order to ensure that collective investment schemes also fall under a sectoral or EU-wide framework for insolvency proceedings.	*Report entitled Discussion of certain legal uncertainties arising from the European Insolvency Law Regulation, dated 19* September 2012, and *Report entitled Response to the European Parliament Committee on Economic and Monetary Affairs' Public Consultation on enhancing the coherence of EU financial services legislation*, dated 30 June 2013

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	• Article 5(1) of the EUIR is intended to protect the rights *in rem* of creditors from where assets are located in a state other than the insolvency forum. The FMLC considers that uncertainty arises as to the meaning of a "right *in rem*". Whilst it is generally regarded to be analogous to a proprietary right, it remains unclear whether particular interests in financial instruments constitute rights *in rem*. This uncertainty may be clarified by the courts; however, uncertainty in the interim is likely to cause difficulty for participants in the financial markets. The FMLC considers that Article 5 of the EUIR does not explicitly establish a conflict of laws rule for questions affecting the rights *in rem*. A common view amongst legal practitioners is that the law applicable to such questions is the *lex situs* of the relevant asset. That Article 5 makes reference to the location of assets may beg this inference, but the FMLC considers that an explicit statement of the conflicts rule would be a useful amendment. • The FMLC also considers that there are key differences between the COMI test, as determined by Article 3(1) in the EUIR and the rules which determine the governing law or jurisdiction under the primary Regulations on conflict of laws enacted by the EU. Under the EUIR, once insolvency proceedings have been initiated, questions regarding the nature of proprietary interest in a claim will be governed by law of the place where the obligor has its COMI. Under Rome I, prior to the onset of insolvency, questions regarding the proprietary effects of the creation, assignment (including transfers by way of security or other security rights) or subrogation of claims will be allocated to the law of the claim in which the relevant security or similar proprietary interest has been created. That law will be the applicable law of the instrument giving rise to the claim (Article 14, Rome I). • The "habitual residence" test under Rome I does not precisely track the COMI test under the EUIR (see Article 29 of EUIR). For corporate bodies, the place of "habitual residence" is the centre of main administration (not the COMI) and, in the case of contracts made by branches, agencies or other establishments, the	

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	place of the relevant branch *etc*. This may be considered unfortunate; however, it is not of as much concern to the FMLC as the way in which choice of law rules (under the EUIR and Rome I) potentially allocate questions regarding security rights to different legal systems depending on whether the corporate entity is subject to an insolvency proceeding or not.	
AIFMD	On 6 June 2012, the FMLC wrote to Jonathan Faull, Director General of DG Internal Market and Services at the Commission, regarding the meaning of “undertaking” under the AIFMD and the issue of the identification of letter-box entities which was raised in the letter to ESMA. The meaning of the term “undertaking”, which demarcates the regulatory perimeter of the AIFMD, was since clarified in PERG (see PERG 16: Scope of the Alternative Investment Fund Managers Directive, response to Question 2.3). Regarding the identification of letter-box entities, the FMLC highlighted that the criteria relating to the presence of such an entity required clarification. In particular, there was a lack of clarity as to the criteria to be fulfilled to evidence a lack of “necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation” (as now set out in Article 82(1)(a) of the AIFMD Level 2), which would tend to indicate the presence of a letter-box entity.	*Implementation of the Alternative Investment Fund Managers Directive (the "AIFM Directive"): the meaning of "undertaking" in Article 4.1(a) of the AIFM Directive and the identification of "letter-box" entities*, dated 6 June 2012
Market Abuse Legislative Review	The FMLC published a paper on 30 March 2012 in relation to the proposal for a European Regulation on market abuse (now adopted as the Market Abuse Regulation). The paper noted that the proposed introduction of a new category of inside information (information not generally available to the public, but which, if it were available to a reasonable investor would be regarded by that person as relevant to the investment decision) would place investor confidence and market integrity at risk and not adhere to the rule of law. The FMLC notes that such new category was not, however, retained in the Market Abuse Regulation, now adopted.	*Report entitled "Analysis of legal uncertainties arising from Article 6 of the proposal for a Regulation on insider dealing and market manipulation"*, dated 30 March 2012

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	The FMLC also noted in its paper of 30 March 2012 the proposed change to the definition of price-sensitivity to mean information a reasonable investor would be likely to use as part of the basis of his investment decisions. The paper highlighted that this change has the result of elevating the importance of the reasonable investor test so that it replaces the concept of "a significant effect on price". This change was subsequently adopted in Article 7(4) of the Market Abuse Regulation; consequently, the uncertainties highlighted in the FMLC paper of 30 March 2012 may remain applicable to the Market Abuse Regulation to that extent. The FMLC wishes, however, to highlight the case of *Ian Charles Hannam v The Financial Conduct Authority* [2014] UKUT 0233 (TCC), where the Upper Tribunal rejected the argument that the "reasonable investor test" should operate to the exclusion of the "price sensitivity test" in identifying inside information. While this decision was taken in the context of the implementation in the UK of the Market Abuse Directive in Section 118(3) of the FSMA, to the extent that it has established a precedent that may also apply in the context of the Market Abuse Regulation, the *Hannam* decision went some way to alleviating these concerns in the UK.	
AIFMD	The FMLC submitted a paper to the Commission in January 2010 in response to legal uncertainties in the Commission's Proposal for the AIFMD and the subsequent Presidency Compromise proposals published by the Council of the EU. A number of the uncertainties identified in the FMLC's paper were clarified in the final text of the AIFMD. On 4 November 2011, the FMLC wrote to Verena Ross, Executive Director of ESMA, to provide comments on ESMA's draft technical advice to the Commission on possible implementing measures for the AIFMD. The letter highlights, *inter alia*, the following issues of legal uncertainty. • In the case of a previously unauthorised fund manager, uncertainty exists as to obligations which are incurred when the value of the assets under management moves above the threshold for exemption set out in Article 3(2) of the AIFMD.	*Letter to Executive Director, European Securities and Markets Authority (ESMA) re ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (November 2011)*, 22 November 2011

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	Neither the draft technical advice nor the explanatory text provide detail on whether, in such a case, the fund manager will be permitted to continue with its existing fund management activities during the three (or, as the case may be, six) months comprising the competent authorities' deliberation period in respect of the fund manager's authorisation request or whether the fund manager will be required immediately to comply with the AIFMD. • In the case of delegation of functions by an AIFM to a delegate, the criteria to be fulfilled to evidence "necessary expertise and resources" in order for the AIFM not to be deemed to constitute a letter-box entity are not clear. • It is unclear whether a depositary's obligations to monitor an AIF's cash flows extend to cash held before it becomes an asset of the AIF (for example, cash held in subscription accounts before "Know Your Customer" and anti-money laundering checks have been completed).	
OTC Derivatives	The FMLC published a paper in October 2011 identifying selected uncertainties in the draft text of EMIR, and suggesting ways in which the draft text may be amended. EMIR was subsequently adopted, on 4 July 2012. Overall, the FMLC noted that the imposition of the clearing requirement is the concentration of risk in CCPs, which may give rise to an increased risk or more serious consequences of CCP failure. The paper highlights the following issues: • There is a danger of overlap and inconsistency with the mandatory clearing requirements in non-EU countries and the requirement under the Regulation. The paper flags, by way of example, certain differences with the Title VII of the US Dodd- Frank Wall Street Reform and Consumer Protection Act. • There is also uncertainty as to the application of EMIR to non-EU establishments	*The European Market Infrastructure Regulation - Report - October 2011*, dated 5 October 2011

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	of entities established in the EU. The paper gives the example of contracts concluded "between third-country entities that would be subject to the [clearing requirement and risk mitigation procedures] if they were established in the EU, provided that the contract has a direct, substantial and foreseeable effect within the EU", stating that further clarity is required as to the circumstances that would constitute a "direct, substantial and foreseeable effect within the EU". The FMLC understands, however, that Commission Delegated Regulation (EU) No 285/2014 may now provide further clarity on this criterion. • It is unclear how a counterparty subject to EMIR will be able to comply with its requirements where it is also subject to an inconsistent third-country clearing, risk mitigation or, as the case may be reporting requirement. • Certain derivative contracts entered into or novated on or after the date on which EMIR came into force (16 August 2012) but before the clearing requirement takes effect are nevertheless subject to the clearing requirement, depending upon the remaining maturity of each contract. The effect is that a class of derivative, that is not subject to a clearing requirement at the time that a party enters into a trade in that derivative, may become subject to the clearing requirement contrary to the contractual expectations of the parties. The parties would have to renegotiate certain terms (including those relating to pricing and the identity of the CCP) of their contract. • EMIR may lead to a possible increase in legal/operational risk as a result of the likely significant increase in the value of collateral provided under security-interest based collateral arrangements, as opposed to TTCAs. Further issues of legal uncertainty highlighted in the paper include: (i) the seeming lack of provisions which protect a CCP from insolvency law challenges; (ii) the seeming departure, by way of the introduction of individual client segregation, from the more universally accepted model in the EU (namely the "principal" model) in favour of the "agency" model; and (iii) the apparent incompatibility of the requirement to inform the	

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	competent authority where it considers that the clearing member of a CCP will not be able to meet its obligations with the automatic early termination election under and ISDA Master Agreement.	
European Contract Law	The FMLC first raised key issues of uncertainty when responding to a Call For Evidence by HM Government on the "Common Frame of Reference". It then raised issues of uncertainty arising from the Commission's Green Paper on policy options for progress towards a European Contract Law for consumers and businesses and later commented on the Feasibility Study which was published by the Commission in 2011. The Commission has published a proposal for a Regulation on Common European Sales Law in order to facilitate cross-border transactions within the internal market. This draft Regulation has not yet reached political agreement. One of the key observations made by the FMLC was that certain provisions in the Feasibility Study were uncertain in their meaning and scope or gave significant elements of judicial control over contracts. They would, as such, be of concern if ever applied to the wholesale financial markets. Chief amongst those were the provisions as to good faith and fair dealing. These provisions, to which the FMLC referred, have been incorporated in the draft Regulation on Common European Sales Law by virtue of Article 68. The FMLC raised its concerns because provisions on the interpretation of contracts place significant importance on the subjective intention of the parties, which is likely to result in uncertainty of interpretation and in contracts being held void for mistake in circumstances where a more objective approach would give contractual certainty both for the parties and third parties (e.g. lenders using contractual rights as collateral). It is a matter of considerable importance in financial markets that contracts be enforceable in a consistent and predictable manner. It is also important in financial markets to know at what point a party owes obligations to the other. Were these provisions to be used in financial contracts, there would be systemic risks relating to	*Letter to DG Justice, European Commission re Feasibility Study by the European Commission's Expert Group on European Contract Law*, dated 13 June 2011

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	uncertainty in the performance of contracts and potential for mismatch in relation to the hedging of contracts with different parties, where, for example, good faith, fair dealing and reasonableness might be interpreted differently in different contracts.	
Securities Holding and Dispositions	The FMLC wrote to the Commission on 21 January 2011 in response to the Commission's consultation paper entitled "Legislation on Legal Certainty for Securities Holding and Disposition", dated 5 November 2010, relating to a set of principles to underpin the CSD Regulation. The FMLC considered that the most important requirement for the proposed Directive was that it should be consistent with and complementary to the legal framework established by the UNIDROIT Convention on Substantive Rules for Intermediated Securities. It should be noted that the UNIDROIT Convention on Substantive Rules for Intermediated Securities has not entered into force. It is currently expected that the CSD Regulation will be finalised by 2015.	*Letter to DG Markt, European Commission response to consultation paper "Legislation on Legal Certainty for Securities Holding and Disposition*, dated 21 January 2011
Brussels I	The FMLC commented on issues arising from the Brussels Convention and Regulation (44/2001/EC) on the jurisdiction and enforcement of judgments in civil and commercial matters. In particular, it was noted that there was a conflict between the principle of respect for the parties' choice of court and the imperative of avoiding parallel proceedings in different Member States' courts. The latter concern was met by Article 27 in Regulation (44/2001/EC). Brussels I was published in the Official Journal as a recast of the earlier text referred to above. Although this text incorporated amendments to the original, specific uncertainties raised by the FMLC in its earlier paper remain salient. These are outlined in the paragraphs below. • Article 29 of Brussels I requires that where proceedings involving the same cause of action and between the same parties are brought in the courts of different	*Report entitled Legal assessment of problems associated with the Brussels I Regulation and suggested solutions*, dated 1 July 2008

Topic	Summary of Issues of Legal Uncertainty Identified	FMLC Publication
	Member States, any court other than the court first seized must stay its proceedings until the jurisdiction of the court first seized has been established. Previous jurisprudence of the European Court of Justice has established: (1) the effect of this provision (formerly Article 27 of Regulation (44/2001/EC)) is that all foreign proceedings must be stayed until the court first seized has declined jurisdiction, even if proceedings before the court arise in contravention of an exclusive jurisdiction clause;[32] (2) courts cannot issue anti- suit injunctions in order to restrain parties from bringing proceedings (whether or not in contravention of an exclusive jurisdiction clause);[33] and (3) where the forum court has jurisdiction (under Regulation (44/2001/EC) as it was referred to then), for example on the grounds that the defendant is domiciled within the jurisdiction, it may not decline to exercise that jurisdiction purely on the basis that the court itself is not the *forum conveniens*.[34] This gives rise to uncertainty as to the enforceability of jurisdiction clauses. • The FMLC recommended that Brussels I incorporate provisions to empower a court favoured by a jurisdiction clause to consider jurisdiction, irrespective of the fact that another court may be seized, and to proceed to address the merits if it considers the agreement to be effective as a means of addressing this uncertainty. This amendment was not incorporated.	

[32] *Enrich Gasser GmbH v. MISAT Srl* (Case C-116/02).
[33] *Turner v Grovit* (Case C-159/84).
[34] *Owusu v. Jackson and others* (Case C-281/02).

Financial Services Consumer Panel–Written evidence (FRF007)

1. This is the UK Financial Services Consumer Panel's (the Panel) response to the Sub-Committee's inquiry into the EU Financial Regulatory Framework.

2. The Financial Conduct Authority (FCA) is required to set up and maintain a panel to represent the consumer interest under financial services legislation (2000 Financial Services and Markets Act as amended by the 2012 Financial Services Act). The Panel represents the interests of all groups of financial services consumers and operates independently of the FCA. The emphasis of its work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are not regulated but are related to the FCA's general duties.

3. The Panel is grateful for this opportunity to inform the Sub-Committee about our view of the consumer protection aspects of the EU's financial services reform. We have only answered those questions where we have particular insights or expertise.

4. Overall, we believe the EU's recent regulatory reforms have taken consumers' interests into account and that the EU is rightly focusing on regulating the conduct of financial services firms to ensure a good outcome for consumers.

5. We will continue to pursue our consumer protection objectives at the European level through cooperation with our partner organisations, including BEUC, an umbrella body for Europe's independent consumer organisations. The Panel also communicates with the EU institutions directly through responses to public consultations, the Financial Services User Group (of which the Chair of the Panel is a member) and bilateral meetings with MEPs and Commission officials.

Question 4: Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency, transparency and integrity; and financial stability?

European Supervisory Authorities

6. The Panel supported the creation of the European Supervisory Authorities (ESAs), especially each Authority's so-called 'article 9' obligations to ensure consumer protection. However, the Panel believes the effectiveness of the ESAs has suffered from a lack of representation of the consumer interests in the regulatory process.

7. Notably, the ESA Boards of Supervisors (EIOPA, ESMA and EBA[35]) are composed of the EU Member States' national authorities, but many of these authorities have no specific consumer

[35] The European Insurance & Occupational Pensions Authority, the European Securities & Markets Authority and the European Banking Authority.

protection mandate. Research by the European consumer organisation BEUC[36] found that the financial supervisory authorities of eight EU countries, including Germany, have no statutory consumer protection objective. It concluded:

"*In some Member States no authority is really in charge of consumer protection in the financial services area. When such authority exists, many of them are under-staffed, have little on-site inspection capacity, have limited legal powers to make binding decisions and limited powers of sanction. Some of them do not have capacity to deal with consumer complaints*."

8. As the ESA's Boards play a prominent role in deciding their respective Authority's work programme and new regulations, the panel believes consumers' interests should be represented consistently and adequately. Because of the differing statutes underpinning the work of national supervisors, many of the EU's national consumer protection authorities are absent from ESA Board meetings and cannot vote on policy changes or regulatory measures that are clearly relevant to their brief.

9. The Panel believes that national consumer protection authorities should be invited to participate in ESA Board meetings where their national financial supervisory body has no consumer protection mandate. More generally, the Supervisory Authorities should demonstrate clearly how they are meeting their Article 9 consumer protection objectives. The Panel will raise these issues with the new European Commission directorate-general for financial services as it carries forward the work of the initial ESA review published in August this year[37].

Direct consumer representation

10. The Panel is also concerned at the lack of direct consumer representation during the preparation of new EU proposals and regulatory measures. The European Commission and ESA stakeholder groups are generally dominated by industry representatives.

11. Research undertaken on behalf of the Panel[38] found that financial services consumer groups often lacked the resources for effective representation:

    - **Lack of financial backing to attend meetings overseas**. This may prevent consumer groups from participating fully in the EU's stakeholder groups.
    - **Limited access to the technical and research resources** needed to participate fully in discussions and to challenge the views put forward by the financial services industry.
    - **Lack of knowledge of EU processes and procedures**. Consumer organisations may not be aware of the existence of specific stakeholder groups or the role they play in the formulation of EU financial services policy.

[36] BEUC, 'Financial Supervision in the EU, A consumer perspective', February 2011.
[37] http://ec.europa.eu/internal_market/finances/docs/committees/140808-esfs-review_en.pdf
[38] http://www.fs-cp.org.uk/publications/pdf/consumer_representation_at_eu_level_panel_final_report_dec_2013.pdf

12. The Panel believes that several solutions should be implemented to redress this imbalance and to improve the representation of consumers at EU-level:

    1. A statutory requirement for the ESAs to provide feedback to their stakeholder groups;

    2. A review of remuneration and expenses to encourage the right balance of expertise on the ESA stakeholder groups;

    3. Increased support and resources for the stakeholder groups to carry out their own research and build up data.

Impact Assessments and Consultation

13. The Panel believes the European Parliament and Council should draw up impact assessments to ensure that new legislation does not undermine consumer protection. This is of particular importance where the EU institutions adopt significant amendments to proposals, as these may undermine the validity of the Commission's original impact assessments. In consequence, there is a risk that EU legislation will be adopted without its impact on consumers being adequately quantified.

14. We believe that such impact assessments should be the responsibility of the European Parliament's dedicated Impact Assessment Directorate, assisted by the General Secretariat of the Council and where necessary drawing on external expertise through public consultations or studies.

15. Consultations also pose problems after European legislation is adopted. Most EU financial services laws delegate responsibility to the European Commission, assisted by the ESAs, to ensure uniform implementation across the EU.

16. Following the financial crisis, the sheer volume and scope of European financial services legislation has made it difficult for consumer groups to respond effectively to Level 2 consultations (see table on page 4). Not all consultations have a consumer protection element, but even responding to all relevant calls for submissions is likely to be beyond the resources of most consumer groups.

ESA	Consultations (2014)[39]
EBA	35
EIOPA	9
ESMA	13

[39] Figures collated from the websites of the EBA, EIOPA and ESMA.

17. For example, the ESMA consultation paper[40] on the new MiFID Directive ran to 311 pages and contained 245 questions, often of a very detailed and technical nature. **Total 57**

Markets in financial instruments

18. The Panel believes that the new Markets in Financial Instruments Directive (MiFID)[41] is a good example of EU legislation effectively addressing consumer protection issues. The Panel welcomes in particular the final text of article 24 of the new Directive, which enshrines a legal duty of care on investment firms:

"*Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients*".

19. We believe that this provision sends a strong signal about the basis of any firm's relationship with its clients and reiterates the overriding need for honesty and fairness.

Question 7: Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?

20. The new financial supervisory architecture has been adopted piecemeal by the EU institutions, and as a result the approach taken to key aspects of consumer protection has been inconsistent.

Alternative Dispute Resolution

21. Access to alternative dispute resolution (ADR) for financial services consumers is notably fragmented. For example, it has been incorporated into the Mortgage Credit Directive but it may be missing or watered down in the new Insurance Mediation Directive.

22. In particular, the Panel believes there should be consistency in the approach to:

    - Whether ADR should be independent or may be set up by the financial services industry;
    - At what stage customers are informed about the system, and by whom;
    - Whether decisions by the ADR body are binding on the industry.

Obligation on firms to act honestly, fairly and professionally

23. As noted above, the Panel supports the inclusion in MiFID of an obligation on firms to act "honestly, fairly and professionally in accordance with the best interests of its clients". We are also pleased that both the Parliament and Council have so far supported an equivalent provision in the new Insurance Mediation Directive (IMD), although the Parliament has opted

[40] http://www.esma.europa.eu/consultation/Consultation-Paper-MiFID-IIMiFIR
[41] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments

for slightly different wording compared to MiFID[42]. For reasons of consistency and clarity, the Panel will call on MEPs to support the same wording as used in MiFID during the trilogue negotiations on the final text of the legislation later this year.

24. However, despite these recent advances, a legal duty of care has not been incorporated consistently into all relevant measures. The Panel believes this core principle should have been embedded across all measures which apply to intermediaries to ensure a similar level of consumer protection across the board. In particular, we regret that the new Regulation on key information documents for Packaged Retail Investment Products ("PRIPs") has no equivalent provision.

25. We also believe there should be a clause equivalent to MiFID article 24 applying to prospectus disclosures under the Prospectus Directive. The review of the Directive in 2016 provides a timely opportunity to amend the wording of the legislation, as it currently does not apply to the prospectus or the prospectus summary.

26. In general, the Panel believes the EU should aim for a consistent reference to this duty of care principle in all legislation still under consideration or proposed in the future. We will continue to push for the inclusion of a legal duty of care in both pending and future legislative proposals.

Question 10: Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?

27. As noted above, the architecture of the new supervisory system has not ensured proper representation of consumer interests. As a result, consumers' interests are not always sufficiently taken into account when regulatory measures are formulated or when long-term work programmes are developed (the fragmented approach to ADR being an example).

28. The tension between prudential and conduct regulation could also pose a risk to an effective EU agenda for consumer protection. The current supervisory structure separates regulation by sector and obliges each regulator to monitor both the prudential and conduct aspects of the sectors it regulates. In practice, we are concerned that this may lead to neglect of conduct supervision because prudential considerations either take precedence or are seen as sufficient to protect consumers through overall market stability.

29. For example, despite the fact that EIOPA, ESMA and EBA have a specific product intervention power[43], this has never been used. Similarly, internal resources at the ESA appear to be overwhelmingly devoted to prudential supervision, with EBA's consumer protection unit consisting of only 2-3 staff members[44]. In addition, as noted above, the composition of the ESA's Supervisory Boards is skewed towards prudential considerations because a significant

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[42] The European Parliament introduced in IMD an obligation for firms to act "honestly, fairly, trustworthily, honourably and professionally".
[43] Article 9(5) of the ESA Founding Regulations
[44] BEUC, 'Review of the European System of Financial Supervision', August 2013.

number of the EU's national financial authorities have no explicit consumer protection mandate.

30. The European Commission has recently announced that it will review the possibility of adopting the UK's 'twin peak' approach by splitting the ESAs into separate authorities responsible for conduct and prudential regulation, although it seems distinctly lukewarm about this prospect. A dedicated conduct regulator appears to be making a difference to consumer protection in the UK, although the tensions with prudential regulation remain.

31. As a general remark, the Panel would also like to underline the continued risk that EU legislation could erode existing rights for UK consumers if uniform standards are adopted that are less stringent than those currently in place. This should be borne in mind in particular during the negotiations for the Insurance Mediation Directive, which could undermine the binding nature of Financial Services Ombudsman judgments in favour of consumers.

29 September 2014

Financial Services Consumer Panel – Supplementary Written evidence (FRF0028)

Gold-plating and front-running

Instances where the UK goes beyond the legal requirements of EU legislation when implementing Directives and Regulations domestically fall into two categories: 'front- running' (implementing reforms ahead of EU initiatives, which may go further than the eventual European legislation) and 'gold-plating' (the practice of 'bolting on' additional or more stringent requirements onto minimum harmonisation Directives already adopted by the EU).

This note sets out the Financial Services Consumer Panel's views on these practices in those cases we have identified where the UK has gone beyond its EU obligations.

Position of the Consumer Panel

The Consumer Panel does not have a standard approach towards either front-running or gold-plating of financial services legislation. We assess all reforms within our remit on a case-by-case basis, regardless of whether the changes originate from EU or domestic initiatives.

In general terms, we would remark that front-running or gold-plating may be desirable in specific cases because certain consumer issues are not on the European agenda and may not be addressed at all except through national measures.

A notable example of this is the ability of the UK's Financial Ombudsman Services to take binding decisions in favour of consumers. We consider this a valuable element of the UK's consumer protection landscape, which allows customers to obtain redress through an independent adjudicator without the need for recourse to a court of law.

However, this issue has not been addressed at EU-level by either the Alternative Dispute Resolution Directive or by existing sectoral legislation (such as the revised Insurance Mediation Directive and the new Regulation on packaged retail investments), which permit Member States to make decisions by ADR entities non-binding.

Front-running

We are aware that 'front-running' is seen as undesirable by many stakeholders in the financial services industry, because it leaves open the possibility that some domestic reforms may be undone by EU initiatives, causing legal uncertainty and duplication of compliance costs.[45]

However, the Panel believes that ensuring high standards of consumer protection in the UK may require national initiatives that have no equivalent at EU-level or in other Member States. As mentioned above, binding arbitration is a case in point.

[45] Review of the Balance of Competences: Financial Services and the Free Movement of Capital (July 2014)

In addition, Member States may need to take action because their market for certain types of product or service is significantly different or more developed than in the rest of the EU. In such instances it would be a breach of the subsidiarity principle to adopt a 'one-size-fits-all' approach at EU-level.In the UK for example, the market for independent financial advice is very different from the rest of Europe. The Retail Distribution Review (RDR) introduced a ban for advisers on receiving commission from product providers for advice.

The UK regime is therefore significantly more restrictive than the provisions of the recently-adopted second Markets in Financial Instruments Directive, which will only ban commission for independent advisers and portfolio managers. The Netherlands has also introduced similar restrictions on inducements for independent financial advice.[46]

In addition, adoption of higher standards at domestic level may also give the UK a stronger negotiating position at EU-level with a view to incorporating our levels of protection into European initiatives, thereby raising pan-European standards and negating any potential competitiveness concerns for UK businesses in the long run.

This can currently be seen from the extension of the scope of the new Insurance Mediation Directive to intermediaries, an approach which was already adopted unilaterally by the UK when the original Directive was implemented in 2004.

Gold-plating

The potential for higher compliance costs (potentially passed on to consumers) and risks to competitiveness are often cited as arguments against gold-plating. However, the 2007 Davies Review concluded that "frequent allegations of excessive gold-plating of European legislation are often misplaced and represent concerns about other issues".[47]

The transposition of the 2002 Insurance Mediation Directive is a notable example of gold-plating. The UK extended the scope of the legislation to cover insurance intermediaries as well as direct insurers, significantly expanding the protections afforded by the Directive's authorisation regime[48]. The revision of the Directive, which is currently underway, will follow the UK's example and make the EU legislation applicable to both insurers and intermediaries.

There is also a perception that other Member States normally adhere to the minimum requirements of the Directive only[49], with concomitant detrimental effects on the competitiveness of UK firms, but we have not seen any conclusive evidence that this is the case. For example, the Belgian Government will introduce a new 'risk labelling' system for investment products alongside its transposition of MiFID 2, a significant departure from the basic requirements of the Directive[50].

Assessment by the Consumer Panel

[46] http://www.afm.nl/nl/consumenten/vertrouwen/kosten-financieel-advies.aspx
[47] http://webarchive.nationalarchives.gov.uk/20121212135622/http://www.bis.gov.uk/files/file44583.pdf
[48] Idem
[49] Review of the Balance of Competences: Financial Services and the Free Movement of Capital (July 2014)
[50] http://www.fsma.be/en/in-the-picture/Article/press/div/2014/2014-06-12_labels.aspx

It appears to us that criticism of the manner in which EU legislation is implemented in the UK originates primarily from industry stakeholders, and is not normally linked to any tangible consumer detriment that arises from either front-running or gold-plating.

Where the UK has adopted stricter consumer standards we have tended to support such measures. Moreover, it is likely that many instances of perceived gold-plating and front- running do not directly relate to areas of business activity linked to customers or business conduct, and are therefore outside the remit of the Consumer Panel.

The Panel has not been able to identify any instances of front-running or gold-plating of EU Directives that have had a negative impact on UK consumers. It therefore remains our position that both practices can be useful tools to provide for higher levels of consumer protection, and taking account of the particular characteristics of national markets.

In this respect, it is pertinent to note that the Government's guidelines on "Operation of the Transposition Principles"[51], which makes it official policy to avoid gold-plating as much as possible, explicitly aim to eschew gold-plating to avoid placing burdens on businesses. Naturally, the Panel's primary concern is the adequate protection of consumers'
interests, although we are keen to avoid regulatory requirements that place additional burdens on firms without commensurate benefits to customers.

Examples of front-running and gold-plating related to consumer protection

The table below shows the instances of front-running and gold-plating within the field of consumer protection that have been identified by the Panel. It is not meant to provide an exhaustive overview.

EU legislation	Transposition measure	Differences
Alternative Dispute Resolution Directive *Directive 2013/11/EU*	*To be confirmed*	**Gold-plating:** The Government has indicated it does not intend to recognise in- house mediation schemes as alternative dispute resolution for the purposes of the Directive, although this would be allowed.[52]
Consumer Rights Directive *Directive 2011/83/EU*	Consumer Rights Bill	**Gold-plating:** The UK legislation will extend the 'hidden costs' provisions to off-premises contracts below £42, to ensure fairness and transparency, and avoid complexity of rules dependent on value of transaction.[53]

[51] "Transposition Guidance: How to implement European Directives effectively" (April 2013)
[52] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/288199/bis-14-575- implementing-alternative-dispute-resolution-directive-and-online-dispute-resolution-regulation-consultation.pdf
[53] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229544/bis-13-1123- transposition-note-on-consumer-rights-directive.pdf

EU legislation	Transposition measure	Differences
Distance Marketing Directive *Directive 2002/65/EC*	Distance Marketing Directive Instrument 2004	**Gold-plating:** The UK has extended the scope of the Directive to include transactions with insurance intermediaries which do not take place at a distance.[54]
Insurance Mediation Directive *Directive 2002/92/EC*	Regulatory Activities Order 2001	**Gold-plating:** The legislation's scope was extended to include sales by direct insurers as well as by intermediaries. FCA standards are also stricter than required by the Directive.[55]
Investor Compensation Scheme Directive *Directive 97/9/EC*	*Investor Compensation Scheme Regulations 1998*	**Gold-plating:** The UK's compensation limit for investments is £50,000, significantly higher than the €20,000 mandated by the Directive.
Markets in Financial Instruments Directive *Directive 2014/65/EU*	*To be confirmed*	**Front-running:** The UK Retail Distribution Review includes restrictions on the payment of commission that go beyond the limits that will be imposed when MiFID 2 enters into force on 3 January 2017.
Regulation on packaged retail investment and insurance- based investment products *2012/0169(COD)*	*To be confirmed*	**Front-running:** The Regulation does not provide for binding dispute resolution, unlike the statutes underpinning the UK's Financial Services Ombudsman.
Revision of the Insurance Mediation Directive *2012/0175(COD)*	*To be confirmed*	**Front-running:** The final Directive is not expected to provide for binding dispute resolution, unlike the statutes underpinning the UK's Financial Services Ombudsman.

21 November 2014

[54] http://webarchive.nationalarchives.gov.uk/20121212135622/http://www.bis.gov.uk/files/file44583.pdf
[55] Idem

Professor Simon Gleeson, Clifford Chance, London and Nicholas Véron, Senior Fellow at Bruegel, Visiting Fellow at the Peterson Institute for International Economics- Oral evidence (QQ 45- 61)

Evidence Session No. 3 *Heard in Public* *Questions 45 - 61*

TUESDAY 9 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witnesses

Mr Nicolas Véron, Senior Fellow at Bruegel, Visiting Fellow at the Peterson Institute for International Economics, and **Professor Simon Gleeson**, Partner at Clifford Chance, London

Q45 The Chairman: Nicolas Véron and Simon Gleeson, you are both very welcome to our continuing investigation into the new framework. We will be very grateful to hear your answers to our questions. As ever with the House of Lords, we will send you the transcript of what takes place this morning. We ask you to check it to make sure that it is right and true, and we also ask you to remain on the qui vive so that if you think of any brilliant answers once you have left the room, you can send them to us—or, indeed, any updates as time moves on quickly in terms of

the investigation. As I say, we will then ask for those to be corrected. We are being recorded and I should say to my colleagues to be aware of that. Any asides that are made need to have the guarantee of being very interesting, otherwise you should not make them at all.

Perhaps I could ask both of you for your overall assessment of what has been done in the reforms since 2008, whether you think they have restored financial stability, in particular whether you think the EU would be able to withstand a further asymmetric shock of any kind, and indeed whether we have sufficient flexibility built into the new framework that is developing. We will go on to look at many other questions related to this. Professor Véron, perhaps you could respond to this first point.

Nicolas Véron: I am afraid it is a tiny point as we prepare for this session. I am not a professor, just Mr Véron.

The Chairman: I am always happy to elevate people, sometimes to the House of Lords.

Nicolas Véron: Thank you. A lot of things have happened. No two crises are identical, so we know that the crisis that has happened since 2007 will not happen again, and that would be the case even if the EU had taken absolutely no action in its wake. I think you are right to point to flexibility, and I suspect that we will come back to that. Let me say that obviously there is a need to distinguish between crisis management measures and regulatory and legislative measures that are more about building up a long-term framework and architecture. The two have come together, however, in what I see as the most significant development since the start of the crisis in 2007, which is banking union.

I will not go into a country-by-country analysis here, and obviously that will cause me to omit major developments that have taken place, not least in the UK. However, looking at it from the European perspective, banking union is the turning point both in terms of crisis management and

the steps towards crisis resolution, which has not happened yet, and in terms of changes in the architecture of regulation and supervision. It is also about crisis management going forward with the resolution authorities. Why did banking union come only in mid-2012, some five years after the start of the crisis? It was because it was a difficult step to take.

The relationship between banks and nations is not only a vicious circle, it is a fundamental tenet of the way economic structures have been built up in European nations. In the past, banks were typically leveraged to finance wars, to finance government activity, and to support industrial and economic development policies. The core of the French banking system arguably dates from Napoleon and his war effort. Similarly, Deutsche Bank was created under the aegis of Bismarck just after the Franco-Prussian war. There is an interconnectedness between banking structures and history and national structures and history that is very strong in Europe. What is therefore remarkable is not that banking union has come so late but that it has happened at all, given how difficult a political step it was for the countries concerned.

The reason it has happened, of course, is that there was no other option left between banking union and renouncing banking nationalism, and the break-up of the euro. It has taken time to come to that conclusion, which I think was correct at the time, and it is why the decision was made only in mid-2012. I will stop there with my introductory remarks because I want to be succinct, but I am sure that we will come back to some of these points.

Q46 The Chairman: Simon Gleeson, is it your appraisal that banking union is pivotal to that response, which is to serve to withstand asymmetric shocks and ensure flexibility of response?

Professor Simon Gleeson: That is a difficult question, so perhaps I may make three quick points. I cannot resist opening by saying that actually I am a professor—a visiting professor at the University of Edinburgh.

If you look at the totality of the European response to the crisis, with the exception of banking union—I will come back to that in a second—the Commission proudly announced that it had 40 different items of legislation. Of those, all of them, with the exception of one and the partial exception of another, follow policies that were already being implemented in the UK. Had Europe not existed, every single one of those directives would have been implemented here for exactly the same reasons that they were implemented at the European level, because they were part of a globally considered response to the crisis. I do not think they preserve us from shocks generally. As measures, they were entirely effective in addressing the problems that gave rise to the last crisis and they do result in a more stable system.

Banking union is really nothing to do with the financial crisis as it was experienced. Banking union is to do with the European sovereign debt crisis. It is, exactly as Nicolas has said, an attempt to unknot the sovereign bank loop. The difficulty is that the only way you can unknot that loop is by creating a single European banking market. You may recall that that is what we are supposed to have been trying to do for the last 20 or 30 years. If banking union results in the creation of a genuinely pan-European banking system—and what I mean by that is a reasonably small number of banks which are present in a large number of European countries; in other words, something that looks a lot more like the banking system in the United States—we will have unknotted the sovereign bank link, and if we do not, we will not. What we have created is a regulatory change. We now have to wait and see whether that regulatory change provokes the change on the ground that is necessary to solve the problem.

The Chairman: Thank you for those three points.

Q47 Lord Carter of Coles: Well, Professor Gleeson and Mr Véron, I think that you have partly answered this in terms of banking union, but the question remains: what is the biggest

achievement that has been made? What is probably a counterpart to that is the policy mistakes that have been made in the regulatory agenda. The second part of that question is: which elements of the reforms have been the most and the least effective in addressing the various issues? By those, I should like to look at consumer protection, market efficiency, transparency and integrity and, finally, financial stability.

Nicolas Véron: Policy mistakes—there have been so many that it is difficult to count them. Maybe I have a slight difference of perspective from Professor Gleeson on the analysis of the early years of the crisis, basically 2007 to 2010, where I would argue that having member states in an integrated or integrating market where there is competition on a cross-border basis, even while there is still a lot of fragmentation, provided the incentive for banking nationalism and thus supporting domestic banks at the expense of financial stability and prudence. This played a big role in the European crisis from the outset, not only in the eurozone but also in the UK.

I would argue that the UK has yielded to the temptation of supporting banking champions, including most visibly RBS in the run-up to the crisis, or at least to let them make mistakes. For example, it was a fact that RBS was allowed to bid for ABN AMRO in a consortium, and banking nationalism was a big part of that. I think that we are going back to the beginning of the crisis. Of course, the immediate follow-up question is whether the UK should turn to banking union, and this House has opined on that question at least by advocating flexibility and keeping doors open, which I think is very wise. However, that is not an issue for us today.

On the four or five categories you mentioned, consumer protection has been very absent from the agenda. Certainly at the European level, and again I am not entering into individual member states, not much has been done. As you know, there is an article in the treaties that was taken as

the basis for the single supervisory mechanism which does not empower the ECB with a consumer protection mandate.

Consumer protection is emphatically not part of the banking union, at least in terms of the supervisory powers of the ECB, but I think we will have to come back to this because it is difficult to envisage a single market without some kind of common consumer protection. Call me naive, but I think this is an area where in substance—I am not talking about the politics, obviously—the UK and its partners in Europe should be able to find common ground.

Market efficiency is the whole point of capital markets union. I suspect that we will come back to this so I will not dwell on it. Basically, what has been done is that some G20 initiatives have been implemented, particularly in the derivatives market, along with some other actions, most of which are minor. In derivatives, it is still very much a work in progress. For the sake of disclosure, I am an independent board member of the trade repository arm of DTCC, which is one of the players in the trade repositories market, so I might have an interest to declare. Most of the action is still to come, and that is integral to the buzzword of "capital markets union".

On transparency, I am optimistic that banking union will result in more transparency from banks. As Professor Gleeson reminded us, we have not seen proof of that—we can see the argument and the narrative but we still have to observe the outcomes. I am optimistic about those outcomes, although we may come back to this and it is true that it is too early to say for sure. Otherwise very little has been done on transparency.

On financial stability, again, no two crises are identical. It can be argued, I think convincingly, that while attempting to resolve this crisis and prevent it from happening again, we might have created opportunities in the EU for new forms of risk-taking that might come back to haunt us.

Lord Davies of Stamford: Such as what?

Nicolas Véron: There is a debate about shadow banking. Obviously Europe is very reliant on banks—this is also the case for the UK, it is not only on the Continent—for the financing of its economy. I for one believe that this reliance on banks is excessive and that new forms of intermediation need to be developed. That is also part of the capital markets union agenda. However, it is also the case that in the same way as big risks have piled up in the banking system, new forms of risk will emerge in non-bank forms of financial intermediation, as we have seen in the US. Shadow banking, in a very simplistic depiction, has been a factor of instability in the US in a way that it has not in Europe.

Conversely, at a higher analytical level, the diversity of the US financial system has been a factor in resilience and stability in a way that we have not had in Europe because we were so dependent on banking. So assessments have to be nuanced on this, but obviously I am not downplaying the possibility of new forms of risk. That said, just to conclude on this, I see banking union already, and certainly going forward, in my cautiously optimistic outlook, as a very stabilising measure.

Q48 The Chairman: Before I come to Simon Gleeson, could you take a step back and say what you think are the two most important policy mistakes? You referred to a glut of them.

Nicolas Véron: I think that European policymakers have been very slow to reach an assessment of the crisis that would not be massively tainted by denial, blame-shifting and finger-pointing to outsiders. This has driven misguided reactions to the crisis from the beginning until now—for example, the current controversy about allowances in financial executives' pay. I am not saying that I am in favour of allowances, but this policy is certainly inspired by a misguided analytical basis.

You asked for specific mistakes. I think that the European member states went too far in extending guarantees to the banking system in late 2008—Ireland did, obviously, but so did the

entire EU. There was a declaration on 16 October 2008 saying basically that banks would be guaranteed entirely, no matter what, under all circumstances. This was not framed as temporary, and indeed this guarantee arguably lasted for the following four years, until 2012.

Then there was the second major mistake. It is very difficult to find a consensus view on what should have been done with Greece, but I think the Deauville declaration of October 2010 will remain a symbolic moment of the core member states of the eurozone removing any guarantee that was perceived before for the periphery countries, in a way that has created a lot of instability. It is a difficult area, and we may come back to it. Taken together, those two moments—guarantees on banks and the removal of sovereign guarantees—have proven to be a very combustible combination.

The Chairman: That is very helpful. Simon Gleeson, would you respond to Lord Carter's invitation and to those five areas that have been outlined?

Professor Simon Gleeson: Starting with the benefit to consumers, one of the most important things is that when we talk about consumers in this context we are talking about people who have to use the financial system whether they want to or not—savers, depositors and those who use cash payments systems. To that extent, when you ask the question, "What makes them best off?", the answer, boringly enough, is Basel III and Solvency II, the measures that require those institutions to hold more capital and make them more robust. What the consumer wants more than anything else is access to a working system tomorrow morning and confidence in it. Measures such as the bank resolution directive have the effect of making consumers better off in the sense that they are confident that they will get their money back if the bank fails, but that is not really their primary concern. The measures designed to increase the amount of capital in the

system and stabilise it actually confer the primary benefit on consumers and, to some extent, corporations and other users of the financial system.

It is quite interesting to look at the question, "What are the most obvious mistakes?". I want to go a lot more granular than M Véron and look at the lawmaking process. The three bits of law that you can most easily point to and say, "That's bonkers" are the AIFMD, the hedge fund directive—

Lord Flight: Hear, hear. That is crackpot.

Professor Simon Gleeson: —the most recent round of persecution of the credit rating agencies, CRD III, and the bonus rules in the bank capital directive. What you notice is that all three of those were primarily politically driven. It is my view as a humble practitioner that populist politics very rarely results in first-class regulation. However, we would say that, shocking though it may be in this environment, populist political interference in policymaking is not unique to Europe; it occasionally happens in other legislative bodies, including possibly even this one. The strange thing is that when you look at that universe of obvious errors, what is interesting is what a relatively small percentage it is of the totality of what has been done.

There is a bigger error, which goes precisely to the point about the development of non-bank sources of financing, and I think there is broad agreement that that is essential for the development of the real economy, the thing we are actually concerned with here. The difficulty—and this points to one of the two really serious errors in policymaking in Brussels at the moment—is a failure to look in the round at the effect of the totality of what is being done as opposed to identifying individual measures.

It is absurd to say at one and the same time that it is a policy objective to improve the supply of money to the real economy through the shadow banking system and then to put in place a series of measures that hobble securitisation, make it harder to establish funds and increase the

regulatory capital cost to banks of dealing with those funding entities. There is nothing wrong with any of those policies individually but, taken collectively, they produce a system where you have one foot hard down on the accelerator and the other foot hard down on the brake.

It is true that this has been a period of hyperactivity in regulation. From time to time, it has been perfectly clear that all those involved—the Commission, the Parliament and for that matter the individual member states—seem almost to have run out of resources to deal with the number of things that have to be addressed at any given time. In a way, all that says is that we have a number of things that now need to be reviewed collectively because the important thing about them is not the impact piece by piece but the collective impact of everything that has been done.

The Chairman: Let us pass on to Lord Dear, who is exploring a very interesting area which is cognate to what you have just said.

Q49 Lord Dear: It is the question of effectiveness. It would help us enormously if you would comment on the effectiveness of the legislative process during the course of the financial crisis and which is still taking its own path at the moment. Which institutions in the EU were the most and least effective? That is a sort of shopping list, I suppose. In your view, was the financial regulatory process improved or weakened by the input of the Council and the European Parliament?

Professor Simon Gleeson: Our view—this is the perspective of those as it were in the greasy overalls with their hands on the nuts and bolts—is that the European Parliament has been a surprisingly effective vehicle for making a large number of small improvements to drafts. My view is that when the European Parliament does grand things collectively, they tend to be embarrassing or wrong, but when individual members take individual issues and push them, the result tends to be an improvement. It is hard to say but, on balance, my view is that the European

Parliament has contributed to significant improvements, certainly in some of the first drafts of legislation which have appeared over the years.

The Chairman: Do you attribute that partly to Sharon Bowles?

Professor Simon Gleeson: Yes. It is unfair to name any specific individual, but there are quite a number of MEPs who are very engaged and very happy to take individual points. Neither the Commission nor the Council can take a list of 450 minor amendments and push through all of them, but among the various available MEPs, that can be done.

Nicolas Véron: I agree with what Professor Gleeson said about Parliament. I do not think it is just Sharon Bowles. No disrespect to her, but it is much broader and something that is likely to stay after her. Irrespective of how the new chair of the Economic Committee plays out, we will see essentially the same form of constructive role of Parliament, at least on small things and incremental improvements, as Professor Gleeson just described.

In a way, it might be unfair to the Commission to say it, but the weak link of the past five years has been the Commission. I would not put that entirely on the shoulders of the Commissioner. I think the Commission has, to put it very bluntly, failed the test of the crisis in a way that the other institutions have not. It did not show an ability to analyse what was happening in a way that was helpful to the policy process in real time. I am thinking specifically of DG MARKT here—not the Commission generally, but the part that specialises in financial services. There is no blame for individuals, most of whom are very dedicated and competent; it is really more of an organisational failure.

It is a bit harsh on the Commission, but if you look at what has been produced in terms of regulatory and legislative initiatives over the past five years, roughly speaking you can map them in four blocks. One is the de Larosière report and its consequences. It was commissioned by

Commission President Barroso with support from the Commission Secretariat, but it was a high-level committee. It was mostly positive and implemented. The second is the G20 initiatives—Basel III, derivatives and the like. The third is banking union. In these three blocks, the origin is not DG MARKT. Then we look at the initiatives that came from DG MARKT, and they are the most questionable. Basically, the fourth block is mostly politically driven initiatives that do not make much sense or have much substance, and some of which were harmful.

On the other hand, Commissioner Barnier has been a powerhouse. He made things happen. He got legislation through. Sometimes it was almost too much. His famous colour-coded table of pieces of legislation gave the impression that the Commission was about quantity not quality, which was not necessarily the right signal to give, but credit has to be given to him because he made it happen. This powerhouse element has been important and broadly positive.

It is important to mention the ECB. The ECB has played an important advisory role, including on shaping some pieces of legislation, not least the single supervisory mechanism regulation. Its role has been broadly constructive.

The Chairman: Before I go on to Lord Hamilton, we will see Commissioner Barnier in two weeks' time. Is there anything in particular we should quiz him about? Simon Gleeson, do you want to mention the Commission, the ECB or the Council of Ministers?

Professor Simon Gleeson: There are two things, really. One is that one of the odder aspects of the way the Commission conducts itself is that when a particular part of it quintuples its workload, its staffing increases by zero, which is suboptimal, to put it at its mildest. One of the extraordinary things is that, despite what needed to be done, the amount of resource available for doing it changed not one iota. That really goes to the point about the effectiveness of the process.

The other thing comes back to something I should have mentioned in my initial answer about weaknesses in the process. To my mind, the biggest single weakness in the European process is the one we are about to encounter in this, which is that when a directive has been cooked, it is incredibly hard to go back into it and amend errors. We are finding drafting errors on a daily basis. That is not surprising. Given the sheer volume of legislation, it would be amazing if we did not. Some of them are minor, but some of them are potentially quite significant. None of them can be changed without another directive. If you travel back in time, this has been an issue ever since before de Larosière. It really goes back to the original CRD. The way this ought to work is that big policy should be made at the top level and implementation should be at a lower level. We still do not have a mechanism for correcting errors in the European legislative process that does not take five years.

The Chairman: That is fascinating. Before I go to Lord Hamilton, I shall ask Lord Kerr and then I will bring in Nicolas Véron*.*

Q50 Lord Kerr of Kinlochard: I am very interested in this point about coherence and the possible failure of the Commission, with individual bits perhaps making sense but with no overall overarching template. You cannot look to the Council to do that with its six-monthly processes. I was rather impressed by the arrival of the permanent President of the European Council and the way he tried to grip these issues early on, when there was still a lot of firefighting going on. I was more impressed by his paper, which was attempting an overall template, than by the Commission paper, where a whole lot of proposals for the fiscal, monetary, regulatory and governance development of the European Union, which had been knocking around in the Commission for years, were relabelled and issued as a programme. I thought that the Van Rompuy exercise was more impressive, more like what Delors would have done in the crisis than what the Commission

actually did. I am not concerned with Mr Barnier. I agree that he clearly gave great impetus to particular bits, but the point about overall coherence is a very strong point, which I would like to press a little further. Did the creation of the permanent President of the European Council and the presence of the first incumbent make any difference? Did it make the problems of incoherence worse or did it provide some palliative to the situation in the Commission which you described?

The Chairman: Nicolas Véron, you wanted to pick up something else that Simon Gleeson said. In response to Lord Kerr's last point, do you attribute it to being a personality-driven thing or was it the position that Herman Van Rompuy occupied that gave coherence to the whole?

Nicolas Véron: I was going to comment on exactly this, actually. The EU institutions are in flux, which is a major feature of the whole environment we are commenting on; we do not have the institutional stability that is taken for granted in every single western nation state. Because the institutions are in flux and constantly being renegotiated and transformed, it is very difficult to disentangle the individual element from the institutional element, especially in the question that you asked. On paper, it should be the Commission's job to bring that sense of consistency. It has not done a good job of it since the beginning of the crisis. I agree with you that President Van Rompuy has done a better job of it, especially in his important, agenda-setting paper of late June 2012 on the banking union, economic union, fiscal union and political repair. That clarified and gave a basis for analytical consensus on the narrative of the crisis. It was very constructive and adequate on substance. Credit has to go to him and his team on this, but I would be very guarded on whether this is a permanent feature of the institutional framework. Also, I think that the Commission can improve. It is not impossible that the Commission will in the next five years do better than the one that we had over the last five years. Again, I make no particular attribution to individuals on this.

I wanted to respond to Professor Gleeson about this question of correcting legislation. It is a feature of legislation that only the legislator can correct legislation. If you compare this with the US, which is the obvious point of comparison, EU directives are easier to correct than Dodd-Frank. So in a way we have the advantage in this comparison. There is a big difference however in that there is much more in European legislation than there is in the equivalent US legislation, and there is more delegation to agencies in the United States than there is in Europe, for all the small print. I am cautiously optimistic about this as well. The creation of the European supervisory agencies, EBA, EIOPA and ESMA, and the banking union, will make us evolve towards a more US-like model, where Parliament will gradually, probably slowly, learn from its mistakes and the Council will learn from its mistakes—as well as the Commission learning from its mistakes, I hope—and we will have a more sensible division of labour between legislation and rule-making at the sub-legislative level. I do not expect this to happen quickly, but I think that we are broadly on the right path to correct that feature of our current process.

The Chairman: Simon Gleeson, could you respond to Lord Kerr—then we must rush on to Lord Hamilton?

Professor Simon Gleeson: All of this really comes down, I am afraid, to good old-fashioned institutional power politics. The reason why the Commission has not really taken account of the Van Rompuy output as it should have done is because it does not regard itself as subordinate to anyone, and certainly not to the Council. For the same reason, I think it is unlikely that we will see any divestment of power to the ESAs until the Commission is positively deprived of powers; it is most unlikely to give them up voluntarily and most unlikely to abandon its stance that it is a legislator and a primary actor—and, if the Council disagrees with what it says, that can come out in trialogue. We have an almost complete centralisation of power in one entity at the moment

and, unless there is a significant change to the constitution of Europe, which seems unlikely to happen, because it would probably require treaty amendment, we are probably stuck with that for the time being.

Q51 Lord Hamilton of Epsom: I would like to broaden the question on growth, which is a big problem for the eurozone at the moment. There is no growth in the eurozone while, in the short term, there is quite brisk growth in the United Kingdom. There are two drivers in the UK: one is the recovery of the financial sector and the other is this extraordinary growth in small businesses and self-employment, which has a lot to do with the lack of regulation or minimal regulation on small businesses. That goes back to previous Governments; I do not think that this one can take an awful lot of credit for it. Are there lessons to be learnt in the eurozone about the growth of small businesses in the UK?

Professor Simon Gleeson: I am afraid that I have to avoid macroeconomics due to having no major expertise. It is true that one thing that makes life harder as far as the financial architecture of Europe is concerned is that there is currently an absence of a European-level investment vehicle that is actually allowed to invest in small businesses. In many respects, one of the most useful things that Europe could do would be to get on and finish the European long-term investment fund legislative architecture, thereby providing a vehicle for that finance to flow. To be fair, what is happening here, viewed from the European level, is a tension between economic efficiency and investor protection. The idea that you should be allowed to sell to investors only something that invests in the shares of big listed companies is perfectly sensible if what you are looking at is protecting investors. It is not perfectly sensible if what you are looking at is trying to find ways in which to channel finance to small businesses. It is quite right that the European banking system, given the regulatory architecture, is unlikely to be able to expand the flow of

credit to European small businesses, so we need another piece of architecture. There is at least a proposal to provide one.

The Chairman: Nicolas Véron, could you respond to the growth agenda mentioned by Lord Hamilton. Lord Flight, could you make it brief?

Q52 Lord Flight: Very briefly, the French tax authorities came over here, looked at the EIS system, and put in an even more generous one in France. The amounts of high-risk capital raised for small businesses from the remaining wealthy French, given the tax rates, has been even greater than the EIS fund-raising here. So France has actually put in one mechanism to get risk capital for small businesses.

The Chairman: Nicolas Véron—the growth agenda.

Nicolas Véron: Sometimes France does something sensible; it does not happen very often, so let us celebrate. I am not sure that that is for the record. The question was about financial legislation and non-financial legislation; that is how I understood it. On non-financial legislation, I could not agree more. On the big opportunity for structural measures at this point, there is a very active debate in each of the member states on structural reform, and which structural reform each member state needs—for labour market reform, and the like.

The opportunity here is really single market reform. Single market reform, which was explored competently and appropriately in the report led by Mario Monti a few years ago, is really about harmonisation, but that means deregulation at home. This will happen only if individual member states—including perhaps the UK, where it might be easier because so much deregulation has already happened—say, "Whatever regulation there is in this area comes from the EU, not from us". It is basically unilateral disarmament, if you want to use that metaphor. There is a case for optimism because there is an alignment of governmental strategies between Italy under Mr

Renzi, France under Mr Valls, Germany and the UK, and also arguably Spain and others. There are fewer veto players among large member states against these single market agendas than there have been for as long as I can remember, so that is an opportunity.

Having said that, we should not underestimate the political difficulty of this stance of unilateral disarmament, which is basically about closing government departments that produce national legislation on these sorts of issues, sector by sector. It becomes very micro very quickly. I hope that there can be an agreement on this at EU level. I have not seen it yet. I see an opportunity. I see an opening. I hope it will materialise, but there is a lot of work to be done before it does.

On the financial aspect, I am of course for long-term investment, corporate loan securitisation, motherhood and apple pie. At this point, there is a consensus shaping up, even as, as Professor Gleeson reminded us, there is still cognitive dissonance about securitisation. I am afraid, however—and this brings us to the whole cluster of issues under the buzz-word umbrella of capital markets union—that there will be no easy fix that suddenly liberates the European financial system from its overreliance on banks. It is a long-term effort that goes across many different policy areas: securities regulation; investor protection and disclosure; prudential regulation; insolvency regulation, which is arguably the most difficult; tax, which is also difficult; and architecture, about the role of the supervisory authorities and what enforcement authority we'll have at the European level.

I briefly mention one example: accounting enforcement. I am not even talking about single-entity accounting. It is a well known fact that IFRS are not enforced consistently across Europe. We have full regulatory harmonisation with the IFRS regulation of 2002, but when you look at how it is implemented, we do not have the consistency to fulfil the promise. To do that, you need a European chief accountant. I, for one, believe that this should be an agenda on which the UK and

the continental nations could find common ground, but we do not have it at this point for a number of different reasons. Some are political, some are turf-related and some are private–interest reasons.

The Chairman: That is really helpful. I am anxious to pass on.

Q53 Earl of Caithness: Professor Gleeson, you have partly answered my question in responding to Lord Carter of Coles. As you rightly said, there are 40 different pieces of legislative enactment in recent years. Where are the contradictions, gaps and overlaps? What have these reforms done in the way of generating extra costs and inefficiencies in the financial sector? The third part of my question, therefore, is what are the unintended consequences of all this? Where has it led to extra costs, the transfer of risks off the balance sheet and that sort of thing?

Professor Simon Gleeson: We have talked about some of the individual instances. It might be helpful to talk about the biggest collective problem, which is not identifiable as any one directive but as an overarching point that goes across many of these 40. That is the fact that the European legislative process seems to have become somewhat disengaged from global consensus on a number of issues, and from a number of these areas in particular: derivatives, clearing and markets are obvious examples. We seem to be seeing an attempt not only to construct uniquely European solutions but to shut out the rest of the world as a result. This is what we call internally the Colditz problem—you start off trying to build a fortress but end up building a prison.

This matters in finance enormously to those countries which have significant cross-border financial business outside the European Union; specifically, this one. The issue in general is that the more you end up with quirky and slightly unique European approaches to particular problems, the more you find yourself constructing obstacles to business between Europe as a whole and the rest of the world as a whole. Although I agree with everything M Véron says about the

importance of developing the single market and creating more business within Europe, it is equally important for Europe to do more with the rest of the world. I would identify the biggest single problem coming out of the architecture of this as precisely the fact that a lot of it makes that harder.

Nicolas Véron: Two things. First, I agree: we can discuss why the EU has become much less of a champion of global standards and even on some aspects, such as Basel III, a laggard as opposed to the champion it was on Basel II. There is denial in Brussels but there is no denying that the EU has become much less exemplary in this global agenda since the beginning of the crisis. The first step towards redemption is to face this reality, analyse it properly and try to understand it—and then to try to overcome it. Like Professor Gleeson, I firmly believe that it is in the interest not only of the UK and individual member states but of the EU as a whole to be a champion of global financial standards and to have an open financial system.

One area for this is derivatives. Here I think the fault really lies with the G20. It was probably a good thing for the G20 to take action on the derivatives markets, but it was a really bad thing to take that action and prescribe a number of initiatives without creating a global process to make sure that these initiatives would be consistent. There are a lot of things happening in derivatives but there is no global standards-setter, at least not in the public sector, on what should be done. We therefore have very divergent legislation between Dodd-Frank, EMIR and initiatives still to come in Asia. Through my involvement with DTCC I discovered the ugly reality on the ground, which is much uglier than anything I suspected.

Back to your question about extra costs, gaps and overlaps and identifying them more specifically, if we want to go beyond our high-level discussion here, which admittedly is not very specific, there needs to be a lot of work. In the paper that Bruegel published last Thursday which I co-

authored with my colleague Silvia Merler, we outlined an agenda for the next commissioner for financial services. One of the key recommendations is precisely to set up a process to identify these areas of overlap, gaps, unintended consequences and the like, and to go through a second round of repair, as Professor Gleeson suggested, in a structured way. It is a lot of work. It has to be done by a special committee, whatever the exact form. We suggest taking inspiration from the Vickers Independent Commission on Banking. Irrespective of what you think about the results, the process was very high quality. They did a very good job of analysing the substance and there is a lot to be learnt from that.

The Chairman: Nicolas Véron, we are very grateful for that paper giving advice to the future commissioner. Perhaps we could pass on to Lord Shutt.

Q54 Lord Shutt of Greetland: On that very point, I failed, I am afraid, in that I did not cope with it in 19 minutes. I felt that I had to read it again, but there we are. Coming on to the point that I want to ask, bearing in mind the work that has been centred on European banking union, market infrastructure and securities regulation, areas in which you are an expert, do you believe that there are particular regulatory risks here—and, indeed, are there remedial mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users?

The Chairman: Professor Véron, you have identified European banking union as being critical. Would you like to respond to the question?

Nicolas Véron: Something I forgot to mention when I expressed optimism that we would have a better division of labour going forward between legislation and rule-making is precisely the impact of banking union. The fact is that the ECB will become a very strong institution, much stronger than the ESAs, in producing or advising on rules, and I think that that will help the

process. By the way, there was recently a very important ruling by the European Court of Justice—the UK against ESMA—which unfortunately the UK lost. The ruling clarifies the previous Meroni doctrine on what EU agencies can and cannot do. It gives them much more autonomy and the ability to delegate on matters where discretionary decisions are required than was thought to be possible before. At least, that is my understanding of the judgment. I think that it is a good thing and is exactly in the spirit of what Professor Gleeson said about having more of the detailed rule-making done at agency level; it makes it legally much more possible than it used to be.

Of course, I agree that the Commission has an incentive to retain its turf, but whether it will do so successfully in the way it currently thinks it can remains to be seen. I am slightly less deterministic than Professor Gleeson. Because of the heft of the ECB and possibly because of future reform of the ESAs themselves, we can look forward to a future in which more of the decision-making and rule-making will be done at the more competent agency level.

The Chairman: Simon Gleeson, would you like to add to that?

Professor Simon Gleeson: I am afraid that I reach exactly the opposite conclusion. We can look at the recent behaviour of the ESAs. While it is all very well for the European Court of Justice to say, "You can exercise your powers a little more broadly", we have a problem at the moment on the margining of uncleared derivatives. There is an error in the drafting of the relevant directive. The error is transparent and quite obvious on the face of the directive. ESMA is currently taking the view that it is absolutely bound by the words of the directive and is able to do nothing on its own initiative in order to correct this error. That is precisely what causes the problem. It is an approach like that which basically makes these bodies really useless for amending and developing law and policy.

This is particularly alarming as we move towards MiFID, the markets directive, because market regulation above everything else is a process that involves a feedback loop. Although it would be much more efficient if a greater degree of power could be given to the ESAs, we have to accept that, first, it is not going to happen without some degree of constitutional change and, secondly, it would mean not just the European Parliament and the Commission, but also national parliaments effectively surrendering another wodge of powers over regulation in Europe. That is hard.

Nicolas Véron: I take a different perspective on this. After all, we are in the Houses of Parliament. The mistakes Parliament makes—this is also true for the EU institutions that make legislation—only Parliament can correct. There is a challenge to democratic processes and accountability if an agency that is less democratically accountable than the EU institutions themselves, including the European Parliament, is allowed to correct a material mistake that has been made in a piece of legislation. So I am tempted to say that the EU institutions should correct their legislation. The good news is that there are better and more flexible tools to do this than the US Congress has with Dodd-Frank, so I guess that this is all relative. I am optimistic looking forward. In future legislation I think that there will be more delegation to agencies, and that clarifies our difference of opinion.

The Chairman: We have some 20 minutes left.

Q55 Lord Kerr of Kinlochard: Perhaps I may test your optimism on another point. If you look at the scene now, there is no doubt that the European financial markets are much less integrated than they were six years ago. That is not the fault of the legislator, it is a consequence of the crisis. However, has the legislator done as much as it could to reintegrate the markets? Let us take, say, banking resolution. The central common funds for dealing with a failing bank are

minuscule and grow extraordinarily slowly. We will see for some considerable time to come banks renationalised in the sense that they will go back to within their national frontiers. Was that inevitable or is there something that could still be done? I am struck by M Véron's opening remarks about how we are seeing the end of national banking. It seems to me that we are miles away from genuine banking union.

The Chairman: Do you want to respond to that?

Nicolas Véron: Yes. The initial remark I made was definitely a forward observation. I was describing my expectation of what I am reasonably confident will happen rather than what has already happened. I think that banking union is the centrepiece of the EU effort to address market fragmentation, and so far what I am seeing on the ground makes me optimistic that it will work. At this point I cannot say that it has worked or even that it works because it is too early to tell. A timetable has been set and in barely more than a month's time we will have the results of the comprehensive assessment. They will give an early indication that goes beyond what we already know. I also suspect that in the second half of 2015 we will see the end of the wave of bank restructuring and recapitalisations immediately following the comprehensive assessment. I think that it will not be before the second half of 2015 that that particular cloud of dust will have settled. At that point we will know more about whether banking union does actually foster cross-border bank mergers and the sort of integration-friendly developments that the ECB says it wants to see. By the way, the ECB has been saying that very clearly.

The Chairman: Let us turn to Simon Gleeson. You responded very warmly to what Lord Kerr was asking.

Professor Simon Gleeson: To some extent, I think the question answers itself. The only thing that could be done was the establishment of a genuine, credible European bank resolution

mechanism. On anything else, national Governments will take the view that if they allow their banks to become Europeanised, if the bank gets into trouble, the problem will fall back on them. The issue is that national Governments need to believe that the European resolution mechanism is credible, and to that extent, such a resolution mechanism would effectively have to be backed by the full faith and credit of all of the Governments of Europe. That is absolutely not the case. We have this, as you say, very small fund.

It is important to remember that Europeanising banks is harder than Europeanising almost any other sort of business. If you look at the experience of the new joiners, the Vienna initiatives and all the rest of that, Governments are very reluctant to give up control over their domestic banks. They are very reluctant to sign up to bailing out overseas depositors, and therefore they prefer to see their banks domestic. Short of the establishment of a credible European resolution mechanism and, I think, an accompanying prudential regulator, we will probably not make significant progress towards Europeanising banking. The question is one of credibility, and the credibility has to be with the treasuries of the member states concerned.

Nicolas Véron: I am aware that I probably sounded very Panglossian about all this, so let me agree with Professor Gleeson, but I would put it more starkly than he has. Basically, going beyond what has already been decided and is being implemented on banking union requires a further political step that was not made in mid-2012, which is significant progress towards fiscal policy integration. Essentially—again, to say it in simplistic and therefore slightly misleading terms—without fiscal union there is not much more you can do in terms of reintegrating the financial space than has already been done, at least in terms of banking. In other words, the shortcomings of banking union and its incompleteness in its current form are essentially unavoidable unless there is further progress in fiscal and therefore political union.

My take on this is simply to say that monetary union with a sort of half-way banking union is much more robust than monetary union without banking union at all and it is much more supportive of an integrated financial system. I see the positive side of it, but you are right that we are not yet there. It is not realistic for the next year or two to go for fiscal union. I do not see it happening unless there is a major new development that is unexpected by at least most of us. It is possible to make progress on the whole capital markets union set of issues. This is where it is possible to take constructive action to make incremental progress and possibly some breakthroughs towards reintegrating, or fighting the disintegration, of the European financial space. Because EU capital markets are centred in London, it has to include the UK in a way that banking union did not, which makes it both a risk and an opportunity.

The Chairman: Let us pass on to Lord Flight.

Q56 Lord Flight: First of all, you did not mention collective or common insurance for the retail market, which I think is fundamental if you want retail bank Eurotisation. I shall ask about something we have partly touched on, which is the interaction between the EU and international regulations and standards. As a practitioner, I see this sort of ghastly thing on top of me. There is the FCA and the PRA gold-plating everything, there is stuff coming from Europe and on top of that, there is stuff coming internationally. America is perhaps the worst for over- and ridiculous regulation. We have FATCA and FATF. How do you see that interaction from the European point of view and how is what is going on from on high internationally developing? Finally, and most importantly, there is Basel and banks. To what extent is Europe going to come in line with that?

Professor Simon Gleeson: The first thing to say about that is if you imagine that none of the international hierarchy existed at all and that we simply had the PRA and the FCA in the UK that

were completely and unrestrictedly sovereign, the rules that would come out of that process would be almost the same as the ones we have today.

Lord Flight: I understand.

Professor Simon Gleeson: What happens above them is almost a policy-making process. One of the things you notice if you look at FSB/G20 level is that most of the policy input is coming from the UK and most of the rest is coming from the US—so, in a funny sort of way, we are making policy for ourselves through a very long and devious route. I entirely agree with your suggestion that the European Union is not as internationally minded as perhaps it could be. You are absolutely right that the United States is also not as internationally minded as it could be. Particularly if you look at derivatives clearing, one of the things that you notice is the ability to make large international disagreements out of microscopically small differences in policy and legislation. We must accept that some of these international conflicts are almost artificially created for political reasons. It is very hard to see how much of this would change if the international architecture was not there, save for the fact that international differences would potentially be even greater than they are at the moment, which would be detrimental.

Nicolas Véron: I have a different perspective. First, on the UK, it is natural that the nation that holds the world's most important international financial centre would be in favour of, would champion and would be a good practitioner of international financial policy co-ordination. I praise the UK for this. I am not surprised that this is the case.

The larger the polity and the more self-contained it is, which the UK certainly is not in financial matters, the more there is an incentive to go unilateral. I am not passing judgment on this but am describing what I think is almost a law of gravity in those matters.

Comparing the US and the EU, there has been a convergence in their positions. The EU has become much less internationalist by default than it was before the crisis. The main driver of this is the need to reregulate some market segments that came from the crisis experience. It is easier to be an internationalist when you deregulate. It is much more difficult to be an internationalist when you reregulate. The EU had to reregulate. It made being an internationalist more difficult. It is not the only driver, but it is the main driver. Conversely, I would argue that the US has become a bit less dreadful at this game and a bit more constructive in international financial policy-making. The contrast between Basel II and Basel III and what has happened with derivatives, warts and all, is testimony to this.

My third and final point is about the FSB. I entirely agree with Professor Gleeson that the degree of UK influence in the FSB at this point is extraordinary. I caution that this cannot last because it is just unsustainable. I think there will be debates about the accountability and representativeness of the FSB that will mechanically diminish UK influence in the FSB compared to its current level, for better or worse. It will be better in terms of legitimacy, and possibly worse in terms of quality of policy-making. That is a matter of judgment. One institution where this has happened, which is an interesting point of comparison for the shape of things to come, is the International Accounting Standards Board. The IASB was uniquely dominated by the UK in its early years, but is much less so now. It is much more legitimate and certainly more balanced in terms of geography. Insiders might judge that that has made the IASB a bit less faithful to its mandate in terms of quality of standards, but not to an extent that would dramatically compromise its mandate. There are compromises to be made here. I suspect that this will be the direction of travel for the FSB, which is an important institution for future developments in the area you have asked about.

Q57 Lord Davies of Stamford: Do you agree that we have now achieved the right balance between the EU and national authorities in financial service regulation and supervision? I might just say to Professor Véron that I detected a certain contradiction in the paper he kindly submitted to the Committee, which he wrote jointly with Silvia Merler. You do not number your pages, which is not very kind to your readers, but on the fifth page you talk about banking union and so on and say: "The respective responsibilities of the ECB and national authorities … are subject to widely divergent insolvency frameworks … All regulated financial firms other than banks … remain supervised at national level … This creates scope for tensions, regulatory arbitrage and ultimately instability". You seem to be arguing that there is insufficient coherence, centralisation and uniformity.

Later on—again I do not have a page number but it is three pages from the end in the section headed "Crisis Management and Resolution"—you seem to be saying the exact opposite. In relation to proprietary trading and so forth, you say that we should, "leave to supervisors the intricacies of the implementation of this principle". If you leave to supervisors the intricacies of the implementation, you might be thought to be creating, in your words, "scope for tensions, regulatory arbitrage and ultimately instability". I see a certain tension in your article on this particular subject. I would be grateful if you could clarify what you really think about the right balance between EU supervision and member states supervision.

Nicolas Véron: Where you see tension I would argue that I and my co-author simply try not to have a one-size-fits-all approach. Depending on the issue at hand, the subsidiarity principle, which I very much believe is a good organising principle for those issues, may give you different answers. At the current juncture—

Lord Davies of Stamford: The subsidiarity principle may indeed be in opposition to the right degree of supervision—

Nicolas Véron: No, the subsidiarity principle simply says that responsibility should be at the level where it is most effective. Basically, if things can be dealt with at the national level in an effective way then they should remain at national level. If they cannot, there is a case for bringing them to the European level. In the case of banking union there is a slightly hybrid level, the banking union area, which is likely to become larger than the eurozone very quickly but does not include the UK. On structural separation, I reiterate my view that, at least for the time being, this is not a priority for legislation and therefore should be left for supervisors, which also means that inside the banking union area it will actually be consistent because it will be consistently implemented by the ECB as a supervisor. But I see scope for differences between the way it should be implemented by the Bank of England in the UK on the one hand and by the ECB in the banking union area on the other. I do not think that is a lethal infringement of the single market as things currently stand. However, I think there are other relevant areas here. You mentioned some of them; I mention also accounting enforcement. Possibly I would also add, and I have to work more on this, central counterparties, where a more consistent—and in many cases that means centralised—European and, in those cases, EU-wide as opposed to banking-union-area-wide delegation of authority would be advisable.

Lord Davies of Stamford: Is it not rather less than desirable that there is no general principle at all emerging from what you are recommending? What you are really saying is that there should be the right sort of balance structurally that makes most functional sense in each individual case. Everyone would agree with that—it has always been the position that any sane person would take—but it does not really help you very much. It leads to a situation that is very opaque,

confused and perplexing, both for the general public, obviously, but also for legislators and indeed for those who are themselves the subject of supervision and regulation, and inevitably leads to issues like regulatory arbitrage because it means that there are certain activities that can more profitably and easily be conducted in one part of the single market than in another, which is contrary to the whole principle of the single market. So your answer leaves me a little less than fully satisfied.

The Chairman: Before I ask Simon Gleeson to respond to that, I am going to ask Lord Dear to table his question, which I think is very germane to Lord Davies's point.

Q58 Lord Dear: It is a parallel point, really, about equivalence, the new rulebook, third-country actors and so on. In a nutshell, what risks do you see from multiple jurisdiction? Is there a danger of what we have put in the question as "multiple jeopardy"—a multiplicity of regulation across the EU and beyond? Are we being weighed down? This question has already been posed in some ways by Lord Flight. We are sitting here under a huge mass of sometimes competing regulations, and where the hell do we go out of all that?

Professor Simon Gleeson: The starting point is, obviously, that it depends. From the perspective of the participants in the market, their ideal situation will be to have a common set of rules across Europe that are enforced equally everywhere in Europe. Actually, the thing that creates the issue of multiple jeopardy is far more to do with the inconsistent enforcement of the rules that exist than it is to do with the rule-making process. In a way, we have sort of harmonised what we need to harmonise by way of rule-making; we really need to think much more about how we enforce what we already have.

Coming on to whether the balance is efficient, a good starting point would be that increased harmonisation is useful for activities that are inherently cross-border and less so otherwise. In the

context of financial regulation, the specific point tends to be that retail savings products, for example, are sold very differently from country to country. An Italian saver buys an entirely different product in an entirely different way from a British or a German saver. It actually makes very little sense to harmonise the marketing of retail—

Lord Davies of Stamford: Ah, but if I could interrupt you, that distortion may be the result of different regulatory traditions and systems, and it may inhibit some savers in some countries from getting the products that would actually suit them best in terms of the risk-reward ratio, liquidity and so forth. That principle works against the economic advantages and the economic case for a single market.

Professor Simon Gleeson: Retail issues specifically are generally more to do with tax than anything else.

Lord Davies of Stamford: I am talking in retail terms. It may be to the advantage of someone living in Glasgow or Frankfurt that he would be able to buy and see marketed a product that currently circulates only in Italy. The whole point about single markets is to remove those kinds of barriers and anomalies.

Professor Simon Gleeson: That is entirely correct and I agree. However, if we go beyond saying that he should be able to buy the product and say, "And we will have a single standardised European disclosure document that describes it", what you are creating is something that may be instantly familiar to someone in Glasgow but is utterly incomprehensible to someone in Milan, just because that is not what he is used to. There is a question of whether standardisation at that level is entirely useful.

That is at the retail level. If we look at the wholesale level, we are trying to achieve a different thing. The easiest way of putting this is to say that if London, for example, wants to be the

European financial centre, Europe must feel that it is able to regulate it effectively. It goes beyond the question of how we generate the best regulation towards how we generate the regulation that allows this entity to perform the job that it wants to in the legal context in which it needs to perform it. It is not simply a matter of saying who is technically the best regulator; you are saying, "Who needs to feel that they have a hand in the regulation of this thing?". To that extent, I would argue that the balance is wrong. We still do not have sufficient European control of the City of London to leave other European Governments happy with the fact that increasingly Europe has only one financial centre, and that is it.

Nicolas Véron: I entirely agree with what Simon Gleeson has just said. It is probably easier for a continental such as me to say than for a UK citizen like him, but we are on the same page here. My way of putting it is that the City of London has this outfit that deals with policy issues called TheCityUK and it is high time for it also to think of having "TheCityEU", not necessarily superseding TheCityUK but certainly existing alongside it. Of course that is just about labelling; more to the substance, I do not think it is possible, with the current state of Europe, to have an extremist view that would say that financial policy is entirely national or entirely European. Maybe one of those two might be desirable but I do not believe it is, and I certainly do not believe it is realistic. Therefore we are in a hybrid—some would say federal—framework where some aspects are national and some are European, and it is appropriate that the subsidiarity principle should guide policymakers in determining what is national and what is European. If it is complex, so are all federations.

Q59 Lord Davies of Stamford: Are you confident that in practical terms you will be able to get a consensus as to the right subsidiarity answer and where the best level of regulation is in terms of functionality? There is not necessarily an indisputably obvious solution in each particular case.

Nicolas Véron: That is true, and this is why all federations that I know are a constantly renegotiated arrangement where nothing is really in a steady state. You see that in the US, in Switzerland and in all federal organisations. That brings complexity but it might be better than the alternatives. On the assessment of what is sufficiently consistent and what is not, I also express my full agreement with Professor Simon Gleeson; enforcement is where the biggest problems are. That is not to say that there are none regarding the harmonisation of legislation, but there are many more in terms of enforcement. I mentioned accounting enforcement but I would also mention single-market enforcement. When you discuss with people inside the Commission's internal market directorate, all those who I know agree privately that the European Commission has not done enough by a mile to enforce single-market legislation. It goes beyond Mr. Barnier.

Lord Davies of Stamford: Is that not a reflection of the fact that it is local national authorities that tend to be responsible for enforcement?

Nicolas Véron: The European Commission has enforcement powers that it has not used to the extent that it should have; that is the assessment that they make, and I fully share it. Again, contrasting banking union with capital markets union, there is a bit of a paradox. As Simon Gleeson said, wholesale markets should be more integrated than retail markets, but with banking union we have segments of retail markets that are now more integrated than wholesale markets. There will be catch-up action here. Again, I give the example of accounting and auditing, which should be relatively uncontroversial, even though there are enormous vested interests. The ECB as a supervisor will supervise banks whose national operations are audited by fully independent national firms; of course, they are part of a network, but we know that these networks are not centrally integrated. Those national auditors are regulated by national audit regulators that are themselves independent from each other. This is a recipe for inconsistency of accounting

practices, which will quickly become unworkable for the supervisor. So of necessity we will see evolution in that area.

The Chairman: Let us move on to our final subject. As a coda, I will say that we sit here in a legislative assembly, or Parliament, and I am often conscious that as Members of Parliament we are very happy making laws. Where we fall down so often is in monitoring and enforcing the very laws that we have created. Let us pass on to our final subject, and Lord Kerr.

Lord Kerr of Kinlochard: This is the painful bit, where our witnesses are playing on our schizophrenia. Professor Gleeson says that if London is to remain Europe's financial centre, Europe must feel that it can effectively regulate it. Sell that in the Palace of Westminster!

Lord Flight: Sell that to the City of London!

Lord Kerr of Kinlochard: What is the deduction that one can draw from how the banking union has been handled by the British Government as something completely separate from the single market? We are distinguishing clearly between the single market, where we wish to see it deepen, and banking union, which is a matter for eurozone countries. The Poles and Swedes can stand around as members if they like, but it is nothing to do with us. On the other hand, by God, if banking union starts feeling that it deserves its own financial centre as a rival to London, it is an appalling attack on the Ark of the Covenant. Have we played something wrong? Was that all inevitable, or did something go wrong in the British approach?

The Chairman: I am going to ask Lord Flight to add his question and then ask our two witnesses to take deep breaths and reply to the composite question.

Q60 Lord Flight: The question is whether the UK has done enough to protect its national interests. My background points would be varied. One is, as Professor Gleeson has already highlighted, we started off with AIFMD, which was crackpot. It is questionable whether it has

done anything for hedge funds but, by attacking every other fund with these ridiculous requirements, it has infuriated practitioners across the board. Certainly, on your comment about how London must be regulated by the EU—pull the other one. Of course, 70% of London's business is not EU anyway, so there is a logic for all that other business. Professor Gleeson has broadly said that it would have been much the same anyway, if the UK had done it. I partly agree, but there are things in MiFID that we certainly would not have done and which are a damned nuisance. MiFID 2 may be protectionist—and I think that we made reference to that. AIFMD is a damned nuisance. So we have all of that where we have not protected ourselves and where Europe has got it wrong as well.

The Chairman: Simon Gleeson, would you care to reply to those questions and take the opportunity to add anything, if you think that there is anything that we have not heard said this morning that is urgent to our report.

Professor Simon Gleeson: Gosh, this is hard. Starting with Lord Flight's point, the UK occasionally finds itself in the most terrifying bind, when it is faced between doing what Europe says should be done and doing what would be most efficient and effective as a regulatory measure. That happens from time to time. It happens in every country with every European measure from time to time. At the end of the day, the question is really very simple: to what extent are we prepared to endanger our position, whatever it is, with regard to whatever else is going on?

The answer to Lord Kerr's point on what went wrong can be very simply summarised. There was an extraordinary UK disengagement at the policy level at a sufficiently early stage. It is my personal opinion that certain UK Government departments, particularly the Treasury, proceeded for far too long under the illusion that they were sovereign law-makers when in fact they were not. Over the last seven years, we have seen a rather violent correction of that illusion. In order to

correct that, it is necessary for those who make financial policy in the UK to be clearly aware that financial policy is no longer made in Horse Guards Parade—it is made in Brussels—and to manage the making of policy on that basis.

The Chairman: Before I bring in Nicolas Véron, the Earl of Caithness has a short question.

Q61 Earl of Caithness: In your paper, under single market integrity, you advised the new Commissioner to "avoid the twin risks of discrimination and special favours". Have there been any risks of discrimination and special favours in the last 40 lots of enactments against the UK and non-eurozone countries?

The Chairman: Would you like to respond to that but also to the following question? As an outsider, could you help us with the United Kingdom's engagement or otherwise with the European Union?

Nicolas Véron: On that last point, I think generally anti-finance legislation tends to be anti-UK, because that is where most of the finance is, or at least wholesale finance. So there has been some discrimination I guess, and traders' remuneration is a good example of that. De facto it is a bit of an anti-UK thing, even though that might not have been the primary driver. Who knows? It depends on who you are talking about. As for special favours, there is a very good case of one in M. Barnier's proposal for structural separation, published last January, where the Commission's legal service has said that to give a free pass to Vickers is not consistent with the fact that this is a regulation not a directive. That is the sort of thing that I had in mind when drafting this jointly with my co-author.

On the broader question about EU legislation, again, I want to see the bright side. The EU process can improve and the UK help to improve the EU process. The UK was instrumental when the Commission was committed to better regulation processes. There has been a pause in better

regulation but there is no necessity that better regulation cannot come back. I can only agree with Simon Gleeson that the isolation of the UK from the EU policy process is very bad from that perspective, because we lose an important force to push for better regulation.

On the big question of national interests, I see basically three different sets of interests. Of course, the reality is much more complex, but let us simplify it for the sake of argument. There is the turf interest of the UK government institutions, including Parliament but also the Treasury, the Government and agencies such as the Bank of England—that is number one. Number two is the interest of the City, which can probably be proxied by the increase of wealth of all the people who work there. Number three is the interest of the UK as a nation, which is the common interest of all its inhabitants and citizens. Depending on which of those three sets of interests you want to maximise or optimise, you get different outcomes.

What is clear to me at this juncture is that the City's interest and the turf interest of the UK Government are more divergent than at any time I can remember. I have not been there very long, but long enough to say that they are particularly divergent at this point. There is an interesting question about where the national interest of the UK is in this tussle. I instinctively see that this points more to the City's side than to the turf interest of the UK government side in our debate, which is where the locus of regulation should be, in the way that Professor Gleeson has framed it. That is a very difficult situation to be in. It is not easy, so I have sympathy for my friends in the UK in all parts of society and government who struggle with it.

Capital markets union—to use again the moniker that Jean-Claude Juncker has introduced—is a test of this. Can we find a positive agenda where the interests of the UK, those of other European countries, the common EU interest and the interest of the City of London are sufficiently aligned so that significant progress can be made towards more integrated capital markets, with

appropriate enforcement, monitoring and supervisory mechanisms? I believe that it is possible. I see the UK government authorities, including but not only the Treasury, being tempted to stonewall and say, "Well, of course we love capital markets union; it should be an amendment to the directive on prospectus and some new legislative text on securitisation which will not have much substance", which is another way of saying, "Let's say we love capital markets union and do nothing on capital markets union, or so little that it will not make any difference". I am not sure that this strategy—if it is a strategy—is aligned with the UK national interest. I cannot opine on the politics of it, not being a UK citizen myself, but I can certainly say on policy that I see much more scope on substance for a constructive agenda of capital markets union where the interests of the UK as a nation, of London as a financial centre and of the EU as a whole are broadly aligned. I hope this will materialise. I am not sure that it will.

The Chairman: Simon Gleeson, Nicolas Véron, thank you very much indeed for coming before us this morning and for your excellent testimony—and for avoiding any reference to the Scottish referendum!

Nicolas Véron: We said the UK!

The Chairman: As I indicated before, we will send you a transcript of our conversation. Please improve it; please add to it if you have any further thoughts. But you can tell by the reaction of my colleagues that this has been a very invigorating hour and a half, and we are most grateful to you both for coming in and starting our "September Song".

Christos Vl. Gortsos–Written evidence (FRF0011)

Summary

1. The new EU framework pertaining to financial regulation, supervision and oversight is a 'child of crisis' and, to be more precise, of two crises: the recent (2007-2009) international financial crisis, and the current fiscal crisis in the euro area, which erupted in 2010. It addresses most of the causes of these crises by introducing a set of extensive rules aimed at three primary goals: enhancement of financial stability, of market efficiency, transparency and integrity, and of consumer protection. It has also established two pan-European mechanisms for the micro-prudential supervision and resolution of (at least) systemically important credit institutions and investment firms, within the framework of the European Banking Union (EBU).

2. In the author's opinion, the new framework, which applies to all 28 EU Member States, with the exception of the rules on the EBU institutions (SSM, SRM, and SRF) that are confined to euro area Member States, is characterised by the following:

- it is more robust, consistent in principle, and has curtailed the overall risk exposure of the EU financial system,
- its biggest achievements are the establishment of the Single Supervisory Mechanism (SSM) and the adoption of the resolution framework,
- its major − though intended − drawback is the very short period of time within which it was adopted (albeit justified given the circumstances under which it was introduced),
- the legislative process has definitely been improved, enabling the adoption of rules by EU institutions with a more active involvement of supervisory bodies, through the three 'European Supervisory Authorities' (EBA, ESMA and EIOPA), which *de facto* have definitely superior technical knowledge of the subject-matters,
- it transfers considerable powers from Member States to EU institutions and bodies, mainly within the institutional framework set by the Treaties, and
- it imposes substantial compliance costs on financial actors, including a heavy cost of raising more own funds to meet capital adequacy requirements.

3. It is also worth pointing out the following on this new framework:

- it would be premature to judge its resilience under circumstances of new, unforeseeable crises,
- the framework is too recent to be in need of immediate revision, even though developments in the relevant international agenda must be constantly kept under close watch,

- its flexibility enabling it to withstand a new crisis must be assessed both on the basis of the existing legal framework and with regard to its adaptability,
- in the light of differences in regulatory costs between the EU and other international financial centres, the case for enhanced international cooperation and coordination is even stronger in order to avoid regulatory arbitrage, and
- the single element that needs more careful monitoring and review is the BRRD (Directive 2014/59/EU).

4. Finally, new areas of immediate reform pertain to the winding-up of credit institutions and the direct recapitalisation by the European Stability Mechanism (ESM) of credit institutions faced with insolvency.

A. Broad assessment of the EU regulatory framework

Question 1:

1. Since 2008, several legal acts have been adopted by EU financial regulators (*i.e*. mainly the European Parliament, the Council of the EU, the European Commission and to a certain extent also the ECB) in order to enhance the stability of the disrupted EU financial system, market efficiency, transparency and integrity, as well as consumer protection in financial services. The legislative process for adopting such acts has also been improved (*on the latter see below, under Question 5*). In the author's view, these legal acts are categorised in two groups, since they address problems relating to two different crises (even though the first *partly* triggered the second).

2. The first contains a set of legal acts adopted as a regulatory response to the recent (2007-2009) international financial crisis. For the most part, regulatory measures in this set were taken over from the international financial reform agenda, mainly the work orchestrated by the Financial Stability Board (FSB) and soft law rules adopted by international fora, such as the Basel Committee on Banking Supervision and IOSCO. Pure EU interventions were − at least in the beginning − rare, with the exception of Directives adopted in the field of consumer protection in financial services and the new Directive (2014/49/EU) on deposit guarantee schemes (DGSD).

3. The second group contains legal acts adopted as a regulatory reaction to the current fiscal crisis in the euro area, which erupted in 2010. The main by-product of this response, as regards financial law, was the establishment of the European Banking Union (EBU), and, in particular, of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the Single Resolution Fund (SRF). *On the other hand, the 'single market' element of the EBU, notably the new Capital Requirements Directive (CRD IV), the Capital Requirements Regulation (CRR), the Bank Recovery and Resolution Directive (BRRD) and the DGSD, is a by-product of the international financial crisis.* For an overview of the legal acts pertaining to the EBU, see below Table 1.

4. The establishment of the SSM, the SRM and the SRF constitute bold institutional novelties. Especially the creation of the SSM is a reform element, that of improved financial supervision, that was not addressed adequately during the first sub-period since 2008. It should be recalled

that the 2009 de Larosière Report,[56] which was elaborated in order to identify the causes of the recent (2007-2009) international financial crisis, highlighted weak financial supervision as a major cause. *It is worth noting that even this Report concluded that (contrary to macro-prudential oversight) micro-prudential supervision should not be assigned to the ECB, a proposal that has been rejected with the establishment of the SSM.*

5. It would necessitate a precise cost-benefit analysis of each and every single legal act adopted, as well as their actual implementation and enforcement, in order to assess adequately the overall efficiency and effectiveness of the new EU financial framework. In principle, however, the legal framework pertaining to financial regulation, supervision and oversight is definitively more robust.

6. Nevertheless, the use of the term 'over-regulation' is not inappropriate in this case. EU financial law (mainly administrative in nature, if viewed from the perspective of national law) currently covers almost every single aspect of financial activity. More regulation, however, does not linearly lead to higher levels of financial stability, market efficiency, and consumer protection. Effective supervision and enforcement are conditions *sine qua non* towards that end. These have to be ensured by the ECB (within the SSM), the national competent supervisory authorities in the fields of banking (again within the SSM), capital markets and insurance, as well as, to the extent they are competent for this, by the EBA the ESMA and the EIOPA (*on the 'European Supervisory Authorities' see below, under Question 5*).

7. Finally, when assessing the efficiency of the reform agenda, relative compliance costs imposed on EU financial actors must also be taken into account within a globalised and highly competitive environment. *On this aspect see below, under Question 11*).

Question 2:

8. Traditionally, the majority of regulatory reforms undertaken in order to address recent and current crises and problems in the financial sector are mainly backward-looking. Accordingly, new institutions and rules are 'children of crisis'. The conditions that led to the establishment of the Basel Committee (in 1974), the FSB and the G20 (in 1999) and the adoption of the 'Basel I' and 'Basel III' Capital Adequacy Frameworks are only the most striking examples thereof. In addition, it is reminded that the use of macro-prudential financial oversight was strongly advocated by international financial institutions (such as the BIS) since the late 1990s, but was only included in the agenda after the recent (2007-2009) international financial crisis.

9. The new EU financial framework is also the child of not one but two crises. It was adopted hastily, under enormous political pressure (reflecting a widespread loss of public confidence in the financial system, at least in some Member States). It addresses most of the causes of these crises, by introducing a set of extensive rules aimed at three primary goals: enhancement of financial stability, of market efficiency, transparency and integrity, and of consumer protection. It has also established two pan-European mechanisms for the micro-prudential supervision and

[56] *The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, Report, Brussels, 25 February 2009, available at*: http://ec.europa.eu/commission_barroso/ president/pdf/statement_ 20090225_ en.pdf.

resolution of (at least) systemically important credit institutions and investment firms, respectively, to assist in the achievement of these goals.

10. To the extent that the EU financial framework extensively regulates and thus restrains financial activity (maybe to the limits of a market economy) in order to ensure the achievement of its primary goals, it can be argued that the overall risk exposure of the EU financial system is curtailed. Nevertheless, it would be premature to judge its resilience under circumstances of new, unforeseeable crises. Apart from stress arising from inside the system (which is the main focus of the new framework), crises might be due, indicatively, to persistently negative developments in the real sector of the EU economy (which would strongly affect all sectors of the financial system), a generalised sovereign debt crisis (thus far averted), the negative spill-over effects of geopolitical developments in the region (an aspect which until recently was not taken into account), or from inappropriate fiscal and/or monetary policies (very improbable, but still one of the main causes, in the author's view, of the recent (2007-2009) international financial crisis, at least in some cases).

11. The flexibility enabling it to withstand a new crisis *on the basis of the existing legal framework* will heavily depend on the way supervisory, resolution and other designated authorities will exercise the powers conferred upon them, and the effectiveness of their cooperation. The complicated procedures that have sometimes been introduced most strikingly, bank resolution procedures under the SRM) raise doubts as to the effectiveness of actions to be undertaken (often within a very short period of time, e.g. resolving a bank over a week-end).

12. Another aspect of flexibility is the *adaptability of the existing legal framework*. This depends, firstly, on the effectiveness of the legislative process. *See on this below, under Questions 5 and 13*. It depends also on the ability of EU financial regulators to recognise, without undue delay, imminent threats and react promptly. Recognition and reaction lags are harmful.

Question 3:

13. In the author's view, the biggest achievements are two: the establishment of the SSM and the adoption of the resolution framework.

14. The academic debate on the creation of supranational supervisory authorities for the European financial system can be basically traced back to the early 2000s (after the start of the EMU), and its prospect was even embedded in the Maastricht Treaty (Article 105(6) of the Treaty on the European Community, currently Article 127(6) TFEU). At a political level, this prospect was put forward, for the first time, in 2009 by the de Larosière Report, following the onset of the recent international financial crisis, only to be rejected.

15. It was the current fiscal crisis in the euro area which acted as a catalyst for conferring certain designated banking supervisory tasks on the ECB within the framework of the SSM. This development alleviates one of the main asymmetries of the EMU, notably that the monetary and foreign exchange policies in the euro area are conducted at supranational level, while banking supervision remained national.

16. The second major achievement was the adoption of the resolution framework. When one or more credit institutions are exposed to insolvency, and if a 'private sector solution' cannot be found, supervisors and governments face a 'trilemma' between the following options:

- to wind up the credit institution(s), in which case they risk negative contagion to the banking system (in the form of bank runs), and the deposit guarantee scheme must be activated, or
- to recapitalise the credit institution(s) by means of public funds, i.e. the main option during the initial phase of the crisis but subject to budgetary constraints and strong public disapproval and pressure, or
- to resolve the credit institution(s).

17. With the implementation by 2015 of the BRRD (and by 2016 of the SRM) Member States have at their disposal, for the first time, a comprehensive set of rules (harmonised at EU level) on the recovery and resolution of credit institutions (and investment firms), which also apply to systemically important ones (the main target group). There are good reasons to expect that resolution will become the new norm in the context of the above trilemma.

18. The major − though intended – drawback of the regulatory agenda is a by-product of the conditions under which it was adopted: the very short time frame. Almost none of the legal acts adopted contain a robust cost-benefit analysis of their impacts. The French proverb for such cases says: "*à la guerre comme à la guerre"*, meaning that one does not necessarily comply with the rule of law in times of crisis.

19. The main comparative advantages of the new EU financial framework are the following:

- the positive signalling effect of a prompt and mainly decisive regulatory response by European institutions to the causes of the two crises,
- its adoption without an amendment to the TFEU, which would compromise the speed of reform and the flexibility to resort to an Intergovernmental Agreement (on the SRF, even with abstention of two Member States) if the TFEU did not provide the appropriate legal basis,
- its compliance with international financial standards, subject to the constraints arising from the fact that other international financial centres may not have complied with such standards (*see below, under Question 11*).
- its 'unbiased approach', in the sense that new rules have been adopted across the board, applying to all four sectors of the financial system (banking, capital markets, private insurance, and payments).

20. On the other hand, its main comparative costs are the following:

- as a result of the rapid adoption and implementation of several legal acts simultaneously, an enormous compliance burden imposed on financial actors,
- in more detail, a need for credit institutions to raise significant amounts of new capital within a relatively short period of time, and meet the new liquidity requirements imposed on them, leading some to reconsider their business model, and
- the fact that the achievement of its three primary goals may compromise, at least in the short run, the positive contribution of the financial system (and in particular of its banking sector) to the real sector of the economy, in terms of both borrowing costs and available credit.

Question 5:

21. The legislative process has definitively been improved. This is due to two factors.

22. The first is the amendment to the Treaties through the Lisbon Treaty. According to Article 289 TFEU, in force (by coincidence) since 2009, the European Commission maintains the right of initiative for proposing legislative acts (the acts formerly called 'basic legal acts'), while the European Parliament and the Council have the main political responsibility to adopt Regulations (which are directly applicable) and Directives (which need to be transposed into national legislation).

23. The new Article 290 TFEU has introduced the instrument of delegated acts, which can be adopted by the Commission without following the 'Comitology procedure' (still necessary only for the implementing acts under 291 TFEU, according to the provisions of Regulation (EU) No 182/2011 of the European Parliament and of the Council). This Article provides that a legislative act of the European Parliament and of the Council may delegate to the Commission the power to adopt such acts, including *ex ante* and *ex post* restrictions on this delegation.

24. Particularly as regards the provisions of European financial law, in Declaration No 39 annexed to the Treaties, the Commission states its intention: *"to continue to consult experts appointed by the Member States in the preparation of draft delegated acts in the financial services area, in accordance with its established practice."*

25. The second factor is the adoption, on 24 November 2010, by the European Parliament and the Council of three (3) Regulations establishing the three 'European Supervisory Authorities' with a view to strengthening the efficiency of micro-prudential financial supervision in the EU:

- Regulation (EU) No 1093/2010 on the European Banking Authority (EBA),
- Regulation (EU) No 1094/2010 on the European Insurance and Occupational Pensions Authority (EIOPA), and
- Regulation (EU) No 1095/2010 on the European Securities and Markets Authority (ESMA).

26. These Regulations (along with Regulation (EU) No 1092/2010 of the European Parliament and of the Council establishing a European Systemic Risk Board (ESRB), and Regulation (EU) No 1096/2010 of the Council conferring specific tasks upon the ECB concerning the functioning of the ESRB) converted the proposals of the 2009 de Larosière Report into rules. The three Authorities succeeded and replaced the three 'Lamfalussy Committees' (*i.e*. CEBS, CESR and CEIOPS), maintaining the 'sectoral approach' with regard to European institutional arrangements on micro-prudential financial supervision. The tone is set in recital 8 of each of the establishing Regulations, which stresses the need to upgrade the role of the Lamfalussy Committees, since: *"the Union has reached the limits of what can be done within their context."*

27. According to the provisions of Articles 10-15 of these Regulations, the Authorities have the power to elaborate draft regulatory and implementing technical standards, then submit them to the European Commission for endorsement through the issuance of delegated and implementing acts. This solution was evidently adopted for both categories of technical standards, because Authorities do not have the power to issue legally binding acts. Such a power could only be conferred upon them by amendment of the TFEU, which was not an option. According to the applicable institutional framework of the EU, the legally binding nature of these technical standards was ensured through the endorsement by the Commission of the drafts developed by the Authorities (in the legal form of Commission Regulations and Directives).

28. The Authorities can also adopt acts of soft law, in the form of guidelines and recommendations (Article 16), for the consistent application of EU financial law across Member States.

29. Overall, the new legislative process enables the adoption of rules by EU institutions with the more active involvement of supervisory authorities, through the three Authorities which *de facto* have a definitely superior technical knowledge of the subject-matters. For an overview of the legislative process applied to financial law, see below Table 2.

B. Interconnections, overlaps and gaps in the regulatory agenda

Question 7:

30. In principle, the new EU financial framework is totally consistent. An inefficiency in terms of overlapping could be identified in the reporting framework, which definitely requires improvement.

31. As already mentioned under *Question 3*, financial actors are confronted with a heavy regulatory burden, in terms of both systems and procedures, and (any other) cost. This is a result of the overall agenda which they have to comply with. The type of business model is decisive on this. Obviously, institutions and groups operating according to the universal banking model are more heavily affected. The same applies to systemically important financial institutions, which are the addressees of rules specifically designated for them.

Question 8:

32. The new EU financial framework is too recent to need any immediate revision. Nevertheless, developments in the relevant international agenda must be constantly kept 'under close watch'.

33. In several legal acts the Commission has been given a review mandate. It is up to it to table proposals for review with a view to allowing financial actors and consumers of financial services to position themselves appropriately. Short-notice consultations and hasty revisions are not consistent with efficient decision-making.

34. A regulatory pause would be desirable to the extent that compliance with the provisions of all the legal acts of the new EU financial framework requires some time for absorption. This is one of the most legitimate requests posed by the financial industry.

Question 9:

35. In the author's view, an area in need of immediate reform is the winding-up of credit institutions. Credit institutions' winding-up proceedings in the EU fall within Member State competence. Directive 2001/24/EC of the European Parliament and of the Council, which governs both the reorganisation and the winding-up of credit institutions, did not even provide for a minimum level of harmonisation of national reorganisation measures and winding-up proceedings, having only introduced the principle of mutual recognition of such measures and provisions.

36. The discussions on the creation of the EBU did not touch upon the prospect of changing this regime. Accordingly:

- credit institutions' winding-up proceedings will remain national, at least in the foreseeable future,
- also activating the repayment procedure of national deposit guarantee schemes according to both Directive 94/19/EC, still in force, and the DGDS (which will apply by July 2015).

37. Another reform issue is the *direct recapitalisation* of credit institutions faced with insolvency (albeit viable according to the evaluation of supervisory authorities) by means of the European Stability Mechanism (ESM), thus curbing the public debt of Member States in which such credit institutions are incorporated. Under the applicable regime, the ESM may provide financial assistance to euro area Member States for the purpose of bank recapitalisation, albeit indirectly. On 10 June 2014, however, the euro area Member States reached a preliminary agreement on a new instrument, the 'ESM Direct Recapitalisation Instrument' (DRI). The DRI will be available mainly to systemically relevant credit institutions that are unable to meet the capital requirements established by the ECB in its capacity as single supervisor within the SSM, and obtain sufficient capital from private sources.

Question 11:

38. The compliance costs imposed on financial actors (including the heavy cost of raising substantial amounts of own funds to meet the new capital adequacy requirements) under the

new EU financial framework will inevitably have a negative impact on the pricing of the financial services they provide (mainly in lending and capital markets transactions), no matter how much of the regulatory cost will be internalised by the actors themselves (to the detriment of their shareholders in this case). Accordingly, in the presence of differences in regulatory costs between the EU and other international financial centres, a significant part of financial activity will tend to migrate outside the EU (if it has not already done so). This makes an even stronger case for enhanced international cooperation and coordination, placing it very high on the agenda of EU institutions and bodies in the context of their international discussions.

C. The EU Single Rulebook and the consequences for the Single Market

Question 12:

39. As already mentioned under *Question 1*, the new EU framework pertaining to the regulation, supervision and oversight of financial firms, markets and infrastructures is more robust in terms of institutions, rule-making and rules than the pre-2008 framework. Inevitably, a by-product of this was the transfer of considerable powers from Member States to EU institutions and bodies, within the institutional framework set by the Treaties and especially the TFEU (a notable exception being the SRF, which is based on an Intergovernmental Agreement, due to the lack of a legal basis in the TFEU). For the most part, this new framework applies to all 28 EU Member States, with the exception of the rules on the EBU institutions (SSM, SRM, and SRF), which are confined to euro area Member States (unless a Member State with a derogation decides to place its credit institutions under ECB supervision in accordance with the 'close cooperation' procedure under Article 7 of the SSM). *See also below Question 15*.

40. Of particular importance is the work of the EBA, the ESMA and the EIOPA, where national supervisory authorities put to the test the limits of their cooperation abilities. According to Article 1(5) of the establishing Regulations, the objective of these Authorities is *"to protect the public interest by contributing to the short-, medium- and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses."*

41. Even though their main function is regulatory (*see above under Question 5*), these Authorities have been given powers (not available to their predecessors) to ensure that:

- there are mechanisms in place enabling national supervisory authorities to arrive at the best possible supervisory decisions for cross-border financial institutions,
- there is sufficient cooperation and information exchange between national supervisory authorities,
- joint action by national authorities is not hindered by complex regulatory and supervisory requirements in Member States, and
- Member States and national supervisory authorities do not seek national solutions as a response to problems at EU level.

Question 13:

42. The (rather lengthy) answer on Question 5 above indicates that, in the author's view, the legislative process is both efficient and nimble to adjust and calibrate the new Single Rulebook, especially due to the extensive use of delegated acts of the Commission with the active involvement of the EBA, the ESMA and the EIOPA.

43. In his view, if there is a single element of this Rulebook that needs more careful monitoring and review that is the BRRD (Directive 2014/59/EU) and the relevant delegated acts adopted and to be adopted thereunder. This is due to the fact that it is the first time that harmonised rules have been adopted at EU level in the field of recovery and resolution of credit institutions and investment firms, as opposed to the fields of authorisation, micro-prudential supervision and micro-prudential regulation of credit institutions and investment firms (macro-prudential regulation under the CRR and the CRD IV is obviously another innovative element), as well as deposit guarantee and investor protection schemes, for which a regulatory framework has been in place since the late 1980s and mid-1990s, respectively. Such a monitoring and review should, in particular, take into account:

- the experience from the implementation and enforcement of the rules contained in that Directive (especially those on the bail-in resolution instrument (Articles 43-58), and the partly related write-down of capital instruments (Articles 59-62)), and

- the ongoing work on this subject-area at the international level, and namely the Financial Stability Board ('FSB') Report *"Key Attributes of Effective Resolution Regimes for Financial Institutions"*[57], which was adopted also very recently (in 2011).

Question 15:

44. A 'two-speed approach' to regulation is, in the author's opinion, not a major issue, since the majority of the rules of the new EU financial framework, and definitely those on the single market, apply to all 28 Member States. It arises only with regard to:

- micro-prudential supervision, to the extent that the SSM Regulation applies in principle only to 'participating' Member States (*i.e*. those whose currency is the euro), and

- resolution as regards the application of the SRM and the SRF (but not of the BRRD).

45. Again, an inconsistency problem arises only to the extent that all legal acts of the new EU financial framework contain national discretions to be used either by all of the 28 Member States, when transposing EU Directives into their national legislation, and by their supervisory, resolution or other designated authorities according to specific provisions of Directives and Regulations. It is then up to the EBA, the ESMA and the EIOPA to ensure that EU financial law is implemented in a uniform manner across all Member States through its technical standards and its soft law instruments.

[57] The Report, dated 4 November 2011, is available at: http://www.financialstabilityboard.org/publications/r_111104cc.htm.

Acronyms used in the text

BRRD	Bank Recovery and Resolution Directive *(2014/59/EU)*
CRD IV	Capital Requirements Directive no IV *(2013/36/EU)*
CRR	Capital Requirements Regulation *(575/2013)*
DGS	deposit guarantee scheme
DRI	Direct Recapitalisation Instrument
EBA	European Banking Authority
EBU	European Banking Union
ECB	European Central Bank
ESFS	European System of Financial Supervision
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FSB	Financial Stability Board
IADI	International Association of Deposit Insurers
IOSCO	International Organisation of Securities Commissions
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union

TABLE 1

The key legal sources of the three main pillars the European Banking Union

	Prudential supervision and regulation of credit institutions	**Resolution of non-viable credit institutions**	**Deposit guarantee schemes**
European 'Single Mechanisms'	Single Supervisory Mechanism: • Council Regulation (EU) 1024/2013 ('SSM Regulation') • ECB Regulation (EU) 468/2014 ('SSM Framework Regulation') • other ECB legal acts	Single Resolution Mechanism and Fund: • Regulation (EU) 806/2014 of the European Parliament and of the Council ('SRM Regulation'), and Commission delegated and implementing acts • Intergovernmental Agreement (2014)	No initiatives as yet
Harmonisation of substantive rules ('single rulebook')	• Regulation (EU) 575/2013 of the European Parliament and of the Council (CRR), and Commission delegated and implementing acts • Directive 2013/36/EU of the European Parliament and of the Council (CRD IV), and Commission delegated and implementing	• Directive 2014/59/EU of the European Parliament and of the Council (BRRD), and Commission delegated and implementing acts	• Directive 2014/49/EU of the European Parliament and of the Council (DGSD), and a Commission delegated act

	Prudential supervision and regulation of credit institutions	**Resolution of non-viable credit institutions**	**Deposit guarantee schemes**
	acts		

TABLE 2

Procedure for the adoption of legal acts which constitute the sources of European financial law

	Level 1 (*): **legally binding acts**	**Level 2 (*):** **legally binding acts**		**Level 3 (*):** **non-legally binding acts (soft law)**
Type of legal act	Legislative acts falling within the Authorities' scope of action (Article 289 TFEU)	Regulatory technical standards by means of delegated acts (Article 290 TFEU)	Implementing technical standards by means of implementing acts (Article 291 TFEU)	Guidelines and recommendations (Regulations establishing the Authorities)
Body issuing the legal act	European Parliament and Council (with the ordinary legislative procedure)	European Commission	European Commission	**EBA/ESMA/EIOPA** (according to the scope of action)
Assistance to the issuing of a legal act	EBC/ESC/EIOPC (**) (as advisory committees) **EBA/ESMA/EIOPA** (as opinion-giving bodies)	**EBA/ESMA/EIOPA** (elaborating draft technical standards)	**EBA/ESMA/EIOPA** (elaborating draft technical standards) EBC/ESC/EIOPC (as regulatory committees) **(***)**	

(*) Reference to these "three levels" depicts the wording that was used (without any explicit legal basis) in the Lamfalussy Report

(**) European Banking Committee, European Securities Committee, European Insurance and Occupational Pensions Committee

(***) According to the comitology procedure (Regulation (EU) No 182/2011).

30 September 2014

HM Treasury- Oral evidence (QQ 270- 289)

Evidence Session No. 17 *Heard in Public* *Questions 270 - 289*

TUESDAY 4 NOVEMBER 2014

3 pm

Members present

Lord Harrison (Chairman)
Lord Balfe
Earl of Caithness
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Lord Boswell of Aynho

Examination of Witnesses

Andrea Leadsom MP, Economic Secretary to the Treasury, and **Katharine Braddick**, Director, Financial Services, HM Treasury

Q270 The Chairman: Andrea Leadsom, welcome to the Committee, and welcome also to Katharine Braddick, who is sitting next to you. I think that you will see some familiar faces among our Committee. We have Lord Boswell with us this afternoon. He is a fellow Northamptonshire colleague of yours.

I am bound to say that we are quite exhausted, having come to the end of this long investigation into the new supervisory structures as they have emerged in Brussels. You are very welcome as our final witness on behalf of the Government. We will send you a transcript of our exchanges and I would be grateful if you could correct it and add anything further that you think it would be useful for the Committee to know in its attempt to produce a constructive report which we hope to publish in the new year. As ever, we are being webcast.

When we get on to the substance of what we seek this afternoon, I shall ask you if you wish to make an opening address. In the meantime, given the potency of the EU budget, I believe that you have been advised that we are eager to ask you for an update on what has been the subject of great general interest. At the end of October we wrote to the Financial Secretary to the Treasury, David Gauke, who Lord Boswell and I also met last week, to ask for urgent clarification of the Commission request to pay an extra €2.1 billion into the EU budget by 1 December 2014. While we appreciate that you are not David Gauke, we are keen to have an update. By what means has this calculation been arrived at, and when was HM Treasury aware of the scale of the request?

Andrea Leadsom MP: Thank you. I am delighted to be here, particularly in the presence of my former honourable friend Tim Boswell, who is a non-voting constituent. I am pleased to be given the opportunity to be the last, but hopefully not the least, of your witnesses. However, on this particular question, I suspect that I will disappoint you on the grounds that I have no insight to provide. The FST is with the Treasury Committee, and I understand that he will update that Committee with the latest information. Essentially, the Commission itself said in its press release on 24 October that, "This year, member States were informed of the budgetary impact of the new data on 17 October". This was done at a junior-level meeting and it was not possible to know the net budgetary impact prior to that date. There has been a lot of talk that the ONS

should have, would have and could have known it and that HMT officials could have or should have, but the reality is that it was a very recent fact that came to light. As you will know, the Chancellor is meeting EU Finance Ministers this Friday to discuss what is to be done. However, the Prime Minister has made clear that he does not intend to pay this sum by 1 December and that he intends to challenge it and to require a full assessment of why it is due.

Q271 The Chairman: Let us therefore turn to the main body of the questions today on the European Union financial regulatory framework as it has developed since the crisis of 2007-08. I would ask you to reflect on the changes that have taken place and the responses to them, and what you think of their worth. Further, do you think that the framework puts the European Union in a position to resist any future asymmetric shocks while at the same time providing enough flexibility to be able to respond to the challenges that will undoubtedly arise in the future?

Andrea Leadsom MP: Of course, the essential question is whether the EU has done enough or too much, whether it is well co-ordinated, and whether more could be done. Moreover, the framework has not yet bedded down, so there are all sorts of questions that we all continue to ask and are not yet able to answer. Nevertheless, just by way of setting the scene, as you will know there have been more than 40 new proposals on financial services in the course of the Barnier term as head of financial services in the EU, which on the face of it would seem to be somewhat absurd. But then that was the Commission that spanned the worst financial crisis in history, so it was imperative that the EU should act collectively, quickly and decisively to shore up the financial system and make efforts to ensure that we never have to face such a situation again.

Much of the initial momentum for legislation came from an international push for a stable, safe and globally regulated system, and the UK has certainly played a significant leadership role in establishing that. Indeed, even if the UK had not been a member of the EU, many of these reforms would still have taken place.

There have been some significant benefits: an increase in transparency, a more level playing field across the EU for financial players, the tools to end the adverse relationship between sovereigns and banks so as to ensure that taxpayers never again have to line up and bail out the banks, and a more stable financial system. So it was fast, there was a lot of it, and the speed of the action taken along with the complexity of the issues means that without any doubt there are some unintended consequences. The regulation will need to be refined as our experience of working with it grows.

At times our Government have had to fight hard to make sure that we obtained good outcomes on major EU legislation. An example would be that of making sure that the tools for resolving EU banks are credible and closely aligned with our own banking format, thus making sure that banking union develops in a way that works not just for the eurozone but for the UK and other non-euro members—and particularly removes any recourse to the UK taxpayer with regard to any future failed EU banks.

We built an alliance to reject the proposed bonus cap for UCITS fund managers, secured flexibility for the UK to implement its own macroprudential regime within the scope of the CRD IV proposal, fought for British insurers by achieving capital relief for them on holding assets against long-term liabilities through the EU Solvency II directive, and exempt British pensions from new rules on disclosure for investment products.

Those are just a few examples of areas where we have successfully fought to protect UK interests within the EU, and we have fought even stronger battles where we thought that the EU legislation was at odds with the treaties, such as on the financial transaction tax, the location of clearing houses policy and, of course, the bonus cap.

Nevertheless, in spite of the battles and the robust discussions, the EU single market remains a key asset for financial services right across the UK, with firms establishing themselves in the UK stating that access to the EU single market is a key reason for doing so.

Going forward, we have to ensure that financial services work in the interests of all citizens and businesses in Europe, so we are really keen both in the UK and in the EU to promote competition and choice and to improve access to finance. We see as a huge opportunity President Juncker's proposal for a single capital markets union, although I prefer to call it a single market for capital. If I interchange those terms, the Committee will understand why. I see it as a growth and jobs agenda, not as a kind of "regulate and shut down" agenda. There is huge potential to come from that. So I welcome the Committee's review into regulation and I am happy to answer any questions.

The Chairman: I welcome what you said at the end of your remarks about capital markets union. It may be of interest to you to learn that the Committee has decided, in its dying months, to ask Jonathan Hill to come before us in January, and indeed we hope to do some work on capital markets union. We see the tremendous potential there and we would like to exploit that.

Q272 Lord Shutt of Greetland: Good afternoon. As far as the overall policy direction of the reforms at the global, European and national level is concerned, do you think they are about right or otherwise? Do you think that we are now at the point where the European Union financial regulatory regime has intensified to the point that any further reforms are likely to have a prejudicial effect on the markets?

Andrea Leadsom MP: The year 2008 represented the worst financial shock ever and so, as I mentioned in my opening remarks, there was a great deal of activity at the G20 level, at the Basel III level, at the Financial Stability Board level and at the EU level. Much of the regulatory change has not actually been implemented and thus will not be up and running for a while yet. I completely understand the implication of your question as to whether there is overlap and excessive regulation, but we will know that only in the fullness of time. It is something that we are very aware of. We are trying to create successful, solvent banks that do not need to have

recourse to the taxpayer, not unsuccessful banks. The key to doing that is appropriate regulation that is consistent and allows for mutual regard so that we do not add layer upon layer because the EU wants something this way and the G20 wants it the other way. Whether we have got it all right will become clear to us only in the fullness of time. On balance, we think that many of the necessary measures around capital liquidity, bail-ins and so on are the right things to be doing, but the implementation period, which will be from last year right through to the end of the decade, will give us a much clearer idea of whether it is too much or too duplicative in nature.

Lord Shutt of Greetland: As far as you are aware at the moment, is there any unhappiness from your point of view?

Andrea Leadsom MP: There are individual issues. I have made particular complaints about the costs of certain proposed regulations. One that springs to mind is the mortgage credit directive, where in the UK the argument is that it adds costs to mortgage offerers but does not really benefit them at all because we have already pretty much met the principles of the directive. There are certain areas I would argue with, and I could give the Committee a long list of them, but in general and at a broad level, the regulatory change was necessary and we have made great strides.

The Chairman: On the question of the costs associated with all these changes, which is of great interest to Lord Hamilton, if you do indeed have a list beyond the mortgage credit directive and investigation, we would be pleased to have it. That is something that we are trying to nail down in this report. Do feel free to invite Katharine to amplify your answers if she would like to contribute.

Katharine Braddick: We can certainly supply you with a fuller list. The other example that springs to mind is the AIFMD legislation, which imposes considerable, and in our view disproportionate, costs, given the investor protection requirements for what are essentially professional investors. That is another example of where we estimate the costs to be high.

The Chairman: The number of times we have had ringing "hear, hear"s from Lord Flight when a witness has said "AIFMD" could not be counted.

Q273 Lord Kerr of Kinlochard: Following on from what you have just said, Minister, how do you assess the balance between going back to the legislation that has just been passed and improving it, and allowing for a period of calm during which operators are not required to change the arrangements they have just made? Written evidence submitted to this inquiry is very interesting on this point. Almost everyone calls for a period of calm, but they go on to make a point that is particular to their sector of the market where they think that some reform would be desirable. How do you measure that?

Andrea Leadsom MP: My heart says that we should have a period of calm, because even if a bad piece of legislation has been agreed and implemented, it is yet more painful and expensive to undo it. As a principle, I would say that we should head for a period of calm so as to allow some of the regulation that has already been agreed to take effect. On the other hand, I recognise that when we see something that is glaringly appalling, we feel a desperate human urge to do something about it. That is probably not a terribly useful answer.

In terms of the big picture, MiFID and the bank recovery and resolution directive are big areas with enormous implications for competitiveness, bank systems and so on and ought to have time to bed down. But there may be other measures where tweaks could be beneficial and would outweigh the pain caused by a change of mind.

Lord Kerr of Kinlochard: If we take the example of AIFMD—I ought to declare an interest as a director of an investment trust—investment trusts have been required to make quite a lot of expensive changes that were not necessarily all absolutely essential. It is clear that they would prefer a simplification. AIFMD was one of the earliest and perhaps least coherent of these pieces of legislation. Are you in favour of a review or a period of calm?

Andrea Leadsom MP: On that issue, the very interesting statistic, although it does not completely match AIFMD, is that 80% of EU hedge fund management and 70% of EU private equity management takes place in the UK. You could use that as a proxy to demonstrate that a significant majority of those affected by AIFMD are operating or are involved in the UK. In a sense it therefore disproportionately affects the UK.

However, this may be one that needs to bed down for a period and then be reviewed in the fullness of time. If I were to criticise EU regulation and legislation, it would be on the basis of a failure to look at post-impact assessments properly, to do thorough post-implementation reviews and then to think again about whether something should live on because of the pain of undoing it or whether it is one where we say, "We have made a mistake and we should go back to it". It is certainly something that the EU should look at. As an individual, I am definitely in favour of subsidiarity, so in a situation where it is clear that one member state is overwhelmingly dominant in a sector, I would say that there is a strong case for subsidiarity rather than 28-member state legislation.

The Chairman: Before I invite Lord Boswell to ask a question, I do not know whether other colleagues are having difficulty hearing the Minister.

Q274 Lord Boswell of Aynho: Thank you, Chairman. I am no expert on the evidence that this Committee is gathering, so I am acting as a sort of non-exec for this purpose. Could you comment on what always worries me in the social sciences as against the physical sciences, which is the absence of having a strain gauge and thus the sense that you can tell when something has not worked if it blows up? Equally, you cannot easily see the negative as to whether something has been overprovided for in terms of regulation. With that in mind, given the extent to which there is active in-course evaluation both in the Treasury and the national regulatory framework

and within the European institutions, one has the sense that this is not simply a response to a crisis but an actively developing programme of working out what a proportionate response is.

Andrea Leadsom MP: That is an absolutely key point. One of the main challenges I would level at the European Commission is to improve its impact assessments and consultations. One of the calls that we make regularly to the Commission is for it to publish draft impact assessments. What we have observed is that sometimes the officials just plain get it wrong. That may be simply because generalist civil servants are employed in a particularly technical area rather than financial market specialists, or indeed for any number of reasons. But the impact assessment will come out with glaringly wrong bits in it. Publishing a draft would give industry the opportunity to say, "That is not correct. This is not the right impact". Consultation at that level would be an improvement, as would an impact assessment following a period of implementation to make sure that the regulation is in fact serving the purpose it was intended for.

I would add that the other call that we make is for taking a holistic look at EU legislation. One area we are quite concerned about is that of securitisation, where we can see that proper securitisation markets that are supported and regulated appropriately could mean a big boost to access to finance across the European Union and thus get us away from an overdependence on bank finance. Yet securitisation is treated differently across different pieces of EU legislation. We would like to see an attempt to ensure that legislation is internally consistent as well as consistent in the way it treats different aspects of the financial markets.

The Chairman: Before I bring in Lord Dear to pursue the question of impact assessments, I call Lord Hamilton.

Q275 Lord Hamilton of Epsom: I should like to pursue the question of cost. Douglas Flint of HSBC in giving evidence to us said that the cost of splitting HSBC between its investment bank and its clearing bank was something like £2 billion. The problem with all this regulation is that it is

not a free lunch, and I am sure that the Minister would be the first to accept that. We are now reaching a stage where it is almost impossible for a new entrant to come into the fund management business because the costs of compliance are so high. What is actually happening in fund management as we speak is that many firms are now just consolidating with the smaller players being swallowed up by the big ones. That is not healthy either for competition or for the consumer. Does the road that all this compliance and regulation is leading us down not worry you?

Andrea Leadsom MP: Yes, absolutely it does. There are two parts to your question: one is the cost to banks of ring-fencing and the other is new entrants into the fund management market. On the banking side, the decision was taken that a very fundamental, far-reaching means to achieve a position where never again would the taxpayer have to bail out a bank would be achieved through ring-fencing. It would protect the retail customer from the investment bank. Notwithstanding the fact that Douglas Flint has made these points to me as well, ring-fencing is an area where, having done it for better or worse, you would not then unpick it a couple of years down the line. In our negotiations with the European Union on bank structural reform, which is its equivalent to our ring-fencing, we are keen to ensure that we do not change or unpick UK reforms a little further down the line. That is a very important point.

On banking, we have bent over backwards to improve choice in the sector. We have had reviews of the regulators to make it much easier for a new bank to start up. The liquidity and capital requirements have been loosened to reflect the fact that challenger banks are not systemic and so on. In fact, when I came into Parliament in 2010, Metro Bank was the first full service bank to be given a banking licence in 100 years, but now some 25 new banks are talking to the PRA about getting a banking licence. We have made great strides in getting new entrants into the market and we have done a lot on account switching and so on to try to improve competition in the banking

world. The funds management area is obviously a very different matter. To be honest, I have not had as many inputs from the industry on funds management. It has not been raised with me as a significant issue, particularly not in the context of EU regulation, but it is certainly something I would be interested to know more about. As things stand, however, I do not really have a view.

Lord Hamilton of Epsom: Can I come back on Douglas Flint? He said that not only has it cost HSBC £2 billion to set up the ring-fence but there are also continuing costs year on year. Would it not have been better to have grasped the nettle and gone for Glass-Steagall and thus completely split the two? You would still have the upfront costs but there would be no ongoing ones, and it really would protect the taxpayer from bailing these organisations out if they get involved in casino banking.

Andrea Leadsom MP: The obvious point to make is that there is nothing to stop Douglas Flint from splitting HSBC into an investment bank and a retail bank if he wants to do so. In that sense, ring-fencing stops short of Glass-Steagall. I certainly remember from when I was on the Treasury Select Committee that we agonised over this, as I am sure you have. It is an academic discussion. If you split into an investment bank and a retail bank, do you end up with a form of gaming at the edges? Do you unfairly reduce liquidity for the markets, do you stifle innovation, and do you prevent your retailers from accessing interest rate swaps, foreign exchange hedging and so on? As I say, it is an academic discussion. Based on the evidence of the Parliamentary Commission on Banking Standards in which your Lordships were also involved, we came down on the side that ring-fencing was the right place to be. I can only say again that the banks that have chosen to go along with that rather than split must consider that it is in their interests to keep the group together. I can point to one area where it is clearly in their interests, which is that they can still group for VAT purposes. Is that right, Katharine?

Katharine Braddick: Yes.

Andrea Leadsom MP: That is just one example off the top of my head of the advantage of keeping a group together.

The Chairman: I am anxious for Lord Dear to put his question, but it would be useful if you could write us a letter in which you might want to sweep up some of the comments that we have not had time for. The Committee is anxious about engagement with the industry, because these are issues that have been raised with you by this business sector and the players in it. They are particular and peculiar to the inquiry.

Q276 Lord Dear: Good afternoon. My question goes back in part to the question put to you by Lord Boswell. It is about the EU legislative process and your assessment of how effective it has been over the recent years of the crisis. Could you highlight what you think about the performance of the Commission, the European Parliament and the Council? It would help if in that answer you could tell us what you think about the impact assessments and the consultations that the Commission has put into place. Do you think they are sufficiently rigorous and effective?

Andrea Leadsom MP: I need to keep coming back to the fact that the 2008 crisis was enormous and overwhelming. A great number of steps needed to be taken. A great number of the steps taken at EU level reflect the steps that are also being taken G20 level, Basel III level and Financial Stability Board level. In a sense, a lot of activity was driven by the global desire to avoid a repeat. This was done with some urgency—as we know, in 2011 the eurozone had its own sovereign debt crisis, which kicked it when it was down—so a lot of the measures were brought in in haste and not in a business-as-usual sense. With that as the background, I would say that the impact assessments have not always been as good as they should be and there has not been wide enough consultation. In some cases, there is evidence that some of the assertions by the Commission are just plain wrong. We have had to work quite hard, as I said in my opening remarks, to protect the

UK's interests. I must say that we have been quite successful in that, so I would not say that we have always been beating our heads against the wall.

Nevertheless, on impact assessments, just to give you one particular example, in the case of the Institutions for Occupational Retirement Provision proposal, the Commission's impact assessment twice failed to get the approval of its own assessment board, let alone anyone else's. So there are examples—they are not small; they are quite significant—where impact assessment has not been good enough. As I say, our position is that we would like to see draft impact assessments published so that people can point out glaring inaccuracies or omissions, as well as a post-legislation impact assessment, so that we can see what the result is. Certainly, my hope is that we allow things to settle and do not keep going round and that we achieve some consistency across all measures.

The Chairman: Minister, I am anxious that you reply to Lord Dear's inquiry about the legislative process and whether you think that it was successful with the European Parliament and with the Council, where of course our Government were represented, as well as with the Commission.

Lord Dear: As a supplementary, I was going to say, perhaps not unkindly, that in the early stages of 2008-10 we were all deafened by the sound of stable doors being slammed shut after the horse had bolted. One can understand that the initial response may well not have been quite accurate at that time. The point that the Lord Chairman has made would be my point, too: having now had the passage of time and the opportunity to see that maybe things were not quite right in the initial response, are you satisfied now that the response is correct and that it will be continued in that correct mode?

Andrea Leadsom MP: We are still in the middle of a number of directives being completed and implemented, so it will be difficult to know potentially for two or three years the full implications of whether industry fears are founded or unfounded and whether criticisms that this piece of

regulation does not work with that one are founded or unfounded. I do not think at this stage that we can really say for sure that the measures that have been taken and that are still in the pipeline are exactly spot on or whether they need to be adjusted in the fullness of time. Specifically on the effectiveness of the Council, the Parliament and the Commission, it is true to say that, since the Lisbon treaty of 2009, the co-decision role has increased significantly, so a lot of adjustments have had to be made within each of those institutions.

There have been complexities, which are teething issues. Each institution has a different purpose and different expertise and you could therefore argue that they are effective in different ways. The Council is trying to ensure that the specific requirements of national markets are understood and taken into account. The Commission is supposed to be neutral in developing the legislation but, as I think I have made clear, it lacks expertise, it has acted too far, too fast, it has not consulted widely enough and it has not assessed the impact well enough in cases. I think that I have apologised for it enough, so that is where I leave it: the Commission has work to do.

The Parliament has brought in a distinctly political angle. On issues such as the bonus cap under CRD IV, we are now fighting it and challenging it through the courts. So the European Parliament has had its part to play and, of course, those three institutions do not always work seamlessly or smoothly together.

The Chairman: Do you not want to recognise the role of Sharon Bowles, for instance, in the relevant committee of the European Parliament, setting aside the question of the bonuses? I think it was widely recognised by our witnesses that she and her colleagues played a very constructive and useful role. Lord Kerr, would you like to come in here?

Q277 Lord Kerr of Kinlochard: My question is on the same theme. The Commission published and the Council discussed the future work programme. When it is clear that there is a plan for a piece of legislation, perhaps in answer to a G20 or G8 agreement or to pressure from

the Council, these drafts would be prepared and the impact assessments would be prepared by officials in the Commission who were supervised by a very senior British official in the Commission, the Director-General. When the Parliament was considering amendments, the committee that was considering those amendments was chaired by a senior British Member of the European Parliament, from one of the parties in the coalition. Some of the evidence that we heard, in particular from the Venture Capital Association and from the BBA, suggests that the Government could have been a bit more proactive and that the Government tended to react. You can get ahead of the curve when you know that something is being drafted or that the Committee in the Parliament is thinking of amending it.

I am slightly concerned that you have referred a couple of times to "our negotiations with the EU". We are still in the EU. You have an absolute right, if someone is drafting an impact assessment, to send your experts to see that person and to provide the evidence. You do not have to wait and then complain. I am uneasy. We seem to be in a slightly defensive mode here, and since financial services are par excellence the issue on which we have the greatest expertise and in which we have the greatest interests, I wonder whether we should not be a bit more proactive.

Andrea Leadsom MP: I apologise if I have sounded defensive. That is certainly not the case. In fact, I specifically asked my officials yesterday to give me the exact numbers on HMT, FCA and PRA/Bank of England staff who are currently seconded to the institutions. I can tell you that we have 14 officials in the Commission on secondment, three in the EBA, six in ESMA, one in EIOPA, two in the ECB and a further one in the ESRB—27 officials in total. In addition, from the UK regulators, 74 FCA officials participate in the ESA committees. Added to that, I should pay tribute to the excellent work of MEPs—not just the British ones looking after our interests, but MEPs right across all parties and all member states who work with us and think, "Yes, you've got a

point, so we'll support you in that". I certainly do not wish to suggest in any sense that we are on the sidelines. We are very much plugged in.

I have been in this post for seven months and I am very impressed with the quality of the analysis by my officials of any directive that is coming our way. The options that we have both from a negotiating stance, as in, "This is what makes sense", and from a doability stance, as in, "This, this and this member state might side with us and, if not, there's no point doing that, so we might want to think about doing this", are all incredibly important. One of the big advantages of having a new Commission with a very clear focus on a capital markets union is that that should take the whole financial services portfolio, which is the bit that I am interested in, to a whole new level, in the sense of being pro-jobs, pro-growth, anti-excessive regulation, pro-single market, pro-free trade agreements and pro-implementing the single services directive that we all signed up to years ago. My ambition is to work with Jonathan Hill and with MEPs across countries to ensure that that is what we do. My apologies if I have been defensive or disengaged, as that is not my intention at all. I think that the questions that I have had have tended to be, "How badly is it going?". In answer to "How well could it go?", I can be very much more positive.

Q278 The Chairman: The Committee is very grateful for your numbers on the British personnel, but I refer you to the important and sound report by the British Bankers' Association on the fact that we still are underplaying our representation in Brussels—4% as opposed to 12.5%.

Katharine Braddick: It might be helpful to make some observations about how the Treasury engages at official level with European legislation. I am currently seconded to the Treasury from the Bank of England, so I can comment on the PRA engagement as well. I would say that the Treasury invests in this precisely because in order to have influence you need to be present in discussions with the Commission absolutely from the outset. We invest an enormous amount at

the working level and all the way up to the most senior levels of the Treasury in relationships with the Commission, as well as with MEPs. The regulators are effective at providing neutral briefing to MEPs. It is quite rare to be able to provide technically coherent briefing in English on financial services, but this enables the regulators to brief the MEPs so that they can engage effectively. As the Minister explained, we have about 14 officials seconded at this time to European institutions. The FCA has about 75 people actively engaged in policymaking. In the ESAs, there is a comparable number from the PRA, if not more. I would say that we are alive to the importance of early, frequent and, if you like, soft engagement on important issues in order to get influence.

Lord Balfe: I just want to follow up this issue about engagement with MEPs. When the Committee took evidence from Richard Ashworth, he specifically said that it was difficult to relate to the Treasury. Indeed, David Gauke says in his letter, dated 3 November, that it is regrettable that Mr Ashworth and the Committee feel that they have experienced difficulty in their engagement with the Government on the EU budget.

The Chairman: Perhaps I should advise the Minister that when we were in Brussels in September we also looked at the budget question, not only with Richard Ashworth but with the new chair of the Committee on Budgetary Control and the new chair of the Committee on Budgets. Perhaps you would like to comment on that.

Lord Balfe: They said that it was difficult to relate to the Treasury, not on a specific issue.

Andrea Leadsom MP: To Treasury officials or to Treasury Ministers? Was he specific about that?

Lord Balfe: I think it was the officials.

The Chairman: I think it was generic.

Andrea Leadsom MP: I can tell you that I am off to Brussels on Monday and I am planning to be there every few weeks. My target is to talk to MEPs and to try to promote the UK's interests and

an understanding of where we want to see capital markets union going, the importance of free trade agreements and so on. It is tricky. I have met Richard Ashworth on many an occasion, but I was not in the Treasury then. Is there anything that you can say, Katharine?

Katharine Braddick: I am afraid that I cannot comment specifically on budget issues because they do not fall within my mandate. I am sorry to learn that an MEP would feel that we are inaccessible in any way. In contradistinction, we have had warm feedback from MEPs on our support as regards MiFID and EMIR where we provided very close engagement. It is worth observing that we have a new Parliament in Europe and that we have to re-establish our relationships. The new Parliament will work differently from the old one. We also have a new College of Commissioners. I suspect that all this will make a difference to the dynamics of these operations.

Lord Balfe: Will you be meeting any of them next week—Richard Ashworth or Kay Swinburne?

Katharine Braddick: I meet MEPs regularly and we have an engagement strategy in place.

Andrea Leadsom MP: Are you coming with me, Katharine?

Katharine Braddick: An official will attend and we are working on the Minister's agenda right now. That agenda absolutely will include MEPs. Also, at the official level we have an ongoing engagement strategy involving us, the Bank and the FCA to ensure that we are all engaging coherently with MEPs.

The Chairman: I can quote from Mr Ashworth: "I find it very difficult to get appointments with the Treasury. I find it very difficult to get them to take the subject seriously". But let us move on to the Earl of Caithness.

Q279 Earl of Caithness: Good afternoon, Minister. Most of my question about looking backwards has been answered, so let us look forward. We have 41 pieces of legislation and you have already highlighted a number of areas of concern while stressing at the same time that much of it has yet to settle down. It is clear that a massive number of problems will emerge from this

indigestible pile of papers that have come out of the European Commission. How are you going to change the workings of the Commission so that it takes on post-implementation review, and how will you make certain that timely reviews are undertaken of existing legislation and regulation so that the market does not stultify and we do not lose jobs to places like Singapore? We will never get them back once they go.

Andrea Leadsom MP: I suspect that the first question on how to change the Commission is slightly above my pay grade. However, if we feel that an impact assessment is not good enough, that it does not address the issues, or that a piece of regulation is not appropriate, we make that very clear. The question of how to fundamentally change the approach of the Commission is a big one. I think that all political parties agree that the Commission needs to be much more outward-focused and less inclined towards navel-gazing, and President Juncker has made it clear that that is his opinion too. A lot of hope is vested in the new Commission. For my part, I would like to see a real intention to reduce regulation and going for exemptions and subsidiarity wherever possible. The Dutch Prime Minister has said, "Europe where necessary, national where possible". That fits into my portfolio of financial services. An example is the current review of the European supervisory authorities. It is important to ensure that the roles within them do not encroach on the roles of the national competent authorities. They should remain strategic systems regulators that improve the single market. They should not start saying to national regulators, "Oh, I quite fancy your job". That is a specific example of an area where we need to push hard to ensure that the regulation going forward is appropriate and additive, not simply something that is done because the authorities are there.

Earl of Caithness: Following up on your last comment, Sir Jon Cunliffe said that in the next five years we have 400 pieces of regulation to come in under the Hill regime.

The Chairman: It will be in the form of secondary legislation.

Earl of Caithness: Yes. Are all those regulations necessary? In particular, do we need further regulation on money market funds, shadow banking, benchmarks and bank structural reform? Should we not just say, "Enough."?

Andrea Leadsom MP: I have a great deal of sympathy with you on that. A very important and positive move has been the appointment of Vice-President Frans Timmermans with responsibility for better regulation. Given what passes across my desk, I struggle to see the point of some of the regulation and I ask, "Why are we doing this?". I want to see us asking what the point of something is at all rather than saying that we will do it but minimise the impact as far as possible. This is imperative right across the EU. Britain is looking like the clever one because our economy is on a more stable footing than many other European economies. They even more than we need to be ruthlessly focused on red tape, increasing job creation and growth, and reducing barriers. The Commission's own assessment states that implementing properly the single market in services would add 3% to GDP across the EU. So simply implementing properly the things we have already agreed to would significantly improve the growth and jobs agenda. We will be focused in everything we do on urging the Commission to look at these issues in the same way.

The Chairman: Minister, can you give a couple of examples like those mentioned by Lord Caithness where we ought perhaps to hesitate?

Andrea Leadsom MP: One that springs to mind—I am struggling to think of its name—is the payment services directive and e-money directive. There is a potential for those two to be merged because they do not look like two unique pieces of legislation. They look like one with two different customer bases, so the amount of legislation could be reduced by merging them. I have already said that we feel that the mortgage credit directive does not really add much for us, although we recognise that it may be beneficial for member states that do not have strong regulation in that area. I should mention the pensions legislation, IORPs, where only four member

states make up virtually all the market for privately funded pensions and number of member states are quite against it.

The Chairman: If you have any other examples, perhaps you could let us know about them in writing.

Q280 Lord Flight: I, and I believe the majority of those who work in the financial services industry, felt that it was a great mistake on the part of Gordon Brown to surrender sovereignty in financial regulation to the EU. How would you respond to evidence given to this inquiry suggesting that the EU often does not have a great deal of knowledge of and expertise in financial products, particularly in how they are distributed and transmitted, and thus may almost inadvertently embark on measures that are damaging to the UK. Again in this territory, I had always understood that a principle operated whereby if something was the main industry of an economy, measures would not be brought in without the consent of that country. Thus you would not do anything damaging to agriculture without France agreeing to it or manufacturing without Germany agreeing. But, again, we have had EMIR, AIFMD, CRD IV and God knows what else is coming that is potentially damaging to our major economic activity in the 400 pieces of secondary legislation over the next five years. As we have lost sovereignty, what can we do better than we do now to stop any further EU measures being disproportionate and damaging to our interests?

Andrea Leadsom MP: I am also a fan of the Luxembourg compromise, and indeed I did ask my officials to give me some headlines. The UK is the largest net exporter of financial services and insurance in the world. In December 2013, UK financial services and insurance accounted for more than 1.1 million jobs, two-thirds of which are outside London. I have already mentioned that 80% of hedge fund management and 70% of private equity management in the EU takes place out of the UK. Moreover, three-quarters of European capital markets and investment banking

revenue are transacted in this country. The UK has the fourth largest banking sector globally and accounts for 41% of global foreign exchange.

The Chairman: Minister, perhaps I may interrupt you. The question Lord Flight asked is about how we can intervene better and more upstream.

Andrea Leadsom MP: I agree with Lord Flight that this industry is vital to the UK and that it is more vital to the UK than it is to any other EU member state. That is by way of background. On what we can do, I agree that a good principle to follow would be that a principal industry in one member state should not be undermined by others. We have a unique problem in the financial services area because of the European Banking Union, where the Chancellor and the Prime Minister sought very clever and timely safeguards with the double majority lock to ensure that regulatory measures could not disadvantage euro outs.

Lord Flight: Only for a while

Andrea Leadsom MP: Indeed, and we need to continue to ensure that the interests of non-euro member states are protected. However, we entirely support the need for the eurozone to protect its currency and take measures that work for its members. When I talk to TheCityUK and other trade bodies, the BBA and to individual banks, they all value very highly their access to the single market. I do not think that I have ever heard a banker say, "I don't want to be in the EU". I have learnt on recent trips to other countries around the world that they are looking to base their European headquarters in London because of, among other things, access to the single market. This is a hand-to-hand issue where we need to negotiate very hard on behalf of the UK's interests on a case-by-case basis. At times we have to put up a challenge in the courts, as we have done in the past, but at other times we just have to argue very loudly, but that does then become a negotiation. While I agree completely that it would be a sensible move on the part of the Commission to respond positively to the crucial importance to the UK of the financial services

sector, as I have just outlined, we need nevertheless to fight our corner, which we will continue to do.

The Chairman: I shall come back to Lord Flight in a moment. Lord Kerr is eager to test you on the double lock.

Q281 Lord Kerr of Kinlochard: Not really, no. I do not know whether to appeal to your head or to your heart, but I agree completely with what you have said. We are approaching the idea of a capital markets union, but none of us yet knows what it means. You talked earlier about securitisation and I profoundly agree with you on that. On venture capital, private equity, insurance and private pensions, I can remember the days when we used to enjoy a huge advantage in EU legislation in sectors of the market where we were dominant. That is because we saw EU legislation as a way of knocking down protectionist barriers elsewhere. For 25 years we talked about selling pensions to the Germans, but we never actually managed to do it. Would it not be wonderful if a capital markets union exercise succeeded in breaking down barriers? I am making the same point I made before about approaching this positively. Lord Flight knows much more about these matters, but he is deeply pessimistic. I am optimistic. He may appeal to your head, but I hope that I appeal to your heart.

Andrea Leadsom MP: I will side with both noble Lords. My head and my heart are in different places, which I assure you can be very uncomfortable at times. The key point to make is that if we simply implemented the single market for services, which I think we signed up for seven or more years ago—all the EU member states have now signed it—that would be fine, but we are still not doing it. I agree completely that in any capital markets union, a single market for capital in my terminology, that would be the first, number one move. Let us sort it out so that professional services and financial services are equally valid in every member state. That is absolutely key.

So too are free trade agreements. I have just been to Singapore and India to look at the potential in those countries. There are huge markets in Islamic finance that remain untapped. We could be doing much more with them if we seized the opportunity to do so. We need private placements weaning borrowers off bank debt so that we do not have such an over-reliance. In Europe we are 70% dependent on bank debt, while in the United States it is 30% to 40%. That is a huge imbalance. Securitisation is a huge opportunity. We need to get the prospectus directive right in order to reduce the costs of listing and raising equity. As I say, there are huge opportunities, but equally I share the concern of Lord Flight that perhaps our ambitions do not lie where others' do. I suspect that that is what will be fully tested in the months and years ahead.

Q282 Lord Flight: I understand that it is in the interests of the Big Four banks and Goldman Sachs to remain within the EU, but when you go below that level, business splits so that it is about 70% international and 30% EU. You will hear different views. Do not believe that the big institutions always speak for the industry as a whole. However, I want to raise the issue of international versus EU and the growing areas of inconsistency. We have been trying to exert our influence to ensure high standards of regulation, but the issue is this. What, if anything, should we be doing—

The Chairman: I am sorry to interrupt you, Lord Flight, but a Division has been called in the House of Commons. Minister, do you need to vote?

Andrea Leadsom MP: Yes, I must go and vote.

The Committee suspended for a Division in the House of Commons.

Andrea Leadsom MP: I am terribly sorry, but another vote will be called quite shortly.

Lord Flight: I hear from the industry that there are global initiatives, US initiatives, European initiatives and glib talk about a level playing field. We have ring-fenced banks while Europe does not. Europe is not doing what it ought to do for Basel. The whole thing is a complete nightmare. I repeat that there is all this glib talk about a level playing field, but it is not a level playing field and it never will be. All we can do is try to knock the edges off as much as possible.

Andrea Leadsom MP: I thought that that was what you would ask about and I agree that there is a real risk of extraterritoriality by different regulators and failures to co-ordinate, along with competitor issues around potential regulatory arbitrage. There are all sorts of potential problems. I am extremely aware of and concerned about all this, and it is something that financial services organisations—I do not want to say "big banks" because as you would expect, I do not only see them—have raised with me. There is a risk of a lack of co-ordination, but following the financial crisis I think that is inevitable. Every regulator at every level has got stuck in, and we have to make sense of it all. Our priorities are to make sure that there is respect for the host regulator with potentially a focus on the home regulator. There needs to be mutual recognition of things like clearing houses; some of those issues must be resolved. There are issues around extraterritoriality where one jurisdiction may impose huge fines that impact on a bank that is domiciled somewhere else. We have seen examples of that. I am extremely conscious of and worried about these issues, and you have definitely highlighted one of the key areas that scrutiny and government need to be highly alert to over the next few years.

The Chairman: My Lords, we need to be clever with the time. Let us see how far the Minister can get with the question from Lord Hamilton.

Q283 Lord Hamilton of Epsom: My question is about growth. The Chancellor has made it quite clear that next year the British economy will be threatened by the lack of growth in the eurozone, and indeed a lot of evidence we have received indicates that it will flat-line for five

years. The problem, as you know, is that the eurozone is a half-cocked affair. It has no centrally elected Government and, critically, it has no Treasury. A whole mass of people in the European Central Bank are controlling inflation, may support sovereign debt and may actually go in and support banks, but no one is responsible for making sure that the eurozone economy grows. That is left to the sovereign states. Are there any levers that could be pulled to make growth happen in the eurozone, because that is as critical to us as it is to its members?

Lord Flight: Abolish the euro.

Andrea Leadsom MP: There are some very radical ones, but I think they might have unintended consequences. That is an example of a regulation that you might wish you had never made, but which you might not row back from at this point, Lord Flight.

Better regulation is absolutely key, and as I said earlier, Frans Timmermans' involvement is important. Free trade agreements are essential for growth. There are huge prospects if we can resolve TTIP, the free trade agreement with the United States, and further prospects in the financial services sector. Within that there would be a recognition of the need not to be extraterritorial, not recognise one another and so on. That is important for resolving these issues.

The Chairman: Like John Betjeman, you have been summoned by bells.

The Committee suspended for a Division in the House of Commons.

The Chairman: Minister, welcome back. Just to remind you that you were half way through replying to the question from Lord Hamilton about growth and productive capacity.

Andrea Leadsom MP: I have referred to better regulation and the Frans Timmermans approach, and free trade agreements are absolutely vital. We need also to implement what we have already signed up to in the single market services directive. The Prime Minister's proposals in the Business

Taskforce to exempt very small businesses from red tape and to revoke a number of different measures are very helpful and we are promoting them. There is a great deal that the EU could do, but I would say that so far it has not done it, and now there is some urgency. The Commission should see everything in scope, including revoking legislation that mitigates against jobs, particularly for young people, but that is outside my portfolio.

Q284 Lord Balfe: I want to turn to the single rulebook and its consequences for the single market. While we have yet to see the full fruits of its enforcement, we are concerned that the ESAs, which play a central role, are under-resourced and could be better equipped to handle their duties. My question is in three parts. First, what do you think the consequences are of the imbalance of power, resources and responsibilities? Secondly, can you give some examples of how the UK has been uploading its supervisory expertise in supporting the ESA? Thirdly, do you think that the UK authorities are appropriately focused on implementation and enforcement and, referring to the earlier question, are they sufficiently resourced to carry out their duties?

Andrea Leadsom MP: The single rulebook is an essential part of the single market and the ESAs are very central as a part of the European infrastructure. Our position is this: what they should do is focus on being system regulators to ensure that the different member states are properly supervising their own financial sectors. That is completely distinct from doing it themselves. The ESAs need to work with the national competent authorities to oversee proper implementation in all member states, but they should not do it themselves. With that in mind, we do not believe that they are significantly under-resourced but that they need to bed down against their own stated priorities. They have a key role in strengthening the quality of regulation and supervision and preventing risks of instability through monitoring sectors. So they have made a lot of progress in developing the single rulebook, but that has been at the expense of the rest of their mandate, in particular supervisory convergence. An enormous amount still needs to be done, but before

considering whether an increase in funding is necessary, it is our view that the ESAs ought first to get on with the right priorities within their remit.

The Chairman: Given that ESMA has a statutory right to intervene, and indeed did so a couple of years back on the short-selling problem, is it the Government's intention to roll back what is already existing legislation?

Andrea Leadsom MP: It is not the proactive intention to do that, but I say again that it is our view that ESAs should exist to oversee at the systems level, not to do the job of national competent authorities. My own view is that our own regulators should be looking at implementation in the UK, but as you rightly point out there are some areas where the ESAs are being given particular powers. I would cite the regulation of exchanges, for example, where they own the college of supervisors.

Katharine Braddick: The ESAs are involved with the colleges and obviously ESMA supervises the CRAs. ESMA has some product-intervention powers under MiFID. In particular with ESMA there is a particular set of powers that are currently quite tightly constrained. That is the Government's strong preference.

The Chairman: We had Verena Ross before us last week.

Lord Hamilton of Epsom: Was short selling a problem?

Andrea Leadsom MP: We believe that short selling is a very legitimate market activity. It should be regulated, but we do not wish to see it being regulated out of existence. We think that there is a valid role for short selling, price discovery, hedging positions and so on.

Lord Hamilton of Epsom: I therefore expect that short selling was not a problem.

Andrea Leadsom MP: It is not a problem in that we support the concept of short selling, yes.

The Chairman: The problem was that they intervened two years ago because there was a worry about stability in general. They do actually have that right.

Andrea Leadsom MP: Exactly.

Q285 Lord Kerr of Kinlochard: Minister, I would like to talk about the link between level one and level two in rule writing. Some of the evidence we have had suggests that the Council and the Parliament are putting far too much detail into the level-one provisions. Evidence in particular from Mr Enria of the European Banking Authority suggests that the Commission is overusing its power to check the rules that emerge from the level two operation. Of course it will take time to bed down and perhaps both of the points are correct and do not matter very much because they will be adjusted in due course. How do you think it is working out between level one and level two?

Andrea Leadsom MP: Again, the issue is one of quality, timeliness and the amount of consultation at level one, but often the deadlines are too tight. That comes back again to the need for ESAs to focus on their priorities and not do too much in too short a period of time because that will result in the level two deadlines being too tight. As you say, they go into high levels of detail. There is a risk with the PRIIPs package that the level two legislation may actually take effect before it is finished, which would be complete nonsense. I agree that there is an issue, and certainly the ESAs need to take control of it. There is an element of it still being early days, and in working on the single rulebook and trying to sort out certain regulatory areas it is understandable that they may have tried to do too much too soon. However, there needs to be a bedding down of the priorities. They need to get their arms around the work that they are required to do, hold better consultations, and perhaps aim for less ambitious regulation and micro-level detail.

An example that we are quite concerned about is in the area of benchmarks. We are concerned about the scope that is entailed in benchmark regulation. It is the view of the UK that this could be harmful to perfectly legitimate benchmarks that do not require an EU-level regulation. They

need to take into account the size of the task and set proper priorities. A proper sequence has to be put in place between level one and level two, which is not the case yet.

Lord Kerr of Kinlochard: The Committee was a bit sceptical about whether there was any need for EU legislation on benchmarks at all, and certainly not if the benchmark in question is not tradable. Would you be happy to see simpler level-one legislation setting out more in the way of principles and less in the way of detail? From what you have said, I think you would be, which suggests that you think it is possible to write the detail successfully in the ESAs. You could say that it is possible to write the sort of legislation that would fit the bill in the EBA, and that that might possibly be easier to do than at level one.

Andrea Leadsom MP: My view is that wherever possible it should be for the national competent authority to make the detailed regulation and that the ESAs should focus on single market rules that ensure that there is a proper level playing field at the EU member level. That is not quite the same as saying that they should never go to a certain level of detail; it is more that the level of detail they go into should be appropriate for a particular area. Benchmarks are a good example of where it is not necessary. There is a case for saying that there should be regulation of key benchmarks that are used at the 28 member state level, but certainly not of those that are used in only one or two member states. You could set principles and allow the national competent authorities to look at the detailed implementation.

Q286 Lord Kerr of Kinlochard: Specifically on banking, as the ECB becomes more powerful and exercises its supervisory responsibilities—in the EBA we of course have the double majority system, while it lasts—the key thing is whether the Bank of England can have a good, private working relationship with the ECB if things go well. Then the legislative structure that we are seeing and its complicated architecture could work. If they do not, either the EBA rules will be written at such a high level of generality as to be fairly meaningless or we will see strain being put

on the majority system as we take a very different view from the ECB with its qualified majority of member states. The key issue is this: is the Bank of England close to the ECB and will it remain close to it? What is your view?

Andrea Leadsom MP: I agree with you that it is an absolutely key risk. The EBA and the ECB obviously have different roles. The ECB is the regulator for the eurozone banks, so it fulfils a similar role to that of the Prudential Regulation Authority. The EBA is developing the single rulebook for the single-market banks. However, there is a risk that the eurozone under the QMV system will start to dominate the priorities of the EBA. This is something we have to be alert to. The double majority lock is the solution we have put in place for the moment, but as Lord Flight pointed out, it may not endure for ever if we become the only non-euro member state. I do not think that that is likely for a very long time yet, but it may not be a final solution. The Chancellor has said that it may be that the institutions themselves need to be looked at again properly. However, it is a significant risk and something that we have to guard against.

Lord Kerr of Kinlochard: Do you think that it is working at the moment? We took evidence from representatives of the Bank of England this morning and they argued that it is working very well.

Andrea Leadsom MP: All the evidence shows that it does work. Another set of fascinating facts from my officials show that 120 banks are directly supervised by the ECB while 157 banks, excluding bank branches, are supervised by the PRA. In total, banking firms and groups subject to the PRA number 1,700. That gives the authority a very good seat at the table.

Q287 Lord Hamilton of Epsom: Following on from that, if the eurozone is going to survive it will have to integrate further. At some stage it will have to mutualise its debt and agree to financial transfers. But it will go on producing regulations using qualified majority voting and we

will have no input into them. The eurozone countries will come to us and say, "This is what is happening and you have to live with it". Is that not a worry?

Andrea Leadsom MP: The safeguards that have been negotiated protect us until such time as we are the only non-euro member state, but that, as I say, is a long way off. There is the double majority lock and a number of other safeguards that were negotiated by the UK. The ECB has a specific duty to have regard to the unity and integrity of the single market even when exercising its role as the single supervisor. It has an obligation to ensure that nothing discriminates against a member state, even if it is a non-euro member. There is an equivalent application of state aid rules to the Single Resolution Fund to make sure that non-euro or non-participating states are not forced to contribute to that.

Finally, clear provisions ensure that the EBA's tasks and powers apply in the same way to the Council, the Commission and the SRB when they perform their tasks under the single resolution mechanism. So there are a number of safeguards, not just the double majority lock, which ensure that the UK's interests as a non-euro member state are protected.

The Chairman: Was that not undermined today by the Chancellor of the Exchequer when he said that the growing influence of the eurozone countries would inevitably mean that decisions are made at the eurozone level? While he applauded what the eurozone is doing in order to remedy the problems and challenges confronting it, there is the reality that what would gradually be usurped would be the role of the single market, and the eurozone would inevitably pronounce, particularly on future legislation.

Andrea Leadsom MP: I do not think he was saying that the single market would be undermined by increasing fiscal or monetary union in the eurozone, but that it is inevitable that as the eurozone countries come closer together they will need to make decisions that help to support their fiscal union. That is in the UK's interests. As we know, our economy is still very dependent

on the rise and fall of the eurozone economy. I do not think he was saying that it would necessarily undermine the single market, but of course as the eurozone countries look at issues that relate to their interests, which may not be the interests of the non-euro member states, we will need to be very alert to ensuring that whatever decisions are taken, they do not damage the UK's interests.

The Chairman: One thing he did say was that the status quo would no longer be acceptable to the United Kingdom. Before I bring Lord Hamilton back, what ideas does the Chancellor have for making changes so as to ensure that the United Kingdom is not embarrassed by the developments that he himself has identified? Moreover, he has identified them as worthy objectives.

Andrea Leadsom MP: I cannot speak for the Chancellor; you would have to ask him directly. My own view is that there is a significant risk that the eurozone will start to caucus against non-euro member states. We will have to be extremely alert to that and push back using the safeguards I have outlined. There are very clear and distinct obligations on the European institutions not to caucus against us. That will mean more feisty arguments and even potentially going more often to the European Court for decisions—and we may lose some of them. I think that the Chancellor's view is one that is shared by many Conservatives, which is that we need a reformed Europe. But that would not be a Government intention right now. The Government are obviously a coalition and no significant reforms are intended during the remaining months of this Administration.

The Chairman: Minister, I have three colleagues who wish to put questions to you.

Q288 Lord Hamilton of Epsom: If you have not had notice of this question, I apologise. The European Council recently announced that it had proposals for a €300 billion programme spread over 2015-17 for public and private finance, presumably to boost the European economy. I gather that we are due to be contributors to this fund. I did not realise that we had all that money to spare.

Andrea Leadsom MP: I quite agree. Our initial position is that we should be looking at private finance if we want to be ambitious. At the moment there is no specific proposal for us to consider. But certainly I share your concern that we do not even have our share of that sum of money to bandy about unless we are clear that there would be very distinct benefits for the UK. We need to wait and see what the specific proposal is.

Q289 Earl of Caithness: Minister, my memory goes back to a Council of Ministers' meeting when I was harangued by a Minister from another country in a long, boring and rather irrelevant speech about shipping. He represented a country that had no shipping interests at all; it was in fact landlocked. Do you think that the member states that you are dealing with now, appreciating Britain's dominant position—as for Greece and Britain on merchant shipping in those days—are being helpful, or are they, as this person was, just trying to be downright irritating to those who knew what they were talking about?

Andrea Leadsom MP: I would say that there are some, actually. It is a bit of a curate's egg. On my time on the Treasury Select Committee, Andrew Tyrie invited Mr Barnier to appear before us, with our 40% of EU wholesale financial services. First, the answer was, "No, why should I?". When we insisted and he finally came, we had the most bizarre session where barely any of our questions were answered, and in fact after the session we wrote to him saying, "Since you didn't choose to answer any questions, perhaps you would answer them in writing". I certainly think that good will is absolutely vital, and we are very fortunate in that, in Lord Hill, we will have someone who is at least interested and knowledgeable. While obviously he will be speaking entirely for the Commission, we hope that it will be with a good heart, which is what we are looking for. We are looking for people to understand the significance of this sector to the UK and to just listen—to give us a chance, to give us a hearing.

Lord Kerr of Kinlochard: This Committee had a slightly different experience with Michel Barnier, who we last saw about a month ago.

Is not the answer to the problem that Lord Caithness and Lord Hamilton are drawing attention to a question of your head and your heart again, Minister? We could make the case that it is in the European interest to have one of the world's big three financial markets—and there is probably only room for one in the European time zone and there is only one candidate for the role, the City of London—that we know what we are talking about and that it is in Europe's interests that we are talking. We could talk not about defending the UK interest but about advancing the European interest. That argument used to work rather well.

I am nervous when a Foreign Secretary says that we should be lighting a fire under the European Union. People hear that over there. People are not sure of the degree to which we are committed to the success of the enterprise. When you say, "We need major reform of the European Union", what in your area of responsibility—financial services regulation—is the particular reform that you want? I do not think you mean anything in financial services regulation. I believe that you do speak to the European interest when you are talking in Brussels, and I believe you will be listened to, because people know that you know what you are talking about. The risk is that you are undermined by other people in this country talking as if we wanted to wreck the enterprise or leave it. That is my worry. So when it comes to capital markets union, I hope that you will be bold and buccaneering, on the front foot, putting forward suggestions. I hope that the Treasury is flocking into Jonathan Hill's office now saying, "Capital markets union—great. This is what you should do", rather than sitting in our bunker waiting to see what he comes up with and checking that in every case it precisely fits with the UK national interest. That way, we will lose. We advance the national interest best by advancing the European interest.

Andrea Leadsom MP: I do not disagree with what you are saying. There are a couple of things that I would say. One is that when you look at the European Union academically, philosophically or with your heart, you might say that it needs big reforms. Why? Because if anywhere has more than 50% youth unemployment, then something has to be wrong. If anywhere is failing to grow, there has to be something wrong. The Commission's own stats show that the EU share of global growth will have fallen like a stone over the next 20 years, so there are definitely things wrong and it definitely needs reform. I absolutely buy that. But that is not to say that in the financial services sector I am saying, "Oh, we need fundamental reform. Ditch this and that directive". There it is much more subtle. There the case is exactly as you say. The financial services serve Europe. I remember seeing a statistic somewhere that showed that, before the financial crisis, financial services—largely based in the UK—benefited each of the European economies by about 1% of GDP per year. So everyone is benefiting from something where the UK has a particular expertise.

I do not necessarily agree with you that there is room for only one centre. You can have niche areas. Germany is very good on covered bonds, for example, and other European nations are particularly good in particular product areas, and we can learn from them. But the UK is dominant, so I certainly think it is in the interests of all of the EU to defend this very important industry. The difficult thing is where those things are muddled, so that people say, "Well, we'll punish your financial services sector because you want to reform the EU". That is not grown-up talk and it is not grown-up thinking; it is the equal and opposite of the accusation that British politicians are just trying to wreck the project.

I do not think that either of those things is what people really think. When you talk to European domestic politicians and MEPs, they all want to see this project succeed and it is just a matter of how they interpret it. The rest of it, I am afraid, is media interpretation and the things people say

when they are in a rush and talking in shorthand. It is a much more subtle debate. Where financial services are concerned, there is a huge opportunity for the whole EU. To answer the last part of your question, I completely assure you that capital markets union is my top priority—one of my top priorities.

The Chairman: Andrea Leadsom, we will conclude it there. I thank you on behalf of the Committee for coming today. We will send you a transcript of what has passed between us as sometimes punctuated conversation, because of your visits down the other end. We are sorry that that has happened, but we would be grateful if you would write to us. Katharine has been taking notes about some of those areas that might be supplemented from the questions that the Committee has put. We are very grateful to you for coming. We hope when you leave this room you have the words of Lord Kerr ringing in your ears—to go forward and be bold and buccaneering.

Andrea Leadsom MP: Thank you very much.

HM Treasury- Written evidence (FRF0029)

Lord Harrison
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25 November 2014

REVIEWING THE EU FINANCIAL REGULATORY FRAMEWORK

I welcomed the opportunity to discuss this important area of the EU's response to the financial crisis earlier this month. During the course of the discussion, you asked that I write to you in order to follow up on three areas: (i) the costs of certain regulations; (ii) the pros and cons of bank separation; and (iii) further examples of what I described as "asking what the point of something is at all, rather than saying that we will do it but minimise the impact as far as possible". I will take these in turn below.

With regard to the cost of regulation to industry, I would first like to note that both costs and benefits are often difficult to identify and assess. Reasons for this include:

- much of the costs now borne by financial intermediaries are in fact the redistribution of costs to these entities from the taxpayer or sovereign, i.e. through the ending of implicit guarantees and a re-pricing of risk; and

- many key pieces of legislation are still being implemented, making the observance of costs and benefits difficult.

I would also note that where significant costs to business have been anticipated these have often been recognised, for example, through long phase-in times, i.e. with capital requirements for banks (in CRD IV), or exemptions or lesser requirements for SMEs in the markets abuse regulation or central securities depository regulation.

However, despite these difficulties, in some instances it is very clear that costs can turn out to be excessive. A good example, albeit one that pre-dates the crisis, is the Prospectus Directive. Responses to a UK government consultation in 2010 suggested that preparing a prospectus for a £Sm public offer in line with the Prospectus Directive might cost between £350,000 and £600,000. In practice, this amounts to a significant barrier to the public markets.

To draw out one further example, costs have often not fallen equally across sectors. The Alternative Investment Fund Managers Directive (AIFMD) has imposed significant new costs on the alternative sector, particularly managers above the "AIFMD threshold" (firms managing cumulative assets in excess of €500 million or €100 million if leveraged) and the value of the marketing passport will be substantially smaller . It is also not clear that many of the new

requirements within AIFMD will bring genuine benefits to the investor in the form of meaningful protections. This is in contrast to the many welcome benefits that have been introduced in the regulatory framework for investment funds elsewhere. In particular, the European Venture Capital Fund Regulation (EuVECA) has introduced a proportionate framework for venture capital funds to passport across the EU. Under this regime 13 new venture capital funds have been established in the UK, and are raising money from these new markets. And while UCITS V has imposed some new burdens on UK firms it has also raised the requirements of depositaries of UCITS funds in other jurisdictions that may market in the UK, creating a level playing field for UK firms.

Turning to bank separation, as I recall from my time on the Treasury Select Committee analysing Sir John Vickers's recommendations, there is a difficult balance to be struck between ensuring that core deposit taking services are sufficiently insulated from shocks in other parts of the financial system, while ensuring that costs are kept at a sensible level and services for customers are not disrupted unnecessarily.

The Government believes that ring-fencing best strikes this balance. A robust ring-fence entails a high degree of structural separation that ensures economic independence; removes the government implicit guarantee; and allows for orderly resolution that would provide continuity of vital services in the event of a failure. The electrification of the ring-fence ensures that mandated separation remains a possibility on a case-by-case basis, at the discretion of the regulator (the PRA), should ring-fencing not provide suitable protection for ring-fenced bodies (RFBs).

The Independent Commission on Banking decided against recommending full- separation as they believed that a robust ring-fence would secure the principal stability benefits of full separation, but at a lower cost to the economy, while also ensuring that banks and their customers can reap the benefits of limited association with their wider banking groups.

An example of the benefits of maintaining intra-group relationships is that through agency arrangements, customers can take advantage of the cross-selling of retail and some investments services in one place. It would also allow for expertise and information to be shared across subsidiaries, and for shared services to be maintained. Compared to complete separation, ring-fencing also avoids placing large additional costs on banks, in the form of VAT payments, which would be passed on to consumers. From a stability perspective, there is the added advantage that unlike with full separation, a RFB that remains an economically independent part of a wider banking group could still receive a capital injection from the group if financial support were to be required.

While it is true that there are ongoing costs associated with ring-fencing implementation, it can be argued that these are significant ly less than the cost of a Glass-Steagall type separation. It is worth remembering, as I stated at the time of the hearing, that a bank can choose to go down the route of full separation should this prove more cost-effective.

Finally, you asked me to expand on what I described as "asking the point of something at all rather than saying that we will do it but minimise the impact as far as possible." My point here was that we, both nationally, and within the EU, need to be prepared on occasion to step back from proposals and ask, if they are not achieving their objectives, should we not simply withdraw them

as opposed to amending them. In this regard, I strongly welcome the focus of the new Commission on better regulation, with the creation of a new role of First Vice President Frans Timmermans in charge of better regulation and the programme for Regulatory Fitness (REFIT), which recently recommended proposals for withdrawal. I will work with the Commission to ensure both implemented and proposed regulations meet the subsidiarity and proportionality tests, are adequately assessed both before and after implementation as to their impact and success, and are withdrawn if they are not fit for purpose.

ANDREA LEADSOM

25 November 2014

HSBC Holdings plc- Oral evidence (QQ 199- 214)

Evidence Session No. 12 *Heard in Public* *Questions 199 - 214*

TUESDAY 21 OCTOBER 2014

MEMBERS PRESENT

Lord Harrison (Chairman)
Lord Balfe
Earl of Caithness
Lord Carter of Coles
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Shutt of Greetland
Lord Vallance of Tummel

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Examination of Witness

Douglas Flint, Group Chairman, HSBC Holdings plc

Q199 The Chairman: Good morning, everybody, and a very warm good morning to Douglas Flint, who has come before us this morning in our inquiry into the European Union financial regulatory framework. Please feel free to have any of your colleagues sitting next to you if you so desire, Mr Flint. We are trying to get the best out of our witnesses, so please do come up. We will take names later on. We are doing this inquiry—we are in the middle of it; we are getting towards the end—and we are most grateful to you for coming along. We take a transcript of any

exchange that we have with witnesses. We send that transcript to you to ask you not only to correct it but to improve on it. If on your flight later this morning you think, "Oh, I wish I had said that," please communicate all those good ideas to us. We are being broadcast and I would ask my colleagues to understand that. Before I ask the first question, I know that you are anxious to perhaps say a few words as an opening. Would you care to do that, just to give us an idea, and perhaps just introduce your two colleagues who are sitting next to you?

Douglas Flint: Charlie Haswell heads our regulatory policy team, and Simon Jowers is a colleague who covers mostly European matters within that team.

The Chairman: Thank you very much. Do feel free to come in.

Douglas Flint: Thank you very much for the opportunity. I will just make a few opening contextual remarks, if I may, to consider the work that has been done within the EU regulatory framework over the last five years and to put that into some kind of perspective, remembering that the EU has had to deal with two crises, which are interlinked but also separate. The first was obviously the global financial crisis, caused by major falls in asset values. That led to uncertainty over underlying value of financial instruments, which caused a severe contraction in liquidity for all but the simplest instruments. That led to the failure of a number of banks and other enterprises, and eventually the scale of those failures became so large that it became a systemic problem. This led to government support being required in various guises, together with a recognition that the toolkit and legal framework to deal with failed banks was wholly inadequate, and that really led to the reform of the regulatory framework. Something had to be done, and a set of measures was agreed at the G20 summit in Pittsburgh in 2009. Much of what the EU has been doing has been to implement these reforms: for example, introducing Basel III; improving the role of central clearing of derivatives; and improving resolution frameworks. In terms of looking at where there have

been challenges of operating within the EU and challenges within the EU, it has been where the EU has gone beyond what has been a global agenda—in other words, taking its own particular position on structural reform and adding additional measures on incentivisation.

The second partially linked crisis was the sovereign debt crisis within the eurozone. It became apparent that measures needed to be taken to deal with the financial linkages between eurozone economies and financial systems, which perhaps had not been fully appreciated at the time the eurozone was created; again they needed to be augmented. These steps centred on the creation of a banking union ultimately, with a single rulebook for the EU and a single supervisory and resolution mechanism for the eurozone. Since this affects so many countries in Europe, it has naturally affected the way that the EU itself functions and has implications for the UK.

All this has been done necessarily at some speed, and the new Commission and Parliament have an opportunity now to reflect on how all of that has come together. Do the reforms need adjusting now that outcomes are clear? As part of that reflection, the EU and the UK should consider four areas.

Firstly and most importantly, do we have an overall design for what we want the financial system to look like and to do? There has been an awful lot of focus on institutions, particularly banks, not least because they form the main transmission mechanism for economic policy, but there needs to be more focus on the system as a whole. In simple terms, there is an opportunity now to give regulation the role to shape the system that we want, and less need to continue to use regulation to address what we do not want it to do.

Secondly, have we made sure that we have a strongly competitive EU banking system that is capable of supporting EU growth and EU companies that trade globally, and will that system be able to attract capital and funding into the European banking sector to support those objectives?

The third point where I think consideration is needed is: how do we assess and prioritise the resources that are needed to properly implement the scale of reforms that are under way? Are the timescales too aggressive or, on the contrary, insufficiently ambitious to meet policy objectives?

Finally, do we need to take other actions to support growth? The reforms have contributed to a period of immense change, which has led to a great deal of caution both within the banking system and among its customers. Do we need to find policies that are positive and proactive so that the financial system and its customers are more confident about their ability to seek and support growth? If we want sustainable growth, we need to ensure that finance flows to the productive parts of the economy. For that, we need customers to be confident that the investments that they are contemplating offer good prospects of success, but there also needs to be confidence within the banks that they have a clear and stable environment in which to do business to support their customers, and this enables them to provide risk finance to the economy, which is critical to growth.

Again, this requires a mature reflection six years on from the crisis as to what is the appropriate balance between regulation that is directed towards stability and regulation that is directed towards growth. It seems to me that all too often regulation has acted with the stability priority to concentrate investment into two asset classes—government debt and residential property—both of which have proved not to be risk free but are not part of the productive economy.

It really comes back to an important priority now, which is to be much more thoughtful about what we want the system to do as opposed to an aggregate of measures to prevent it doing things that it used to do in the past that turned out to be suboptimal or just plain wrong.

Q200 The Chairman: If I could just leap on that first point that you made, which was the first of your four suggestions, could you give the Committee an example of how we might work together to do something that would be beneficial in terms of the EU financial regulatory framework as opposed to trying to ward off a problem? What is a clean example of something we could do to help?

Douglas Flint: It is a very simple thing, which is to say to legislators: "Fast-forward five years or even 10 years. You have achieved everything you want to achieve. What does it look like?" The analogy I use is that the financial system is a bit like a big jigsaw box and the regulatory reforms are effectively pieces thrown into the jigsaw box, but no one is given the lid with the picture on it. There are an awful lot of pieces that are really important and they all have a function, but until you know what you are trying to create it is very difficult to make the picture.

I am a simple fellow. There are only six forms of finance. There are mortgages; consumer lending; small-business lending; large corporate lending; infrastructure finance; and government. Essentially that is the financial system. How do we want those assets originated? Who do we want to underwrite them? How do we want them to be distributed? Who are the ultimate owners—holders—of those assets? For the long-term assets, the illiquid assets, how do we want those institutions to get liquidity when they need it on a short-term basis? Once you have defined that, you say: "How do we then shape a regulatory system to give shape to that financial system?" It would be extraordinary if, if you like, an aggregate of anti-avoidance legislation created a coherent picture of something that was to meet an objective to finance the economy. Do not get me wrong; everything that has been done so far has been done with good intent, but when you add it all together, is it coherent within itself and does it promote an objective of funding productive capacity within the economy, creating confidence that businesses can pursue longer-

term objectives, or does it deal with just individual salami slices of, "This was a problem; we need to fix this"? Getting that picture on the jigsaw box would be terribly important, and then we would know where we are heading.

Q201 The Chairman: Before we begin to look at some of the jigsaw pieces and whether they add up to a coherent picture, of the institutions of the European Union that have been so rigorously involved with the changes over recent years—namely the Council, the European Parliament, with its important role, and the Commission itself—which would you say has added to the important process of trying to imagine that picture and finding the right pieces of the jigsaw, and which has perhaps contributed less?

Douglas Flint: I have had this conversation at the highest levels in Europe in terms of what the overall objective is and not really had an answer. There is almost an agreement that there is not an answer to that yet, because the mandate that was given was one of financial stability—protecting the system from repetition of what happened—and the Commission has been focused on the stability objective, for very good reasons. We have had very good dialogue, and we have benefited hugely from the chair of the ECON committee in the European Parliament, which has given a considerable amount of careful reflection on the detail of legislative proposals, as indeed has this House. Once legislation has been formed, it has gone through an incredibly intensive period of review and there has been the ability to interact, particularly with the European Parliament, which has managed to calibrate some of the measures that were good ideas but possibly had unintended consequences. I would give the European Parliament—or at least the economic affairs element of that—very high marks for consultation. The Council of Ministers has also been reflective on thinking about some of the things that they did not want. The UK resisted some of the aspects of reform—the proposed FTT and some elements of incentivisation.

This is a global comment: the whole framework has been on stability rather than growth. One can sense that there is a mood to change that, and there needs to be some political policy direction given to change the emphasis: what is the coherence of the regulatory reform not on an international or even an intra-European basis but with respect to productive capacity building?

Q202 The Chairman: Before I ask Lord Dear to come in, could you respond to the fact that the European Central Bank is growing enormously in our thoughts on these matters and in a way, when you talk about growth, has taken the mantle up for that, and actually its job is somewhat different?

Douglas Flint: Yes. I think the ECB will emerge over time as an increasingly important global institution. There is no question but that the regulatory agenda today is being driven heavily by the Fed and the Bank of England, with significant support from the Swiss regulator and the Dutch regulator—inevitably, because those were the four countries that suffered most acutely in the crisis. Going forward, the ECB will have nine of the world's globally systemic institutions; the UK at the moment has four. In a sense, the ECB will, over time, as it develops the experience and the skill base, become more and more important, because it is going to command the largest number of globally systemic institutions and therefore its voice will be hugely important, in the way that the Bank of England's is today. In due course, I suspect we will have three pari passu regulatory voices—the Fed, the Bank of England and the ECB—and in due course there will be the PBOC in China.

Q203 Lord Dear: A very good morning. To echo the Chairman's introductory remarks, thank you very much for squeezing us in on a very busy day. You have already touched on a number of the points I wanted to raise. I think many of us were taken with your analogy of the jigsaw box, which is particularly graphic. In your introduction, you touched on linkages, and I wanted to come to a

section that in our notes is headed "interconnections, overlaps and gaps in the regulatory agenda". One could even shorten that, as I think you have led us into, and talk about the law of unintended consequences. I would like to focus, if I may—and I would value your comments—on those overlaps. What do you think is the interplay between the various moving parts and the consistency or the inconsistency of all that, perhaps developing your jigsaw-box analogy, but recognising that there is a very wide spectrum that goes from consumer protection right through to market risk and liquidity—the whole gamut of banking in Europe? Perhaps as a strand through that you could help us by talking about what we sometimes see as uneven implementation, and whether anything can be done, either internally or externally—globally externally—to even out the implementation pattern.

Douglas Flint: These are really important areas. One of the things I have come to terms with over the last five or six years is that the level playing field is one of these mirages that people talk about but is pretty impossible to contemplate. You have a US system that is 75% or 80% of the capital markets; the inverse is in Europe. You have got an Asian financial system that is growing very fast, that is substantially deposit-funded, and that is at a different stage of maturity, with much smaller and less sophisticated capital markets. To think that you could have national regulation that was identical in the US, China, Germany and Argentina is a step too far. It is difficult to imagine how that could be the case.

Clearly what is important is that there is a level playing field in terms of minimum standards. One of the things that has been very positive in the whole regulatory reform is that there is now global coherence on the definition of capital and global coherence on the minimum level of capital. There is global coherence on the need for a common definition of liquidity and on a leverage ratio, although it may be calibrated differently—but again, that calibration may reflect different

market structures and market preferences. I do not find that problematic. The area where it is most important that there is a genuine level playing field and total coherence is the wholesale markets, because the wholesale markets transcend national boundaries. It is really important that derivatives markets are globally consistent, otherwise the opportunity for unintended consequences in terms of arbitrage or pushing activity into the least transparent or least regulated sector will continue to be a risk. There are no real anomalies in what is being attempted at the moment. There are clearly areas where they are not the same, but it is really a question of negotiation, primarily between Europe and America, to get mutual recognition or substituted compliance or equivalence in outcome to resolve that. An awful lot of bankers who talk about uneven implementation say, “We used to have a competitive advantage, which we are losing”, or, “We would like to have a competitive advantage”. They are a little bit self-serving sometimes.

In terms of overlaps and gaps, as I said, it is important that we do not have them in wholesale markets. In consumer markets, it is entirely legitimate that individual markets will focus on what their hot buttons are in terms of consumer protection and in terms of market structures. The US has a mortgage market that is predominantly securitised; we have a mortgage market in Europe that is predominantly in banking systems. You cannot reconcile those two things.

On overlaps and gaps, there are two things I would point to. It is really important that the structural reform agenda gets harmonised or at least reconciled so that there is not duplication. In the UK, we have chosen Vickers and we are getting on with it. The EU could come up with something entirely different on structural reform. It would make life very difficult in terms of contemplating how you put resource into something that is going to be very expensive to do—we are all on that journey—if Europe were to come in and say, “You have to do something that is different from that”. Dodd–Frank is a choice that the US has made. I do not think that is a

problem, but where they go extraterritorial and say, "You have to comply with our rules as well as someone else's rules", you end up with a choice as to whose law you break, and that is a very uncomfortable one, particularly when the penalties for breaking laws now are impossibly large. Extraterritoriality is an issue. The US exports its legal system through tying everything to the dollar and we are beginning to understand the implications of that. I will get myself into difficult water, but while I was not surprised to see Europe legislate or regulate remuneration, I was disappointed to see it regulate remuneration globally for banks headquartered in Europe, because it seems to me that what is done in subsidiaries in Latin America and Asia should not necessarily be tied to European law, since they are not in Europe. That is one of the areas of overlaps that is a complex area to reflect on.

The Chairman: Before I bring in Lord Carter, I just wanted to ask Lord Hamilton, who expressed a desire to ask about the costs of all this.

Q204 Lord Hamilton of Epsom: Yes. I apologise, Mr Flint, because you have not been given any notice of this. Compliance is not a free lunch; it must have been an enormous, growing overhead in your business. Have you got any figures—perhaps you could supply them afterwards—on what compliance was costing you pre the crisis and what it is costing now?

Douglas Flint: Let me give you them afterwards, but it is in billions. That is a double-edged statement, because the rebuttal to that is: "Well, you were obviously underinvested". I do not think it would be right to say anything other than the industry was underinvested and we were underinvested. Therefore, some of that investment is stuff that should be done anyway. Some of the investment is hugely significant. Do not in any way, please, interpret this as a pulling back, but ring-fencing will cost £1 billion or £2 billion to implement. It is a structural separation that is going to be very expensive to do. It is very significant. That gets to a point on which the industry is

united: the days of challenging regulatory reform are gone. The industry has lost the right to self-determination. I said that once before and I agree with it still. What we really want is that jigsaw box. Tell us where we are going and we will just get on with it. The real cost comes from starting something and then it being recalibrated and then it being recalibrated again and people seeking perfection, so that we never get to finish the project and you are going back to the beginning to start again something that has already been well under way.

Lord Hamilton of Epsom: Could I just come back on the question of ring-fencing? Will there not be a year-on-year cost of ring-fencing?

Douglas Flint: There will be a year-on-year cost as well.

Lord Hamilton of Epsom: Could you give us those figures as well?

Douglas Flint: I will send you those figures, yes.

Q205 Lord Carter of Coles: Mr Flint, good morning. My question is on the too-big-to-fail problem. Would you agree with concerns that large banks are not only too big to fail but also too complex to resolve? What do you think the best way would be to reduce the implicit subsidy that those large and interconnected banks enjoy? Finally, what elements of the bank structural reform proposals are necessary to complement existing EU financial regulation?

Douglas Flint: When you get down to the whole essence of regulatory reform, it is exactly to deal with that question: too big to fail—although it is “too big to fail in a disorganised way”. What we want to do is to have a banking system where banks can fail but the impact to the system and, through the system, to society is minimised. Too-complex-to-resolve is an issue that is being dealt with differently across the world. Effectively, it takes both the public side and the private side to do a number of things.

On the public side, it requires revisions to the legislative framework for insolvency law for financial institutions. It means building a resolution framework. There have been significant steps in the last couple of weeks in terms of the 18 most systemically important banks in the derivatives markets agreeing to have stays on close-out execution should one of them fail. It takes reflections on regulatory co-operation, crisis-management groups, clarity between regulators and clarity between regulators and policymakers. One of the things that has become evident as people have looked at too-big-to-fail on a cross-border basis, which is our largest banks, is that it requires regulators to trust each other and it requires regulators to trust the policymakers that influence the regulators in other countries. That understanding has led to, if you like, a lack of co-operation, because even if regulators can agree with each other, they cannot be certain that policymakers—Governments—in a country in a crisis situation would say: "We are very uncomfortable with the outcome; we would rather it was different".

From the banks' side, it has led to a number of things that are really important. It is leading to simplification of structure, both in terms of activities and geography. You have seen banks significantly contract in peripheral areas of activity, both geographically and in terms of product type. We have sold 60-odd businesses; you have seen Citi in recent months doing very similar things. It means reducing intra-group interdependencies and it means putting in place arrangements to preserve critical functions. That then gets encapsulated in a living will.

If banks can demonstrate to their regulators that they can be wound down and resolved at minimum cost, it is possible then to have a public-private confidence that, should the worst happen, the impact on society will be minimised. Effectively, there are two ways of doing that. When things still remain connected, someone has to take overall responsibility—the home country regulator. Where things are not interconnected and subsidiarised—and increasingly we

are seeing a world where subsidiarisation de facto or through regulation is happening—then individual countries can take responsibility for their own pieces. HSBC as a bank was structured from the earliest days to be subsidiarised, so that effectively everything is compartmentalised.

The one point I would make, though, is that hopefully all the work that has been done on capital liquidity, structure, proprietary trading, incentivisation and deferral—all these building blocks—should reduce the probability of failure, because although the proposals that are going to be discussed in Brisbane in the next few weeks about bail-in capital are really important and we think are a really good final step, be very clear that these are about distributing the burden of failure; they are not about avoiding the burden of failure. At the end of the day, the burden of failure rests with society. Whether you take it out of society's future income through taxation or whether you take it out through their pensions or savings, society is bearing the cost, and at the end of the day that is the most important thing. To say to people, "Never again will the taxpayer be called upon, because we will have hard-wired it into the pension system", does not feel very comfortable.

The other thing that should get some scrutiny—and I am an accountant by background, so debits and credits—is, if we are going to have a bail-in capital, which we are—the estimates for Europe are somewhere between €300 billion and €500 billion—where that is placed. If we believe that there is capacity for that within the fixed-income community, who are going to receive a yield on that more risky capital of 6.5% to 7.5%—something in that range in today's world—what were they investing in at that risk point that they are now going to displace by investing in banks? What they were investing in was the real economy—the productive economy—so that is either going to have to shift somewhere else or get priced even higher. Is there enough appetite at that point in the risk curve? There is the notion of saying, "We have solved banks"—but that money is coming

from somewhere. Going back to the holistic view of what we want the system to do, by putting more money into banks at that risk point we are taking it away from some other part of the economy.

Q206 Earl of Caithness: I want to pursue a little bit more about the EU regulatory framework. We have developed a regime that includes new rules on sanctioning, securitisation risk, governance and remuneration, clearing and trading obligations. In your view, Mr Flint, how effective is this regime at creating incentives to better manage risks? Or has it made life much more difficult—not only for banks but also for companies?

Douglas Flint: The intention of all of these things is clearly positive. One of the big challenges, again, of the regulatory regime is that Europe wants—rightly—to expand the capacity of capital markets for more securitisation, and yet attempts to stimulate the securitisation market have been modest in their impact so far. One of the reasons is that "maturity transformation" has become a dirty phrase, and certainty of liquidity has forced banks, insurance companies and pension funds to hold a greater proportion of their assets in liquid assets. If we want the natural holders of long-dated illiquid assets to hold them, we also need to give them liquidity. To give them liquidity means there needs to be a market-making ability somewhere in the system to give liquidity to those assets, with the ultimate risk staying with the pension fund, insurance company or whatever. That means that the banking system, which provided that liquidity, has to have the capacity to do so, yet the rules on the distinction between market making and proprietary trading, which are really difficult to write down, and the possibility of a leverage ratio have meant that banks' trading operations have significantly contracted. In one way that is good, because that was the source of some of the issues that arose in the crisis, but on the other hand the proper

functioning of those books was to provide liquidity to holders of long-dated illiquid assets. If we do not give that liquidity, who is going to hold the assets?

The same point arises in discussions when we think about this bail-in debt. Banks are not going to be allowed to hold each other's bail-in debt—that is entirely right—but what do we do about market making? It is not yet clear what that means, but if there is no liquidity in those instruments there will be very few people who will want to own them.

Again coming back to the jigsaw box, if we want to use the securities markets and we want the market to have the right incentive to take risk, we have to give safe harbours to the taking of risk in accordance with the framework that we think gets the optimal sustainable amount of finance into the real economy, and we have to give incentives for the provision of liquidity for those who take illiquid risk and look at the system in a coherent way. We have been over-concentrating, in my view, in the last five years on simply the banking portion of the system.

I will touch on remuneration. Not to get into the desperately difficult subject of quantum, but in terms of design, a huge amount was done post-crisis in terms of deferral and clawback. The structure of remuneration is completely different from what it was. We had got to a state certainly in Europe where the vast majority of reward was deferred, subject to retrieval and then ultimately arrangements put in place for clawback. The proposals out of Europe in terms of capping the ratio of variability to fixed is a retrograde step against long-term deferral, which is what the regulatory community sees as most consistent with creating the right incentives to take risk in a measured way, because if you get rewarded for something that turns out to be different from what was expected, the compensation that went with that will go away. Hopefully we will find a balance over the coming months and years to readdress that. It is terribly important that we have a balanced framework that protects the system from excessive risk-taking, which

deferral and claw-back does, but at the same time is not so deferred and uncertain that we find it difficult to attract people into the industry. The point I make when talking to folk is that we are in an industry that is well paid—I do not doubt that—but so are other industries, particularly the tech industry. When you say to guys in the tech industry that you would like them to join banks to help us with cyber-risk and say, “Your money will get paid in seven years’ time,” it is a very easy conversation; they decline to consider it.

Q207 Earl of Caithness: Given what you have said, do you think that the Commission has listened enough to the market and the practitioners in the market?

Douglas Flint: There has clearly been a resistance to what might be regarded as regulatory capture. It has got better progressively. The quantitative impact studies have been late in the day. Effectively, the regulation legislation is almost framed and you are back-testing against your assumptions rather than saying, “Let us have a roundtable discussion about what are the holistic implications of these proposals”—the impact study. It would be much better to get policymakers, regulators and the industry in a room. It is entirely right that people talk about the culture of our industry; it is deeply depressing that people believe that the culture six years after the crisis is still flawed. There may be elements, but if the people running banks today are not the right people, that is a shameful reflection on the regulatory apparatus not to have replaced those who do not get it. I believe the people in the industry today do get it, because it is not much fun rebuilding from where we have come from.

The Chairman: Just before I bring in Lord Balfe, has there been enough opportunity and time for consultation with the industry? You painted a very interesting picture there of good people getting round a table and having a good old chinwag about it.

Douglas Flint: It does not happen as much as it should. It is beginning to happen. As the pendulum is moving back towards stimulus and growth, there is a desire: “Help us get this to work”. It comes down to trust and confidence. We have to find a point in time where the regulatory world trusts the industry enough that it can dialogue with it on a forward-looking basis without believing that the industry is trying to gain an advantage. Our advantage comes from sustainable economies in the long term, not in short-term profit maximisation.

Q208 Lord Balfe: I wonder if we could turn to the growth agenda and the support of alternative financing sources, and the extent to which you think the EU is promoting them with respect to regulation, and then, moving on, what more can be done for other actors or initiatives, including securities issuers, venture capital funds and infrastructures that support fundraising.

Douglas Flint: These are all hugely important. It is important that capital markets union is a framework for looking at harmonisation of perspectives, requirements and cross-border liquidity within Europe and facilitating securities distribution on a common basis. The most important thing in terms of getting capital markets to work is clarifying the liquidity arrangements for long-dated illiquid assets, but there are so many new areas—peer to peer; crowdfunding; direct internet; venture capital funds; and the infrastructure funds that you talked about—that all have a role. Having said that, for a very long time they will still be subordinate to the banking system, because the banking system does not just allocate; it creates money. Therefore, it is significantly more important than any other part of the financial system. Importantly too, the banking system is heavily regulated, and therefore there is a massive line of sight through the supervisory mechanisms, which are much more intensive than they were historically, to see what is going on and what is happening in the economy. To have an array of alternative providers for whom the regulatory arrangements are more distributed would not give policymakers the line of sight they

have through a well regulated banking system. These are really important, but in terms of getting the economic activity that we want, the banking system will for some time continue to be the dominant engine, because it creates money.

Lord Balfe: What about the EU role?

Douglas Flint: The EU has a couple of roles. The first is to create confidence that the regulatory process has an end point. One of the findings we have in the UK—and it is understandable—is that one of the constraints on small and mid-size businesses' capacity to borrow is not the availability of funds, because banks are stuffed full of money to lend, but a recognition that in the crisis many businesses found their facilities withdrawn, restricted or priced up and determined they did not want to be in that position again. As they contemplate a regulatory agenda that seems to have another five, six or seven years to go from here, if not more, and you see some of the hawks on the regulatory side talking about even more restrictions and higher capital ratios and so on—"This is just a staging post"—business are saying to us, "That might mean you have to rebuild your capital ratios, which will be a combination of raising capital and cutting back your risk, and the risk that is easiest to cut back is the stuff to the small and mid-sized sector because it does not have the long-term arrangements that a larger company would have. We do not want to be there again, so we are going to build our businesses on the basis of less debt." Maybe that is a good thing too, but one of the things the EU can do is get to a point where we say we have done enough. There still is ambition in elements of the regulatory framework for this to go on for quite some time, the leverage issue being a very good example, which could be very important to the UK given the shape of the market. Basel set it at 3% but there are many people who talk significantly higher numbers, and that would have a significant impact on the shape of the UK banking system—a significant impact.

Q209 Lord Flight: First, Douglas, thank you for your introductory speech, which I thought was a very good summary of where we have got to. Secondly, I congratulate HSBC on being the one bank that rode out the crisis without trouble. It is pretty extraordinary that three out of four had to be bailed out. Can I continue the consultation point? First of all, do you think the ESAs are of any use? Have they facilitated consultation with the industry, particularly in relation to the single market, that has been satisfactory to you? Could I just quickly make one other point as well? In the industry that has been my career—the fund-management industry—there are things have come from Europe that are wrong and a pest: AIFMD and the MiFID requirements for private-client fund managers. It is important that we know from the banking industry what has come from Europe that is bad and needs fixing, and that ultimately is part of your crucial point about having the full picture of where we want to be.

Douglas Flint: To be honest, with the exception of the debate that is going on between Europe and the UK at the moment in terms of the structure of remuneration arrangements, it is very difficult to point to individual things in Europe that have been particularly problematic. There have been some technical issues around trade finance risk weighting and parts of derivatives, but really these are things that can get ironed out. The UK has in many respects gone further than Europe because of the particular nature of the marketplace, and I do not object to that.

Lord Flight: Could I just raise one, which is the increased AML requirements, particularly with regard to PEPs? It makes it completely uneconomic for any bank to have a PEP bank account.

Douglas Flint: I found that myself the other day. We did a bond issue in terms of this new alternative tier 1 capital about three weeks ago—a very successful issue. We listed it in Ireland, and the Irish considered that it was a PEP for some reason and required me to furnish a utility bill.

Lord Flight: Is that all?

Douglas Flint: And a copy of my passport. We understand AML very well because we have had to repair elements of our framework, which was not as good as it should have been. There is no question but that the financial system more generally is now the gatekeeper to access to the system and has been given a much greater role, with very severe penalties for admitting folk to the system who abuse it and not monitoring transactions carefully enough to identify patterns of activity consistent with crime. That burden used to be a fairly passive one; now it is a very aggressive one, and the regulators on a global basis regard those with political influence—without distinguishing jurisdictions—as those who are capable of misusing their power and therefore need an enhanced level of due diligence. It is difficult to blame regulators because they are following a mandate they have been given. This is a really important policy decision as to how exclusive we want the financial system to be, because by definition, with the exception of PEPs, the enhanced due diligence requirements effectively make some elements of society much more difficult to deal with because they are uneconomic, or you see the kerfuffle over remittance businesses, where it is very difficult to send money to emerging markets because those emerging markets harbour some interests that are inconsistent with our values. The same has been true in charities, yet if you look at the history of terrorism financing, charities have been a conduit for a small part of the money that went in, but banks have been punished severely for being associated. There are a number of cases going through the US at the moment that are seeking to extend the responsibility of banks—two in Europe; one in the Middle East—beyond that which banks historically thought they had. If they were to come to pass and become law, it would again be very restrictive.

This to me is a G20 policy decision on what is the appropriate level of due diligence that is consistent with a financial inclusion policy that has in the last 20 years been very successful in

bringing more people into the formal system. The penalties for getting it wrong are now so extraordinary that it is a no-brain economic decision for bank management.

The Chairman: Do you want to say anything more to Lord Flight's inquiry about the ESAs? We had Mr Enria from the EBA last week and we have ESMA in next week.

Douglas Flint: The ESAs are responsible for policy and the single rulebook. One has to say that anything with a supervisory board with 28 members must be a challenge to run. It is also fair to say in relation to the EBA that at the moment it is a policymaker for 28 national regulators. Going forward, there will be five or six, of which the ECB is going to be the gorilla in the room, and the relevance of having a policymaker above something that is so dominant is going to be a challenge as to how that governance works. To have a policymaker different from the supervisor is one possibility. Others would put the two together. It is fairly light on resources and heavy on responsibility at the moment.

The Chairman: You put it so well.

Q210 Lord Carter of Coles: We could do with a bit of help on the integrity of the single market and the disjunction between the single banking market and the banking union. What do you think the spillover risks are to that integrity and the effective governance of the single capital market from that banking union?

Douglas Flint: This is going to be a growing issue. There is no reason why, for the capital markets union, we cannot have a single banking market in Europe, because the capital markets should be geographic-boundary independent—on a global basis, not just on a European basis. The banking union will increasingly be a dominant force within the shaping of the EU banking market. The protections that the Chancellor put in for dual approval between the ins and the outs are very important, but as the outs become smaller the question is whether that is sustainable. I am a

huge supporter of banking union, although there are clearly still steps to go. A banking union really requires a shared deposit insurance scheme, and that requires an acceptance, at least, of contingent burden sharing. That is opening a big box. A single market requires a single banking market, and I am therefore very supportive of that. One of the obvious inefficiencies in the single market today is that there is not a single banking market. Real-economy companies pay different prices for their debt depending on their nationality and you see people shift across the border and get better terms because they are now in Country A as opposed to Country B. That does not feel like a single market at all. It is driven by the fact that ultimately the tax base supporting the institutions, to the extent that Governments ever decided that they would bail out, is the tax base of a national boundary rather than the European Union. That is the dilemma.

Q211 Lord Vallance of Tummel: Mr Flint, can I ask you perhaps a rather philosophical question? To whom were you really addressing your cri de coeur earlier on about the jigsaw, when you said, “Tell us where we are going and we will go there”? The reason I ask is that there are those who would say that the public policy issues here—the regulatory issues—are fairly straightforward: on the one hand, there is removing the constraints to the proper operation of the market; and on the other hand there is trying to temper the excesses of the market. But the shape of the market, its driver, and what the jigsaw is like within those constraints is a matter for the market. That would not be the case for utilities, but for most markets that would be the case. Whom are you asking? Who is meant to answer this question? Is it the market or are you wanting public policy people to do it—in which case, you are implying that banking is a utility?

Douglas Flint: It is a question for policymakers, because regulation will shape the way the market can operate and therefore there has to be some direction as to what kind of a shape of market we want and then regulation can contribute to directing the market in that way. I do not think that is

inconsistent at all, particularly since the key policy objectives that are coming from the European Commission, the European Union and, indeed, the UK Government are: "We want to do more to incentivise money going to small businesses, we want to do more to invest in long-term projects and we want to do more on infrastructure". If these are policy objectives, do we have a regulatory system that incentivises the direction of financial resources to these policy objectives? For the last five years, people have said, "The securitisation market is not working," and the answer is that it was broken in part because of the leverage and liquidity rules. If we want the market to respond to stimulus, we have to take the stimulus away from simply putting resources into housing and government bonds, which is where a huge amount of resources have gone, because the incentivisations have been at those. They are the two most privileged asset classes in the capital framework. Even today, in the collateral rules, government bonds are advantaged. We have a system that incentivises government bonds and housing but we want to put money into productive capacity. These are policy decisions, and then the regulation can frame around policy.

Lord Vallance of Tummel: Do you think there is more to it than just setting constraints to the objective function?

Douglas Flint: Yes. Liquidity is the really good example. If we want money to go into long-term illiquid assets—which we must do, because someone has to do that—then we need to say, "What stops people holding long-term illiquid assets?" Either it is Solvency II that is constraining on mark-to-market risk or it is the fact that the liquidity that holders of those assets would require for temporary need is not the way it should be. Who would be the natural holders? Insurance companies and pension funds. Go to them and say, "Why do you not hold the assets?" and they will say, "Regulation." Either we want to change the regulation to incentivise them to hold those assets or we say, "That is the way it is." But who gave the mandate to regulators to say that the

most important thing was certainty of short-term cash realisation from assets? That is a policy decision.

Lord Vallance of Tummel: Can I push you slightly further on the first question I asked? To whom exactly are you putting your question? We are talking about regulators, but regulators have quite constrained objectives; they are not there to—

Douglas Flint: No, it is not regulators.

Lord Vallance of Tummel: It is not regulators; they are there to do what I was saying, in effect, to make sure that the market works properly. Where in the political arena are you addressing that question?

Douglas Flint: This would be to the Commission in Europe and to the Treasury and the Chancellor here.

Q212 Lord Hamilton of Epsom: Can I come back on bail-ins? I totally accept your reservation about bail-ins, but on the other hand they have the attraction of trying to save taxpayers. At the same time, Glass–Steagall presumably does a lot to save taxpayers from picking up the liabilities of banks that have gambled and lost. Are we comparing apples and apples or apples and pears? You have already told us it is going to cost you billions to construct Chinese walls in HSBC. I do not know whether they will work in HSBC, but a lot of people do not think they are going to work anywhere else, because people are working night and day to find ways of permeating these Chinese walls. You are incurring the cost anyway. Would it not be better for the banks in Britain to start promoting the idea of splitting investment banks and clearing banks? Then there is a very strong argument you will not need bail-ins so much.

Douglas Flint: I am not sure I agree. At the end of the day, splitting something in two in and of itself does not do anything, except to the extent that the separation takes away the implicit

subsidy that was certainly there in the past. Because investment banking operations were alongside society's deposits, there was an implicit underwriting of all the debt within the operation because one would not risk the systemic panic that would happen if people thought their deposits were at risk, and we have had experience of that. The resolution arrangements that have been put in place go a long way to addressing that. Going back to something I said earlier, bail-in is only about the distribution of burden. What we should really be focused on is avoiding the burden befalling. All the stuff that has been done on structure, the resolution frameworks, the incentivisation and the bail-in capital with triggers—lots of technical stuff—is there to reduce the probability of banks getting to the point in time when their depositors are at risk. Whether the separation of wholesale and retail banking is an added step that adds anything is uncertain until we have another crisis. You are going to have potentially three models: a US model that has banned prop trading; a European model that—we do not know what it will do yet—will probably be permissive and market-making but has to define it; and a UK model that has done ring-fencing, which is not dissimilar to Glass–Steagall in a way. Hopefully we will never find out which is best because we will not have another crisis, but it is not clear to me that structure in and of itself changes anything. There is an awful lot that goes before structure that has been helpful and, indeed, really constructive in reducing the probability of a future crisis.

The Chairman: I am anxious to finish early. Lord Shutt, and then we will move towards a conclusion.

Q213 Lord Shutt of Greetland: I apologise for missing your obviously well received jigsaw opening, but I will read it up. Can the UK be accused of gold-plating international measures? If that is the case, what implication does it carry for the UK in terms of the EU's development of the single market and the single rulebook?

Douglas Flint: There are always those who will say the UK has gold-plated. So far the major gold-plating, if you like, has been more in timing about accelerating the adoption of rules that will take place in the rest of the world at some later point. There are some things where the UK has gone in a different direction; there are proposals out at the moment on liquidity that would be really quite distinctive to the UK. When people do not like things, they say they are gold-plating. There is a responsibility on regulators too to reflect the specific circumstances of a market and say, "That might be good for everyone else, but our marketplace"—whether it is our housing market or our small business market—"needs a different treatment". I believe in minimum standards and it is entirely right for policymakers—which would be the Financial Policy Committee here through macropru—to say, "We are worried about something that other people may not be", and then for regulators to give effect to that. Being different I do not think is a problem where there is an argued case. It comes back to the fact that we need to have a good dialogue with the industry, we need to know what we are trying to do, and we need quantitative impact studies. If there is a reason for the policymakers and regulators believing that we need something that is a bit different, that is a legitimate choice that they should have. The pushback I would have on it is where you did something differently in wholesale markets, because that has to be an international agreement. However, in domestic banking markets, banking regulators are entitled to say, "We are a little bit different and we want to reflect that in the way we regulate".

Q214 The Chairman: Just one final question: given we are likely to be outside the banking union, what are the challenges not just for the United Kingdom but also for those others who choose for the moment to remain outside the banking union? How do we identify upstream issues that are important to the United Kingdom or, indeed, for that group of those who are outside the banking union?

Douglas Flint: It comes down to size, in a way. At the moment, many people would say that the Fed is the dominant interlocutor in all the regulatory discussions because of its size. The ECB will have a very significant voice given the community of banks and the size of the economy that it supervises. Essentially, they will have more weight than they have today in international discussions, and therefore they are likely to want to shape regulation in a way that is—"helpful" is maybe the wrong word—supportive of their ambitions for the eurozone. There is no reason why that should be different from where the UK is in terms of policy—it could very easily be the same, and the UK and the Fed tend to find themselves in agreement on most things—but clearly the ECB will have a distinctive voice, reflective of the characteristics of their banking system, that will have more weight in the future, and those who are outside it will basically be following on. The comment we hear from much of the rest of the world is: "This agenda is being driven by the West without much consideration as to the distinctive characteristics of Asian or Latin American or Middle Eastern banking systems". The response to that is: "That is where the problems came from in the West and therefore we have to address them". We need to watch it and we need to make sure we have sufficient presence in the European decision-making fora and a very constructive relationship with the ECB so that we have the influence that we have today.

The Chairman: What jigsaw puzzle would you buy Lord Hill as he starts his very interesting job in Brussels?

Douglas Flint: In a way, it would be good to have fewer pieces in the box. Get the big things right and worry less about whether some of the tertiary rules are exactly the same as those in the United States. There seems to be an awful lot of obsession with harmonisation on really minute areas, and yet the big-picture issue is: are we getting the right amount of financial capacity into

the productive economy to support the economic objectives of the European Commission and the UK Government?

The Chairman: Douglas Flint, you have done so well this morning in conveying that big picture to us, and perhaps the necessity of finding the right pieces of the jigsaw for the EU regulatory framework as it develops. We are most grateful to you for your very thoughtful responses to us. I turn to your two colleagues and say that, when you as a group reflect upon what has been said this morning and reflect upon the transcript we send you, if you two gentlemen have any ideas that you would care to add, we would be most grateful. In the mean time, our very deep thanks to Douglas Flint for coming before us this morning.

Douglas Flint: Thank you very much indeed.

International Regulatory Strategy Group–Written evidence (FRF0017)

Response to the House of Lords EU Economic and Financial Affairs Sub-Committee's inquiry into the EU financial regulatory framework

The International Regulatory Strategy Group (IRSG) is a cross-sectoral practitioner-led body of leading UK-based representatives from the financial and professional services industry. It is an advisory body to the City of London Corporation, and to TheCityUK.

We welcome the opportunity to input into this inquiry. Our response below focuses on 4 key areas that are of most concern to us. Fuller responses to the questions posed by the Committee can be found in the Annex.

Key messages

- In general, we support the EU's efforts to improve the regulatory framework for financial services and to implement the G20 Pittsburgh agenda. This was necessary to remedy the serious failures in the existing regulatory framework that were exposed during the financial crisis. However, we question the need to go beyond the G20 Pittsburgh agenda.

- International regulatory coherence is a major concern for the financial services industry. In the EU, the treatment of third countries in EU legislation has often proved problematic for cross-border business and could have adversely impacted trade and investment to and from the EU.

- Another key concern regards the process for introducing EU regulations. In the past 5 years, we have seen the Commission prioritize regulations that did not tackle the root causes of the crisis (such as the short-selling and Credit Default Swap (CDS) regulation) where we believe more emphasis should have been on tackling areas which would have a substantive impact on financial stability (for instance the Bank Recovery and Resolution Directive). The quality of impact assessments and the interplay between Level 1 and Level 2 could also be improved.

- In terms of future priorities, implementing and enforcing the huge amount of new legislation should be the primary objective for the next 5 years. Priority should also be given to jobs and growth, in particular advancing the long-term finance agenda. Finally, completing the reform agenda, in particular proposals on recovery and resolution for financial market infrastructure, should also be prioritized.

Compatibility between international standards and the EU regulatory framework

The majority of the new rules introduced in the EU since the financial crisis have been necessary to ensure financial stability and implement internationally agreed standards. We fully support the

G20 Pittsburgh agenda and support the work the EU has done to implement these agreements into EU law.

However, we do have some concerns that the EU has a tendency to modify or go beyond internationally agreed standards. While in some cases, these changes are welcomed by the industry (for example the modifications made to CRD4 on trade finance), in many cases, these changes lead to difficulties for cross-border business dealing with multiple rules and distorts competition for firms operating in different jurisdictions.

Third country issues and international regulatory coherence

The inclusion of third country provisions has been problematic across a number of regulations, including AIFMD and MiFID. While the end result in these dossiers has ultimately been workable for the industry, the starting position by the Commission would have severely restricted cross-border flows with third countries pending equivalence decisions, a process which is often lengthy.

More generally, the issue of mutual recognition/equivalence is one that needs to be dealt with at an international level and needs to be based on outcomes. This is why we would support equivalence assessments being based on compliance with international standards. Reciprocity should be avoided.

Process and procedure

A key concern regarding the EU financial framework is centred more on the process than the content. The financial crisis exposed deep failures in the existing regulatory architecture which required sweeping changes across the board, including the regulation of sectors which have previously been largely unregulated. In approaching this task, we believe that the European Commission should have prioritized work which was central to tackling the key lessons learned from the crisis, such as too-big-to-fail and interconnectedness, which was not always the case. For example, some of the earliest legislation proposed included AIFMD and the short-selling and CDS regulation, neither of which tackled issues which were central to the causes of the crisis, but rather responded to political pressures to regulate unpopular sectors the financial system. Whereas the Bank Recovery and Resolution Directive, which is key to ending too-big-to-fail and ensuring the taxpayers does not need to step in to rescue banks in the future, was one of the last pieces of legislation to be proposed and agreed at EU level.

This lack of coherence and prioritization in the way the Commission approached the task of re-regulating the sector can also be seen in the area of Credit Rating Agencies. Never before has the EU been simultaneously implementing one directive (CRA1), while finalizing a second (CRA2), while the Commission proposes a third. This constant flux in the regulatory system not only diverted resources from other areas, but led to huge uncertainty for the industry and investors, which ultimately is detrimental to the wider economy.

Another key area of concern is that of impact assessments. Currently, the European Commission produces an impact assessment when it publishes its proposal, but that proposal is often radically transformed during the negotiations in the Council and European Parliament, without any of these changes being subject to any form of impact assessment. This means that there is no way of gauging whether the cost-benefit analysis remains valid once the legislation is finally agreed.

Furthermore, we believe that the Commission's impact assessments were too heavily focused on direct costs to the industry, instead of analysing the broader impact for the financial system as a whole and on end-users in the wider economy.

Finally, we believe that the Level 1-Level 2 relationship has not functioned as it should in many cases and that this needs to be addressed. We would like to see greater clarity and certainty in Level 1 texts and in mandates for the development of Level 2 rules. The timescale for producing delegated acts is also an area of concern, as the policymaking process often leaves too little time for delegated acts to be adopted and for industry to prepare for implementation. We suggest that the ESAs produce an initial timeline for the implementation of the Level 1 rules and conduct periodic reporting on how the rule-making process is being implemented between Level 1 and Level 2. It is important that appropriate time is available for rule-writing and testing during the development of new rules or guidance.

Future priorities

In the past 5 years, over 40 new directives and regulations have been agreed in the EU, including some covering areas of the financial sector which have hitherto been largely unregulated (such as CRAs). However, the agreements reached at Level 1 are only a first step and the priority for the next 5 years should be the implementation and enforcement of these directives and regulations across the EU. Over the coming years, a number of review clauses will also fall due and it is important to seize these opportunities to assess the effectiveness of this new legislation and amend it as necessary to ensure that the objectives are being met and unintended consequences are avoided.

In terms of further legislative work, we believe that the focus should be on the jobs and growth agenda. Financial stability has been the focus of the legislative agenda over the past 5 years, but we must now look at how we can promote investment and trade in the face of bank deleveraging. This, of course, does not mean undoing the good work that has been done over the past 5 years, as financial stability is a pre-requisite for growth. Rather, we would like to see additional focus on the calibration of the rules to ensure that the correct balance is achieved between growth and competitiveness and stability.

The move towards central clearing has also lead to the concentration of risk in CCPs. We would therefore support the introduction of recovery and resolution legislation for financial market infrastructure.

ANNEX

1. **What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis of your assessment?**

We are generally supportive of the reforms brought forward since 2008 as necessary to implement the Pittsburgh G20 agenda following the financial crisis. However, differences in regulations across jurisdictions have caused difficulties for cross-border business operating in multiple jurisdictions and legal frameworks and could negatively impact global capital flows.

2. **Will the new regulatory framework enable the EU to withstand further asymmetric shocks and future crisis as yet unforeseen? Is there sufficient flexibility in place to enable it to do so?**

Yes, we believe that the EU will be in a much better position to withstand future crisis following the reforms. However, we must be vigilant to new risks being created in the system, including the systemic importance of CCPs and risks arising from shadow banking.

3. **Where do you think the biggest achievements have been made and why? Do you believe that there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?**

The sheer scale and breadth of new regulation, in such a short space of time, is in itself a big achievement. It is difficult to assess at this stage what unintended consequences might arise as a result of this new legislation and to assess the costs and benefits of the new regulatory framework until it is fully implemented.

4. **Which elements of the reforms have been most and least effective in addressing consumer protection; market efficiency, transparency and integrity; and financial stability?**

Market efficiency, transparency and integrity: *MiFID2 and MiFIR, once implemented should be effective in addressing some of the unforeseen consequences of MiFID 1 as well as improving transparency and price discovery and taking into account advances in technology in the trading environment. However, we believe that ESMA and the national regulators should look very carefully at how these new transparency requirements will be calibrated at Level 2 of the legislative process. An inappropriate calibration will damage a market maker's ability to trade from inventory and will negatively impact liquidity.*

Financial stability: *Bank recovery and resolution is critical to end too-big-to-fail and ensure that the taxpayer does not have to bail out the banks in future.*

Consumer protection: *The revision of MiFID and the new rules on PRIPs should ensure better transparency for consumers.*

5. **How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were the regulatory proposals improved or weakened by the input of the Council and the European Parliament?**

While it is to be commended that such a radical overhaul of the regulatory framework was undertaken in such a short time, flaws in the legislative process were apparent. A key concern is the role of impact assessments, both at the stage of the proposal, which is too heavily focused on costs rather than impact, but also the lack of assessment of any amendments made by the Council or Parliament.

With regards to the input of the Council and the European Parliament, the end results, compared with the starting point of the Commission proposal, would show that their involvement was positive. However, this generalisation disguises large disparities across dossiers. Taking CRD4 for example, the Parliament's input on trade finance was positive but their push for a cap on bankers pay for negative.

Finally, we believe that the Level 1-Level 2 relationship has not functioned as it should in many cases and that this needs to be addressed. We would like to see greater clarity and certainty in Level 1 texts and in mandates for the development of Level 2 rules.

These issues should be addressed within the context of the next Commission's focus on 'Better Regulation'.

6. **How do you think the 'growth agenda' and support of alternative financing courses can be best promoted by the EU with respect to regulation?**

Policy actions should include revitalising the European ***securitisation*** *markets, fostering* ***long term investments*** *and developing a* ***private placement*** *market.*

Work on the demand side, such scaling and reducing fragmentation of institutional investors should also be looked at, but many of the levers necessary to have an impact on this are Member State competence.

7. **Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?**

The treatment of securitisation in CRD4 and Solvency 2 is an obvious example of an inconsistency but there are many others that cannot all be enumerated here.

More generally, we are concerned about the contradiction of objectives. Policymakers talk about promoting jobs and growth, but introduce rules that introduce the opposite incentives for financial actors, such as the treatment of infrastructure investments in Solvency 2 or the push to introduce a financial transaction tax. The regulatory framework needs to be considered in the round and ensure that the incentives it creates support the broader aims of the economy.

8. **Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensure that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?**

The imperative is implementing and enforcing the rules that have been agreed over the past 5 years. While some measures will need to be adjusted, we believe that this can only take place once the rules are fully implemented and that the full body of regulation can be evaluated in the round and any changes made. While a hiatus from further reform would be welcome, there are still gaps

in the regulatory framework before we can say that the reform project is complete, including proposals on recovery and resolution for financial market infrastructure.

9. **The Commission argues that the new and/or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?**

We agree that measures relation to recovery and resolution of financial market infrastructure and benchmarks is necessary to complete the reform agenda.

Europe should also promote policies that ensure that financial markets can maximise their role in funding the wider economy. This includes policies that will revitalize the securitization market.

The increase of shadow banking activities may pose new risks, which policymakers will need to continue to monitor.

We do not see the need for bank structural reform to be done at EU level. National measures have already been taken where it was deemed necessary to respond to the specificities of that market and trying to harmonise this area at such a late stage will only lead to uncertainty and additional cost.

10. **Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?**

The focus of the reforms has rightly been on financial stability and market integrity but we are concerned that the needs of end-users have often not been taken into account during the policymaking process, particularly with regards to the assessment of the impact of regulation on end-users in impact assessment. The area of consumer protection has been identified as a priority area both by the European Parliament and for the ESAs so we anticipate more work will be undertaken in this space over the coming years.

11. **How concerned should we be about the range of unintended consequences from such regulation- such as regulatory arbitrage and transferring risk off balance sheet?**

In the past 5 years, over 40 new directives and regulations have been agreed in the EU. Many of these proposals are still being implemented. It is only when all the proposals are fully implemented that policymakers and market participants will be able to assess what the cumulative impact will be. It is only then that potential unintended consequences will become fully clear. This is why we believe that implementing and enforcing the vast swathes of recent legislation should be the primary objective for the next 5 years.

However, there are already signs that some of the legislative proposals may negatively impact markets' abilities to finance growth. An example of this is the calibration of transparency measures under MIFID, which if not well calibrated, may impact financial institutions' abilities to

make markets. It is therefore important that any new proposal is measured against the growth objective.

12. **Is there now an effective balance between Member States and the EU in terms of regulation and supervision of the financial sector? If not, how can such an effective balance be struck?**

Yes, we believe that, on the whole, the balance of competence between the Member States and the EU for financial services is in the right place in order to ensure a level playing field across the Single Market. In the area of wholesale financial markets, a greater degree of harmonisation and integration is appropriate. In other areas, such as the retail sphere, a greater degree of flexibility is warranted to take into account differences in local markets. A greater emphasis on subsidiarity and better regulation would be helpful going forward.

13. **Is the EU process for adopting rules efficient and nimble enough to adjust and calibrate the new Single Rulebook? Which single element of the new Rulebook is in most acute need of careful monitoring and review?**

Achieving the right balance between flexibility on the one hand and regulatory certainty is always finely balanced, as is the balance regarding granularity between Level 1 and Level 2. We would encourage greater clarity and certainty in Level 1 texts and in mandates for the development of Level 2 rules.

14. **What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to 'equivalence'? Is there a danger of 'multiple jeopardy' arising from the multiplicity of regulatory regimes across the EU and beyond?**

The inclusion of third country provisions has been problematic across a number of regulations, including AIFMD and MiFID. While the end result in these dossiers has ultimately been workable for the industry, the starting position by the Commission would have severely restricted cross-border flows with third countries pending equivalence decisions, a process which is often lengthy.

More generally, the issue of mutual recognition/equivalence is one that needs to be dealt with at an international level and needs to be based on outcomes. This is why we would support equivalence assessments being based on compliance with international standards. Reciprocity should be avoided at all costs.

15. **In light of the fact that some of the regulatory framework applies at EU-28 level, and other elements for the Eurozone only, is there a danger of a two-speed or inconsistent approach to regulation?**

There is no inherent conflict between regulation being decided at the EU-level and supervision taking place at Eurozone level. However, we believe that the Single Rule Book should always apply at EU28 and that the role of the ESAs and the European Commission in protecting the Single Market, by ensuring a level playing field between ins and outs, will be crucial.

16. **What are the challenges of the regulatory reform, agenda for non-Eurozone Member States? In particular, which specific challenges does the UK face? How has its approach to the regulatory reform agenda compared with that of other non-Eurozone Member States such as Sweden and Denmark, as well as those such as Poland who are required to join the Single Currency in due course?**

The potential for contradictions between the Single Market and the Eurozone exists and it is necessary to ensure that financial services regulation remains for all EU28. The threat of caucusing by the Eurozone theoretically exists but there is, as yet, no evidence of this taking place. The key difference between the UK and other non-Eurozone Member States is the attitude and engagement of the UK Government towards the EU.. In a world where no single Member State has a veto, it is essential that the UK be fully engaged in negotiations and work with its allies to deliver better outcomes.

17. **Overall, do you believe that the UK's interests have been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?**

We believe that the UK's interests have been taken into account in the regulatory reform agenda, but compromise is necessary in a Single Market. A good example is the inclusion of double majority voting in the revised EBA Regulation that accompanied the SSM proposal to ensure that non-SSM members cannot be outvoted by the SSM members. This is a good example of the UK being able to deliver a good outcome for the UK and we believe that the UK Government could achieve such outcomes more frequently if it were better engaged in the European debate and able to build a coalition of support with like-minded countries.

The UK has an essential role to play within the EU to continue to make the case for open international capital markets, to improve the competitiveness of European industry and to influence the creation of a Single Rulebook for the benefit of the EU as well as the UK.

4 October 2014

Investment Management Association–Written evidence (FRF0025)

The IMA represents the UK-based investment management industry. Our members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members manage investments worth more than £5 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Our members' interest in your work is therefore in their role as the "buy-side" of the market, accessing capital markets on behalf of their clients.

The IMA's purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

This letter responds to some of the key themes that the inquiry investigates. It draws on the IMA response to HM Treasury's Balance of Competences Review, which addresses the issues in greater detail (please let us know if you would like a copy).

Please see the IMA website *for more information on the Association, its membership and its purpose.*

Importance of the EU to UK Asset Management Industry

The importance of European markets as sources of export income for UK-based asset managers can be seen in a number of ways. IMA data suggests that almost £1trn is managed in the UK on behalf of European clients. This ranges from retail savers using investment funds such as OEICs and SICAVs through to institutional clients such as pension funds and insurance companies. The UCITS framework in particular has established a pan-European fund product set and an accepted brand that has also served as a springboard for fund exports internationally, from Asia to the Americas.

At the same time, while the UK as a domicile for funds has been eclipsed in growth terms by other jurisdictions, notably Ireland and Luxembourg, there is significant delegation of the asset management function to UK-based managers. An estimated £720 billion is managed for overseas-domiciled funds.

With changes to the UK tax regime now making it more attractive to domicile funds (as well as manage assets) here, the UK 'Investment Management Strategy' will hopefully contribute to greater growth in this area and enhance the UK's role as a world-leading asset management centre.

Serving overseas clients is not simply a matter of the scale of the UK as a financial services centre. It is also about the ability to develop new expertise for export. One example in recent years has been the development in the UK of an 'exportable' product set for Liability Driven Investment (LDI, which better seeks to match scheme asset and liability profiles for Defined Benefit pension schemes). There has been some success in 'selling' this product set in the US.

Within the EU, with a shift towards Defined Contribution (DC) schemes likely to accelerate in coming years, there will be opportunities for the UK asset management (and pensions) industries to play a role as welfare systems evolve across the EU.

The importance of a single EU market is not just about benefits to the financial services industry and an associated contribution to UK balance of payments and the economy. It extends to UK savers and investors, in the form of access to a broad range of products and expertise. Ultimately, greater scale in consolidated fund ranges also feeds through to more efficient, lower cost investment vehicles. There may be a moral here for the pensions debate, too. There might be particular benefits from the emergence of tax transparent funds, serving highly diverse individual European member state fiscal arrangements.

Strengths and Weaknesses in the EU Financial Regulatory Framework

In the IMA's view, while the manner in which certain EU institutions operate in practice may sometimes leave something to be desired, it is hard to argue with the logic of a balance of competences between Member States, Parliament and Commission-plus- European Supervisory Authorities. In financial services this framework facilitates regulation at EU level, which helps (wholesale) markets to function fairly, promoting confidence and thereby ultimately serving the broader economy. Combined with measures to protect retail customers from unfair practice, one has a common EU framework that supports business across a single market.

The basic framework for EU financial services legislation appears to be consistent with the approach of the UK, in that it sets out key principles for conduct of business, distinguishing between levels of expertise in the market and envisaging a major role for proportionate supervision.

However, the institutional arrangements clearly embed an incentive for the European Commission to produce ever more legislation, as part of its raison d'être. There have been periods where this has been tempered but the past five years are not one of those periods. The temptation more recently, however, appears to have been that 'more' regulation ensures better outcomes and that 'more' must be expressed as new pieces of legislation. This phenomenon is not unique to the EU, but that does not make it right. For example, to introduce requirements for clearing OTC derivatives without first establishing how these obligations will work for a wide range of end-users strikes us as ambitious at best.

The counterpart of excessive Commission – and EU co-legislator – resource devoted to proposing and legislating new laws is inadequate attention to making the existing laws and rules work more effectively. The ESAs too are obliged to devote an excessive amount of their more limited resources to advice, rule- making and guidance-giving under new EU legislation. It would be better if all these actors, but especially the Commission, devoted greater resource to proper,

consistent application of existing laws and rules. This would be in keeping with the better regulation agenda, to which the Commission, for example, is already committed.

The sheer amount of new legislation – and the haste with which some of it was proposed – has been a burden on members. While legislation after 2008 may have been inevitable, too little account was taken of the need for firms to plan ahead and to create related infrastructure (notably IT). The volume and detail of EU rule-making can be problematic in accumulating overlapping requirements. Firms particularly mention a multiplicity of reporting obligations across the EU, each of them challenging in their own right.

In certain areas connected to financial services, notably pensions, EU objectives have sometimes sat uneasily with one another. For example, consumer protection ('safety') is emphasised heavily in the Commission's 2010 Pensions Green Paper. While an emphasis on consumer protection is perfectly logical per se, it can be dangerous if taken to an extreme and in isolation from other considerations. Safety should manifestly be balanced with the goals of adequacy and sustainability, which will almost certainly entail some degree of risk-taking. Yet the objectives of adequacy and sustainability could be made far more difficult to achieve in an environment where a shift to (low-return) 'safety' results in sub-optimal long-term investment decision-making. Indeed, one could argue that a regulatory bias towards de-risking – which tends to encourage increasing exposure to fixed income instruments, even in a period of historically low interest rates – is anything but a position of safety.

The current system lacks rigour in cost-benefit analysis. Impact assessment tends to be high-level and can be driven by dogma, in a manner which threatens to bring the whole process into disrepute. Greater economic cost-benefit analysis is important, as is the preliminary application of common sense (for instance, considering what the real impact of a financial transactions tax would be). A measure such as the Short Selling Regulation is in danger of punishing markets for the messages they convey, when the underlying problem lies elsewhere.

In addition, too often recently the EU legislative process has departed significantly from the widely supported Lamfalussy blueprint by locking technical detail into primary legislation. Examples include the AIFMD, which incorporates in measures on VaR calculations and on retention standards (in relation to securitisations) quantitative provisions which are arguably adequately better covered elsewhere, in ESA measures. It is also debatable whether the changes proposed to the UCITS regime by the Commission in its 2013 Green Paper truly merited a new piece of legislation, rather than technical 'fixes'.

The current EU framework also fails sufficiently to protect the role of the ESAs. While ESAs are doing more work than ever, paradoxically their role appears to have been undermined, which is unfortunate. The potential for the work of the ESAs to become a political football for the Commission and Parliament appears to be high, based on experience with technical standards under EMIR specifically and, more generally, the ease with which the Commission can choose to ignore ESA conclusions. It is also unsatisfactory that the time available to ESMA to develop technical standards was eroded by delays in finalising EMIR. This is particularly disappointing, since the ESAs' work does in principle provide an important check on the legislative process, incorporating as it does genuine consultation with industry.

As regards supervision rather than legislation, the gradual shift towards more power for the ESAs is something that requires careful scrutiny. The system of passporting is tried and tested and, while we strongly support the role the ESAs can play in promoting consistency and enforcement of EU legislation, we believe this will be at its most effective if it is backed by healthy national supervision, which can in principle cope better with the subtle differences between Member States and their financial markets.

Somewhere in between legislation and supervision lies the issue of forbearance, which under the EU system is orphaned. In fact, once a piece of legislation comes into force, the EU system as currently operated is conspicuously and unhelpfully lacking in any way to create legitimate exceptions – whether temporary or permanent – or to amend legislation quickly. Review clauses go only a very short way to addressing this and there is a strong case for relying much more on framework Directives, to avoid unnecessary rigidity in the system.

29 September 2014

JP Morgan- Written evidence (FRF0026)

1) Reflection on the evidence from Sharon Bowles that proposals were internally consistent at the point that they were brought forward by the Commission but became inconsistent as a result of amendments in Council and the EP

We agree with Sharon Bowles' remarks that there may have been instances in which draft proposals published by the European Commission may have been written without a full analysis of the changes made in the European co-decision process to rules that previously passed both the European Parliament and Council.

With regards to Ms Bowles' testimony, however, in which she made specific reference to the "time limits [granted to the European Parliament] for approving regulatory technical standards and delegated acts", more research would need to be done to identify each proposal for which this may have been the case.

We would however point to the following as an example for "consistency" in the European Commission's approach to new draft rules, which then "became inconsistent as a result of amendments in Council and the EP" (as per the wording in your question):

In recent capital markets proposals, the Commission has repeated a particular policy view, even though that same approach had previously been rejected and modified by the Parliament and the Council in earlier legislation. For example, the Commission has proposed to simply expand the scope of equity regulation to non-equity markets, based upon the assumption that equity markets and non-equity markets share a wide range of characteristics and can therefore be governed under the same statutory regime without negatively impacting the efficiency and functioning of non-equity markets.

Despite efforts by the Parliament and the Council to correct this approach in MiFID 2/MiFIR, the Commission subsequently proposed to take the same approach under the Central Securities Depositories Regulation, by extending the mandatory buy-in regime applicable to shares under the Short Selling Regulation to non-equities markets. Provisions in the Markets Abuse Directive and Regulation are another example.

2) Figures on the cost of compliance compared to turnover and profitability before the outbreak of the financial crisis, if possible broken down by EU obligations and global obligations that the UK would have had to carry out even if not a member of the EU

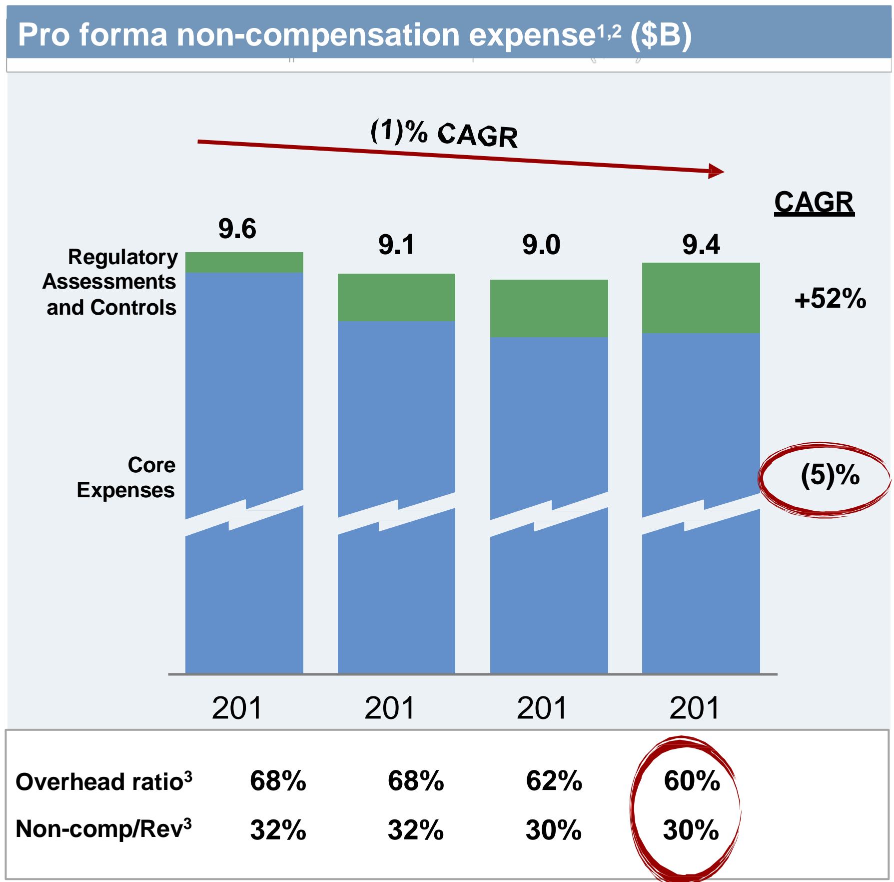
Since 2012 through end 2014 13,000 employees will have been added to support regulatory, compliance, and control efforts across the firm. Of those, 8,000 alone are focused on our AML programme. 500 work globally across various lines of business to support functions working on firm's annual recovery and resolution plans. 400 are dedicated to building out liquidity risk management.

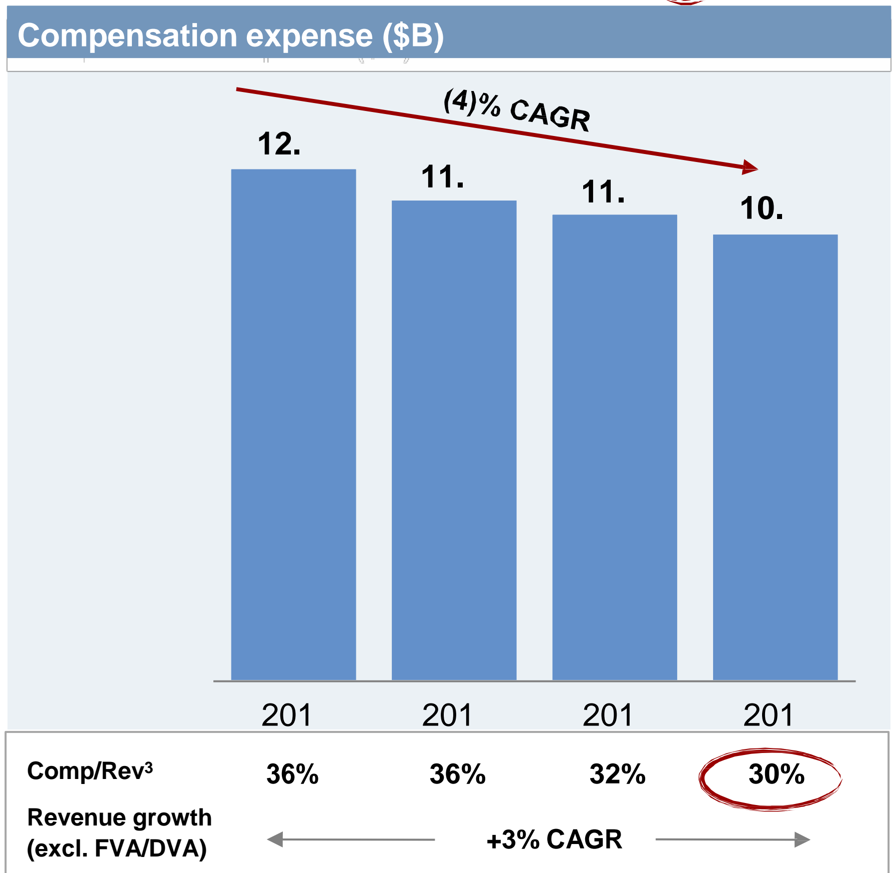
In addition, we spent $2bn in additional expenses on control efforts (between 2012-14) and $600m spent on technology focused on regulatory and control space agenda.

We would also like to draw your attention to the attached slide from our 2014 investor day presentation, which indicates our work in offsetting increases in regulatory and controls spend via enhanced expense discipline.

Please note that we do not publish UK-specific numbers.

CIB expense discipline across both non-comp and comp have offset increases in regulatory and controls spend


Pro forma non-compensation expense1,2 ($B)
(1)% CAGR
CAGR
9.6
9.1
9.0
9.4
Regulatory Assessments and Controls
+52%
Core Expenses
(5)%
201
201
201
201
Overhead ratio3
68%
68%
62%
60%
Non-comp/Rev3
32%
32%
30%
30%


Compensation expense ($B)
(4)% CAGR
12.
11.
11.
10.
201
201
201
201
Comp/Rev3
36%
36%
32%
30%
Revenue growth (excl. FVA/DVA)
+3% CAGR

- Significant investment in enhancing controls driven by AML / KYC, trading surveillance, cyber uplift
- Increase in control spend for legal, compliance, operations and risk functions
- Disciplined SVA accrual driven framework for compensation

1 Excludes Commodities transaction fees and related expenses; litigation losses included as core expense

2 Regulatory assessments include FDIC, UK Bank levy, FSA and other regulatory fees. Controls expense includes both Corporate-allocated and CIB incremental expense

3 Overhead, comp/revenue and non-comp/revenue ratios exclude FVA and DVA impact. 2010 compensation expense of $12.4B includes $0.6B related to UK Bank Payroll tax, while the comp/revenue and overhead ratios in 2010 excludes the UK Bank Payroll Tax impact

Source: Investor Day presentation 2014

JP Morgan

5th November 2014

Karel Lannoo, Centre for European Policy Studies- Oral evidence (QQ 62-79)

Evidence Session No. 4 *Heard in Public* *Questions 62 - 79*

TUESDAY 23 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witness

Mr Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

Q62 The Chairman: I warmly welcome Karel Lannoo, who has been with us before. Thank you very much for coming again today to our investigation into the EU financial regulatory framework. Just to give you some background, we are both looking backwards at what has been done over recent years in Brussels and looking forward to trying to get a feel, as we ourselves come up to a general election and we see a changeover in the Commission, for the kinds of things that will be important on the agenda. We know that you could be very helpful to us on that. As before, and as you will recall, we make a note of what is said and a transcript will be sent to you. We ask you to have a look at it and correct it. As ever, when you have some wonderful new ideas after you have left the room and you think, "Gosh, I didn't mention that", please forward those on to us, to tell us about those things that are always being updated.

Perhaps you could say a little about where you come from and what you think about what has been done with reform since 2008 in terms of stabilising and improving the functioning of the financial sector in Europe. Do you think that we are anywhere near being able to withstand further asymmetric shocks and future crises? Perhaps as important, has what has been done introduced sufficient flexibility into the system so that, although we never quite know what will be different and what will change, we will be able to respond as 28 member states to those kinds of changes?

Karel Lannoo: Thank you. It is a pleasure to be here. I have followed financial regulatory issues for a long time—more than 20 years, I think. Initially, that was more a matter of survival, because it was an area that was progressing well compared with many other areas on the European agenda, but of course we have seen since the financial crisis that this issue is extremely important and that awareness of it was far too limited.

I have directed CEPS for the past 14 years, so I not only follow these issues but I am in charge of the management of the organisation. We are, I think, the largest think tank in Brussels. There are a few others around, but we are the one without any subsidies. We participate in issues for the European authorities, but we do not have any sponsorship from national or European authorities in terms of subsidies, so we have to be in the market all the time and make sure that we are relevant as an organisation.

Of course, our work on financial sector regulatory issues has been extremely important over the past five or six years, with the financial crisis and then the sovereign crisis, and we have been in the news a lot on that. Our investment in these issues has paid off, so to speak. Of course, today other issues are emerging, such as the institutional reform that we see not only at European level but also, as we were discussing, in energy policy, which is becoming one of the most important issues. Within CEPS as well, that is the most important unit revenue-wise this year, for example.

Where are we in financial sector reform? As I said, and it is an important caveat, we have no subsidies and rely on sponsorships, so we try as a think tank always to be entirely independent from interest groups, of which there are many around. Certainly in financial sector reform, there are many very strong and very well organised groups, which can push the agenda in one direction or another. I will certainly come back to this in a moment, if I speak about capital regulation in the banking sector or structural reforms. To a large degree, independence is always to some extent fictitious—it is an illusory concept. I think that we can claim to be very independent from any interest, even if we are private, so to speak, and get no subventions from any state or European authority.

What can we say has been achieved in financial sector reform? I think a lot. I have overall been very positive about what we have achieved since the April 2009 G20 in London, which was basically the starting shot. I think that Commissioner Barnier can leave on a very high note, as he has achieved almost everything that was foreseen on the G20 agenda. The last important building blocks were achieved over the last months, with the recovery and resolution directive. That was an extremely important piece of legislation, on which the UK and UK law firms have been very helpful. For me, it is almost unprecedented to think that we have a piece of legislation covering liquidation for 28 countries, which is something that we have tried to achieve since the early days of the single market, also for the non-financial services sector, which is extremely difficult and continues to be a barrier to market integration. So the recovery and resolution directive is an extremely important piece of legislation. With this, we also have something designed for banking union, which is the single resolution mechanism.

We have also got agreements in the past few months for MiFID II, which is to do with trading. It is an update of MiFID I, but it also deals with price transparency for trading in bonds and derivatives instruments. That was also related to the G20 agenda, but I think that

it is extremely important that what we have in equity markets also applies to the bond markets, meaning that there is much more transparency in buying and selling of all forms of bonds—not only government bonds but corporate bonds.

We also got agreement on the deposit insurance directive, which is sometimes overlooked. It is said that the three legs of banking union are SSM, the single supervisory mechanism, then the BRRD resolution, with the third one being the deposit guarantee directive. That was not what some people dreamt, which is probably why they may have forgotten it—they dreamt of having a single deposit insurance system. We have a further harmonisation of the national and in some cases private deposit insurance systems in the member states. There is agreement on a prefunded level of 0.8% of eligible deposits, which has to be put into a fund. This has to be prefunded, which is new, and it has to be paid out if it ever comes to a banking crisis, within even a limited period of 10 days or 12 days. Of course there are transition periods.

Q63 The Chairman: Let me stop you there, before I bring in Lord Shutt. Is that an example of what has been done to make matters much more secure but also an example of flexibility being exercised? The deposit guarantee scheme was not seen as an important third part. You are right to remind us that it was put in place very much as a second best.

Karel Lannoo: I personally think that it is not second best. I think that it is a good solution. Of course, the debate will go on about whether we need a single Europe-wide system, as exists in the United States with the US Federal Deposit Insurance Corporation. Of course, if you have systems that are well funded and have a lot of money, while others have nothing, it is extremely difficult to acquire and to merge, as you can imagine. If you know that the first requirement is that all funds over a transition period—by 2024, I think, at the same time as the BRRD resolution fund has to be in place and fully funded—have to be fully funded at 0.8% of deposits, I think that that is a big step forward. The requirement is for them to be

prefunded not ex post but ex ante. Many funds today are ex post, which means that they can call on the banks if there is a shortage, but now we have it ex ante. They are paid out within a limited period of time so that we do not have bank runs. That is extremely important. Also, there are some European elements. There can be lending or borrowing between funds, so that in a cross-border bank the branches should be bailed out by the home country. The home country can borrow from the host country if there is a problem with paying out, for example, and a loan can be concluded between the two schemes, which has to be paid back over a maximum of five years. That is now in place. On top of that, there is another facility in the new directive. There is borrowing between funds and there is another thing, which I am afraid escapes me now. I think that this is a big step forward from what we had. On top of that, there is harmonisation of a maximum, so that we can pay a maximum of €100,000. You have to realise that we have the bank resolution and recovery directive, so that everything above €100,000 could in principle be bailed in. The system that we have today, as applied in the context of Banco Espirito Santo in Portugal, for example, means that only subordinated debt can be bailed in. The new bank resolution and recovery directive also means that all forms of senior debt can be bailed in, with some exceptions, such as deposits, but only up to the level under which they are covered by the depository schemes. Once above €100,000, if the banks have very limited liabilities left, as we have seen in Cyprus, they could be bailed in. That is the new framework in place for the three legs of banking union.

Q64 Lord Shutt of Greetland: I was quite fascinated to learn that your unit is independent. To whom do you belong?

Karel Lannoo: You have many charities and non-profit organisations in your country. We have members: we are a membership-driven organisation. Our members have an annual general meeting to approve our accounts and our budget for the next year, appoint a board. We have statutes, like any other organisation.

Lord Shutt of Greetland: Are you basically funded by foundations of Europe?

Karel Lannoo: We are 25% funded by sponsorship of corporations. More than 100 corporations are members—for example, BP is one, as I mentioned David Simon. We also have many individual members and many associations in Brussels are members. Half of our funding comes from projects in which we participate with EU organisations, which may be the Commission, the Parliament, the Committee of the Regions, the Court of Auditors, the ECB and so on. There are whole procedures in Brussels for how to tender projects. We apply for projects where we have expertise. The last quarter is basically all other forms of funding, which may be many different ones.

Q65 Lord Shutt of Greetland: That is fine. You were labouring the point about all this independence, and I wondered: who do you belong to? Coming back to our inquiry, what do you think have been the biggest mistakes? Have there been any mistakes in terms of the EU regulatory framework?

Karel Lannoo: The biggest mistake, first of all, is that we were unprepared for this crisis. We had many rules in place, but we basically kept the system going along thanks to huge state aid but, for example, we did not use deposit insurance systems. How many banks have we let fail? There are a few in Iceland, one in the UK, two in the Netherlands and four or five smaller banks in Denmark—that is basically all. Until today, we have this huge debate about overbanking: is Europe overbanked? The European Systemic Risk Board of the ECB published an extremely popular paper on that—it has been downloaded 120,000 times—*Is Europe Overbanked*? That is still the question today. I have charts on this if you want, because I took some slides from a presentation which I gave on *Is Europe Overbanked?* The asset to GDP ratio is three times.

Lord Shutt of Greetland: It would be useful to have it, and then Members can get copies.

Karel Lannoo: It remains Europe's biggest problem: the whole issue about credit to the non-financial sector, to small and medium-sized enterprises. We have such a huge financial sector, there is excess liquidity and yet still there is a great problem. Why? I do not have the answer. I can give many explanations, but I do not have a single answer.

The second problem is that, because we were not prepared, we have reacted in a fairly panicky way. We needed to have a regulatory framework in place, but it still took us five or six years to put everything in place. I think that we have now achieved more or less everything, but in the mean time we have overlooked, for example, for the UK, what will be the impact of different rules. For example, the hedge fund directive, or, as it is called, the alternative investment fund directive, was fundamentally rewritten in the Parliament and in the Council, just because the Commission was not prepared to have something like that in place. Many pieces of regulation had to come out very rapidly. That was certainly a shortcoming in the response. It was much more a response to the G20 than to a European agenda. I have written another paper on this. I am very positive about what the G20 has managed to achieve, but you can ask whether it was a democratic process. At the global level, we agreed that we need to do this, this and this, which was extremely good, but to what extent was this driven by democratic institutions? It is good that we have a global agreement for a regulatory framework in Europe.

We have also seen a race to the top in regulation. Again, we were unprepared. We needed to have more regulation. The big question for me now is: can we please stop at some stage? Certainly at level 2, which are implementing measures, which are done by the European Banking Authority in London for the whole of the EU, the process is getting out of control. Also there is the accountability for the process. For one piece of regulation, the capital requirements directive CRD IV, there are 75 implementing measures that are finalised or being prepared by the European Banking Authority. Each may be five pages, 20 pages or 100

pages. That is level 2. Proposals for level 2 are sent to Parliament here in Brussels. Parliament has three months to react, and if it does not react, it is adopted. That means that the Commission has almost a free hand. If the EBA or whatever authority has asked to make implementing measures for part of a regulation or directive, it drafts them, they are sent to the Commission, the Commission puts them forward to Parliament. If it does not react in three months, they are considered to be adopted.

Lord Shutt of Greetland: Are people up to taking on those 75 measures and giving them proper scrutiny?

Karel Lannoo: That is what I wonder. I have no answer to that question. Only yesterday evening, I asked someone from the banking sector that question. I have tried to get reactions on this from people from the banking sector: can you cope with compliance? I have the impression that they do not dare answer. Because of the situation of the banks today, they do not want to have any public scrutiny on this issue, so they do not reply even to us on these matters. If they are asked to speak about it in public in conferences and seminars, they avoid the topic. I wonder whether they can really cope. Certainly smaller banks must have a huge problem in doing so. If you have to follow the new rules at level 2, up to the final letter, it is extremely difficult and you need a compliance department of at least 20 people if you are a bank with even small operations.

Q66 Earl of Caithness: Looking back, which of the European institutions have done well and which did not come up to the standard that you would have expected? Do you think that the regulatory proposals were improved or weakened by the input of the Council and the European Parliament?

Karel Lannoo: It is difficult to say. I should try to remember specific pieces of legislation and how they fared through the decision process. Overall, if you are asking for my assessment, all three institutions have managed to get through a huge workload in a very short time. This

is also the case for the Commission, the Parliament and the Council. You have to imagine that there are thousands of pages of draft legislation to go through to understand the technicalities of, for example, liquidation measures or the control of rating agencies. That is enormous. Of course, as I said, the Commissioner sometimes did not have the time to do enough of an impact assessment and probably issued proposals too rapidly, but they were often corrected by the Parliament. The Parliament, which is often underestimated, has done a huge job. The economic committee in the Parliament has a staff of 20 people dealing with this as experts. My feeling is that it is almost impossible. Today we have seven or eight people in CEPS working full-time on financial services. A public body has probably 20 people to do this, together with the party secretaries. The real experts are in the economic committee. That is not sufficient. However, the Council and the member states have done a huge job just by respecting deadlines and the timing. If this piece of regulation—the BRRD—is adopted within 18 months, that is a piece of legislation of about 300 or 400 single-spaced pages, if you take the Council text rather than the PDF. It is enormous.

Earl of Caithness: Do you think the Commission has done a good job?

Karel Lannoo: Overall, I think it has done a good job. This morning people have asked me what the task of your new Commissioner, Lord Hill, will be. I cannot say, as was said in the media, that Lord Hill, since he is British, will be questioned by the European Parliament. I cannot say that Barnier was French in the way that he has done this. I think he has done his job as a European Commissioner and I think he is probably one of the best Commissioners. That is probably the yardstick for your Commissioner.

The Chairman: We are seeing him tomorrow, by the way.

Karel Lannoo: I have met him already, thanks to your permanent representative.

The Chairman: No, I mean M Barnier.

Karel Lannoo: I have seen him several times, of course, but his weakness was that he did not speak English well enough, which I regret, but that is the only thing I can say against him.

Q67 Earl of Caithness: Talking about our Commissioner leads me on to my second question, which is about growth, because our Commissioner has capital markets union—whatever that means and however you define it. How do you think the growth agenda for alternative finance sources can best be promoted? What are the chances of a well regulated capital market? Is that not a contradiction in terms?

Karel Lannoo: I also have difficulty with these two concepts—the capital markets union and the growth agenda to fill them in—certainly from a capital markets perspective. If I think about it, first, we will have to define capital markets union. If I look at what initiatives we have taken over the past 20 or 25 years in this field, you may remember that in the early 1990s, we tried to create more a horizontal stock market for all of Europe long before Euronext, but we did not achieve it. One trading platform, one settlement platform and one clearing platform did not succeed. Today, most stock exchanges are vertically integrated. That is one thing we will have to do, but does it mean that we have to regulate? I think we have to apply the rules, which we have, and we have to apply the rules of competition.

If we look at settlements, you probably know the UK Stock Exchange owns an Italian entity, Monte Titoli, and the Italian stock exchange. Many exchanges still earn a lot of money with settlement, which is basically a monopoly at the level of the member state. It is an area where we do not have real competition. It may now change with the CSDR—Central Securities Depositories Regulation—but we still have to see. It is only now starting to have an effect.

From there, how could we create growth through having a more vibrant capital market? I think it has to do with reducing the dominance of banks and raising awareness, which is not something you can regulate, by saying to people on both sides, the buying and the selling

side—meaning those that have IDs—that there is a capital market and not only a bank, and saying to the capital market that it has to consider these initiatives much more carefully, like in the United States. How is it possible that Twitter has a market capitalisation of so many billions but has revenues of probably only $200 million and it still managed to go to the market and find funding? Why can we not have similar things in Europe? It has to do with many things, but it is not something that we will manage to regulate right away to create it.

I also think that at the moment as a result of the financial crisis there is far too much risk aversion, not only among the banks but among investors. They are averse to taking any risks, so that is why they have massively invested in government bonds. That is why yields on government bonds are so low, certainly for German Bunds, but they have changed a bit. That is why many households have just gone away from investing in stock exchanges and equity. That is why the MiFID II initiative, which I have mentioned, will be extremely important. MiFID II regulates transparency in bond markets and derivatives. Certainly the bond side is also important. If you cannot go to the equity market, at least you can issue bonds as a private enterprise. That is still something that is limited to large corporations, not small or medium-sized corporations. If, for example, the cost of issuing bonds is far too high, and buying and selling these bonds is not attractive because the spread is far too high, you do not do it. Many of these things were discussed in the early 1990s, even in the Financial Services Action Plan, which was driven through here in Brussels during the earlier part of the past decade. There is plenty of regulation. For example, we have worked on prospectuses, in MiFID I we worked on market abuse, we have worked on insider trading and we have harmonised and amended many of these rules. I do not think that capital markets union means another wave of regulation—absolutely not. It is above all about making sure that what we have adopted works, that markets integrate, that we have a European capital market, not a series of national capital markets next to each other, that

there is awareness that capital markets exist, and that there are many different initiatives to help people who have good ideas to go to the markets, not only at the stock exchange but at the level of—I would not say local organisations—national or regional governments to stimulate these things.

To what extent this can be co-ordinated at a European level is a matter of applying the rules. I just do not know. Of course we have the European Investment Bank and other organisations which can do this but, as we see in the stimulation of small and medium-sized enterprises financing, it is mostly an issue that is left to member states or regional governments.

The Chairman: Has the European Investment Bank gone quiet?

Karel Lannoo: Not as far as I know. I think its capital was increased two years ago, meaning there was a strong desire from member states for the EIB to become more active. That is also a constant theme which we have seen since 1997, or even before. I remember in 1997 there was pressure. I think Lord Kerr will remember from his time that it was on the agenda, and it comes back regularly. It is coming back on the agenda now. There is also pressure that the EIB should lend more, but then the EIB says that it cannot take on too many risky investments. The EIB also started, I think at the end of the 1990s or in the early 2000s, the European Investment Fund by which it participates in equities, not only debt finance but also equity finance in ventures, even in small ventures. I have not looked at the success of this, but apparently it says that it is the biggest multilateral investment bank in the world.

The Chairman: Is there a cry for it to do more? In a way, does that say that it is not big enough to do what it would like, or else that it is very concerned about the winners it picks?

Q68 Lord Kerr of Kinlochard: The EIB tends to like guarantees. It is not a risk-taker in the sense that it rushes to help an entrepreneur with a good idea. It tends to want national Government guarantees or European Union guarantees, or both.

I have a slightly different question. I think that much of the Barnier agenda was laid down by the G8 and the G20, so we would have had to have done it. So when we accuse the Commission of overlegislating, we should remember that we would have done it nationally, had we not been in the European structure. I think a better criticism is that we are dealing with the problems of the last crisis. As you say, we have been doing that in immense detail and the effect has not been to increase lending for growth or to open capital markets for growth. The banking system has been renationalised and the capital markets are sticky. What should we have done that we did not do? Let us stop talking about what is wrong with the things we did, and talk about what we should do. Where are the gaps? What unintended consequences have arisen? Is there a problem of regulatory arbitrage? I do not think there is, but if there is, can you describe what we should have done about it?

Karel Lannoo: To some extent, I have responded to some of these questions already. What are the gaps in the regulatory framework? The one which you hear about most often is the debate about shadow banking, but I am still not convinced—I do not speak for the rest of the world, but for Europe—that shadow banking is such a big issue because we have regulated for most of the things, even, for example, for off-balance sheet items for which a bank is structuring or setting up investment funds. There are fairly clear rules and a regulatory framework for these issues. On top of that, the European banking sector is so dominant that there is little room left for shadow banking. What is shadow banking? It could be mostly hedge funds, but hedge funds are now regulated, as I mentioned, and on top of that, hedge funds come and go. In the past few days we have seen in the newspapers that pension funds are stepping out of the hedge funds sector. It is purely market driven. So I do

not believe that shadow banking may be a problem. It may be a problem in the United States. I do not know its financial sector so well, but I know it has a much more fragmented overall financial system than we have in Europe.

What other gaps do we have? I think we have covered the financial system well. I think there are certainly issues on the retail side which are still outstanding. We have had a mortgage credit directive for only two years. There was nothing regulating mortgage credit at the European level before. We now have a directive on the level. It awaits implementation. It is in the process. It is a directive, not a regulation. There are other initiatives which could be taken on the retail side to stimulate the integration of European financial markets. That is related to the fact that we have the three authorities which are functionally organised—the banking, insurance and securities markets—but there is nothing that looks at, for example, the interests of consumers. We are starting to have many more cross-border consumers in Europe. The US started its Consumer Financial Protection Bureau as a result of the Dodd-Frank Bill. If you go to its website, it is an impressive organisation which today employs 1,500 people for a population of about 300 million. In Europe, our three authorities each employ about 150 people. If I download the data the Consumer Financial Protection Bureau publishes on its website, I say, "Wow!" That is something we may need to give consumers confidence that not only at national level but even European level there are ways for redress. I think that is a gap as a consumer issue. What are the unintended consequences? For my part, many may be related to overregulation or to the single rulebook. I think that previously the rulebook was good, but somewhere in the rulebook we need to have a rule concerning the extent to which we harmonise and where that goes. If you basically say that there is a single rulebook, the sky is the limit—you do not stop. You can regulate everything. Everything has to be the same for 28, or 31, countries. I think that that is extremely difficult to achieve because there are huge differences in the levels of development in the EU. What

can be good for London is not necessarily good for Bucharest. There may be a danger that we put the barrier far too high.

In certain areas, I am personally looking at the overlap between the EBA and the ECB. There are overlaps between the tasks that both authorities now have. I think that somewhere we need the REFIT exercise—that is what it is called at a European level—to set out clearly the differences between what one organisation is doing and what the other is doing. We need to check that there are no overlaps which then lead to competition between both organisations. For my part, the EBA is clearly the standard-setter for the single market. The ECB is one of the supervisors, but there should not be things where co-ordination would apparently not work between both organisations. I do not have specific areas in mind; we can only signal that there may be areas where there are problems. For example, the EBA sits on supervisory colleges. Have they been sufficiently adapted to the existence of the ECB? I do not know. The EBA can moderate on supervisory colleges, which is certainly useful between the eurozone and the non-eurozone, or the SSM and the non-SSM, but I think it is much less important than it was in 2010.

Q69 Lord Kerr of Kinlochard: May I ask about coherence? Sometimes it looks as though bits of the Commission might not have been talking to each other or watching how some other bits of the Commission's texts have fared in the Commission. Sharon Bowles was quite interesting in talking about the implementation periods and so on and about how the Commission kept sticking to its original model, even though the Council and the Parliament kept changing it. Could there be more coherence inside the Commission and, if so, will that be solved by the sorts of changes that President Juncker is going to bring in? Do you think that impact assessments could be done better? They often look as though they are written with the authors of the proposals, sometimes looking more like justifications than impartial

assessments. Should more outside advice be taken on the likely impact before a proposal is actually submitted?

Karel Lannoo: On your first question about coherence in the Commission, the good thing is that we had financial services within the market all in charge of one DG and one Commissioner, so I think that there was a wide degree of coherence. We now know that that has been reformed a bit, and the part which was looking after the financial stability of the EDF has been put with DG MARKT, so that will be an improvement.

Lord Kerr of Kinlochard: That was one awful piece of financial services legislation which seems to be not completely dead, a sort of zombie: I refer to the Financial Transactions fax. It came from a quite different bit of the Commission.

Karel Lannoo: Exactly. There are two DGs which have related responsibilities: the one on taxation and the one on consumer affairs. The funny thing is that the Consumer Credit Directive—the rapporteur at the time was Arlene McCarthy—came from the consumer DG and the Mortgage Credit Directive from the DG MARKT. That is not consistent but it is a retail issue. Then of course you have the FTT and tax-related issues, which are in the hands of DG tax. Then you may have incoherence. On the one hand you have DG competition, which looks after cartels and mergers, and it may have views different from those of other parts of the Commission, which may think that mergers are good for Europe's might in the world. If I follow DG MARKT over 15 or 20 years, I think that it has become more dominant in rule-making. That is why it has more responsibility for the Mortgage Credit Directive than before. So I think that the danger of inconsistency or lack of cohesion has probably decreased.

Going back to your question, what we see with the new Juncker Commission is that basically we have to restore the College. We have to say that if the Commission proposes something, it has the trust of all Commissioners. What Juncker has put forward—the project teams,

which are basically the Vice-Presidents and the Commissioners—are an extremely difficult challenge to put in place, but it is a very good development to make sure that these things which come from the Commission are properly debated and carry the consensus of the entire College and not necessarily just one person in the College.

We have embarked on a lot of work on impact assessments overall, rather than on a horizontal level, and we say that the quality of impact assessments continues to differ. We have databases that cover over 10 years of impact assessments. Impact assessments have been carried out widely at an EU level since 2003. Initially we started to see a decrease in quality and then, since the mid-2000s, an increase in quality, but we still see a lot of heterogeneity between DGs in the way that impact assessments are done. We also see an enormous difference between the ways that impact assessments are done at the member-state level. Essentially northern Europe is ready for impact assessments, not southern Europe. The REFIT exercise is basically trying to make rule-making better but there is still a lot of filling in to be done.

Is the Commission taking outside advice? I know that the Commission is doing that a lot. It has many advisory groups which have been created on an ad hoc basis. Some remain and some disappear. The question that I hear from colleagues on these kinds of advisory groups is: what happens to the input? Many people are giving a lot of time to attend these groups but what is done by way of follow-up from these groups is often very unclear. I am thinking, for example, of advisory groups in the context of EBA, ESRB, EIOPA and ESMA, as well as the many advisory groups which DG MARKT has. All those that exist in an ECB context certainly bring together very interesting people. What do they change? We do not know.

Q70 The Chairman: Before I move on to Lord Hamilton, I have a couple of points from Lord Kerr's questions. Do you divine any inconsistencies in the pattern of regulatory supervision that has built up? Could you help the Committee? We hope in time, perhaps as

our last cry before the general election in the UK, to do something about the evolving role of the European Central Bank. You have already talked about the potential overlap with the EBA. Could you give us a bit of help there? Are there inconsistencies with the evolving role of the European Central Bank?

Karel Lannoo: There are certainly inconsistencies in supervision, even in the new regulatory framework. However, first, we have to see it working. We have seen that the creation of EBA did not help. The EBA's stress tests were done on different reporting standards, so it was comparing apples with pears, so to speak. It did not work, so that is why we had to create the ECB. The ECB is doing a hell of a job to be ready by 1 November to take over supervision but I still have questions about supervisory reporting standards in the European Union. We know that supervisory reporting standards are based on accounting standards and we know that accounting standards have been harmonised in Europe only for listed corporations. To date, the commercial banks in Europe that are listed correspond to about one-third of the assets of the European banking system. That means that around two-thirds of the reporting of the banking system in Europe may not be harmonised, but we do not know. That is one of the big questions that I have. The EBA has tried to work on this over many years but apparently we needed the ECB to put its fist on the table and to say we need to have this, not more. Again, it is extremely difficult to get exact information and we can only guess to some degree. My biggest concern over the ECB in years to come, as we saw yesterday in Draghi's hearing in the Parliament, is that the ECB is asked to do too much, which it cannot do. It is now expanding from being a monetary policy agent to becoming a supervisor, so it will be asked to do even more. Basically, this is not in a negative sense, but there may be an overreach of the ECB because no other institution is taking over this task.

The Chairman: Or there has been a failure in the member states?

Karel Lannoo: Exactly. That is why the ECB is becoming the supervisor by default. It became a supervisor by default because we saw that the member states were not capable of doing it, or there was too much protection of national champions, and so on. That is one challenge. There is a whole debate about SSM and opt-ins and those countries that joined the SSM without being members of the eurozone. I have a chart in my presentation where you see this problem. Those with the opt-ins will not have a say in the governing council, which is the final decision-making body within the ECB. That is a problem but we cannot say too much about it because not one country has said that it will join, but a few are very close to deciding. Apparently Denmark wants to join. Whether it will be politically agreed upon is another issue. Another issue for the ECB is to distinguish its monetary policy from its financial stability tasks. We see already how difficult it is today in a context of deflation to take the right measures, but apparently giving additional liquidity to the financial sector does not help. We do not know the extent to which the ECB will be even more biased towards the financial sector if it takes monetary policy decisions. We heard last week that the ECB's first TLTRO was not successful. The question remains and we discussed this last week in a group that was held by our chairman, Alphandéry. Otmar Issing, a former executive board member of the ECB was there. He said that in the end we will have to have two separate institutions—one dealing with supervision and the other dealing with monetary policy.

The Chairman: We met Otmar Issing at the European Central Bank last year.

Q71 Lord Hamilton of Epsom: You mentioned the role of the ECB as supervisor. One of the things coming up quickly is the stress tests. How do you view these tests? Will this be a big event, revealing all sorts of horrific things, or will it be quite minor?

Karel Lannoo: To be sincere, I had expected this period to be an extremely nervous one in the markets, but so far we have seen the opposite. There were predictions earlier this year. We have a paper on our website by two well known American academics. The shortfall in

the European banking system will be in the lower end—between, say, €50 billion towards €200 billion and not much in excess of this. There will be some shortfall but apparently what we see today will be at the lower end rather than at the higher end. It is not because the economic environment has improved so much. Basically, banks have anticipated what is going to happen and an enormous amount of convertible bonds have been issued. Banks have done rights issues and the most important thing is that banks have been pushed to disclose much more information. We know from the United States that disclosure is best. As they say, sunlight is the best disinfectant. We have sunlight on what is happening and that is what markets want. Basically, markets react favourably, not negatively to that. We do not know what will happen in the coming four to five weeks. The ECB is supposed to have an asset quality review of the European banking system in the third week of October and that will give the banks with shortfalls six to nine months to fill those in. There are already rumours that that will be the German Landesbank. That is the least of our concerns. If it is another corner, that is a greater concern. Apparently we will be able to cope with the problem.

The other issue is that the European stability mechanism has a tranche within its funds designed to help banks that cannot find the means at national level to apply for European support, which was already used for Spanish savings banks. The structure exists to respond to this. I mentioned the Banco Espirito Santo case in Portugal. The way in which that case was handled was more or less according to the new European standards. We may see in the coming weeks a few more of these Portuguese-type bank failures but we also see that the authorities are prepared. That was one of the appellations I gave in the Portuguese case. It is thanks to the fact that we have two teams of auditors looking after the bank: one for the ECB and the asset quality review and the other of the bank. That has made them speak to each other and say, “Look, guys, something is not in order”. In the past we had only one auditor working for the bank and now we have another working for the supervisors. It

would risk their reputation if they did not reveal what they see. Relating to disclosure, I would expect more of this kind of bad news, but in a good sense that will increase in the overall soundness of our European financial system. I also have a chart on the increase in the overall capital ratios and European banking ratios. We have recorded the risk-credit ratio, which has improved a lot, and even the tangible equity ratio, which is not as much as it should be, but it certainly has increased from about 3.5% to close to 5%, even in very difficult times. Even if we have overbanked the capital levels of the European banking systems have improved. The risk rated assets—the Basel ratios—have improved even more. The soundness of the banking system should have increased.

Lord Hamilton of Epsom: Having said that, the integration of the financial markets in Europe has gone the other way with cross-border movement.

Karel Lannoo: That remains a big question.

Lord Hamilton of Epsom: Is that regulation or the banks rebuilding their balance sheets?

Karel Lannoo: Can we regulate to push people to go cross-border? I think there is great fear about dealing with foreign banks. Icelandic banks are one example. Most indicators show that even if financial integration has increased—if I remember from the ECB data—we are at a level of 1999. We are at the same level as when we had monetary union. That is a big question that came up in the conference we had last week. Will we see again new market integration in Europe or will we see national markets as we knew them in the 1970s and 1980s? That is the big question to which we do not have an answer.

Q72 Earl of Caithness: In an earlier answer to Lord Kerr you said these lovely words: "To what extent do we harmonise?" Do you think, though, that there is an effective balance now between member states and the EU in terms of regulation and supervision of the financial sector? If not, what should be done?

Karel Lannoo: Could you repeat the second part of your question after, "To what extent do we harmonise?"

Earl of Caithness: That is what you said. Is the balance right now between member states and the EU in terms of regulation and supervision? If not, what needs to be done?

Karel Lannoo: As I said, in my reaction on the single rulebook, the balance is probably a bit too much towards the single rulebook and the other term used in this context, maximum harmonisation. The rules should be exactly the same for everyone. It is something that your country has been arguing in here for Brussels—we need to have some competition among rules. There is very little support for that at the moment at European level. On top of that, we have seen that most pieces of regulation have become regulations rather than directives. They are directly applicable, mostly, three or four weeks after they have been published in the official journal. The straitjacket is enormously tight in the financial sector. Only a few directives are left. Sometimes you have directives that coincide with the regulations. I do not fully understand from a legal perspective how this exactly works. The BRRD is a directive; the SRM is a regulation; and there are other examples. Next, I think—certainly in the capital markets union exercise—we should certainly try to avoid the opinion that we need to have another wave of regulations. What we need above all—and this will be the next big task of your Commissioner—is to apply rules, make sure that they are effectively in place and that we have enforcement. This should be done at all levels, not only here in Brussels but at the level of the member states. There may be a need for some other initiatives but, again, I shall not say too much. What we need more is a REFIT exercise. I have already given the example of EBA and ECB. There may certainly be other areas where this may need to be done. One thing I forgot to mention, not only in this context but in the context of previous questions, is that there are still important powers left to the member states, also in the context of the SSM—for example, microprudential buffers and capital buffers. Additional capital buffers for

banks in this year before are clearly a responsibility of the member states, not the competent authorities, and EU law—not of the ECB, for example. Will there be a conflict between the ECB and some member states about the capital buffers? I do not know. Of course, as regards the ECB and the SSM regulations, we keep the right for us to superimpose our own buffers if we think that member states are not doing enough. One thing I expect more at the European level, institutionally in the financial supervisory arena, is the possibility of a conflict between the ECB, member states and the European Commission. If you think about the resolution board, which will be based in the Commission, some have seen it as the Commission saying, "Ooh, we have lost power to the ECB. Now we want to have some power of our own". Basically, once the ECB decides to withdraw a bank's licence, it is up to the resolution board here in Brussels to decide how to resolve the bank. But can a political entity be a resolution authority?

Q73 The Chairman: Before I come back to the Earl of Caithness, can you comment on that interesting area of other regulation, the Basel Committee on Banking Supervision and indeed international standards? They come knocking up almost alongside the European Union's own framework. Is that important? Does it work?

Karel Lannoo: So the international regulation?

The Chairman: The Basel Committee on Banking Supervision and its interests. There is general acknowledgement that there is a wider world of international regulation.

Karel Lannoo: I wrote about that in the paper. It is a few months old.

The Chairman: We would be very pleased to receive the other papers that you mentioned.

Q74 Earl of Caithness: You mentioned REFIT again. Is it not notoriously difficult for the Commission to refit? It is very good at producing new regulations and directives, but going

back over old ground and tweaking what it has already done is a major exercise. Will there be any improvement? Do you see any light there?

Karel Lannoo: I must ask my colleagues who have looked at these exercises in the past. As you say, we are extremely sceptical. One of my colleagues was involved in the Stoiber group in the Commission, which looked at these things and, over seven or eight years, achieved very little. So I would be extremely sceptical as to whether we managed to achieve a lot. It is a big slogan at European level but will it really work? Repealing laws is extremely difficult.

The Chairman: Our last set of questions is for Lord Shutt, who has a very personal interest.

Q75 Lord Shutt of Greetland: We are from a place called the UK. What are the challenges of the regulatory reform agenda for the non-eurozone member states? Are the challenges different for us, as opposed to other non-eurozone states such as Poland and Sweden?

Karel Lannoo: I think the challenges are huge in managing not to be second-tier, to be part of it, and to be fully in it. I was more concerned one and a half or two years ago than I am today. The Commission over the past months, certainly with the BRRD and also with the SRM—which, by the way, was signed by 26 countries; the governmental agreement on the funding for the SRM was signed by 26 countries—has managed to keep the cohesion of the single market. That was a big achievement. There may, of course, be differences in approach. We know that Sweden and the UK are the most notorious countries that stayed away from this, and they may have their reasons to do so. But certainly the Commission has managed well. We have also seen this in the context of there being no decision on a president of the euro group, which is related to that. So let us keep our divisions to a minimum. Also, within the Parliament there is no other committee dealing with, for example, only eurozone-related issues. The Commission and the Parliament have managed to say, "Look, we are working for

28 member states, not for only 17 or 18 member states." If you were to speak to Van Rompuy, he would say, "It's probably two or three years since I had a Eurogroup Council. All the councils have been European Councils for the past three years". I did not count them exactly, but I remember that he once said that in public. So the cohesion is there. Also the changes that were rapidly done to the European Banking Authority regulations were part of that—to make sure that in the voting procedures the "out" countries could not be outvoted. The big challenge will be more from a monetary policy perspective, not for the UK but more for countries in eastern Europe with small banking markets. If they are not part of the monetary union and do not want to be part of the SSM, how can they get liquidity for their banking systems? If you are in the SSM, the banks of countries such as Slovakia and Slovenia have full access to the liquidity-providing operation of the ECB, which is important. That also applies to the UK, whose banks have also participated in these exercises. If you are a small member state with a small banking system, you want to be competitive liquidity-wise as compared to your European peers who are active in the same markets. There may be a competitive disadvantage there.

Lord Shutt of Greetland: Are you saying that there is no danger, as far as the non-eurozone countries are concerned, of a two-speed approach to regulation?

Karel Lannoo: No, I do not think so.

Q76 Lord Shutt of Greetland: We have received a very helpful document of two pages written by you on 11 September—a bold bid to restore the college, the Juncker Commission. In it you refer to our colleague Lord Hill. You say, and I quote: "Maintaining coherence in the single financial market will be a challenge, especially for a politician from a non-eurozone member state". Of course, we now think that he is a splendid European. Why do you think that this will be particularly difficult for him? Indeed, you mentioned working with vice-presidents responsible for the euro, social dialogue, growth, investment and

competitiveness. Would you like to expand on that in terms of the difficulties that he will face?

Karel Lannoo: I think that it was a very intelligent move on Juncker's part. That was also said in some of the media afterwards. The big challenge, once we have seen the SSM in operation, will be to make sure that there is not, as I have said, a first and second tier—those that are supervised by the ECB and those that are outside. That applies not necessarily for the UK but also for the other contributor parts of the SSM. If you do not take on top of that a representative or a Commissioner from a country that is not part of it and which will not be part of it very soon, that is a clear sign that, as Commission President, you will want to keep it together. You see that the danger exists, but the most important thing is the single market is probably more important than having this single supervisory mechanism. Of course, that mechanism should work, but it is part of making the supervision in the single market better. If some countries have chosen to do it together, let them do so. But overall the objective is not to create a second tier in the single market or a primus inter pares group, which is part of the SSM. This is what I wanted to say in the sentence that you quoted and in my response to your previous question. Lord Hill does not have the profile of a banker, whatever is being said in the media, or a representative of a high-level organisation; he comes from your institution, basically, so he knows the political system very well, but he is not somebody who has been involved in a financial sector organisation. So he is certainly not biased towards the financial sector. From that perspective, he is a very good choice from your country—to choose someone in that position, which is the opposite of what many people would have expected to happen.

Q77 The Chairman: Bearing in mind where Mr Juncker came from as president of the Eurogroup, how much of an outrage would it be considered if the UK were given a

privileged position to attend the Eurogroup of 18 countries, especially given the UK's knowledge of and primacy in the financial services world?

Karel Lannoo: I have no immediate reaction to that question. I know that there are some issues of tension between the eurozone and non-eurozone countries, on issues such as access of CCPs to the eurozone or to euro overnight clearing facilities, and so on. There are some things which people say belong to monetary policy or are not part of it. We have the same debate in the governing council in the SSM. Those countries that are opt-ins and not part of the eurozone would like to be in the governing council, but the council says, "No way, you are not part of the EMU."

The Chairman: You have never heard that the UK has had that offer made to it?

Karel Lannoo: I do not think so.

Q78 Lord Hamilton of Epsom: May I broaden the issue? We have the in and out referendum coming up, conceivably, in 2017. Prime Minister Cameron says that he is going to produce a package of reforms to entice the British people to stay in the EU. Bearing in mind that there cannot be any treaty change, what do you think he can offer as a reform package to persuade people that it is worth staying in the EU?

Karel Lannoo: To some extent, your Prime Minister indicated this in his speech in Amsterdam about the reform of the EU. In the way in which Juncker has presented the new Commission, a lot of the things that he is trying to change are in response to that criticism, among others. Apparently, Juncker said that this Commission is the last chance. I was surprised to hear that although, of course, we have seen that in some newspapers and from some commentators. He said that it was the last chance for Europe and that if we do not get it right now, it may fall apart. He is apparently extremely concerned about the dangers for Europe. Reforms like the ones that we have today going forward are extremely important in the way that the EU functions. On what Juncker has proposed, my question is whether it will

work. We have seen these kinds of attempts in the past. Commissioner Prodi tried to change the Commission and was basically ejected by his institution. Today the Commission is even larger than it was at that time. Is what he proposed really supported by the people inside? I think so, but I do not know. That means that it cannot be the proposal of one person; it is the proposal of a large group of people in the European Commission. Another issue is accountability. There is the whole debate about the trialogue for getting compromises on pieces of regulation and the trialogue on having agreement on the three entities—the Commission, Parliament and the Council—on a piece of regulation. I do not think that this is an open and transparent way of taking decisions on outstanding issues on a piece of regulation, for example. If we can reform that, it would be very important; then we would have more openness in decision-making and more accountability. The accountability of Commissioners for what they are doing is also what Juncker is trying to achieve in his Commission—that if they propose something, they are fully accountable if they do not manage to achieve what they should have achieved, and they can be called before the European Parliament and asked to be removed. There are many things on the table. We probably should have reduced the number of Commissioners to have a more efficient Commission, but that is extremely difficult. I see that it works in the context of the ECB, where there are only six executive board members. We have now changed the voting procedures and the governing council of the ECB to take the rotating system into account. So that organisation is evolving, whereas the Commission has not evolved at all. Also there is an issue on the level of communication about what the EU is doing; that is an extremely important issue, which has to do with the media, which we cannot change. But something that is being considered in the Commission is that there will be only 10 spokesmen, and not every Commissioner will have a spokesman any more. That will make sure that the messages that the Commission wants to pass on are much more co-ordinated. Many other things can

certainly be done in this domain. On the one hand, there should be more accountability to Parliament and more transparency and, above all, better communication of what the Commission is doing to citizens.

Q79 The Chairman: I have one last question, building on what Lord Hamilton and Lord Shutt have been saying. Please be as blunt as you can. How is the UK seen here in Brussels? There is an ambiguous feeling. We feel wanted and liked at the same time as we are not wanted and not liked. Is that true?

Karel Lannoo: I heard the same question when I was in London with theCityUK organisation at the end of June, when I said that I had seen a decline in the representation of the UK in Brussels. I have been following these debates for the financial services industry since the early 1990s, when I came across many UK banks. If I look back over the past five years, interest in what is going on here has declined. So it is an issue for UK organisations to be visible. I have seen this place being taken over by countries that were certainly not so visible in the past. For example, Germany is extremely visible today, at all levels, not only in the media but at the policy level and the associations level, as well as the lobbying level. I would not say that the UK is seen badly in Brussels. The Government may have certain attitudes towards Europe, but that does not mean that the population at large has this attitude. There are many Brits active in many places all over the European institutions and the EU. They are part of the internationalisation. We know very well that the UK is a very important pillar of the EU overall, not only for financial services but for the defence and foreign policy area, as well as in the functioning of democratic institutions. Sometimes it is difficult to reach compromises in European institutions on certain issues of regulation. I was once called by a director-general in the Commission because I had written something saying that the EU has given in too much to some member states. The person called me and said, "No, but we have given in a lot to Britain as well", because I had said that it had given in to

France and Germany on a piece of capital markets regulation. Sometimes there is an obsession within the institutions that the UK gets too much special treatment. That probably was the case; I do not know whether it still is the case.

The Chairman: Karel, once again it is my pleasure to give the thanks of this committee to your absolutely intriguing range over this EU financial supervisory framework and what we are going to do about it. Many thanks indeed, and thanks for the further offers of the papers, which we will be grateful for. We will forward the transcript to you, so please correct it and add to our continuing argument. Doubtless, we will see you again before this Committee. Once again, we are very grateful to you.

Professor Rosa M Lastra–Written evidence (FRF0018)

Following the invitation to submit written evidence to the House of Lords' European Union Committee – EU Economic and Financial Affairs Sub-Committee – with regard to its inquiry reviewing the EU Financial Regulatory Framework I respectfully submit this memorandum.

How effective are the reforms to the financial regulatory framework introduced since the 2007 outbreak of the crisis?

The reforms adopted since 2007 have resulted in a massive regulatory overhaul – still ongoing – at the national and European level, as well as a redrawing of the Basel rules and other soft law instruments. My main concern is that the different types of reforms (national, European and international) are not always coordinated; indeed, at times they are disjointed.

Structural reforms provide an example of uncoordinated reforms, since the Volcker rule (according to the Dodd Frank Act 2010 and its implementation), the ring-fence solution adopted in the UK following the recommendations of the Vickers report and the proposed solution – ring-fencing of trading activities – of the Liikanen report (which still has not resulted in legislative initiatives at the EU level) all point in different directions.

Another key example concerns the design of macro-prudential supervision, given the different solutions adopted in the US (with the Financial Stability Oversight Council), in the UK (with the Financial Policy Committee of the Bank of England) and in the EU (with the European Systemic Risk Board, the powers of the ECB and the committees/entities set up by national authorities). Since episodes of systemic risk do not respect geographic boundaries nor institutional mandates, such diverse solutions can pose a real problem. Rule divergence, whether it comes to compensation, stress testing, capital or liquidity, creates incentives for jurisdiction shopping, gaming and regulatory arbitrage.

The curtailment of bank activities can instead lead to a crisis beginning in the less supervised shadow banking system. The 2008 crisis showed us that systemic risk can arise from derivatives, securities and insurance markets.[58]

We should also test the very concept of stability, since we should not aim for the 'stability of the graveyard'. We need financial resilience for sure, but in our efforts to combat the too big to fail problem, we must also be wary about not curtailing unnecessarily the government's ability to act in a crisis. Crisis management must be inspired by the following principles: clarity (in particular in terms of lines of responsibility), predictability, speed and flexibility.

Which are the biggest strengths and weaknesses in the regulatory framework?

A welcome addition to the regulatory framework has been the adoption in several jurisdictions of special resolution regimes for banks and other financial institutions. Efforts to

[58] The systemic importance of CCPs should be considered further. See European Systemic Risk Board, 'Central counterparties and systemic risk', *Macro-prudential Commentaries*, 2013, No. 6, 7.

build an effective cross border resolution framework are most commendable. However, the EU Bank Recovery and Resolution Directive (in particular the bail-in tool) will take time to implement, and internationally we still rely upon soft law rules and MoUs. Elsewhere I have expressed my preference for a Treaty or convention in this area.

The biggest challenge (still a major weakness) in our regulatory framework still lies in the interaction between large global private financial institutions subject to a myriad of national laws. It was the dichotomy between national laws and global markets and institutions that was at the root of the catastrophic consequences of the Lehman collapse. This remains a major fault line in our international financial architecture, and uncoordinated/disjointed reforms exacerbate the problem.

We must also look at the asset side of the balance sheet of banks when it comes to developing a harmonized regulatory framework. In this regard, the research I am currently undertaking on non-performing loans (NPLs) and asset classification, with other academics and staff of the Bank of England – in line with EBA work in this area and incipient international efforts – is a welcome development.

Housing finance is another area that needs reform.

Changes in corporate structure and corporate governance are also needed. The 'public interest' in banking is not aligned with the private interests of managers and shareholders. Whether the public limited company, *société anonyme*, should continue to be the corporate form of banks should be discussed further. Focusing mainly on the interests of shareholders and managers ignores the interests of many other stakeholders that are crucial for a healthy banking business: depositors and other creditors, taxpayers, pensioners etc.

Finally, the 'banking culture' must become more ethical.[59] There are a number of concepts – credibility, confidence, fairness – that should permeate through different layers of regulation and influence the behaviour of bankers and financiers.

How effective has the EU's attempt to harmonise rules in the form of the Single Rulebook been? Have the needs of consumers of financial services and products been met satisfactorily?

The Single Rulebook (still in the making) is a welcome development since it provides a common financial language and harmonized rules and procedures that are an essential component of the single market in financial services. However, differences still exist with regard to tax divergences, national rules, etc. Furthermore, there should be no complacency in thinking that the rules adopted are always optimal. We must avoid excessive group think (an underlying cause of the crisis) and we must provide adequate mechanisms of accountability to question the efficacy of the rules adopted or proposed and to revise them when necessary.

[59] See http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27ii02.htm

What is the best balance between the powers of Member States and the EU when it comes to regulation and supervision?

In terms of supervision, this question will become somewhat rhetoric after 4 November 2014, since the ECB will be the supervisory authority for significant credit institutions (and indirectly for non significant ones) in the Eurozone/SSM Member States. The transfer of supervisory responsibilities from the national to the supranational arena is a seismic change in the financial landscape of the EU.

When it comes to regulation there will be further cascading of rules, with ECB rules in the eurozone/SSM, co-existing with the Single Rulebook and national rules (implementing Directives and others).

Are there any inconsistencies between regulation of the eurozone and of the wider European Union?

The Euro area, the SSM area, the EU and the EEA represent concentric circles of integration, subject to differentiation and conditionality.

The problems of coordination amongst different authorities – in the case of the EU, the ESRB, ESM, EBA, ECB, ESMA, EIOPA – are real, as the tripartite arrangement in the UK showed during the Northern Rock episode. Complexity frustrates accountability. The European Banking Authority (EBA) will remain in charge of the single rule book (i.e. regulations and technical standards) and will be guardian, with the Commission, of the single market (the Commission will retain its key legislative function, level I legislation). Furthermore, state aid rules are a fundamental component of the Single Market, and are intrinsically related to the area of resolution.

The single resolution mechanism (SRM), as outlined in the SRM Regulation, is part of the EU resolution framework, together with the rules on recovery and resolution (Bank Recovery and Resolution Directive or BRRD). However, while the jurisdictional domain of the SRM is the SSM/euro area (the jurisdictional domain of the RRD is the EU area as a whole (plus EEA). The BRRD is a fundamental component of the single market, a piece of legislation that needs to be transposed into national law in all EU Member States.

Article 1 of the SRM regulation states that its rules and procedures will be applied by the Commission together with a Single Resolution Board and the national resolution authorities and that the SRM will be supported by a Single Resolution Fund. Article 18 deals with the resolution procedure, which is a rather cumbersome procedure in light of the principles that should inspire crisis management.

A key question is whether or not the SRM can succeed in the absence of fiscal union (the issue of fiscal backstop). Credibility and adequate resources are fundamental for the success of the SRM. Furthermore, decisions about allocation of losses involve an exercise in distributional justice.

Resolution – like central banking – requires adequate expertise, thus raising issues of resources and technical competence.

While the ECB is and will remain a creature of primary law (proper EU institution), the ESAs and the Special Resolution Board (and Fund) are conceived as creatures of secondary law. It is always easier to amend secondary law than it is to amend primary law. As well, by definition, secondary law is not as democratically accountable as primary law.

The SRM may end up being a first step in the construction of an adequate Eurozone resolution framework (in the same way that when it comes to supervision, first we had Lamfalussy, then de Larosière and only in 2013 the SSM).

The relationship between an independent ECB and – by definition – more politically motivated national resolution authorities (national governments provide capital of last resort) to ensure a smooth transition from supervision and early intervention to actual crisis resolution remains untested.

The needs of a well functioning single market in financial services cannot be disentangled from the design of the banking union. The problems of coordination and different jurisdictional domains must be continuously assessed.

6 October 2014

Professor Alistair Milne–Written evidence (FRF0016)

Summary

This response is based on (a) my long standing involvement as a researcher and commentator on both financial regulation and monetary and banking policy; (b) my research in recent years on financial infrastructure (payments, settlement i.e. the "plumbing" of the financial system) and on messaging and data technologies in financial services. This response draws in particular on current externally funded research on the global legal entity identifier and on standards in wholesale financial markets.

The context of my response is, first, the considerable amount of testimony you will have received from the industry about the heavy burden of compliance with post-crisis regulation; and second more general concerns, which may be shared by members of the committee, about the sheer volume of post-crisis financial regulation and the consequent danger of unintended consequences.

The essence of my evidence can be summarised in two well worn phrases "The devil is in the detail" and "Wishing the end but not the means". In this regard I focus on two EU regulations, the European Markets Infrastructure Regulation and the Single Resolution Mechanism Regulation.

Taken as a whole, this response provides additional research based evidence supporting the view that – because of a host of details not taken into account by the architects – post-crisis regulation is very costly, both in terms of direct compliance costs and indirectly through inhibition of competition and restriction of the supply of risk finance. At the same time the benefits of many aspects of this regulation, particularly in terms of promoting financial stability, remain unclear.

I also add a further view (personal, less evidence based) that the thrust of regulation has been misdirected because it has focussed on substituting regulation for corporate governance. A much better balance of cost and benefit would have been achieved, in my view, if reform had focussed primarily on the legal and other institutional environment both for external shareholder control and the internal management of European financial institutions. We should be ensuring that financial institutions and their employees have strong incentives to do the right thing, not attempting to micro-manage their behaviour.

Response to questions

I respond to the following specific questions (I change the order of these questions in order to provide a more structured statement of my underlying analysis).

2. Will the new regulatory framework enable the EU to withstand further asymmetric shocks and future crises as yet unforeseen? Is there sufficient flexibility in place to enable it to do so?

While there has been a substantial post-crisis reregulation around the world, two key and closely related issues remain unaddressed (both central to the global crisis of 2008-2009 and both foci of my own research):

- Information available to both senior management and regulators, both about the exposures of individual institutions and the networks connecting different institutions, remains fragmented and inconsistent. The underlying "engineering" of our financial institutions is a patchwork of different systems which cannot exchange information at all easily (these difficulties are documented further in several research papers of mine:[60] [61] [62] [63]). An absence of standardisation, within firms and at jurisdictional and global level, makes any effort to aggregate data a substantial project.
- The incentives on financial firms to serve customers remain very weak. The same problem exists in non-financial corporate, but it is much more curtailed, non-financial firms are mostly quite transparent and those that fail to provide goods or services at a price and quality desired by customers typically quickly get into difficulties. The few that are able to generate short term returns, e.g. by failing to reinvest or running down quality, may be able to exploit customers or shareholders in the short term, but over the medium to longer run investors get a good idea of which firms are performing well. Financial institutions, in contrast are far from transport, because of poor data quality (see below) and also the absence of standard measures such as free cash flow to assess performance (this issue was addressed in my inaugural lecture at Loughborough university[64]). This is a chicken and egg problem. Because of the chaotic nature of data in financial firms, neither management nor outside investors have much idea of how firms are actually performing with respect to the needs of their customers and also firms cannot make the case to shareholders for investment to improve the quality of their data.

The issue is therefore not so much flexibility in regulatory response (this has been increased) but continuing lack of actionable information. When the next crisis comes, there will likely once again – in the absence of blanket government guarantees – be panic, because no one, either practitoner or regulator, will know what is going on.

The Basel Committee on Banking Regulation has sought to address this problem in its principles for effective data aggregation[65], but has done so in a remarkably poorly thought

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[60] Chan, K. K., & Milne, A. (2013). *The Global Legal Entity Identifier System: Will It Deliver?* (p. 56).
[61] Houstoun, K., Milne, A., & Parboteeah, P. (2014). *Preliminary Report on Standards in Global Financial Markets*.
[62] Milne, A., & Chisholm, M. (2013). *The Prospects for Common Financial Language in Wholesale Financial Services* (No. 2012-005). *SSRN Electronic Journal*. doi:10.2139/ssrn.2325362
[63] Milne, A. (2013). The Rise and Success of the Barcode: Some Lessons for Financial Services. *Journal of Banking Regulation, forthcomin*.
[64] Milne, A. (2012). Risk Appetite and Risk Aggregation: Do Banks Know What they are Doing? Retrieved September 30, 2014, from http://www.lboro.ac.uk/news-events/events/inaugural/past-lectures/2012/alistair-milne.html
[65] BCBS. (2013). Principles for effective risk data aggregation and risk reporting. Basel. Retrieved from http://www.bis.org/publ/bcbs239.pdf

out way (see Chisholm, 2014 [66] for a critical evaluation of these principles) with a totally unrealistic deadline for compliance of January 2016, and no practical engagement with how banks actually manage their data. They are “wishing the end but not the means”.

[66] Chisholm, M. (2014). The Implementation of Basel Committee BCBS 239: An Industry-Wide Challenge for International Data Management. Loughborough: Loughborough University: IDIMC conference.

8. Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?
I wish to point out some aspects of the current regulation which are not working particularly well (supported by example evidence from my work on OTC derivative reporting and on the European Single Resolution Mechanism). My key point is that the design and implementation of the regulations to supporting technology and operating systems. Regulators have assumed, incorrectly, that technology and systems are malleable, transparent, predictable in behaviour and hence can be easily adapted to new regulatory requirements. None of this is true, rather the adaption to new regulatory requirements is extremely costly. As a result:

(a) Regulations have imposed unnecessary, substantial and ongoing costs and complexity.

Take for example the European Financial Markets Infrastructure Regulation, which came into force in February of 2014. This requires firms to report all OTC derivative transactions to trade repositories (initially all new trades and all outstanding trades as of 16th Aug 2012, eventually a large volume of historical trades as well). The costs involved include the following (a) need to develop an entirely different and parallel reporting system to that developed for equivalent reporting requirements in US Dodd-Frank act (b) Failure to adapt the regulations to market practice, so for example a “foreign exchange swap” (a single contract which consists of a commitment to a spot foreign exchange purchase or sale followed by a later unwinding sale or purchase) must be reported as two separate contracts (this is not reuired by the CFTC in the US). Special arrangements then have to be put in place for the systems of the bank and counterparty to provide special processing of the trade for regulatory purposes (c) need to update historical trade reports over time with new information as clients acquire “LEIs” over time, with no clear guidance or statute of limitation on when it is necessary to ensure this is done.

Many of these problems arise because of the lack of any arrangements for consulting on the details of European regulatory during implementation. Consultation is a requirement for all new financial regulation, but this takes place and is complete before implementation begins. “The devil is in the detail” however, most of the costs and complications only emerge when consultation is over and implementation begins. At this stage there is no opportunity for consultation on these details and there is no possibility for flexible amendment of the rules (once implementation begins it is the letter not the spirit of regulation that counts).

(b) An unintended consequence has been a sharp reduction in competition in the markets for interest rate swaps, foreign exchange derivatives and other “over the counter” derivatives with a number of major banks withdrawing their presence in these markets in London (e.g. Scandinavian banks, Unicredito and others). The business model for major banks that remain is now client servicing, helping their non-financial corporate clients through the maze of regulatory reporting. This might be thought of as being a concern only to market insiders, not to customers, but this is mistaken. This lack of competition raises the costs to non-financial corporate of managing interest rate, foreign exchange, commodity price and other risks, with a real impact on final customers.

More generally the very heavy burden of post-crisis compliance makes it very difficult for new institutions to challenge incumbents, in a wide range of financial services (foreign exchange, trade and invoice finance, SME lending, infrastructure finance). I have not myself done detailed research on these markets, but I believe the consequent reduction in competition and innovation results in substantial costs to customers and a seriously adverse impact on the “growth agenda”.

(c) Substantive inadequacies in the Single Resolution Mechanism Regulation EU No 806/2014. The evidence unearthed by my research on operational and information systems in banks leads me to conclude that this regulation is another example of “willing the end but not the means”. I give a couple of examples.
The regulation requires all credit institutions within the European Banking Union to agree resolution plans with the European Single Resolution Board or (where this can be delegated) the appropriate national resolution authority. See Article 8, paragraph 9-11 (replicated below as an Annex to my response). The challenge is that, without fully standardised internal data systems, these resolution plans can never be properly developed in conformance with the regulation. A clear example is the requirement that banks provide “a demonstration of how critical functions and core business lines could be legally and economically separated, to the extent necessary, from other functions so as to ensure continuity upon the failure of the institution.” There are very few banks in the European union with internal operational and data systems that will be able to make such a demonstration in the foreseeable future. Their operation and data systems are a tangled together and in most cases cannot be at all cleanly separated. Being able to do this in the context of resolution requires in most institutions a multi year IT investment to *either* upgrade the myriad of internal legacy systems so they run on consistent and standardised fashion across business lines; *or* alternatively this to have fully standardised recording of contracts and communication of positions between systems, so that the remaining intragroup exposures can be quickly established and the firm resolved.

Similar criticism applies to the requirement in the regulation that regulators assess if a firm is “resolvable”. Without adequate data systems it is unclear how this remit could ever be fulfilled.

3. Where do you think the biggest achievements have been made, and why? Do you believe there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?
The biggest achievement has been in forcing the banking sector to hold considerably more equity capital. This was an essential step that should ensure that we do not see a repeat of the loss of confidence in bank solvency on the scale that emerged in 2008 and spread to periphery Europe in 2010, with the consequence of sharp contraction of credit availability. I would add some provisos: the new higher levels of capital are yet to be fully achieved and could still be reduced by regulatory and compliance fines & there is continuing uncertainty on how the regulatory capital regime will be applied when institutions are in difficulties, so as a result we may not have totally ended the possibility of bank runs and credit contractions, but still this is a substantial benefit.

The major costs, as much of the evidence I provide attests, are (i) the very large compliance burden, both financially and in terms of the time and attention of senior management; and (ii) the substantial hinderance created by the burden of new regulations to competition in

most areas of financial services (firms are withdrawing from activities, new firms based on the dramatic improvements in financial technology cannot enter because of the costs of regulatory compliance.) Also the provision of risk-bearing financial services in both insurance and banking. In particular because of data inadequacy makes it very difficult now for banks to engage in any risk taking.

Finally, in my view, it has been a substantive policy mistake to substitute detailed prescriptive regulation for governance. From my contacts with practitioners I would estimate that some 80%-90% of senior management time in the European financial sector is now devoted to regulatory compliance; most firms have large teams devoted to “change management” in order to be able to continue to both deliver customer services and also meet with the regulatory requirements. Change has been long overdue, but it remains far from clear that the particular changes resulting from the new regulations are yielding the desired benefits in terms of improved product quality and pricing for customers alongside stability of the financial system.

Opinion more than evidence, but I believe it might well have been much better to focus on the ultimate objectives of ensuring that banks and their employees were incentivised to manage their risks and serve customers effectively. Much discussion could be provided about how best to achieve this, but effective resolution of failing institutions (for which a precondition is good data systems), transparany of exposure and activities (for which a precondition is once again good data systems) and possibly also a reconsideration of whether banks and financial institutions need to be placed in a different corporate legal environment where individual employees and management are subject to legal sanction for failing to act in the interest of customers (and once gain a precondition is effective data systems that leave an audit trail of employee actions and their customer impact).

6. How do you think the ‘growth agenda’ and support of alternative financing sources can best be promoted by the EU with respect to regulation?

Here I offer what are again primarily my opinions rather than evidence, but these are consistent with my own research. The reregulation of the financial sector has made it very difficult for banks and other financial institutions to take on risks, with consequent reduction in financing and risk bearing services e.g. in trade finance, SME lending, infrastructure finance and other areas.

This is, in my view, because only half the job has been done. Banks prior to the crisis could take substantial risks, even though they did not have the necessary supporting data and systems to assess those risks, because capital ratios were so low. Shareholders were rewarded with large upside risk and protected against substantial losses, their rather murky gambles were worthwhile.

Now we have much higher capital ratios which disincentives risk taking, but we still have ineffective supporting data and systems. Until these are developed and standardised banks and insurance companies remain unable to effectively assess and exchange risks, so they will not minimise the extent to which they take risk. Before they took the wrong risks. Now they take little risk at all.

A related point is that the heavy burden of compliance, which EU financial regulators fully intend to impose on alternative funding sources such as peer to peer lending because this is “shadow banking” will substantially reduce competition and the provision of risk finance.

If the growth agenda is to be seriously promoted then much of the recent regulation will have to be simplified and unwound and banks required to undertake the necessary standardisation and upgrading of data and other systems so they can properly assess and exchange risks.

11. How concerned should we be about the range of unintended consequences from such regulation – such as regulatory arbitrage and transferring risk off balance sheet?
This question has got things the wrong way around. The key concern today is no longer excessive risk taking but inadequate risk-taking, regulators are under heavy pressure to remove all risk from the system, and will ensure that this does not appear in alternative “shadow” banking as well as in conventional banking and insurance. The unintended consequence is a substantial reduction in the available of risk finance and risk hedging and insurance.

17. Overall, do you believe that the UK’s interests have been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?
An issue uncovered by my research, which should be a key concern to the UK, is the relatively high and unnecessary burden of regulatory compliance in Europe viz a viz the United States. In the context of derivative markets regulation the CFTC, has greater flexibility in rule making and is so able to better adapt the US equivalent of then European EMIR regulation on OTC derivatives to correspond to market practice. Examples have been given above. Potentially, this could lead to business moving offshore from London to New York.

1. What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?
My answer is evident in the above evidence, my overall assessment is a “D” . The financial system has been made safe but because the regulation is primarily addressing symptoms, not the underlying problems of poor data and information and poor governance, this has come at a major cost in terms of reducing the functionality of the system.

Annex: text from the Single Resolution Mechanism Regulation.

Article 8 paragraphs 9-11 (the required elements of a resolution plan)
9.The resolution plan for each entity shall include, quantified where appropriate and possible: (a) a summary of the key elements of the plan; (b) a summary of the material changes to the institution that have occurred after the latest resolution information was filed; (c) a demonstration of how critical functions and core business lines could be legally and economically separated, to the extent necessary, from other functions so as to ensure continuity upon the failure of the institution; (d) an estimation of the timeframe for executing each material aspect of the plan; (e) a detailed description of the assessment of resolvability carried out in accordance with Article 10; (f) a description of any measures required pursuant to Article 10(7) to address or remove impediments to resolvability identified as a result of the assessment carried out in accordance with Article 10; (g) a

description of the processes for determining the value and marketability of the critical functions, core business lines and assets of the institution; (h)a detailed description of the arrangements for ensuring that the information required pursuant to Article 11 of Directive 2014/59/EU is up to date and at the disposal of the resolution authorities at all times; (i) an explanation as to how the resolution options could be financed without the assumption of any of the following: (i) any extraordinary public financial support besides the use of the Fund established in accordance with Article 67; (ii) any central bank emergency liquidity assistance; or (iii) any central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms; (j) a detailed description of the different resolution strategies that could be applied according to the different possible scenarios and the applicable timescales; (k) a description of critical interdependencies; (l) a description of options for preserving access to payments and clearing services and other infrastructures and an assessment of the portability of client positions; (m) an analysis of the impact of the plan on the employees of the institution, including an assessment of any associated costs, and a description of envisaged procedures to consult staff during the resolution process, taking into account national systems for dialogue with social partners, where applicable; (n) a plan for communicating with the media and the public; (o) the minimum requirement for own funds and eligible liabilities required pursuant to Article 12 and a deadline to reach that level, where applicable; (p) where applicable, the minimum requirement for own funds and contractual bail-in instruments pursuant to Article 12, and a deadline to reach that level, where applicable; (q)a description of essential operations and systems for maintaining the continuous functioning of the institution's operational processes; (r) where applicable, any opinion expressed by the institution in relation to the resolution plan.

10.Group resolution plans shall include a plan for the resolution of the group, headed by the Union parent undertaking established in a participating Member State, as a whole, either through resolution at the level of the Union parent undertaking or through break up and resolution of the subsidiaries. The group resolution plan shall identify measures for the resolution of: (a) the Union parent undertaking; (b) the subsidiaries that are part of the group and that are established in the Union; (c) the entities referred to in Article 2(b); and (d) subject to Article 33, the subsidiaries that are part of the group and that are established outside the Union.

11.The group resolution plan shall: (a) set out the resolution actions to be taken in relation to group entities, both through resolution actions in respect of the entities referred to in Article 2(b) and subsidiary institutions and through coordinated resolution actions in respect of subsidiary institutions, in the scenarios provided for in paragraph 6; (b) examine the extent to which the resolution tools and powers could be applied and exercised in a coordinated way to group entities established in the Union, including measures to facilitate the purchase by a third party of the group as a whole, or separate business lines or activities that are delivered by a number of group entities, or particular group entities, and identify any potential impediments to a coordinated resolution; (c) include a detailed description of the assessment of resolvability carried out in accordance with Article 10; (d) where a group includes entities incorporated in third countries, identify appropriate arrangements for cooperation and coordination with the relevant authorities of those third countries and the implications for resolution within the Union; (e) identify measures, including the legal and economic separation of particular functions or business lines, that are necessary to facilitate group resolution where the conditions for resolution are met; (f) identify how the group

resolution actions could be financed and, where the Fund and the financing arrangements from non-participating Member States established in accordance with Article 100 of Directive 2014/59/EU would be required, set out principles for sharing responsibility for that financing between sources of funding in different participating and non-participating Member States. The plan shall not assume any of the following: (i) any extraordinary public financial support besides the use of the Fund established in accordance with Article 67 of this Regulation and the financing arrangements from non-participating Member States established in accordance with Article 100 of Directive 2014/59/EU; (ii) any central bank emergency liquidity assistance; or (iii) any central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms.

Article 10 paragraph 11 (powers provided where a credit institution is deemed not to be resolvable.)

11. For the purpose of paragraph 10, the Board, where applicable, shall instruct the national resolution authorities to take any of the following measures: (a) to require the entity to revise any intragroup financing agreements or review the absence thereof, or draw up service agreements (whether intra-group or with third parties) to cover the provision of critical functions; (b) to require the entity to limit its maximum individual and aggregate exposures; (c) to impose specific or regular additional information requirements relevant for resolution purposes; (d) to require the entity to divest specific assets; (e) to require the entity to limit or cease specific existing or proposed activities; (f) to restrict or prevent the development of new or existing business lines or sale of new or existing products; (g) to require changes to legal or operational structures of the entity or any group entity, either directly or indirectly under their control, so as to reduce complexity in order to ensure that critical functions may be legally and operationally separated from other functions through the application of the resolution tools; (h) to require an entity to set up a parent financial holding company in a Member State or a Union parent financial holding company; (i) to require an entity to issue eligible liabilities to meet the requirements of Article 12; (j) to require an entity to take other steps to meet the requirements referred to in Article 12, including in particular to attempt to renegotiate any eligible liability, Additional Tier 1 instrument or Tier 2 instrument it has issued, with a view to ensuring that any decision of the Board to write down or convert that liability or instrument would be effected under the law of the jurisdiction governing that liability or instrument. Where applicable, the national resolution authorities shall directly take the measures referred to in points (a) to (j) of the first subparagraph.

30 September 2014

Chiara Oldani–Written evidence (FRF0019)

Issue n.7 Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda?

The new European regulatory agenda aims at creating a sound environment and at limiting financial instability; however, it has been heavily focused on insurance and financial operators (either banking or shadow), but has not addressed the role of non-financial operators, like firms, governments and local administrations and their contribution to financial instability. Small evidence is provided in the economic and finance literature on the effects of excessive risks of non-financial operators trading, due to the lack of data on such contracts and related losses, but that does not mean that the system is safe.

More in details, non financial operators trade around 10% of the global OTC derivatives markets under no capitalisation, no collateralisation, no monitoring and no risk control; the Centralised CounterParty (CCP) system applies if the size of the portfolio exceeds €3 Billion, but a number of non-financial operators can lie below the threshold and then counterparty risk is not reduced. The accounting standards for non-financial operators have been recently revised in order to cope with the evolving financial innovation (IFRS n.9) but will be applied only after 2018.

With respect to the public sector, the UK has banned the use of OTC derivatives contracts by local administrations back in 1988, while many other EU countries have not yet addressed the issue. An example is Italy where local administrations have outstanding OTC derivatives (with foreign and domestic banks) worth €10.784 Million in 2013 under no clear domestic regulatory system.

24 September 2014

Seimas of the Republic of Lithuania Committee on European Affairs–Written evidence (FRF0020)

Answers to the inquiry on the EU's financial regulatory

Broad assessment of the EU regulatory framework

1. What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?

We welcome the reforms taken in the field of financial sector since 2008. We believe that they were necessary and essential to take into account the lessons learned after the financial crisis. Nonetheless to evaluate the overall impact of reform undertaken in financial sector at the moment might be too early since some of the reforms are still under negotiations or are not fully in force.

3. Where do you think the biggest achievements have been made, and why? Do you believe there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?

In our view, the greatest achievements are related to the creation of the banking union and single rulebook, including strengthened capital requirements for credit institutions. These changes will help to ensure the financial stability in Europe, strengthen the confidence in financial institutions and help to avoid negative effects on tax payers' money.

One of the most significant achievements was also the adoption of the review of Markets in Financial Instruments Directive (MiFID), which will help to strengthen investor protection and increase market transparency.

We believe that the biggest benefit will be decreased probability of major financial crisis in the future due to more transparent, safer, sounder and more resilient financial system. This could outweigh the additional cost financial regulatory reforms may impose on financial intermediaries. This assessment is confirmed in various studies carried out by international bodies (Financial Stability Board, European Commission).

4. Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency, transparency and integrity; and financial stability?

It is difficult to evaluate the effectiveness of the reform as of now, since a large part of the legislative proposals have entered into force recently or they will start applying only in the future. In our view, more time is needed for a proper assessment of the different elements of the reform.

5. How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were

financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

In our view, the EU legislative process in the case of the legislative proposals related to the financial crisis was as effective and rapid as this was possible according to the current procedural and legislative framework.

<u>Interconnections, overlaps and gaps in the EU regulatory agenda</u>

7. Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant cost and inefficiencies for financial actors?

We have not identified any overlaps, contradictions or inconsistencies.

9. The Commission argues that the new and/or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-Bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?

We agree in principle that the mentioned proposals will broadly complete the main legislative reforms in the financial sector. However, further work in relation to long-term financing for growth and increasing alternative financing would be beneficial.

10. Have the needs of consumers of financial services and producers been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?

We believe that a number of initiatives, such as Payment Accounts Directive, PRIPS, MiFID, etc., will contribute to better consumer protection.

<u>The EU Single Rulebook and the consequences for the Single Market</u>

15. In light of the fact that some of the regulatory framework applies at EU-28 level, and other elements for the eurozone only, is there a danger of a two-speed or inconsistent approach to regulation?

As for Banking Union we think that this separation should not cause big differences in regulation since legal acts which are applicable just in Banking union countries mainly establish mechanisms of common supervision or resolution. But all instruments which those common mechanisms will use come from the Single Rulebook (legal acts which are applicable in all 28 member states).

15 October 2014

Standard Life–Written evidence (FRF0024)

Inquiry into the EU Financial Regulatory Framework

Response to the Call for Evidence

Standard Life welcomes the opportunity to provide evidence to the House of Lords' EU sub-committee on Economic and Financial Affairs on the EU financial regulatory framework.

About Standard Life[67]

At Standard Life we're in the business of helping build a more prosperous world. We're dedicated to making sure that everything we do helps our customers to save and invest for their future, our industry to improve and our society to progress. These things have been important to us since we were established in Edinburgh in 1825.

Since then, we've also been growing globally. Today, the Standard Life group employs around 8,500 people internationally - through businesses in the UK, Europe, North America and Asia. We're one of the Fortune Global 500's largest companies by revenue. And Standard Life plc is listed on the London Stock Exchange with around 1.3 million individual shareholders across over 50 countries.

Around six million customers worldwide trust us with their financial future - and we're responsible for the administration of over £314.6 billion[68] of their assets. We support a further 16 million customers through our Chinese and Indian joint venture businesses. The Standard Life Investments brand also offers truly global asset management expertise with strong investment capabilities.

Wherever we operate in the world, we're motivated by a sense of responsibility. It's what helps us to be a sustainable business. We're proud to be listed as a leader for corporate sustainability in our industry in the Dow Jones Sustainability Indices (DJSI World and DJSI Europe).

Framework

Standard Life recognises the significant benefit to our industry and our consumers across the EU of access to the single market as well as the associated challenges of working within a dual layered regulatory and legislative system. We need to protect, improve and promote the Single Market and work to ensure the EU's regulatory structures and systems work effectively. UK firms, like Standard Life, need to maintain our role in proactively informing and shaping the EU policy agenda, particularly where challenges exist, with an open, constructive, and thoughtful approach.

Financial services that are located in the UK offer third-country firms market access to the EU whilst providing the infrastructure, labour and technical know-how that international firms require. Significant examples include passporting, providing insurance across borders

[67] All information correct as of 30 June 2014

[68] Assets under administration at 30 June 2014 plus assets acquired through acquisition of Ignis Asset Management which completed 1 January 2014 and began generating revenue from 1 July 2014.

and managing cross-border assets. Our customers are at the heart of our strategy and compliance ethic; this ethic matches well with EU consumer policy. Policymakers, legislators and regulators can rely on the integrity of our input. We want regulation to enable positive outcomes for our customers.

1. What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?

1.1. The reforms made since 2008 have contributed towards the completion of the Single Market. In turn, it can be an impetus for greater objectives – protecting a wide consumer base across Member States and shaping complex policy initiatives, such as capital regimes for banking and insurance undertakings.

1.2. Standard Life has been involved in the development of the capital regime for insurance undertakings, the so-called Solvency II. Although this legislation started before the financial crisis, the document updated an outdated capital regime from the 1970s. When it comes into force in 2016, it will introduce a risk based approach to calculating solvency requirements. The lessons from 2008 have been incorporated into the text, along with the new European supervisory authority that was created after the financial crisis. Although the process has been lengthy and unpredictable at times, we are pleased that we have been able to contribute our expertise to the EU institutions' challenge of delivering modern capital requirements for an international business.

1.3. Standard Life views the Single Market as an opportunity to access a wider market and provide our services thanks to rules that make cross border activity possible and more affordable to consumers. The Single Market is clearly a work in progress. Many of the rules that govern it are being drafted as a reaction to 2008; sometimes they are viewed as being too detailed and sometimes they are viewed as too broad. However, we would counter that on the whole, the EU and the Single Market provide our business with the opportunity to provide our customers with a wider range of options. The EU and the Single Market provides all its Member States access to markets that would otherwise be surrounded by tariff barriers. Being part of this barrier-free union allows the UK to act as a portal to third countries who want access to all EU markets.

1.4. For Standard Life, the introduction of the Third Life Directive (now the Consolidated Life Directive 2002/83/EC), enabled us to set up our branch operations in other locations in Europe without host state authorisation. In addition, this directive facilitated our business to operate on a cross border basis, benefitting from the freedom to passport (on freedom of services basis). Although there are still many barriers for these operations, we were able to take advantage of the opportunities offered by the introduction of the insurance passporting regime.

1.5. Financial services in the UK gains significant benefits from Single Market access to our largest customer: the European Union. The strong competitiveness of financial services in the UK depends, to a degree, on being part of the European financial services framework. We call for a constructive and informed debate with all stakeholders on what can be

achieved by reform in Europe to understand the significant commercial and economic benefits provided by membership.

1.6. In the asset management arena there have been a number of significant implemented changes that impact our business. The most significant have been EMIR and AIFMD. There are also a number of policy changes currently at different stages in the legislative process including MIFID, SRD II, and Money Market Funds, with changes to UCITS being considered.

1.7. Although the financial crisis did not necessarily indicate instability in the asset management sector, there have been multiple regulatory changes that are now being focused on it. We recognise that there is a need to ensure that the industry is well regulated and trusted and therefore will continue to work with regulators to build appropriate regulations that protect our customers. We must also ensure that the implementation of regulations do not simply add cost with little increased protection. It will be of central importance to remain engaged with the institutions of the EU to explain our investment decisions, governance and evaluation models.

1.8. An example of regulation that may add costs without contributing significant benefits would be a section of AIFMD which, in the UK, now applies to all investment trusts and non-retail collectives. Investment Trusts have been in place for over 150 years, including over the period of the 2008 financial crisis, without the requirement of such a regulation to protect clients and it is therefore not clear whether the added cost of this regulation, which is generally met by end investors through fund costs, will bring meaningful benefits to them. Investment Trusts are only sold in the UK and there is little if any prospect of them benefiting from an EU passport.

1.9. In general, new regulations would benefit from a better assessment of outcomes from investors to bring clarity to their purpose before design and implementation. An example would be the Shareholder Rights Directive proposal; it does include some good aspects of the outcomes it is seeking. More details can be found at paragraph 2.2.

2. How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

2.1. The input from the Council and European Parliament are invaluable. It offers a more balanced version of legislation and increases democratic legitimacy. In addition, it also gives practitioners different levels of intervention to provide expertise to the different institutions. It also gives time for the debate around the legislation to develop, rather than simply one unit in the Commission drafting regulation without the benefit of a wider discussion on the proposal.

2.2. An example of Standard Life contributing to the wider debate is in the field of corporate governance.

The European Commission’s Corporate Governance Action Plan has gained traction in 2014. It is likely to stimulate asset managers and owners across Europe into the types of engagement that have become commonplace in the UK following the introduction of the

Stewardship Code. Progress will be slow but the importance of the stewardship role will become further recognised and asset owners will start to require more from the asset managers they appoint in the area of governance and stewardship. Standard Life has an important role to play in highlighting our best practice to a pan-EU audience. We plan to continue interacting with all institutions, opinion formers, companies and peers to assist in the process of delivering high-quality governance.

2.3. On the whole, the UK benefits from EU action to further the Single Market. Market access is of central importance to financial services and we welcome the further strengthening of the Single Market to ensure that consumers are protected equally across borders. We call on an active dialogue between government and industry to ensure a synthesis of economic and commercial benefits provided by membership of the EU are more fully recognised.

2.4. On a practical level, we would like to see an increase in FCA and PRA secondments to EU institutions and supervisory authorities and to other international regulators. We also hope that the UK will make efforts to secure more UK nationals in the Commission. Active participation from the UK will ensure that British interests are being represented throughout all three institutions and policy benefits from UK expertise.

2.5. The difficulty that is found in the European Parliament is the multitude of views and constituencies that are required to agree on the final legislation. Unfortunately this means that clear outcomes that are envisaged for regulation can result in less than optimal legislation. As there are significant differences in the financial services industries in member states across Europe it is understandable that a regulation applied in one Member State will have different impacts in others, therefore the drive for more detailed regulation within European directives become difficult to agree and to implement with consistency.

3. Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?

3.1. Certain processes have been effective for consumer protection, such as impact assessments; other processes are less effective, such as short consultation periods. An example of this would be the recent pre-consultation for the European Securities and Market Authority (ESMA). They were working through the development of level 2 measures for the directive and regulation. The pre- consultation consisted of 245 consultation questions and two accompanying documents of 311 and 533 pages. The consultation ran from 22 May 2014 to 1 August 2014; we have much experience in this field, and would have valued additional time to input to the consultation.

3.2. This reinforces our answers from question two. In order to share Standard Life’s best practice and market expertise, it is imperative that we stay engaged throughout the full process of legislation. We engage in detailed discussions at all levels in Brussels, Frankfurt and Paris (i.e. the institutions, EIOPA and ESMA) and allow clear, evidence-based regulation to be issued in a timely manner.

3.3. EU processes can result in solid outcomes. We are at a stage in the EU regulatory process that requires even greater precision, and much of the legislation is at an exceptionally granular level. Although these processes present challenges such as opaque negotiations, red tape and delays in procedure, there is a trade-off involved; arguably it is far better to take more time to decide highly complex legislation. Whilst we want coherent legislation, delays and lack of information can lead to problems if the actors involved are not aware of the impact that delays have on the consumer and market participants.

3.4. Development of EU regulation can be lengthy and unpredictable. The complexity of the network of players is also extensive. Surprise last-minute development can unravel business response plans. These are the very reasons that that the UK should stay strongly and consistently engaged with the process of EU rulemaking. Many businesses rely on long-term planning and when capital requirement directives and regulations are being drafted, there may be instances of capital being tied up unnecessarily or not being able to procure and assign adequate or appropriately skilled resource. Last minute changes can also mean capital and resources are inefficiently assigned which could have cost implications and consequently filter down to the real economy. The UK must be involved heavily with the decision making process to ensure that their expertise in complex financial services legislation is captured.

3.5. We note that the UK is consulted on legislation that has an element of subsidiarity. We urge all national parliaments to carefully scrutinise legislation in keeping with the Treaty provisions. Indeed, all national parliaments have the opportunity to assess and register opinions with the EU if they feel that legislation risks breaching subsidiarity.

3.6. A period of reflection would be useful to agree what needs to be addressed and what outcomes are being sought before progressing with the legislative process.

4. The Commission argues that the new and/ or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?

4.1. We believe that all structural reforms should be done in line with international initiatives to ensure a coordinated approach across countries. We look forward to reading the outcomes of the G20 meetings on shadow banking.

5. Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?

5.1. The growth agenda, which could be broadly described as economic growth, job creation and long- term investment, will be dominant themes for the new Parliament and incoming Commission. All these points have direct impact on the real economy. In addition, the growth agenda can ensure that there is a balance between risk, policy holders and shareholders.

5.2. Financial services in the UK acts as a hub because the UK can offer market access to the EU whilst providing the infrastructure, labour and technical know-how that international firms require. We benefit from the free movement of labour, which adds to the UK's highly-

skilled labour. Please see paragraph 1.4 with regards to our example of passporting in the business.

5.3. Consumer protection is of central importance to Standard Life. The EU is working on creating a Single Market that provides greater choice and protects more than 500 million citizens. It is not a perfect system, nor is it complete. We engage with the EU to highlight best practice from across the EU and third countries where we operate. The single rulebook must be finalised to ensure that consumers from across the EU are equally protected. That being said, it also needs to remain flexible to ensure that it can deal with the particularities of individual markets. The UK has a significant role to play in the future with promoting this.

5.4. For Standard Life, the effectiveness of regulation's ability to protect customers and provide them with real benefits is paramount. Whilst acknowledging the prudential regulation is both technically complex and very important, especially following recent banking issues, we feel that a different approach to both the volume and level of detail in these regulations is likely to result in better regulation and a safer industry. For example, clearer legislation that delineates where national supervisory authorities have competence and where the European supervisory authorities have competence would simplify governance and compliance.

5.5. Focused engagement on EU policy work on the growth agenda will benefit both customers and society at large.

5.6. Our industry needs to protect and promote the Single Market and work to ensure the EU's regulatory structures and systems work effectively. UK firms, like Standard Life, need to maintain our role in proactively informing and shaping the EU policy agenda, particularly where challenges exist, with an open, constructive, and thoughtful approach.

6. How do you think the 'growth agenda' and support of alternative financing sources can best be promoted by the EU with respect to regulation?

6.1. With the growth agenda in mind, it will be important that the EU does not unduly constrain industry, thereby limiting growth. UK industry, government and UK representatives in Brussels need to work together to understand the differences in Member States' markets. Firms in the UK use a wide range of financial services tools, and we hold an important position in the EU of contributing technical details for legislation that reflects the particular needs of our markets. The UK is a leader in ensuring coherent, logical regulation. Straightforward and unburdensome regulation will allow us to invest EU-wide and encourage job growth.

6.2. It may be difficult to use regulation alone to satisfy the growth agenda. The most significant mechanism to encourage investment into areas of alternative financing is through tax benefits; this area is not controlled by the EU. The introduction of new product rules to direct investment into certain areas may not always be the best way of creating good products.

7. How concerned should we be about the range of unintended consequences from such regulation– such as regulatory arbitrage and transferring risk off balance sheet?

7.1. A significant potential risk lies in the interplay between EU regulation and international regulation. Bodies such as the ECB, G20 and international supervisory agencies have given us a forum to come up with international solutions to international problems. The financial crisis has not been limited to the UK alone. During the crisis, more agreements and actions have been made possible by the participation of these international bodies. Our business is international; our regulations need to have an international dimension as well.

7.2. An example of this would be the development of international capital standards by the International Association of Insurance Supervisors (IAIS). There could be potential risk of the EU and the IAIS develop diverging models for capital requirements, thus adding the possibility of regulatory arbitrage. The principle of common treatment for common risk should play into all decisions taken.

7.3. The EU and the international community's coordination of capital requirements and regulation is an absolute necessity. The UK is more effective in a group of many rather than being a single voice in the crowd. Leading UK representatives who chair international standard settings bodies gain a substantial voice by being a member of the EU club. An example of regulation done in the EU and US that was not coordinated was EMIR and Dodd-Frank. They are excellent examples of work done separately that has resulted in non-joined up terminology, different application of the rules and different specifications for equivalency. Though EMIR and Dodd-Frank largely align, the details of implementation have revealed much larger issues for the market that regularly uses transatlantic derivatives.

7.4. Another unintended consequence that our business must consider is that of timelines. Standard Life has been working on Solvency II for several years now. The negotiations have been long; to be sure, they are an update on an outdated piece of legislation from the 1970s. Solvency II is a highly sophisticated risk-based approach to capital requirements for insurance undertakings. Legislation of this scale takes time; however, it has been difficult to forward plan at times. The negotiation's twists and turns have left us with uncertainty at times. A specific instance of this type of uncertainty pertains to the long-term guarantee debate; the change in scope for several months on the application of the directive made forward planning challenging.

7.5. The third unintended consequence of highly detailed, granular regulation comes from the levels system that has been utilised for a majority of the financial services regulation. Deviations and inconsistencies between levels one and two is problematic; as a business, we work on long timescales. If we begin planning at level one believing that level two will follow, it can lead to misallocation of capital if level two goes in a different direction.

7.6. There is a risk that some of the regulation will be significant enough to cause financial services businesses to review their business operations. For instance the attack on bankers' pay could result in the most sought after employees moving to jurisdictions that do not use such stringent restrictions.

15 October 2014

Dr. Kay Swinburne MEP- Oral evidence (QQ 140-156)

Evidence Session No. 8 *Heard in Public* *Questions 140–156*

THURSDAY 25 SEPTEMBER 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Lord Shutt of Greetland

Examination of Witness

Kay Swinburne MEP, Conservative/ECR MEP for Wales

Q140 The Chairman: Kay Swinburne, a very warm welcome to the Committee for the second time. This time, the Committee is looking at the EU financial regulatory framework in the light both of all that has been done since 2007-08, and looking forward to 2018-20, and so on and so forth. It is in part looking back and in part looking forward; it is prospective as well as retrospective. We are very grateful to you for coming this morning to help us with this inquiry. We will finish it off with a flourish with Andrea Leadsom coming in on 4 November. She comes in the afternoon. That morning, we have three of our heavies from the Bank of England, Sir Jon Cunliffe, Andrew Bailey and the head of the PRA, so that will be very useful, but we have seen as a high point Michel Barnier yesterday. That was a very useful session, but we have met other colleagues as well. After you, we finish with Richard Corbett, who I think will be able to give us a lot of background material, having seen it from

the perspective of the Van Rompuy cabinet, who we visited when preparing our banking union report.

As an opener—but feel free, if you want to, to give an introduction—I ask you to cast your mind back over the past few years and prospectively and say whether you think that there is in place a financial regulatory framework that would certainly withstand asymmetric shocks, which would introduce stability but with a freedom of manoeuvre which would allow the authorities to move to any new challenge. You may say that there is a new challenge in the form of a threat of disinflation, which is being talked about now. Give us your thoughts about how well or otherwise we have done so far.

Kay Swinburne: Thank you, and I appreciate being able at least to explain some of the things that I have been involved in over the past five years. I have taken the position of the co-ordinator on the Economic and Monetary Affairs Committee for the European Conservatives and Reformists, which is where the British Conservatives sit here in the Parliament, which means that as well as being involved in individual pieces of legislation on which I am either rapporteur or shadow for the Parliament, I also co-ordinate the group's response to the legislation across the piste. That means that I probably have had as much oversight as anybody here over the past five years during what has been a flurry of legislation on financial services, the eurozone crisis and all those issues for member states.

We have had an unprecedented period since 2009, when I joined the Parliament here. Obviously, in the wake of the crisis, work has been done—in particular, a piece of work by Jacques de la Larosière putting in place what he thought was a framework for future European legislation and the way in which we needed to co-ordinate better in the financial market's single market. Across Europe, he thought that we needed some form of supervisory authority to co-ordinate European activity. The biggest result of that report was the change in how the Lamfalussy committee structure worked, so we now have the

delegated Acts and implementing measures—instruments that in theory should make it far easier to change legislation as when it needs doing, rather than waiting to go through an entire legislative process. In theory you can change things in six months or a year, rather than having to go through a two, three or four-year period of getting compromises agreed and new legislation on the table, then to be implemented via directives into national law.

So there are a few shortcuts to try to ensure that we have a single market that is working. That structure is in its infancy, but will potentially safeguard the European single market for financial services against future shocks.

To have three supervisory authorities for insurance, for the markets and for the banking sector to try to co-ordinate and have a single rulebook across Europe is also a major step. Ultimately, you cannot have a single market unless you have one set of rules that you all apply in the same way. Historically, although we had single market legislation such as the markets and financial instruments directive, it still had local interpretations, so the directive was transposed into national legislation in very different ways in different countries. In theory, we now have a structure that allows us co-ordination of the single market across Europe, a single rulebook making sure that the national competent authorities are supervising or regulating in the same way, and we have the instruments that allow us, through delegated Acts and implementing measures, to try to move in a more flexible way.

Within various systems, we have built in safeguards so that at every point in time in member states and national competent authorities there are various levels at which the peer review system genuinely imposes some checks and balances. At every stage, the Parliament, as you would now expect since the Lisbon treaty, has more authority here than we had previously. There are a lot of checks and balances by the Parliament as well, which has scrutiny over every stage.

Every rule that comes out under these new powers for the supervisory authorities is scrutinised by the Parliament and can be rejected. We cannot suggest modifications formally—we can either accept or reject—but ultimately that means that there is a dialogue between the Parliament and the Council to ensure that the rules reflect what was intended within the political discussions. That is the framework we are now working in. I think it is fair to say that it is established but not tested, so we will see when the next crisis comes along.

The Chairman: That is extremely helpful. For your information, we will be seeing Mr Enria from the EBA as part of our investigations.

Q141 Lord Shutt of Greetland: Thank you for that. You seem very confident about the structures. What do you think have been the biggest achievements, and why do you think that; have there been any policy mistakes in the regulatory agenda; and which elements of the reforms have been the most and least effective in addressing consumer protection, market efficiency, transparency and integrity and financial stability?

Kay Swinburne: We have to look at all these because we deal with legislation as salami-sliced rather than in the whole. Dodd-Frank was a large piece of work in the US, and I almost look with envy at my US political colleagues who seem to have been able to walk away from the original work and wash their hands and have no intention of going back and redoing it over the next five or 10 years. They hope that work will stand the test of time. We have salami-sliced this so every piece of legislation has been done sometimes in parallel and sometimes sequentially. The G20 insisted that the European Union took its role within global financial markets and put in place, for derivative instruments in particular, a framework to make sure that they were centrally cleared, where possible, that the OTC market disappeared and that, in particular, we had reporting of all trades so that on a global

basis regulators knew what they were dealing with ultimately to put stability into the capital markets.

Those derivative pieces of legislation, particularly EMIR, have worked. They have separated the trading obligation from the reporting and clearing obligation, which has caused some issues with partners across the pond in the US. We have done it in two separate pieces of legislation, but EMIR works. It is being implemented right now. It is having an effect and is being done on a global basis. For me, the key is that it fits within the global mandate given at G20 and is working. It is a piece of work about which we can hold our heads up and say that we managed to get a piece of compromise legislation. Ultimately, all European legislation is a compromise of 28 member states and 750 people. That works.

In my mind, and these are political assertions more than anything else, there are a couple of very bad market-related pieces of legislation that should never have been brought forward in the format they were. They were politically motivated. The two that really stand out as a big scar on the five-year mandate I have had so far are the AIFMD and the short-selling regulation. As someone who previously worked in the financial markets, I believe both were unnecessary, misguided and misplaced and I do not believe that they will achieve the objective they were trying to achieve. They are a lot better than when they started out. The proposals were amended significantly over the course of the Parliament's work, but I still do not think they are good legislation, particularly that on short-selling, which is a regulation that does not have transposition into national law and the ability for flexibility in interpretation. It causes me some concern. Those are the two that I do not like. We have already amended bits of the short-selling regulation in the CSDR, the settlements regulation we have just done. As the rapporteur on that dossier, there are some bits in the short-selling regulation that we knew needed amending and we used another regulation to amend some of the more onerous parts. We will continue to do this. There will be this fluidity in

the legislation where you amend a previous piece of legislation via a new one. Those two are the ones I would least wish to be associated with in my last five years here.

There are others where I can say that I am proud of the outcome. We could have done better. MiFID and MiFID II are only just getting to the stage of level 2 rules. Several hundred rules are being written. We will monitor them very carefully to make sure that they reflect what we wanted in the level 1 text, but some of that work moves us in a very good direction for transparency in our capital markets, not just the equity market, but the bond market and other asset classes. It reflects some of the work we have been doing in the UK about transparency. I am very disappointed that we did not do more on consumer protection, but some of the disclosure and transparency tools will be good for consumer protection because when customers know they are paying over the odds and that they are not getting the best service they could, it helps. I would have liked a lot more of what is in the retail distribution review in the UK to have been accepted on a European platform. Given the diversity of models, it was deemed to be too strong a piece of legislation to jump straight into on a pan-European basis, so we have taken the disclosure elements of it and tried to put them into it, but we did not succeed in banning, for example, all commissions for all sales channels. We have taken the view that, on a pan-European basis, there is a ban on commissions for independent advisers so that an independent adviser has to be just that. So some changes are already there, and we have introduced some things, but on consumer protection, I think we are behind the curve. I think we can do a lot more.

Q142 The Chairman: Did you want to say anything about the categories of efficiency, transparency and integrity? Do you want to pick any of those up?

Kay Swinburne: Two years of my life have disappeared in doing MiFID, and I suspect that another two years of my life will disappear doing the level 2 work on it to make sure that, as they come through, all the rules reflect what we wanted in the political agreement the first

time round. That is a strong piece of work about market efficiency, market stability and transparency, but it was so long in the making, and level 2 will take even more time.

The Chairman: Before I bring in Lord Hamilton, why did AIFMD and the short-selling legislation come in? Was it related to the Dangerous Dogs Act? Was it done in a rush in similar circumstances?

Kay Swinburne: I would say that it is the equivalent of our Dangerous Dogs Act. It was rushed in, and it was highly political in the middle of the storm of the crisis. It was easier to distract attention from some of the eurozone and sovereign debt crises that were happening at the time and go after those evil people who were short-selling government bonds and causing the sovereign crisis, seemingly. This was the connection that was made in certain politicians' minds. That is why.

Q143 Lord Shutt of Greetland: When we met Michel Barnier, he told us that written into the script was the business of being able to look again in about three years' time. Bearing in mind that you are here for five years, are you already lining up what you are up to for these revisions?

Kay Swinburne: We are, and the legislation I know we will have to review, which will come up mid-term, is the EMIR legislation on derivatives. Of course, things move globally. The US has been ahead of us in implementation, as have some of the Asian markets. We now need to look at where they have moved to, what they have done better than we have and what we need to change. On EMIR, I would go further this time on things such as client segregation. We have done it within MiFID and MiFIR. We now need to strengthen some of the rules on client segregation of assets within EMIR next time round. I think the appetite will be there under the review of some of the things we failed to do when we failed to take bolder steps the first time. In a review with more data and more evidence, it will be a lot easier to get people to move in the right direction.

Q144 Lord Hamilton of Epsom: You mentioned the big question of commissions and the fact that they are not charged any more. Certainly, in principle, it must be right. Commissions were hidden and therefore people did not really know what they were paying. On the other hand, we now have a situation where someone with a small amount of money to invest goes to an IFA who says, "I've got to charge you £150 for the advice I'm giving you", and people say, "God, I don't think I am in the business of paying £150". Is the net effect that people are not getting financial advice who might have got it before?

Kay Swinburne: One of the reasons why my colleagues, particularly my German colleagues, did not feel it appropriate to take the UK model and apply it was because they genuinely thought that savers with very small amounts of money would be put off getting the advice and investing in the first place, and would not use proper, effective savings products at all as a result. They felt it was a step too far. They obviously made the exception that any member state that wanted to go further could, which meant that the RDR was allowed to continue. The Netherlands had a system very similar to RDR, so its system was also allowed to continue, but there is no obligation for everybody else to come up to that level of intervention within the commissions market. An independent financial adviser has to be independent, so commissions are not allowed to be paid. However, if you go into your local bank branch, which is heavily branded, you know that it is likely to be promoting its products and therefore you are making a choice by going in. If there are commissions associated with that, it is very transparent that you are paying for that service. That type of payment is still allowed across Europe under MiFIR and MiFID II. So, yes, there is transparency but the disclosure has to be there and the customer has to know what, broken down, in their service they are paying for, but that is as far as it goes. It does not prevent it. In some ways, I think that that is probably a good stepping stone to assess what impact that has on consumer behaviour. My suspicion is that the big bang effect of the RDR has almost taken

away consumer choice completely. You either go and get your advice, or you do it on your own. Most friends and family with relatively modest sums of money for their retirement years are finding it very difficult to justify the sometimes thousands of pounds upfront that an IFA has wanted to charge them. That is a very difficult situation to be in in the UK. Having just attended a conference on long-term savings and pensions, I know that the industry is very worried about the outflows of money, and money that is just sitting in ISA accounts, because people do not want to commit a relatively large amount of money in order to get the advice that they require. Of course they were always paying it, but because they never saw it, the psychology of it is probably very different. So I cannot criticise my colleagues here in Europe because ultimately, if I were to do this, I might have taken a slightly different approach in the UK too.

Q145 The Chairman: Before I turn to the Earl of Caithness, just reflecting on the Barnier suggestion that there will be revisions, and the potential for revisions, the business and financial actors on the scene sometimes get worried about politicians coming in and making changes. They are sometimes almost happier to have something that is semi-defective. At least there is a sense of stability in the background over how they are trying to operate. How careful should we be when we introduce those changes that are perhaps necessary?

Kay Swinburne: I do not think the model of one piece of legislation and then, 10 years later, a new piece of legislation is ever going to work again in the financial markets. You need a system of continuous review—not just a review of primary legislation, which needs to be built in; you need the flexibility of the authorities being able to move. Whether it be a national competent authority or at the European level, you need to be able at least to make a judgment that things have moved on, and to be flexible. We are nowhere near as flexible in our day-to-day implementation as the US authorities would be. So the SEC and CFTC are agencies set up to have complete independence, and there is very little scrutiny of what they

do when they change things on almost a weekly basis. I would not want that system either. I believe that agencies should be scrutinised and held to account. Ultimately, people need to make sure that they are going along the same lines as those originally intended by the politicians who set the legislation in motion. So we have certain reviews built in. I would advocate that every piece of legislation should have a three-year review period built into it. Whether you need the review when it comes is another matter, but you have that process built in as a matter of course. We had one on FICOLD, the combined financial entities covering insurance and banking activities. The conglomerates fall outside many other pieces of legislation. Those conglomerates were reviewed as a matter of course and a legislative review was built in. We did not do anything during that review. We went through the motions, the process, and the research was done, but it was deemed that nothing was required to be done. The piece of legislation had stood the test of time and was working and therefore did not need amending. The review period for me is a safety net, and it is good practice to monitor what has been happening and to then take the opportunity, if need be, to change it.

The Chairman: It sounds a very good idea.

Q146 Earl of Caithness: What do you think we have learnt from the past seven years about the way in which the legislative process works, and who has done well out of the three big institutions—the Council, the Parliament and the Commission?

Kay Swinburne: I have been here since 2009 and it is a five-year picture that I am able to give you, rather than in relation to the real crisis of 2007-08, which was obviously a time of flurry among everyone to try to work out what needed to happen. From 2009, when we started to implement some of those changes proposed post-crisis, it coincided directly with the Parliament's new powers under Lisbon, which means that the ultimate institution that is number one in terms of influencing legislation is the European Parliament. However, that is

not necessarily to do with the crisis but more the fact that the Lisbon treaty empowerment of the Parliament happened in that mandate. We are now the co-legislators on every file. One area on which we did not have co-legislative status was, for example, the single supervisory mechanism for the eurozone banks. However, we sat in every single negotiation and did all the negotiating until the very last crossing of "t"s and dotting of "i"s because we had to amend the European Banking Authority's legislation in order to accommodate the Single Supervisory Mechanism. That meant that we were co-legislators on that key piece, which meant that it could do nothing unless we agreed to what it was doing on the SSM. It is amazing how much power that actually gives you, even when it is nothing to do formally with the Parliament. We actually had that ability to block and change the proposed legislation to make sure that it was in line with the EBA. Who has won? The Parliament very definitely, but because of Lisbon more than because of particular pieces of legislation. The process has changed, however, the way in which everyone is engaging with the system. It is fair to say that in 2009 my Ministers did not necessarily come and talk to the MEPs about the priorities in the UK. That has very definitely changed. I am not sure that any Minister would even contemplate any more not speaking to people across the political parties here in the Parliament—not just to their own member state's MEPs but to all the actors involved across the political spectrum. So they do come.

Earl of Caithness: Is that a move for the better?

Kay Swinburne: I would say that the issue of whether co-legislation is for the better is a very big topic. Everyone accuses the European Union of not being democratic and not having democratic accountability. Well, 751 of us here are elected and we are engaged in the legislative process at every step, which is presumably the democratic deficit that people wanted filled. From that point of view, I suspect that that is a good thing. Do I believe that at every stage the politicians know exactly what they are doing in terms of the legislation that

they are working on? As you will know, many of the regulations are very detailed and we are not always the experts. I would like to think that we are getting better at accumulating evidence and data before we legislate, but there have been some very bad examples over the past five years where that has not been the case.

Q147 Earl of Caithness: Can I ask you one other question? Are you concerned about the unequal implementation of the 41 pieces of legislation in the Barnier bible across member states? We heard evidence yesterday that in some member states MIFID II was agreed before MIFID I had even been introduced into the member states' laws. We might have built an edifice that looks good, like a Hollywood studio, but the props behind are not in place.

Kay Swinburne: That is a very good analogy. There is one member state—a large member state with a significant capital market—which did not implement MiFID I, and its capital markets were running very much on a national basis for some time. There were some very creative methods of bypassing that, and many of those stocks were traded in trading venues across London in a quasi-secondary market, even if it was not a formal one. Therefore the market already found ways to defeat the member states' nationalistic tendencies. They have now recognised that they cannot stay; ESMA has played a key role in helping them to understand how they have to modify things. They have had fundamentally to change their national law to accommodate many of the things that were in MiFID I and MiFID II. However, the good news from that perspective is that the modifications to their legal system mean that they have not just modified it for the retrospect of MiFID I but are now ready for MiFID II. Therefore ultimately this is the one big change they needed to make; they are on their way to doing it, and they will be implementing MiFID II. Of course, ESMA plays a key role here. When it has identified that a member state is not doing what it needs to do—particularly under the regulations, but under the directives to a lesser extent—when it

identifies that there are mechanisms by which the peer review process kicks in, in theory it will be able to go in and be heavy-handed. It is questionable as to what powers it can use.

Q148 The Chairman: Has it been more helpful since ESMA was headquartered in Paris?

Kay Swinburne: I honestly do not think it matters where ESMA is headquartered, provided that it has the quality of staff it needs to do the job and that it is completely impartial to where its headquarters is. There is a move here in the Parliament for all three of the European supervisory authorities to be in the same place. I fundamentally disagree. In this day and age, the location does not matter provided that the communication channels are there and the formal process is in place to deal with it. However, ultimately, ESMA has a board which is made up of member states, and their competent authorities sit and talk on a regular basis. Therefore, when one member state is out of line, its peers are there to pull it back in line. Going forward, that process should start to show itself as working.

The Chairman: I was obliquely asking whether it was France you were talking about.

Kay Swinburne: No, it was Spain.

Q149 Lord Hamilton of Epsom: On the growth agenda, Draghi has made it pretty clear that the eurozone economy is not going anywhere very much, and some people are saying that it will flatline for the next five years. Over the past couple of days, we have been hearing that people are looking to the banks to stimulate some sort of growth. Do you think it will come from the banks? Are banks in a fit state to start lending again? Where do you think that is going?

Kay Swinburne: Given that for 80% of European firms, investment generally comes from the retail banking sector—historically, there is an 80% dependency on those providers of that, as loans in particular—that is not sustainable, particularly given that those banks are now required to hold a lot more capital against those loans. Under the capital requirements directive and regulation, they are in a very different place in terms of the amount of funds

that they can transfer to their customers. Given that that is within the international framework of Basel, that will not change. This situation is the new norm. Therefore we have to find alternative sources of capital and look to the capital markets. We have to look, too, at where the big pools of money are currently sitting and therefore could be used for long-term investments and stimulus. Most of those are sitting within the insurance companies, the pension funds and within large corporates. Certainly, for us, the way forward and the stimulus—and the sources of capital—will come from what I see as the traditional capital markets, but within a European context we now have to redefine that. Therefore, rather than being national pools of money, it needs to be a European pool of money—and I do not even see it as European but as a global pool of money. We need to pull the money in from other areas; particularly in Asia and the US, you have large banks of money looking for investment opportunities, and the long-term investment opportunities in some of the infrastructure and some of the innovation projects here in Europe should be of interest to them. Therefore, we need to make sure that we allow third-country access to our capital markets and make sure that we do not put other regulations and rules in place that prevent that money flowing.

Ultimately, however, the capital markets union that has been spoken about by President Juncker, in looking forward at what his next Commission will do, is where the future lies, as opposed to in our traditional banking sector. Depending on who you ask, you get a different definition of what they mean by the capital markets union. However, therein lies the opportunity, particularly for financial players, to define what their role will be in funding the future of Europe's growth. That is a huge opportunity that we should not be missing, and I hope that Lord Hill will be the person to guide that through and that he will take that capital markets union forwards as a positive engagement of how we will get capital flying into Europe and get these long-term projects working.

Lord Hamilton of Epsom: That, of course, is the macro end of the market, but there are also people who look to the SMEs and to start-up businesses. In Britain we are seeing some emergence, as you know, of peer-to-peer lending, crowdfunding, and that sort of thing. I do not get the impression that the EU is embracing that with much enthusiasm.

Kay Swinburne: It is a very new concept to much of Europe. Particularly, many of the smaller continental European countries have been very focused on their banks as being the only source of funding. Therefore, given that we are at the early stages of some of these—crowdfunding is an unusual concept for many to get their heads around as regards whether it is stable and something that will stay when you need it to stay—will the terms and conditions be suitable for all businesses going forward? It is a case of, if the cap fits, then yes. However, it will not suit every business. Some will need more stability in their financing than crowdfunding can probably provide. However, as part of a mix—crowdfunding comes into a capital market mix—it is a new, innovative source of capital. It is market-led, and will continue to have that impetus from the demand side. There are all sorts of interesting opportunities, but we are in the very early stages. A framework needs to be put around it, but it needs to be there to facilitate, not to restrict and constrain.

Lord Hamilton of Epsom: To follow on from that, let us be honest: crowdfunding is going to be completely unregulated. It will not be possible to regulate it at all in my opinion. Therefore there will be some appalling accidents, but that does not mean that you should therefore get rid of it because you cannot regulate it. You have to mark it up as a very high-risk form of funding things but, on the other hand, it is a very easy way of getting money into small businesses—but a lot of people will lose everything.

Kay Swinburne: Ultimately we need to be careful here. Of course we can regulate those entities that are already registered with national competent authorities. Therefore, if any of those regulated entities are providing sources of crowdfunding, de facto we will have

regulatory oversight of the activities that are happening. However, I would encourage any of the platforms set up for crowdfunding to adopt a transparent model, so that transparency is ultimately what will protect the businesses and the individuals who are using them as a source of funding. For me, rather than making a whole load of work for legal teams, transparency is probably the best way of making sure that this is what it should be, and what makes it that innovative, flexible and fast-moving source of funding, because the transparency will allow people to move from one place to another depending on where the best deal for them is at any particular time. Its charm is in the flexibility it offers people, which ultimately means transparency and fast movement across players in the marketplace. Without transparency, you will not get the real benefits of what I see crowdfunding as being.

Q150 Lord Kerr of Kinlochard: What should be in this capital markets union? I worry that there will be those in the legislative machine who say that a necessary component is the unfinished dossiers from the past five years, most of which seem to be unfinished for very good reason. I would be tempted to leave a number of them—for example, benchmarks, where I do not see any particular point in legislation. I think that there will also be those who talk about revision of some of the great, and in some cases unsatisfactory, pieces of legislation that got on to the statute book, such as the AIFMD. There is probably a delicate balance to be drawn between the case for improvement, which in some cases is quite strong, and the case for no change, because operators have spent enormous sums of money adjusting to a new structure, and changing it again would be pretty unwelcome. So far, mine is a rather gloomy agenda for capital markets union, and it will clearly need something that takes the story further forward. But are we really thinking of regulating all areas of the capital markets? Is that really a good idea? What is the case for attacking hedge funds or for approaching securitisation as something that needs to be controlled and regulated? What is the case for looking at private equity, fund management or all these pools that are lying

around? What is shadow banking and does it matter? What would you, as a senior member of the relevant Committee, advise Commissioner Hill to see as the guiding principles of a capital markets union?

Kay Swinburne: On the legislation that I have been working on—markets-related, particularly the post-trade environment—everyone working in the industry has welcomed a pan-European framework. In particular I have worked on the settlement process—a very technical file which was probably the least political of all the files here because no one found it particularly interesting. In terms of the technicalities, we have put in place a system which is now a T+2 settlement across the whole of the EU. That benefits both sides of the trade and it provides efficiency to the market. That is a pan-European piece of work which is being hampered. If we had a common securities law within Europe, there would be greater efficiency across the capital markets and the secondary markets. So securities law is now a fundamental barrier to having easy capital flows around Europe. At the heart of a capital markets union, we need some form of securities law legislation. We need some form of securities code that is uniform across the EU to allow that capital to flow freely. It is supposed to be one of the fundamental pillars of the treaty that there is a flow of capital, but there are some very significant barriers in law that still prevent those flows of capital.

We also have very different insolvency laws between different member states. Insolvency law is a major barrier to some of the cross-border transactions and to some cross-border companies operating. Many of them are British companies, or at least UK-based companies. Those companies are saying to us, “This is a major problem for us in terms of our investment going forward into the European markets because we have to operate under 28 insolvency laws. If there is a problem with one country, potentially we have to ring-fence capital without having any say over it”.

There are three fundamental pillars on the technical side to the capital markets union: insolvency law, a securities code of some kind and tax, which ultimately is also a barrier. I do not think we are going to harmonise tax. We certainly do not need one tax system but we at least need to find a way of co-ordinating the tax systems across the EU.

Q151 Lord Kerr of Kinlochard: Can I stop you there? Why have these three pillars? Surely it is possible to have a capital markets union where national capital markets have national characteristics. We have an insolvency regime in the European system. You are saying that we need to have a deeper insolvency regime and that we need to standardise the insolvency regime.

Kay Swinburne: We need to make sure that we can solve the conflicts of the law. We do not actually need the same laws but they need to be compatible, which at the moment in many instances they are not. So I think that it is a case of removing those barriers. That does not mean having one insolvency law, because I do not think that we will ever even vaguely get to that situation, but we need to be able to solve the conflicts, and that ultimately is important.

Why do we need that? A study came out recently which showed that for every transaction that comes across the border within the capital markets, there are 13 intermediaries in the chain for that transaction to happen. That is 13 points of inefficiency. Ultimately, if we can start to reduce that inefficiency by the barriers being removed, that will be a positive thing for consumers. It would have a positive effect upon the cost of trading and the cost of investing. So we need it because 13 intermediaries accounts for a huge cost in transactions. Just in the equity markets in Europe, the cost of trading is significantly more than it is in the US. That costs every pension fund and every pensioner, and, for me, ultimately that shows the need for efficiencies in the market. The only way we can do that is to get some form of removal of the barriers and that needs to be done through negotiation. Making sure that the

conflicts are resolved in terms of legislation for insolvency and securities seems to be a sensible way to go.

The Chairman: I want to make best use of our time with Kay—and I am most grateful for the time we have been given—so I am going to ask Lord Kerr to jump to his questions on the new Commission, and then I am going to go back to Lord Shutt with a question on the United Kingdom. We will pick up some of the other pieces if we have time. But I feel that we want to hear your views on the new structure of the Commission.

Q152 Lord Kerr of Kinlochard: We of course know Jonathan Hill pretty well from the House of Lords. It is our common view—I am an independent and we are a multi-party Committee—that he is likely to be a very good Commissioner, but I am interested to know what advice you would offer him. At present, I think that the agenda you are suggesting is quite a big one. Are you seeking a common definition of securities when you say that we need a new securities law? I have not quite got the purpose of that. If I want to buy equities in Spain, I can do that now—there is no problem. There are not 13 intermediaries; there is one. What would you want to do? I certainly have no idea where there are dark pools in Spain and I do not particularly want to find out. Supposing that I was a small entrepreneur and I wanted access to German investors, I think I know how I could do that and I do not quite see why—

Kay Swinburne: The intermediaries come in the post-trade space. So you may be able to transact but for that transaction to happen and for the shares to change hands and be registered, there are 13 places where that has to be transacted. You cannot use a CSD in one member state if you do not have some form of recognition of the legal system. So you have to use the domestic CSD and you have to use domestic registrars and systems in order for your share to be recognised as being yours. So, yes, you may have one phone call to your broker but your broker will have to have gone through many, many institutions in

order to make sure that, under a law that you recognise, you are the owner of that share and that it is in your name. There are a huge number of processes to go though in order to do that. Unfortunately, that all bears a cost and you pay that as a cost to your broker. Ultimately these are things that are unseen behind the scenes but they are real and very costly. I would be very happy to talk about this at length. In terms of the new Commission structure, I want to do nothing to jeopardise Lord Hill's hearing next week and any process that takes place. For me this new structure of the Commission is a very bold move. As the UK Conservative delegation we identified that the structure of the Commission was a big issue with regard to the volume of legislation. If there are 28 commissioners with 28 agendas, they would almost be setting up an internal competition on who could do the most legislation during their five-year tenure. The generation of large amounts of legislation was key. We should make them work in clusters and very much as a team so that they do not have a single agenda on legislation but start to talk across disciplines, refining what legislation is required and what needs to be done at European level rather than at a national level. I suggest that the best way of doing it is to justify to your peers why it is necessary and why their work is not more necessary than yours. This clustering will be a positive step forwards in terms of reducing the volume of work. Within the structure that Jean-Claude Juncker is proposing there will be one vice-president who will be his immediate number two who will be responsible for better regulation and for communication back to member states' Parliaments. The big missing link all along has been trying to work out the level at which legislation needs to be done—whether it needs to be done at the European level or, indeed whether it could be done better and more effectively at national level. The role of the vice president is a critical change along with the clusters which will limit the amount of legislation that comes through the process. We proposed this structure as Conservative MEPs within our delegation some four years ago. It was worked up by a colleague of mine, Malcolm

Harbour, whom many of you will know very well. Malcolm has done a lot of work on this. He has worked with the likes of Mario Monti to make sure that this is not just a British idea. Ultimately I am pleased to see a former Prime Minister of a member state take such a strong lead in reconfiguring the Commission. Not all of my colleagues will agree with this. Many of them believe that it reduces the authority and power of the commissioners of their member states. I believe that it is a very positive move if it can be made to work. Ultimately, the gatekeeper situation should mean that many of the pieces of legislation that I really do not care for would never have made it through the process of peer review to the Commission.

Q153 The Chairman: I am going to intervene now because I want to advise that I am anxious to hear all that you might have to say on these important issues. What you have said in response to the proposals on the Commission is extremely helpful and it is on the record. I understand that you are here until 10.30 am. We will try to get through other important questions, but if you want to finish that point in as far as you want it on the record.

Kay Swinburne: I hope that the structure gets through. Obviously we have the hearings but we do not have a formal vote on the structure. We have a vote only on the whole college. I am hoping that some of the individuals will be quite controversial within our hearings, notwithstanding that the UK in charge of financial services is creating quite a few issues here. The former French Finance Minister in charge of eurozone matters is just as controversial. There are some controversial positions across the entire Commission. I hope it means that we will focus on the individuals and not on the structure of the overall Commission which would mean that we would accept the overall structure with less discussion and debate.

Q154 Lord Kerr of Kinlochard: On the fine-tuning function, looking at the level 2 text, we hear terrible stories of 700 draft rules in your in-tray and the silent procedure whereby if the Parliament does not speak up these rules become laws. How is that going to work and do you think that the ESA structure will work? You talked about this as the answer to the

problem of the difficulty of bringing about amendments and correcting mistakes. You said that you believed that this two-tier structure of legislation with a lot of delegation was quite a good way of doing that because the revision of the level 2 text would be easier. I agree with all that. But how are you going to deal with the bow wave of level 2 texts that you must now face?

Kay Swinburne: At level 2 we have 420 within financial services to do as a result of the last few years' work and what is outstanding. There are 420 to come and we are getting them bit by bit. They do not come in a big wave because of the timings of different pieces of legislation. Through the ECON Committee, Parliament has set up a formal structure whereby it is formalised that the negotiating team from the original legislation at level 1 is formally responsible for scrutinising level 2. When we have had a change of Parliament here, when people have not made it back, every political group has been asked to nominate someone to take the lead negotiating role for each group, so there will be a shadow and a rapporteur for every file with a level 2 outstanding on it. Certainly on the files that I have been involved with, I intend over the next few years to spend more time scrutinising level 2 than in doing new legislative work. That is a choice that I have made. The importance of getting level 2 correct on things such as MiFID, CSDR, and so on, are critical to the trading environment, particularly operating in the UK. We will keep a close eye on them. We rely quite heavily, given that we do not have significant resources, on interested parties—stakeholders—coming forward and informing us when consultations happen. They suggest to us that things are not as they thought they would be. Many stakeholders have resources way beyond what we would have and are committing major resources. There is significant monitoring within the industry, consumer groups and elsewhere. It feeds back to us and we use it. There is a formal system in each of our monthly committee meetings when we formally review the level 2.

Lord Kerr of Kinlochard: That is a silent procedure. Somebody who has a worry will speak up but otherwise it goes through.

Kay Swinburne: In all fairness it depends. The regulatory technical standards effectively are Commission-delegated acts, so if the Commission changes what ESMA proposes we can send it back to ESMA to have it reviewed again. We get to scrutinise everything. In all fairness it is not a silent procedure. The silent procedure may be that if we are satisfied with it, we give assent. Ultimately, we are in negotiations and dialogue with ESMA, EBA and EIOPA as negotiating teams. We are in regular dialogue with the Commission which, ultimately, has to decide whether to accept what ESMA does with each of those roles. We are continuously in dialogue, both formally and informally, and teams such as mine will be following each and every one of those roles. It is a huge amount of work and I can only give my assurance that on my files we will be following them. Yesterday we had a big discussion on market abuse regulation, when we picked up on a few things that we thought were going in the wrong direction. We know that the Commission has taken them on board and will know that if it goes down the route it has been going down, and publishes a rule to that effect we will veto it. We have threatened to do that and came very close to rejecting one of the rules. It did not just fire a warning shot over ESMA's bows and the authority's bows here, it fired a major shot across the bows of the United States so the CFTC commissioner/chairman was quite surprised that we had this ability because it would have messed up his bilateral discussions with Europe as well. Having that impact was significant. We did it earlier on and it is very cautious now to take parliamentarians with it as a negotiating team to ensure that it is in line.

The Chairman: Colleagues, to make the best use of time I am going to be quite ruthless.

Q155 Lord Shutt of Greetland: This is returning home. As you obviously appreciate, and we appreciate, we are all from the UK and we are not in the eurozone. In terms of our

inquiry, what are the specific challenges that the UK faces, not being in the eurozone, with the regulatory reform agenda? How does the UK approach compare to that of other non-eurozone countries such as Poland and Sweden? Is there any sense, with the regulatory reform agenda of the 28 states and then the eurozone, of a two-speed Europe?

The Chairman: Just to let you know that we have met the Polish and Swedish equivalents of UKREP, which is the kind of innovation we have had on this visit, and it was illuminating.

Kay Swinburne: Excellent. In terms of the eurozone and the non-eurozone, we are seen as the leading non-eurozone country by virtue of our size, capital markets and a whole load of other issues. They tend to look to us to set the tone and direction that the non-eurozone is going in. That was certainly true during the discussions on the banking union for the eurozone. Within that banking union legislation we had to try to find a way to allow the banks to be supervised by the ECB for the eurozone and anyone who chose it, while protecting the overall market of 28 countries for banking products and capital flow. The EBA has responsibility for the 28 and the ECB has responsibility for however many countries choose to use it. At last count we were up to 18; at least another two countries will probably choose to join the single supervision mechanism, even though they are not in the eurozone. We are at the stage at which the dual-voting structure we put in place is critical, and that dual-voting structure works until the number of countries outside the eurozone falls below five. Once we get below that, we have to go back to the drawing board to try to work out how we protect the non-eurozone versus the eurozone. I would have liked to have negotiated an even stronger dual-voting structure. However, we were pretty pleased when we got the dual-voting structure through the Parliament. I had to resort to some fairly strong negotiating to do so; it certainly fell under my mandate to do that. The dual-voting structure means that we have managed to protect in the mean time the single rulebook from

overt pressure by eurozone members. Ultimately, however, the threat going forwards is when we fall below five countries outside, and the system we then adopt as a result.

Q156 Lord Hamilton of Epsom: This is just a question on equivalence—a perfectly awful word—the impact of these new rulebooks on third-country access to the EU and the risks of multiple jurisdictions and jeopardy. Can you give us an update on that?

Kay Swinburne: I have a real issue with the way in which the Parliament and the institutions here have dealt with third countries. There is no single cross-cutting piece of work on third countries throughout. Even with the markets and banking legislation, in every piece there is a slightly different regime, mainly because of the way in which negotiations have happened. Each team is different and therefore the outcome is slightly different. That does not work in a global world. We need to have one piece of work done on third-country recognition. We are at the stage where we are trying to persuade, and we got some way in persuading, Commissioner Barnier that it was necessary to do a cross-cutting piece of work that would allow an omnibus piece of legislation on third countries to go through. That omnibus piece of legislation will sort out all the issues of third countries across the different dossiers. I hope that that is something of which I can persuade Lord Hill when he takes up his position. We need to have these tools, when legislation is moved in slightly different directions, which can cross-cut and bring the issues back in line. Third-country issues in our capital markets are critical. We cannot operate in a vacuum and we know that. We have tried to accommodate third-country issues but they have all become rather complex. One omnibus piece of work, as much as I do not like proposing new legislation, would be beneficial to everybody.

The Chairman: That was absolutely fascinating. Colleagues, I am going to close it there. I apologise to other colleagues on the Committee for having chopped and changed. Kay, you have been marvellous at responding to an ever-changing agenda. We will mull over the

quality of your answers with great interest. We thank you and your assistant very much indeed for helping us out today. We will send you a transcript; please correct it. I officially close the meeting now because we can only use the room until 10.30 am and people are beginning to drift in. Thank you very much.

Wealth Management Association–Written evidence (FRF0014)

1 What is your overall assessment of the reforms brought forward since 2008 that have aimed to stabilise and improve the functioning of the financial sector in Europe? What is the basis for your assessment?

1.1 A large number of reforms have been implemented since the financial crisis. Many have only recently taken effect; some are yet to do so. This makes it too difficult to assess the success of these reforms at this time.

1.2 A major issue has been the failure of reforms to differentiate between financial service sectors. Some reforms have damaged business areas that did not need reforming. Others have disproportionately burdened firms which did not cause the crisis. Very small, non-systemic firms have thus been caught by legislation designed for large cross-border institutions. The result is high costs and reduced competitiveness, not better legislation.

1.3 EU legislators increasingly use EU-wide Regulations rather than Directives to implement legislation without national Parliaments intervening. This works for wholesale cross-border markets, but not for retail markets that are national and constrained by local culture and tax laws. National Parliaments can implement Directives for the retail sector directly in their own member state so Directives are more appropriate for retail financial markets within a framework of EU-wide high level principles to ensure consistency of overall approach.

2. Will the new regulatory framework enable the EU to withstand further asymmetric shocks and future crises as yet unforeseen? Is there sufficient flexibility in place to enable it to do so?

2.1 No in both cases: legislative proposals reflect ‘lessons learnt’ from the financial crisis rather than attempts to predict or deal with the causes of the next. European institutions are notoriously inflexible and do not co-ordinate sufficiently amongst themselves.

3. Where do you think the biggest achievements have been made, and why? Do you believe there have been any obvious policy mistakes in the regulatory agenda? What are the relative benefits and costs of the new regulatory framework?

3.1 Achievements should be measured by outcomes rather than by input or by the scale of new legislative or regulatory structures. It is too early to determine the biggest achievements. Legislators’ failure to differentiate between financial services firms and sectors is discussed in 1.2 and 1.3 above. Legislators have also failed to consider whether improvements to supervision, rather than more legislation, would be a better approach.

3.2 Major costs are associated with the amount of new legislation and the related constant IT and other system changes in firms. In 2012, KPMG estimated that wealth management firms spend 10%-20% of their turnover on regulation[69]. For agency businesses in the UK and Ireland, this could equate to up to 50% of profits. An appropriately targeted regulatory régime protecting retail clients on the basis of justifiable costs and focussed proportionately on managing key risks should be implemented and would be sustainable in the longer term.

4. Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency; transparency and integrity; and financial stability?

4.1 Consumer practices in EU Member States vary widely and National Competent Authorities (NCAs), not EU level organisations, are best placed to manage retail financial consumer protection. Such consumers are more likely to be aware of their NCA than of remote EU bodies and to take them more seriously. NCAs are much better placed than European Supervisory Authorities (ESAs) to engage with small firms locally. Retail consumer protection issues that could be managed on an EU-wide basis within the EU framework of principles referred to in 1.3 should include such concerns as those about cold calling.

4.2 Market efficiency in the financial sector, especially retail, is hard to maintain against the panoply of EU reforms passed and implemented. European Parliamentary proposals for retail consumers to sign and return Key Information Documents before investing in packaged retail investment products could have seriously and needlessly damaged efficiency, whilst proposals to force all retail transactions in equities through a clearing house would have destroyed the UK's Retail Service Provider (RSP) model that handles some 95% of UK retail on-exchange deals and offers real protections to retail consumers. These proposals were dropped, but only after significant effort by the financial sector. Many other reforms that have been passed impact the sector's efficiency, such as disproportionate and excessive aspects of CRD IV, and excess unwanted information from investment firms to retail clients that the latter cannot choose not to have.

5. How would you assess the effectiveness of the legislative process over the course of the financial crisis? Which EU institutions were most or least effective? In your view, were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

5.1 MiFID II is a particularly good example of just how inefficient and ineffective legislative processes can be, with consultation starting at the end of 2010 but the legislation only taking effect in 2017, by which time it is addressing yesterday's not today's problems. This is a side-effect of the size and breadth of issues covered, making agreement across Member States or political parties extremely difficult. The European Commission (EC) should propose more targeted, less detailed legislation, and a narrower scope of proposals should be maintained during the legislative process. The European Parliament and Council should not use amendments to extend or alter the scope and purpose of the original proposal,

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[69] KPMG (2012) '*UK wealth management at its tipping point?*', http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Market%20Sector/Financial%20Services/UK_Wealth_Management_Report_open.pdf

which should allow targeted proposals to be agreed and implemented more quickly, efficiently, and effectively.

5.2 It is difficult to point the finger at any one institution, as which one improves or weakens particular proposals varies. Typically, however, the European Parliament has tended to use the amendment process as a catch-all for any amendment they wish to see implemented, regardless of whether due process is followed – the much maligned bonus cap in CRD IV is an example – and MEPs are often influenced by their own political or national non-financial concerns. On the other hand, the Council tends to comprise more skilled and expert individuals from Member State finance departments or treasuries and thus usually – but not always – manages to deliver better argued and well thought-through texts.

6. How do you think the 'growth agenda' and support of alternative financing sources can best be promoted by the EU with respect to regulation?

6.1 Our responses to Questions 1 and 3 make clear that undifferentiated legislation has impacted the ability of small and medium-sized investment firms to compete effectively in the retail sector and is thus out of line with the growth agenda.

6.2 EU institutions have also been known to explicitly ignore the growth agenda when proposing new legislation, as in the case of the proposed financial transaction tax (FTT). Such openly anti-growth legislation reduces the EU's competitiveness, and demonstrates how financial services legislation can be used by the EC, Council members and MEPs alike to win praise and votes for populist policies at the expense of more balanced approaches that better achieve the EU's wider objectives.

6.2 Alternative financing sources are difficult to find in the retail sector given the suitability requirements firms must meet for retail clients that reduce the range of products that firms can recommend to such clients, and many alternative finance products – such as the proposed European long-term investment funds – may be unsuitable for retail investors. That European institutions want to see retail involvement in such investments whilst proposing suitability requirements that prevent this shows a lack of understanding of markets and investor protection requirements in some policy areas that should be rectified. The UK AIM market, however, attracts substantial retail liquidity with 25% of all UK retail trades being in AIM-listed securities and may be a model for assisting in this area.

7. Do you identify any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda? Which combination of reforms has generated the most significant costs and inefficiencies for financial actors?

7.1 We have identified a number of inconsistencies between individual pieces of regulation[70], but these have often been resolved before final texts have been published in the Official Journal. In relation to outstanding legislative proposals, there are potential inconsistencies between the proposed General Data Protection Regulation and the 4th Money Laundering Directive, and whether the use of existing third party systems that

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[70] See http://www.thewma.co.uk/uploads/files/29/ep_econ_questionnaire_on_enhancing_the_coherence_of_eu_financial_services_legislation.pdf.

provide many financial services firms with due diligence reports and screening tools essential for meeting their anti-money laundering obligations will be allowed to continue.

7.2 It is not only combinations of legislative reforms but also individual proposals that generate significant costs for small investment firms, such as the costs associated with new reporting requirements introduced in CRD IV, and the significant costs associated with future systems changes resulting from MiFID II implementation.

8. Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured? How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?

8.1 Pieces of legislation that we would like to see revised immediately include CRD IV. This covers both large multi-national credit institutions and small retail investment firms but legislates for both as if they were the former. There should instead be a prudential approach and related reporting requirements tailored to the risks connected with the scale and type of business model operated by different investment firms, most of which do not give rise to systemic risk.

8.2 We support review clauses rather than EU institutions proposing amendments to legislation without carrying out proper evidence gathering or impact analyses. This approach could improve effectiveness by passing better targeted legislation and developing a more transparent work-stream of future proposals.

8.3 There should be a period of calm before further legislative reforms are introduced. This would provide implementation and bedding down time for firms and allow policy-makers to evaluate the impact of the current reforms. New legislation could later be targeted where it is needed, based on good evidence.

9. The Commission argues that the new and/or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution further complete the financial sector reform agenda. Do you agree? If not, which policy gaps remain?

9.1 Yes, but the new Commission's First Vice President's power over better regulation should also be used to enforce a "one-in-two-out" format such as that used in The Netherlands. This must apply to the financial sector too, unlike the current UK better regulation provisions.

10. Have the needs of consumers of financial services and products been appropriately addressed by the reform process? Do particular risks in relation to consumer protection arise from the reforms?

10.1 There are two main risks to retail financial consumer interests in the reform process deriving from failure to comprehend that excess ill-targeted regulation does not benefit these consumers. First, it reduces the available product range, restricts choice, limits

competition and imposes lower returns. Second, it increases costs, which consumers pay for, thus limiting their access to market and reducing the numbers who can, for example, afford advice. These effects impact mainly the poorer end of the consumer market that the authorities most need to help.

10.2 Tendencies to over-harmonise in retail financial legislation exacerbate, rather than alleviate, this situation. This reinforces the case for Directives rather than Regulations in the retail financial sector.

11. How concerned should we be about the range of unintended consequences from such regulation – such as regulatory arbitrage and transferring risk off balance sheet?

11.1 The range of unintended consequences arising from legislation includes higher barriers to entry for agency-only wealth management firms, and the costs of complying with undifferentiated legislation better suited to large, international banks. This could encourage consolidation in the retail wealth management industry with fewer, larger, more homogenous firms leading to reduced competition, higher risk concentration, fewer jobs, and less diverse service offerings.

12. Is there now an effective balance between Member States and the EU in terms of regulation and supervision of the financial sector? If not, how can such an effective balance be struck?

12.1 There is not an effective balance between Member States and the EU in regulating and supervising the financial sector. Member States do not implement legislation to the same standard, meaning that even where Regulations are used, there are inconsistencies. This is regularly tackled by introducing more legislation to cover gaps from failed implementation instead of enforcing proper implementation of existing legislation. This exacerbates matters and introduces more inconsistencies.

12.2 The role of the ESAs in supervising retail financial sectors should be carefully considered. The ESAs are distant from these markets, and untested. They do not engage with the firms, especially small retail investment firms affected by the rules they write. A good role for the ESAs would be to carry out their legally mandated function of enforcing consistency of implementation by NCAs in full. There is insufficient evidence so far of how they are doing this.

12.3 A much more effective balance can be struck at the legislative level through the use of Directives, not Regulations, for the retail financial sector.

13. Is the EU process for adopting rules efficient and nimble enough to adjust and calibrate the new Single Rulebook? Which single element of the new Rulebook is in most acute need of careful monitoring and review?

13.1 Under the European Commission’s Financial Services Action Plan (1999), the single market and any associated harmonised or ‘single’ rules (there was no Single Rulebook at that time) were not applied to retail financial markets. European institutions should continue with this differentiated approach given the differences in such retail markets across Member States.

13.2 We question the efficacy of the EU processes for adopting new rules: see our response to Question 5 for more information.

13.3 There is also a problem with national law and the creation of EU rules. If local supervisors say they must follow the approaches set out in ESA papers without interpretation then it may not be clear to firms what the supervisors want them to do, especially as ESA requirements govern supervisor behaviour rather than prescribing expectations of the supervised entity. Firms, and indeed NCAs, may not understand precisely what is needed, resulting in unnecessary friction between firm and supervisor. This matter should be tackled.

14. What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to 'equivalence'? Is there a danger of 'multiple jeopardy' arising from the multiplicity of regulatory regimes across the EU and beyond?

14.1 Within the retail space, third-country access is less of a problem now that MiFID II allows existing provisions to continue. However, the position of the Channel Islands and the Isle of Man as third countries is often overlooked in negotiations even though the UK has important business – and strong historical links – with them.

14.2 EU equivalence tests must not prevent global business, and must allow the UK to continue to operate its economy on the principles of open market access, exports (including of services) and strong international trading links. European colleagues may take a more protectionist approach, but it is the best way to allow the UK's financial sector to flourish and contribute to the wider UK economy in terms of growth, tax-take and employment opportunities.

15. In light of the fact that some of the regulatory framework applies at EU-28 level, and other elements for the Eurozone only, is there a danger of a two-speed or inconsistent approach to regulation?

15.1 This is a problem but the bigger danger in retail financial services is not of a two-speed or inconsistent approach to regulation but of one-size-fits-all regulation being developed to tackle issues within the Eurozone and then automatically applied to non-Eurozone Member States with no consideration of its relevance and no participation by non-Eurozone Member States in its creation. We would like some comfort that this will not happen.

16. What are the challenges of the regulatory reform agenda for non-Eurozone Member States? In particular, which specific challenges does the UK face? How has its approach to the regulatory reform agenda compared with that of other non-Eurozone Member States such as Sweden and Denmark, as well as those such as Poland who are required to join the Single Currency in due course?

16.1 Banking union will bring with it increased risks of the UK being block-voted against in certain areas of financial services legislation, which may go beyond banking into the territory of investment firms. We need to be very aware of the boundaries and defend them, especially given the different market structures in continental Europe. In retail, the *bancassurance* model is very common on the continent and retail consumers buy the vast

majority of financial products via their bank. They do not in the UK, so bank-focussed regulatory mechanisms do not work here. This differentiates the UK from other non-Eurozone Member States. We must be very careful to ensure that the mooted Capital Markets Union does not create similar dilemmas.

17. Overall, do you believe that the UK's interests have been compromised or enhanced by the programme of regulatory reforms? Has the UK done enough to protect its national interests?

17.1 Our answers to earlier questions demonstrate that the UK's interests have been compromised in numerous ways by EU regulatory reform.

17.2 The lack of transparency in EU legislative processes makes it difficult to answer the second question. But in our opinion the UK has not done enough to protect its national interests.

17.3 There seems to be little coordination between MEPs and Westminster MPs in the same Parliamentary grouping and MPs rarely demonstrate knowledge of European happenings. Improved coordination could rectify this and strengthen the quality of Parliamentary debate on EU matters in Westminster and Brussels.

17.4 The way that financial services legislation is agreed within Europe does not take into account the scale, level of sophistication, development or structure of each country's financial services sector. The UK's financial services industry (and related professional services) is the largest, most diverse, and most sophisticated in Europe, and the UK, EU, and Europe more widely benefit from its existence. But agreements in Council are reached based on the size of each Member State's population. We have no right of veto under Qualified Majority Voting (QMV), so the UK cannot block proposals on the grounds of impact on our financial markets. Most of our range of such markets do not exist in other EU Member States, but despite this they each have a Council vote that can determine how UK financial markets will be regulated.

17.4 In extremis, the UK should be willing to use the Luxembourg compromise forced by the French over 30 years ago when their key national interests were at stake. The value of financial services to the UK economy places it in the category of a key national interest and it should on occasion be defended with the same zeal.

30 September 2014