IRSG

INTERNATIONAL REGULATORY STRATEGY GROUP

BALANCE OF COMPETENCES REVIEW – ECONOMIC AND MONETARY POLICY

This is the response of the International Regulatory Strategy Group (IRSG) to HM Treasury's call for evidence in response to the Balance of Competences Review – Economic and Monetary Policy.

10 July 2014

1. International Regulatory Strategy Group

1.1 The IRSG is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to be one of the preeminent cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments.

1.2 Within an overall goal of sustainable economic growth, it seeks to identify opportunities for engagement with governments, regulators and European and international institutions to promote an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views.

1.3 It is an advisory body both to the City of London Corporation and to TheCityUK. TheCityUK, the City of London Corporation and/or the IRSG have responded to the following chapters of the Balance of Competences Review so far: Single Market (synoptic); Trade and Investment; Financial Services and the Free Movement of Capital; and Free Movement of Persons.

1.4 Given our remit, we confine this response to areas where the balance of competences relate to the economic and monetary governance have a direct bearing on the competitiveness of the UK as an international, and particularly European, financial centre.

1.5 Of the questions posed in in *Call for Evidence on Economic and Monetary Policy: Review of the Balance of Competences between the UK and EU*, we have chosen to address five which are most relevant to financial and related professional services:

- 3) What do you consider to be the most appropriate role for National Parliaments in the economic governance system?
- 5) Given the UK opt-out from the single currency, is the current level of UK participation in the EU's economic, monetary and fiscal policy coordination appropriate?
- 6) What evidence is there of the indirect impact on the UK of the economic and monetary union and the relevant EU competences exercised over euro area Member States?
- 8) Have recent developments to the economic governance system as a response to the euro area crisis taken account of all the interests of Member States (whether euro area, non-euro area or those with an opt-out)?

- 13) What are the key challenges in terms of implications for the UK of likely future developments in these areas?

2. Key messages and recommendations

Messages

- Appropriate economic and monetary governance in the euro area is conducive to the stability of the financial system in Europe. The UK should support efforts, as an engaged EU member, toward stronger post-crisis EU governance and economic recovery, with stability in the euro area a desirable outcome for UK interests.
- The UK has a special interest in the working of EU economic governance: this springs directly from the UK's unique position with regard to its obligations relating to economic and monetary policy as a result of its opt-out from Economic and Monetary Union and the single currency.
- Implementing necessary reforms (e.g. Banking Union) and focusing on the effectiveness of all institutions charged with euro area governance is positive for the euro area but will bring challenges as well as potential positive developments for non-euro Member States.
- One of the major challenges facing the EU is to find mechanisms to ensure that the integrity of the Internal Market is maintained while the euro area integrates more closely. The UK also needs to ensure compliance with the principle of non-discrimination already set out in the Treaties.
- The UK should support the reforms of euro area institutions as well as playing a full role in Internal Market institutions.
- In these areas, the technical expertise and political leadership of the UK will have a crucial role in securing outcomes that will preserve the UK's role as Europe's financial centre through strong, multi-layered UK engagement.

Recommendations

- It is of crucial importance that the UK remains engaged in European coordination of financial services rules. This entails focus at senior levels of Government on the formal structures of the European System of Financial Supervision and dialogues and joint work between the European Central Bank and Bank of England.
- It is important that the Council, as the key forum for the views of Member States' governments to be exchanged, continues to operate as a key component of the governance system.
- The European Commission should address the principle underlying Article 18 TFEU and propose rules on non-discrimination in line with Article 18.
- Single Market deepening should focus on those services that are most readily tradable across borders, with due regard for the characteristics of each market.
- The components of GEMU and Banking Union should be assessed for their positive impact on the strengthening and deepening the Single Market – and the impact on consumers and investors in Europe.
- It would be helpful for Government to set out its expectations of how the Bank of England will develop its relationship with the ECB
- The UK should lend its expertise and engagement to bolstering the ESAs' independence and encouraging their alignment with Single Market principles.

- Banking Union and any other policy or legal developments not involving all EU Member States should adopt the safeguards of the enhanced cooperation procedure.
- It will remain an important UK interest to ensure that the right intra-EU balance continues to be maintained between institutions of the euro area (EWG, Eurogroup) and those of the European Union (EFC, ECOFIN).
- A permanent observer status for the UK and other non-euro Member States similar to the status currently held by the European Commission and European Central Bank in the Eurogroup could ensure the UK Government's involvement from early on.
- The UK should pursue the appointment of well-placed Seconded National Experts (SNEs) as well as permanent UK staff within the European Commission and focus its efforts in this area on key Directorates-General (DGs) that are of relevance to the UK's core national economic interests.

3. Introduction

3.1 At the time the euro currency was launched in 1999, concerns existed that the UK's position as the leading global centre for international financial services might be damaged as a result of not being a founding member of EMU. However, since then, the UK has maintained its position in many global wholesale financial markets has continued and, in some cases, even strengthened. Today, London and the wider UK have the leading share of trading in many international financial markets such as foreign exchange trading (41% of the global total), OTC derivatives trading (49%), cross-border bank lending (17%) and international insurance (22%). It follows that it is in the UK's interests for there to be a successful single currency in the euro area, and to support it.

3.2 The UK is also the leading European centre for investment and private banking, hedge funds, private equity, exchange traded derivatives and sovereign wealth funds.[1] Average daily euro-denominated foreign exchange turnover in the UK totaled $930bn in April 2013, making up around 44% of all euro denominated foreign exchange trading worldwide. Euro trading in the UK has increased five-fold over the past decade. There are twice as many euros traded in London than in all the euro-area countries combined. These euro developments have been a source of success for the UK, which should however remain mindful of global competition.

4. Governance and stability of the Euro area

4.1 Following the euro area's sovereign debt crises, European authorities have introduced some initial measures to improve governance arrangements in the currency area and tackle the macroeconomic divergences that helped precipitate the crisis. These include:

- European Semester: the European Commission analyses the fiscal and structural reform policies of every Member State, provides recommendations, and monitors their implementation;

[1] Driving Economic Growth; Creating Sustainable Jobs: How financial and related professional services serve the UK, TheCityUK, April 2014

- Treaty on Stability, Coordination and Governance ("fiscal compact"): builds on the budgetary rules outlined in the Stability and Growth Pact;
- Six pack: designed to ensure stricter application of the EU's fiscal rules, through five Regulations and one Directive, covering fiscal and macroeconomic surveillance under the new Macroeconomic Imbalance Procedure;
- Two pack: two mooted regulations aimed at further strengthening surveillance mechanisms in the euro area;
- Banking Union: Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and deposit guarantee scheme (DGS);
- European Stability Mechanism / European Financial Stability Facility: crisis resolution mechanisms for the countries of the euro area.

4.2 These measures complement existing governance arrangements in the euro area, including the five criteria set out in the Treaty on European Union (Maastricht criteria)[2] for countries wishing to join the single currency and the Stability and Growth Pact which lays out the budgetary requirements that Member States must follow building on the Maastricht criteria. Future policies for economic and monetary governance and integration are set out in the Genuine Economic and Monetary Union proposals and include further integrating the financial, budgetary and economic policy framework of Eurozone Member States. A roadmap was presented at the December 2012 European Council meeting which suggested a stage-based approach to the completion of GEMU, covering among other things, the establishment of an effectives Single Supervisory Mechanism, a Single Resolution Mechanism and a deposit guarantee mechanism.

4.3 The economy in the euro area is closely linked to that of the UK. The EU accounts for around 45% of UK exports of goods and services and around 50% of imports of goods and services. In addition, over 80% of UK firms that trade, do business with Europe.[3] It is therefore desirable for the UK to support reforms to the euro area that are compatible with financial stability and economic growth whilst at the same time preserving the integrity of the single market for all 28 Member States and upholding the principle of non-discrimination.

4.4 Amongst the reforms to economic and monetary governance in the EU, Banking Union is of greatest direct relevance to the UK financial and related professional services. Approximately 130 banks will be within the Banking Union, the majority of which have branches or subsidiaries in London.

4.5 Banking Union represents an unprecedented move towards a European financial backstop for its banking sector and has gone some way in restoring confidence in the investability of European banks. The more consistent and trusted both supervision and regulation are seen to be across the EU banking systems, the deeper and more stable funding is likely to be for the

[2] The Maastricht criteria are: 1) inflation must be no more than 1.5 percentage points above the average rate of the three EU Member States with the lowest inflation over the previous year. 2) The national budget deficit must be at or below 3 percent of GDP. 3) National public debt must not exceed 60 percent of GDP. However, a country with a higher level of debt can still adopt the euro provided its debt level is falling steadily. 4) Long-term interest rates should not be more than two percentage points above the rate in the three EU countries with the lowest inflation over the previous year. 5) The national currency is required to enter the ERM 2 two years prior to entry.

[3] Analysing the case for EU membership - How does the economic evidence stack up?, Analytically Driven, April 2014

regulated entities. ECB supervision and ESM recapitalisation help to give confidence that each institution in the system has valued impaired assets conservatively and has adequate capitalisation. The greater breadth, credibility and consistency with which ECB supervision is applied will drive the level of stability that it contributes.

4.6 The IRSG acknowledges the UK Government's intention to remain outside of Banking Union. It is of crucial importance that the UK remains engaged in European coordination of financial services rules. Partly, this entails focus at senior levels of Government on the formal structures of the European System of Financial Supervision and dialogues and joint work between the European Central Bank and Bank of England. The UK should seek to ensure high-level attention is focused on this coordination and that the UK is also well-represented at a technical level. The Bank of England should further articulate its relationship with the European Central Bank and how this relationship will develop.

4.7 In response to Question 5 in the call for evidence, the IRSG believes that current levels of UK influence in policy coordination are broadly appropriate, but it is important that the UK remains fully engaged and also increases its efforts to participate in informal and formal governance processes.

4.8 The UK has historically played a central role shaping the financial services policies of the European Union (see IRSG response to the financial services chapter of the Balance of Competences Review). More recently, the UK has been able to secure important (if probably time-limited) safeguards such as the double majority voting rules at the European Banking Authority and assurances that euro area integration should not undermine the interests of non-euro area Member States.

4.9 There is no reason for complacency, however. Following the Lisbon Treaty and anticipated accession of Lithuania to the euro area, as of November 2014 EMU Member States will have a qualified majority in the Council. This will in theory enable euro area Member States to caucus and out vote the non-euro area contingent in policy areas subject to qualified majority voting.

4.10 Furthermore, recent examples of enhanced cooperation and other intergovernmental agreements being used as an alternative to the Community method of EU policymaking[4] could threaten the influence of euro outs.[5]

4.11 There are also relatively isolated but concerning examples of euro area institutions developing policies that risk fragmenting the Internal Market, notably the ECB's location policy for clearing of euro-denominated assets[6]. This is an example of an indirect impact on the UK of EMU, as referred to in question 6 of the call for evidence, and arguably an example of discrimination

[4] Recent examples include the Treaty on Stability, Coordination and Governance, that was signed in March 2012 and the FTT through enhanced cooperation approved in January 2013

[5] With the Euro Plus Pact and the Fiscal Compact the use of enhanced cooperation extends into core areas of European integration.

[6] The ECB has proposed that CCPs offering euro-denominated clearing above a set threshold must be based within the Eurozone. In September 2011, the UK launched a legal challenge at the ECJ, arguing that the measure contravenes EU law and the principle of the Single Market. In February 2012, the Treasury filed a second legal challenge.

contrary to Article 18 of the TFEU, the principle underlying which the European Commission should address directly and propose rules on non-discrimination in line with Article 18.

5. Integrity of the Single Market

5.1 Completing the Single Market and preserving its integrity should be a core activity of the EU28. Single Market deepening should focus on those services that are most readily tradable across borders, with due regard for the characteristics of each market: such as whether it is retail or wholesale, the impact and use of technology, the sophistication of the end-user and the extent to which market activity is domestically or internationally orientated.

5.2 Here, there is an increasing recognition amongst EU actors that the interests of euro outs must be taken into account of as the euro area integrates. The finance ministers of the UK and Germany, for instance, recently stated that "future EU reform and treaty change must include reform of the governance framework to put euro area integration on a sound legal basis, and guarantee fairness for those EU countries inside the single market but outside the single currency."[7]

5.3 Coordination of economic policy should go hand-in-hand with prioritising compatibility with the progress of the Single Market: the ECB should work closely with the Bank of England and other non-euro area central banks to coordinate prudential policy and assess whether new supervisory rules are compatible with the Single Market. Indeed, it would be helpful for Government to set out its expectations of how the Bank of England will develop its relationship with the ECB. The components of GEMU and Banking Union, including the Single Supervisory Mechanism (SSM), should also be assessed for their positive impact on the strengthening and deepening of the Single Market – and the impact on consumers and investors in Europe – with UK financial services and central bank expertise prominent within the assessment.

5.4 The integrity of the Internal Market and emphasis on the principle of non-discrimination are of crucial importance to UK financial and related professional services and the tax revenues and FDI associated with them. Not only is the EU the world's largest market with 25% of global GDP accounting for around 45% of UK exports and 50% of imports, the EU is also the biggest individual market for UK exports of financial services, responsible for a third of the UK's surplus in financial services. Its position within the Single Market contributes to the UK attracting more FDI than any other EU Member State, with close to a half of total FDI coming from the other EU member-states.[8] For all these reasons the UK has a vital interest in the Single Market's integrity and expansion.

5.5 European legislation for financial services has recently begun to explicitly protect the integrity of the Internal Market and emphasise the principle of non-discrimination. For example, MiFID III contains a clause stating that no action taken by any regulator or the European Securities and Markets Authority (ESMA) and other supervisory authorities should discriminate against any Member State as a venue for the provision of investment services and activities in any

[7] "Berlin boosts David Cameron's effort to renegotiate links with EU" FT, 27 March 2014.
[8] Key Facts about UK Financial and Related Professional Services, TheCityUK, January 2014

currency. Provisions such as these are to be welcomed and should be a negotiating priority of UK authorities where appropriate.

5.6 The introduction of European Supervisory Authorities (ESAs) is to be welcomed (c.f. Section 2.0 and how stability in the euro area is a desirable outcome for UK interests, an end to which the ESAs should contribute). The UK should lend its expertise and engagement to bolstering the ESAs' independence and encouraging their alignment with Single Market principles. Double majority voting requirements for EBA decisions on mediation and on technical standards are to be welcomed, but there are a number of caveats to be taken into account. This voting method only applies to technical rule-making, whereas euro outs enjoy no such protection for voting on primary legislation in the European Council. Financial and technical constraints mean that new accession euro outs do not always participate in deliberations. Furthermore, the eventual obligation of many Member States to join the euro means that the double majority voting rule may be time limited (as it requires a minimum of four euro outs). Reaching a new settlement that will protect the fundamental interests of euro outs should be considered, not only in relation to the EBA but also other ESAs and potentially in other policymaking fora.

5.7 It will remain a key UK interest to monitor how the ESAs will develop, and to be clear on how their future progress will affect financial and related professional services and the Single Market.

5.8 On the whole, efforts have been made to take account of the interests of all Member States (whether euro area, non-euro area or those with an opt-out). There can be different interpretations of commonality of interest; and there have been a number of cases in which the UK has had to fight hard for its interest to be acknowledged. Instances in which UK financial services have been involved have included the short selling regulation, Financial Transaction Tax, remuneration provisions in CRD IV and third-country access issues. The UK's legal and policy views are not always shared by other Member States and the EU institutions, as the decision of the Court of Justice of the EU in the short selling case reveals.

5.9 There will be an ongoing need for safeguards. Banking Union and any other policy or legal developments not involving all EU Member States should adopt the safeguards of the enhanced cooperation procedure, that "such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them."[9]

5.10 Pursuing these objectives will require strong communication of UK concerns across the European institutions and in all Member States, deploying the UK's full expertise at both government and private sector level: the UK should optimise its ways of communicating to its European partners any practical and technical competition concerns behind euro area finance-related policy objectives, applying its expertise constructively to the furthering of GEMU and the wider EU's global competiveness. To promote that objective, TheCityUK and City of

[9] Art. 326 TFEU

London Corporation are developing relationships with counterparts in other EU Member States.

6. UK in the European Union

6.1 The UK benefits economically from access to the world's largest market of more than 500 million people. Eight out of ten business leaders representing a variety of different sectors would prefer the UK to remain a member of the EU.[10] It is recognised that this view is not necessarily shared by the electorate as a whole and we believe that it is important to bridge the gap between these views.

6.2 The UK's financial services centre is also Europe's financial centre and its leaders are clear about the importance of EU membership. Its role as Europe's financial centre is the reason international firms invest, locate and create jobs in the UK and across the EU. It is important for Britain to remain at the heart of Europe and for the UK government to take a leading role in reforming the EU, helping it to focus on competitiveness, jobs and growth.

6.3 As noted in the Call for Evidence (paragraph 3.4), the UK has a special interest in the working of EU economic governance: this springs directly from the UK's unique position with regard to its obligations relating to economic and monetary policy as a result of its opt-out (secured in the Maastricht Treaty) from Economic and Monetary Union and the single currency. It follows that, if the UK safeguards all aspects of this economic position, its voice as an individual Member State needs to be clearly heard. For that to happen effectively, various features need to be – and remain - in place. Among them, it is important that the Council, as the key forum for the views of Member States' governments to be exchanged, should continue to operate as a key component of the governance system. UK Ministers must retain their ability to voice the UK economic interest in the Council.

6.4 It will remain an important UK interest to ensure that the right intra-EU balance continues to be maintained between institutions of the euro area (EWG, Eurogroup) and those of the European Union (EFC, ECOFIN). To achieve a balance catering for UK interests, the UK government will need to remain as fully engaged as possible in EU economic governance discussions, whether relating to the euro area only or the wider European Union.

6.5 While the Eurogroup has its own distinct mandate, its agenda has been dominated by the ad-hoc responses to the global financial crisis and subsequent euro area crisis and European recession. In order to address issues around competitiveness and productivity in the EU, stronger internal cooperation within the Eurozone is inevitable. However, the legal basis for the Eurogroup is only laid out in two articles under Protocol 14 in the Lisbon Treaty. While these grant formal observer status to the European Commission and the European Central Bank, non-euro area Member States are not given a formal role. Given the UK's leading role in shaping the Single Market and its expertise in economic and financial regulation, it is crucial

[10] In the manufacturing sector, a poll in 2013 showed that 85% would prefer the UK to remain in the EU. See EEF (2013). Similarly, in the financial sector, 84% of business leaders would prefer the UK to remain a member of the EU. See TheCityUK (2013a). Eight out of ten CBI members (including 77% of SMEs) also said that they would vote for the UK to remain in the EU, if a poll were held tomorrow. See CBI (2013).

that the UK Government stays actively engaged in shaping the Eurogroup's agenda, perhaps through a formal observer role. Increased cooperation between the Eurogroup and non-euro area Member States is in the interest of all participating parties. We recognise that granting the non-euro area Member States observer status would amount to Treaty change but this could be considered as part of any renegotiation of the UK's relationship with the EU.

6.6 Especially in light of discussions over a unified representation of the euro area in international institutions, such as the IMF and G20, it is crucial that non-euro area Member States are not left out and their voices continue to be heard. A permanent observer status for the UK and other non-euro Member States similar to the status currently held by the European Commission and European Central Bank could ensure their involvement from early on.

6.7 The European Parliament has a Treaty role in EU legislative procedures, enhanced under the Treaty of Lisbon. But the EU legislation that it helps to enact is complemented by national legislation, all the more so as the EU does not have exclusive competence in economic and monetary issues. This shared competence means that the UK Parliament continues to have a very important role. Indeed, the UK regulatory institutions that - among other activities - act in a supervisory role to implement EU regulation are created under UK Acts of Parliament (most recently the Financial Services Act (2012) creating the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), which together are responsible for the supervision and regulation of financial businesses in the UK). In this and other ways the UK Parliament has a central role in economic governance.

6.8 It is important for members of the European Parliament and the UK Parliament to understand their respective roles and work together effectively in performing them. There are well-established opportunities for the UK Parliament to act in EU matters (e.g. in scrutinising proposed EU legislation) and to exert influence (e.g. under the subsidiarity provisions of the EU Treaties). It is important that the UK Parliament should use these opportunities, in the interests both of influencing EU policy in the UK interest and so as to engage UK parliamentarians in developments in the EU with potential for affecting the UK. Due regard should be paid to the importance and scrutiny of European legislation in the UK Parliament, which might also help increase the perceived legitimacy of EU legislation. There are healthy signs that this is happening: the House of Lords recently noted that "The House of Lords has a strong track record of engaging with the European Parliament, with Members regularly visiting Brussels to discuss key policies with MEPs, and participating in biannual meetings with UK MEPs and members of the European Scrutiny Committee of the Commons"[11]

6.9 The UK should also pursue the appointment of well-placed Seconded National Experts (SNEs) as well as permanent UK staff within the European Commission. Here, it is worth noting that the British contingent of SNEs, at 5%, is well below the level that might be expected given the UK's population share of the EU, at nearly 13%. The UK should focus its efforts in this area on key Directorates-General (DGs) that are of relevance to the UK's core national economic interests.

[11] House of Lords European Union Committee - Ninth Report "The Role of the National Parliaments in the European Union" (11 March 2014)

6.10 In July 2017, the UK will take over the Presidency of the EU, giving the UK Government a crucial opportunity to shape for EU reform. The UK has an important role to play within the EU to continue to make the case for open international markets and to secure the completion of the Single Market. It will also be important to ensure the EU delivers solutions to the benefit of all its 500 million citizens and, most importantly, to preserve the integrity of, and deepen, the internal market for all 28 Member States. To this end, the UK can lead in lending its extensive expertise in capital markets to Europe. Here, UK views on shadow banking and its relationship with Banking Union should be made clear to European partners, as should explicit UK promotion of completion of the Single Market in financial services.