IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

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.

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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.