Costs and Benefits to the UK of EU Setting of Financial Services Regulation

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1 INTRODUCTION

1.1 In this paper, commissioned by Open Europe as an input to its thinking ahead of the early-December 2011 EU summit, we shall consider some of the pros and cons of the European Union setting financial services regulation to apply to the UK. We shall identify a number of strong reasons that can be offered for why, up to this point, EU setting of financial regulation might reasonably be believed to have been to the net benefit of the UK. However, we shall go on to argue that some of the most material of those reasons are unlikely to apply over the next few years. In other words, the case for the UK accepting the applicability of EU financial services regulation has weakened.

1.2 The report is organised as follows:

(a) Section 2 considers the traditional case for why having financial regulation set at EU level might be beneficial. We shall contend that that central case rests principally on the contentions that influence promoting liberalisation which in turn promotes direct trade increases within the financial services sector, and liberalisation driving an increase in growth in other countries thereby increasing trade opportunities for UK businesses in other sectors are significant, and that the risk of over-rule of the UK in any fundamental aspect of financial services regulation has been limited by the close alignment of the concept of the Single Market with traditional UK concepts in financial sector regulation, by the high esteem in which UK financial sector regulators were regarded by the European Commission, by the fact that the City of London was understood as an EU asset, not merely a UK one, and by the Luxembourg Compromise and the culture it created.

In interpreting the arguments of this section it will be important to recognise that it is not our purpose to argue (or dispute) that EU-level setting of financial regulation has, up to now, been to the UK's benefit. Our key purpose is to identify what would be the key planks of the argument upon which someone wanting to argue such a case would depend.

(b) Section 3 considers the possibility that the main elements of the case for EU-level setting of financial services regulation have reversed — i.e. over the next decade will provide cases against EU-level setting of regulation, rather than in favour. We shall explore the risk that the core thrust of regulation will be de-liberalising, that the EU financial services sector will grow very slowly or shrink at a time when opportunities for the financial services sector to expand in China, India and elsewhere are significant, and that Britain has a greatly enhanced risk of being over-ruled in respect of fundamental issues.

(c) Section 4 Concludes

1.3 There is also an Appendix exploring models of the relationship between financial sector development and economic growth.

2 THE TRADITIONAL CASE

2.1 The traditional case contending that the UK benefits from having financial services regulation set at EU level can be reduced to five main propositions:

(a) Common EU-level policymaking allows British regulatory concepts to influence overall policymaking, and thence to have an impact on the regulation in other Member States. Since Britain is traditionally a pro-trade country, the impact of its influence will tend to be to increase opportunities for trade in financial services, to the benefit of British firms and British consumers.

(b) When financial services regulation is improved in other Member States, under British influence, those other Member States grow faster. That increased demand leads to opportunities for British businesses in other non-financial sectors, also.

(c) Without EU-level setting of regulation, some EU Member States might set regulation below the ideal minimum level, with the objective of attracting businesses to locate away from Britain.

(d) Compliance costs may be lower for companies operating cross-border within the EU, if they have only one set of common EU regulations to deal with.

(e) A straightforward system of common regulation means that the UK can be used as an entry point to the EU for global investors and financial services firms from outside the EU.

2.2 These notional potential advantages can be conceived as, according to the traditional case, outweighing five potential drawbacks:

(a) Regulation might not be set in Britain's national interest. A simple case might be where Britain is outvoted on some regulation, and the result is that regulation is imposed upon Britain that is conceptually inferior to British-set regulation.

(b) Regulation set at EU level might be technically inferior to British-set regulation. For example, designing regulations that are applicable across all Member States might result in messy compromises on certain technical points, creating anomalies and loopholes.

(c) Compliance costs might be higher for firms focused upon Britain, because EU-level regulations might, by the nature of applying across 27 states, have greater complexity and greater redundancy (with respect to UK-focused business) than UK-focused regulations.

(d) The loss of regulatory competition might undermine both the long-term quality of regulation (because of the loss of processes of learning from the mistakes and successes of others) and remove the pressure, from the threat of regulatory arbitrage, to keep regulation at a low level — which offsets natural bureaucratic and democratic tendencies to over-regulate. Furthermore, Britain could be a beneficiary from regulatory arbitrage if all other relevant countries had a natural tendency to over-regulate — i.e. ideal regulation could be the attractive regulatory minimum.

(e) There might be more difficulty in dealing with and attracting foreign investors and foreign financial services firms from outside the EU in respect of global activities.

2.3 We do not need, for our purposes here, to develop a full analysis of the merits of each of these ten traditional pros and cons. We shall focus mainly on three — two pros and one potential con: the first two potential benefits (influence and growth in other Member States) — these are chosen because they are much the most material; and the first potential con (the risk of over-rule on some fundamental issue of difference) — this is chosen because it is an area in which there may have been a significant change between the past two decades and the next.

Influence and Growth

2.4 We contend that the first two of these potential notional benefits — influence promoting liberalisation which in turn promotes direct trade increases within the financial services sector, and liberalisation driving an increase in growth in other countries thereby increasing trade opportunities for UK businesses in other sectors — are overwhelmingly the most important.

2.5 Furthermore, in later sections we shall argue that it is likely that in the future the case from these two dominant potentially beneficial factors seems, as matters stand, likely to reverse, along with a reversal in respect of the third effect. That is to say, in the future

(a) it, at present, seems more likely that the EU will be a de-liberalising force in the financial services sector, that British influence will be negligible in preventing this, and that, if anything, European thinking will be more likely to influence the British debate in a de-liberalising direction; and

(b) the consequence of EU-level setting of regulation (which, because EU, may be more de-liberalising than might be sustainable in the presence of regulatory arbitrage and regulatory competition), seems likely to be slower growth (or greater contraction) in EU member states than would otherwise be the case; and

(c) absent EU-level setting of regulation, Britain would be more likely to be a beneficiary of regulatory arbitrage than a loser, as business would be more likely to be attracted to Britain as regulation introduced elsewhere was regarded by some firms and investors as inappropriate and/or excessive.

2.6 We shall explore these points in more detail in later sections. For the moment, we shall explore the senses in which, up to this point, there is a case to be made that EU-level setting of financial services regulation has been beneficial to the UK. As stated, we shall focus upon the ways in which EU financial services regulation has been liberalising in certain Member States, and ways in which such liberalisation has been positive for growth.

The Benefits of Influence

2.7 The stated ambition of EU directives and regulation and judgements of EU competition authorities and the European Court of Justice (hereafter frequently referred to as "EU-level decisions") has been, in general, "liberalisation" across most industries. More specifically, it has been to strip away government subsidies, government-created monopoly power, and legal impediments to trade and competition (both explicit and implicit).

2.8 It is, of course, strongly disputed how ideal or complete EU-level decisions are in delivering upon these stated objectives. However, as a sweeping generalisation, one might observe that EU directives and regulations quite often increase the level of regulation in the UK, but reduce it in many other Member States. This reflects the fact that for many Member States, participation in the Single Market programme is a mechanism for delivering liberalisation that would not be chosen by purely domestic political processes. But for the UK, there was a much longer-standing tradition of liberalisation that was domestically-driven. So, Britain would very often choose, for itself, at least as liberalised rules as those delivered at EU level.

2.9 The key gain for Britain, then, has never been conceived as that the EU would deliver liberalisation within Britain that Britain could not deliver for itself. Rather, it has been that

(a) by being involved, Britain would influence policy positively, so that it delivered more and better liberalisation than would be delivered absent British ideas;

(b) where the final result distinguished between the treatment of different parties (e.g. between firms within and outside the EU), by being involved in the decision, Britain would be more likely to be on the more advantageous side of the line (e.g. by not being subject to tariff or non-tariff barriers).

2.10 It can be argued that the ways in which, influenced significantly by British ideas, EU-level decisions are liberalising for other countries has, in recent years (specifically, taking EU membership and the Single Market Programme to 1992 as given), been much the most significant benefit to the UK of EU-level decision-making. This is particularly true in the financial services sector in respect of the Financial Services Action Plan (FSAP) of 1998-2006, which sought to create / deepen the Single Market in Financial Services.

The Financial Services Action Plan

2.11 The potentials benefits of creating/completing a Single Market in Financial Services were explored by the Lamfalussy group of "Wise Men", who identified in particular the following[1]:

(a) Improved allocation of capital — through more efficient, deeper and broader security markets enabling savings to flow more efficiently to investment; lower transaction costs and improved market liquidity; more diversified and innovative financial systems; and more opportunities to pool risk.

(b) More efficient intermediation between savers and investors — through Intensified competition among financial intermediaries across Europe, leading to fewer inefficiencies; giving users greater freedom of choice; and the opportunity to reap economies of scale and scope across a larger market.

(c) Hence, a stronger faster-growing European economy.

2.12 The European Parliament's ex-post evaluation of the FSAP[2] identifies the following as the most material FSAP measures:

(a) For the Banking sector:

- Directives relating to money laundering[3];
- The Capital Requirements Directive[4];

(b) For the Insurance sector:

- The Insurance Mediation Directive[5];
- The Solvency I framework[6];

(c) For the Securities sector:

- The Markets in Financial Instruments Directive[7];
- The UCITS directives[8];
- The Prospectus Directive[9];

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1 See *Creating a Single European Market for Financial Services - a discussion paper* — City of London
2 *The Impact of the New Financial Services Framework* — IP/A/ECON/ST/2005-86, report prepared by Europe Economics for the European Parliament, http://www.pedz.uni-mannheim.de/daten/edz-ma/ep/07/pe385.623_part_I-en.pdf
3 …particularly 2001/97, the "second money laundering directive"
4 2006/48/EC and 2006/49/EC
5 2002/92
6 …particularly 2002/13 and 2002/83. The report also identifies the Solvency II framework, but this is part of the FSWP, not the FSAP.
7 2004/39
8 2001/107 and 2001/108

(d) For Financial Conglomerates:

- The Financial Conglomerates Directive[10].

2.13 A number of analyses have been conducted regarding the costs of these measures to British financial sector firms and consumers, and also of their potential benefits. Some of these are detailed in the following table.

9 2003/71

10 2002/87

Table 2.1: Costs and Benefits of Key FSAP Measures

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates	Notable subsequent developments
Third Money Laundering Directive	HM Treasury undertook the consultation exercise £25 – 52 million[11] (£10.5 – £13 million in administration costs arising from new monitoring requirements. More detailed "know your customer" procedures, enhanced due-diligence obligations, and the "fit and proper" vetting).	HM Treasury undertook the consultation exercise £31 million in savings from simplifying record keeping requirements[12] £10 million over 5 years (other simplifying measures)[13]	One-off: 0.16 – 0.29% operating expenses Ongoing: 0.05 – 0.13% operating expenses[14] Other estimates Ongoing: £66-87 million[15]	To provide a common EU basis for implementing the revised Financial Action Task Force Recommendations on Money Laundering.	The EC is currently reviewing the Directive
Capital Requirements Directive	Ongoing compliance costs: Securities and futures firms: £0.2 million per firm per year; Investment managers: reduction of £3 million[16]	Enhanced risk management Greater financial stability Market confidence and consumer protection	One-off: 0.00-1.53% operating expenses Ongoing: 0.00-0.23% operating expenses[17] One-off: £7 – 10 billion; Ongoing: £210 million per year. (implementation costs for UK credit institutions, ongoing cost of maintaining systems and financing extra regulatory capital)[18]		In 2011, the Commission adopted a legislative package to strengthen the regulation of the banking sector.
Insurance Mediation	One-off: £56.23 – 58.89	Increase in the quality of the	Ongoing: £400 million (ex-post		In 2009, the EC announced its

[11] HM Treasury (2007), "Regulatory Impact Assessment".
[12] HM Treasury (2007), "Regulatory Impact Assessment".
[13] HM Treasury (2007), "Regulatory Impact Assessment".
[14] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[15] Z/Yen survey estimate results/Treasury RIA/KBA extrapolation in Open Europe (2006). "Selling the City Short? A Review of the EU's Financial Services Action Plan".
[16] FSA (2006), "Strengthening Capital Standards 2".
[17] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[18] Treasury RIA/PWC figures in Open Europe (2006). "Selling the City Short? A Review of the EU's Financial Services Action Plan".

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates	Notable subsequent developments
Directive	million (authorisation related requirements for firms and individuals); Ongoing: £71.65 – 205.89 million[19]	intermediary market as a result of authorisation. Reduced likelihood of market disruption or consumer detriment through the introduction of financial safeguards. Payment of compensation to consumers Reduction in costs from supervision of conduct of business requirements[20]	estimate of costs to industry and consumers of UK General Insurance Regulations which include DMD and IMD)[21]		intention to review the IMD.
Solvency I framework	N/A	N/A	N/A	N/A	Solvency II
MiFID	One-off: £877 million to £1.17 billion for firms; Ongoing: £88 million to £117 million per year; (sizeable compliance costs from client categorisation, best execution, introducing the appropriateness test and the systems changes required by markets transparency provisions) [22]	£200 million per year in direct benefits (principally to firm from reductions in compliance and transaction costs); £240 million in 'second round effects (accruing to the economy more generally from competition, reductions in transactions costs likely to be passed on to end-users).[23]	One-off: 0.52-1.46% operating expenses[24] Ongoing: 0.08-1.09% operating expenses[25] Other estimates £1.2 billion (IT costs)[26]	£100 million per annum (reduced costs of complying with regulation) £20 billion to £500 billion per annum additional turnover (improved access) £0.1 – 1 billion per annum (reductions in transactions costs because of aggregation	In 2010, EC's MiFID review begins. Turquoise trading platform created by a group of investment banks in 2008. It allows trading both on and off traditional exchanges.

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[19] FSA (2003), "Prudential and other requirements for mortgage firms and insurance intermediaries".
[20] FSA (2003), "Prudential and other requirements for mortgage firms and insurance intermediaries".
[21] ABI figure in Open Europe (2006). "Selling the City Short? A Review of the EU's Financial Services Action Plan".
[22] FSA (2006), "The overall impact of MiFID".
[23] FSA (2006), "The overall impact of MiFID".
[24] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[25] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[26] Atos Origin figure in Open Europe (2006). "Selling the City Short? A Review of the EU's Financial Services Action Plan".

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates	Notable subsequent developments
				benefits) £1.8 – 25 million (realisation of economic value of data) Extension to range of passportable activities and simplified passporting regime Reduction in cost of capital Increased inflow of funds into the UK Deeper, broader and more liquid capital market[27]	
UCITS III	Ongoing: £11 million per year (increased capital requirements, maximum extra cost of capital)[28] Simplified Prospectus Requirements One-off: Large firms: £0.1 – 0.5 million Medium firms: £1.0 million Small firms: £3.9 million Continuing compliance cost minimal because of similarity to existing regime. [29]	Furthering competition through allowing authorised funds in one Member State to be sold to the public in each Member State without further authorisation Requiring disclosure of the portfolio turnover rate (PTR) may benefit the efficiency of competition, as well as improving the quality of funds bought by consumers		.	UCTIS IV in 2010

[27] Europe Economics (2006), "The Benefits of MiFID, A Report for the Financial Services Authority".
[28] FSA figure in Open Europe (2006). "Selling the City Short? A Review of the EU's Financial Services Action Plan".
[29] FSA (2004), "Implementation of the Simplified Prospectus requirements in the UCTIS Management Company Directive".

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates	Notable subsequent developments
Prospectus Directive	One-off: £2.3 million (familiarisation with rules); Ongoing: £1.9 million	Does not radically change the substance of existing rules; benefits will not be significant[30]	One-off: 0.48% – 1.46% operating expenses[31] Ongoing: (-)0.15% – 0.16% of operating expenses[32] <u>Other estimates</u> One-off: £2.3 million (familiarisation with new prospectus rules); Ongoing: £7.55 million (companies required to issue approved prospectuses where had previously not, and filing annual update information).[33]	Unquantifiable incremental benefits of a new regime which encourages UK companies to raise capital across the EU. Reduction in costs for those companies offering securities or admitting them to trading in more than one Member State. Overall benefit of Single Market in Financial Services estimated as reduction in cost of capital by 0.5%. Unquantifiable incremental benefits from providing UK investors with more and wider investment opportunities across the EU.[34]	Reviewed by EC in 2009 and amending Directive published in 2010. Amendments were brought into effect in the UK in 2011. In 2011, EC mandates ESMA to deliver advice on level 2 measures
Financial Conglomerates Directive	One-off direct costs range: £440,000 - £500,000 Annual direct costs range: £30,000 - £40,000 One-off compliance costs: £160 million - £1.7 billion	Prudential soundness and financial stability Coordination between supervisors promotes consistency of treatment of firms and standards of regulation across the EU, encouraging competition	One-off 0.00% - 0.01% of operating expenses On-going: 0.00% - 0.01% of operating expenses[37]		Following review, in 2010 the EC proposes a directive to amend the FCD.

[30] FSA (2004), "The Listing Review and implementation of the Prospectus Directive – Draft rules and feedback on CP203" Annex 3.
[31] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[32] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[33] HM Treasury (2005), "Final Regulatory Impact Assessment".
[34] HM Treasury (2005), "Final Regulatory Impact Assessment".

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates	Notable subsequent developments
	Annual compliance costs: £134 million – £200 million[35]	The benefit of securities and futures groups being subject to consolidated supervision, is to decrease the risk of failure of such groups, thereby increasing financial stability, and in turn market confidence in the sector.[36]			

[37] Europe Economics (2009), "Study on the Cost of Compliance with Selected FSAP Measures", report prepared for European Commission DGMARKT
[35] FSA (2003), "Financial Groups". (CBA focused on four key policy lines developed to implement the requirements of the FGD and the changes to the insurance group risk regime.)
[36] FSA (2003), "Financial Groups". (CBA focused on four key policy lines developed to implement the requirements of the FGD and the changes to the insurance group risk regime.)

2.14 A number of these directives were significantly influenced by British thinking — indeed, in many key respects they sought to conform the regulation in other Member States to pre-existing British regulations — and significantly liberalising for many Member States.

British influence: the example of MiFID

2.15 A clear illustration of British influence upon directives in the Financial Services Action Plan can be seen in arguably the single most important component of the FSAP: the Markets in Financial Instruments Directive (MiFID). MiFID is a directive that sets out how Member States must regulate "investment services". By "investment services" we mean activities such as trading shares or bonds or commodity derivatives on behalf of other people, or running a stock exchange where other people trade, or virtually any other investment service apart from a small number of foreign exchange activities. The firms affected included[38]:

(a) investment banks;

(b) portfolio managers;

(c) stockbrokers and broker dealers;

(d) corporate finance firms;

(e) many futures and options firms; and

(f) some commodities firms.

2.16 MiFID aimed to:

(a) Increase harmonisation, in particular in order to limit the ability of Member States to set regulation above the EU standard (under the directive that MiFD replaced — the Investment Services Directive — states had been entitled to gold plate the EU regulations, and many did in ways that the EU authorities regarded as protectionist);

(b) Increase the ease (and reduce the cost) of trading across borders within the EU;

(c) Increase competition;

(d) Protect investors;

(e) Increase efficiency;

(f) Increase transparency.

2.17 For our purposes here we do not need to understand all of the voluminous detail of MiFID. Neither do we need to come to a conclusion about how successful it was in its aims, or to adjudicate upon the fierce debate there has been about how costly it has been to comply with. But what is of interest is to see (a) how its form was heavily influenced by

[38] See http://www.fsa.gov.uk/pages/About/What/International/mifid/background/index.shtml

pre-MiFID UK regulation; and (b) that it was materially liberalising for a number of other Member States.

2.18 Two illustrations of the influence of UK thinking are the ways MiFID requires firms to categorise their clients; and some of the forms of trading MiFID says must be permitted.

Categorisation

2.19 MiFID requires firms to categorise clients into three groups:

(a) “eligible counterparties”

(b) “professional clients”

(c) “retail clients”

As one might expect, the level of consumer protection in the regulation increases as one goes down this list — i.e. is greater for professional clients than eligible counterparties, and greater still for retail clients.

2.20 Before MiFID, UK regulation, set by the Financial Services Authority (FSA), had required firms to categorise clients into three very similar groups:

(a) “Market counterparties”

(b) “Intermediate customers”

(c) “Private customers”

2.21 The MiFID groups were not *precisely* the same as the pre-existing FSA categories (e.g. certain FSA “market counterparties” counted as MiFID “professional clients”). But the choice of categories in the MiFID was consciously made so as to closely reflect the pre-existing UK regulations, and to learn from them.

Permitted forms of trading

2.22 Prior to MiFID, a number of countries (e.g. France, Italy, and Spain) had what were called “concentration rules”. Concentration rules stated that if an ordinary investor ordered an investment firm to buy or sell shares on her behalf, that order could only be “executed” (i.e. carried out) on a “regulated market” — which in practice meant the main exchange. Put less technically, that meant that if you asked an investment bank to buy shares for you, that bank was only permitted to buy them at the stock exchange.

2.23 Britain, by contrast, had for some time permitted certain firms to act as “systematic internalisers” (some readers may be familiar with the concept of a “market maker”, which has some overlap with that of a systematic internaliser). To make things concrete and simple, let us think of a systematic internaliser in some shares. A systematic internaliser will have some clients that want to sell and other clients that want to buy the same shares. Instead of executing the buy orders on the main stock exchange, and then the sell orders on that same stock exchange, a systematic internaliser can simply match up those seeking to buy with those seeking to sell. (So, instead of going "externally" — to the stock exchange — it "internally" matches up between its own orders.)

2.24 MiFID required all countries to be like Britain, in permitting systematic internalising. This was a large change — a significant liberalisation introduced by EU regulation — as, prior to MiFID, even in Member States where systematic internalising was not specifically forbidden, it was effectively so by the complex interplay of other regulations. And even in some Member States where there was some systematic internalising (e.g. Germany), it was much less widespread than in the UK.[39]

2.25 MiFID was an extensive and complex piece of regulation, affecting many areas of investment business. The above two areas are simply examples of the widespread ways in which MiFID was heavily influenced by, and conceived itself as learning from, pre-existing British financial regulation.

Other ways in which the FSAP was liberalising for other Member States

2.26 One of the key goals of the FSAP was increased liberalisation and competition. Where the FSAP has enhanced competition, the single most important mechanism is that the FSAP increased openness to foreign firms, which can lead to enhanced competition directly through an increase in the number of firms in the market or via the threat of entry.

2.27 The main European Parliament evaluation of FSAP found that its impact on Italy was particularly significant, leading to enhanced competition in banking, insurance, securities services and in relation to financial conglomerates.

2.28 The FSAP was also found to have resulted in increased competitiveness in the banking sectors of Italy, Poland and Spain.[40] Italy also increased its competitiveness in insurance, securities services and in relation to financial conglomerates.

2.29 FSAP (and Financial Services White Paper) directives and regulation, when implemented in full, were predicted to lead to a significant lowering in the cost of equity capital for Italy.[41] The key drivers of this were seen as being reductions in transaction costs and reductions in servicing costs as liquidity increases. Transaction costs in Italy were relatively high and liquidity low, compared, for example, with the UK. A fall in the cost of equity was also expected to lead to an increase in the use of equity.

[39] In Germany, internalisation was allowed, but investment firms were required to obtain explicit permission for every order before internalising trades.

[40] The term "competitiveness" is used here in relation to the relative efficiency and attractiveness of the output of domestic firms compared with foreign firms.

[41] Europe Economics (2007), "The Impact of the New Financial Services Framework. A Report by Europe Economics for the Internal Policies Directorate of the European Parliament".

2.30 However, the largest impact of the FSAP was seen in New Member States, though it is difficult to disentangle the impact of the FSAP from other impacts, including the Member States' Accession to the European Union.

Table 2.2: Illustrative Impacts of FSAP on Italy, Poland and Spain

	Italy	Poland	Spain
Key liberalising effects	• Increase in competition in banking, insurance, securities services and financial conglomerates. • Increase in competitiveness in banking, insurance, securities services and financial conglomerates • Increase in consumer protection in banking and insurance • Large fall in the cost of equity capital	• Increase in competition in banking, insurance and securities services • Increase in competitiveness in banking • Increase in consumer protection in banking and securities services	• Increase in competition in banking • Increase in competitiveness in banking

Source: European Parliament, The Impact of the New Financial Services Framework — IP/A/ECON/ST/2005-86

2.31 Indeed, perhaps partly reflecting UK influence via its influence upon EU institutions and thence down into action in other Member States, the common caricature that the UK is materially more liberal than other EU Member States is something of a UK myth. Considering the World Bank's Ease of Doing Business survey or WEF's Global Competitiveness Report the UK comes across as actually rather run-of-the-mill in its overall approach (i.e. not limited to just financial services): more liberal than a France (or Greece or Italy), less so than Ireland, Netherlands and Finland. Germany, for example, is much more liberal in action than is often thought.

Limited Risk of Over-Rule

2.32 As detailed above, one of the potential draw-backs of EU-level setting of regulation is the risk that Britain is over-ruled in some fundamental aspect of financial services regulation with regards to which its concept of the regulation differs from that of other EU Member States.

2.33 Through most of the period of Britain's membership of the European Union and its forerunners, this risk has been relatively limited. There have been three key classes of reason why:

(a) The thrust of EU regulation has been liberalising, pro-trade, and pro-competition. This has meant that, although Britain might have preferred the details of certain regulations to be different, some compromise provided the opportunity, overall and the considerable majority of the time, to extend British concepts at the EU level.

(b) EU policymakers at, in particular, the European Commission have been highly influenced by British thinking and typically regarded British financial regulation as definitive of international best practice.

(c) It has long been understood that financial services, particularly at the wholesale level, were an industry in which Britain had a particular specialism and was much the leading player in the EU, and there was a general reluctance at EU level to over-rule a country that was especially dominant in the industry concerned.

2.34 This last point, regarding the reluctance to over-rule, is worth dwelling upon, because it will be important in our discussion later. Shortly after qualified majority voting (QMV i.e. the process of over-ruling national vetoes by a weighted vote of all Member States) was introduced, President de Gaulle came to power in France. He regarded qualified majority voting as an impingement upon the sovereignty of France, and there was an extended "empty chair" crisis in 1965, when France refused to participate in European Council proceedings. This led to the Luxembourg Compromise of 1966. According to the Luxembourg Compromise:

> "Where, in the case of decisions which may be taken by majority vote on a proposal of the Commission, very important interests of one or more partners are at stake, the Members of the Council will endeavour, within a reasonable time, to reach solutions which can be adopted by all the Members of the Council while respecting their mutual interests and those of the Community".

2.35 The Luxembourg Compromise was never formally accepted by the European Commission or the European Court of Justice, and was widely regarded as becoming largely obsolete with the Stuttgart Declaration of 1983, in which the French accepted the principle of widespread curtailing of national vetoes. However, the French have occasionally subsequently invoked the Luxembourg Compromise to prevent themselves being over-ruled in agriculture[42], and the Compromise was in place for so long that it became part of the culture, still informally curtailing or at least influencing the conduct of QMV. As the Member State with much the largest presence in wholesale financial services, and very large involvement in other financial services activities as well, the cultural echo of the Luxembourg Compromise has been a significant protection for the UK up to this point.

2.36 We shall see in the next section that this has now changed. The implications for the efficacy of EU-level setting of financial services regulations are potentially profound.

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42 Indeed, the British government position is that the Compromise is still in place, and the possibility of the UK's applying the Luxembourg Compromise to financial services regulation was floated by Mark Hoban at the Treasury Select Committee on 8 November 2011 (see http://uk.reuters.com/article/2011/11/08/uk-britain-financial-hoban-idUKTRE7A74WO20111108).

London as an Asset for the EU

2.37 Another traditionally important reason why British financial regulation concepts were influential and there was limited risk of Britain being over-ruled in anything fundamental with respect to financial sector regulation was the understanding that the City of London, as a global player in the financial services sector, was an asset to the European Union.

2.38 Before the financial crisis, in the mid-2000s, it was estimated that London provided 41 per cent of all City-type financial services activity in the European Union, and had a dominant international market share in six of eight major international financial product areas. If London's financial cluster did not exist, it was estimated that the cost of financial services in the EU would rise sixteen per cent and EU GDP would be €33bn lower in the short term, €23bn lower over the medium term, with the loss of 100,000 jobs.[43]

2.39 Of course, the benefits of the financial sector to the broader EU go far beyond the simple generation of jobs and activity in the City.[44] The financial services sector has a much broader contribution — to how business investment is funded, including small local businesses; how pensions are paid for; how companies manage to buffer themselves against bad times, to hedge against risks, and insure against disaster; how broader access to financial services enables households to smooth consumption during periods of unemployment or unexpected drops in income (e.g. short-hours working) or family surprises (illness, divorce, babies) and hence to deliver greater overall macroeconomic stability (contrary to much recent discussion); how interventions in distressed businesses can preserve value and restore long-term jobs; how governments use international financial centres to borrow to service public spending in periods when tax takes are temporarily depressed.

2.40 Such contributions are not simply within one Member State. Some Europeans gain returns on their investments in the UK; others travel to the UK to work in the City. And the benefits of the business activities carried out in the City are not accrued only by the UK. The activities of London's financial centre benefit car companies in Sweden, pharmaceuticals manufacturers in France, clothes manufacturers in Italy, agribusinesses in Poland, and so on.

London as an Entry Point to the EU Single Market

2.41 One traditional thought has been that the European Union would be a zone in which financial services would have strong growth opportunities, and that international financial services sector players from outside the EU would see London as a natural beachhead for EU business. Indeed, during the 1990s and 2000s the EU financial services sector

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43 *The City's Importance to the EU Economy 2005*, City of London & CEBR, February 2005

44 See, for instance, *The Value of Europe's International Financial Centres to the EU Economy*, Report prepared for the City of London Corporation and TheCityUK by Europe Economics, July 2011, http://217.154.230.218/NR/rdonlyres/583EB1BD-3CAE-4EAD-8BEA-41B2CEC1EFD6/0/BC_RS_ValueofEUsFinancialCentres_FullReport.pdf

was a significant growth area. We have already seen above how financial sector increased during the 2000s in a number of Member States.

2.42 Volumes of business increased, also. By the mid-2000s, EU business supported 22 per cent of London's City-type activities and EU companies owned about one third of the foreign banks operating in London.[45] (By way of reference, we note that about 15 per cent of UK GDP is exported to the EU across all sectors.[46])

2.43 The growth in financial services activity was not uniform across Member States. While the amount of leverage and volume of financial services varied between Member States, the 2000s was a decade of increased integrated in financial services between Member States and growth in the volume and global pre-eminence of EU financial services. It was reported in 2005, for example, that in 11 out of 15 categories of financial service the trading and activity increased in the EU relative to the US between 1998 and 2004. This report also noted the $33 trillion of commercial banking assets in Europe were nearly four times the $9 trillion assets of the US commercial banking sector at end-2003.[47]

2.44 The growth of financial services in Europe over the 2000s is explained by a range of factors, but is almost certainly both a cause of, and consequence of, increased leverage. Increased financial development creates opportunities for liquidity-constrained households to obtain better access to credit. Increased credit provides a stock of debt that wholesale financial intermediation optimises (e.g. by investing into an appropriate mix of risk-and-return, and hedging), creating an increase in finance sector activity in this optimisation process.

2.45 Increased leverage, in turn, tends to support increased household spending and business investment, which boost towards economic growth, encouraging further provision of financial services.

Impacts on Growth

2.46 Academic research confirms that when financial sectors are more developed, economies grow faster, and that the greater development of the finance sector is a key *cause* of that faster growth.

2.47 In an Appendix to this Report, we use a standard model (used by a previous European Parliament study) to estimate the impacts of economic development on growth, considering how much the increase in economic development over the 2000s (which in some parts of Europe was quite significant) has promoted growth, and how much scope

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[45] *ibid*
[46] Source: www.uktradeinfo.com
[47] http://www.thecityuk.com/assets/Uploads/EuropevsUS2005.pdf

there is for some Member States to enhance their growth rates by catching up to the level of financial development of the most advanced states.

2.48 The table below quantifies how much financial development increased over the 2000s in selected Member States.

Table 2.3: How financial development increased over the 2000s (selected Member States)

	Index of financial development in 2000	Index of financial development in 20008	Change: 2000-2008
Germany	1.15	1.02	-11.3%
Greece	0.42	0.92	119%
Spain	0.65	1.72	165%
France	0.81	1.06	30.9%
Italy	0.71	1.03	45.1%
Luxembourg	0.96	2.11	120%
Netherlands	1.25	1.93	54.4%
Poland	0.25	0.41	64.0%
Portugal	1.18	1.72	45.8%
UK	1.21	1.89	56.2%

2.49 Next we report our results for how much this increase in financial development affects growth. The first column considers how much growth was increased by the increase in financial development during this period. The second column considers how much higher growth is in these Member States on account of their having higher financial development than Poland (the least developed in our sample). The third column considers how much higher or lower growth is in these Member States on account of their having different degrees of financial development from the UK.

Table 2.4: How differences in financial development increase/decrease growth (selected EU Member States)

Gains from increased financial development		Gains relative to Poland		Gains (Losses) relative to UK	
Germany	-0.26%	Germany	1.2%	Germany	-1.7%
Greece	1.0%	Greece	1.1%	Greece	-2.0%
Spain	2.1%	Spain	2.6%	Spain	-0.3%
France	0.49%	France	1.3%	France	-1.6%
Italy	0.66%	Italy	1.3%	Italy	-1.8%
Luxembourg	3.2%	Luxembourg	4.7%	Luxembourg	+0.6%
Netherlands	1.5%	Netherlands	3.3%	Netherlands	+0.1%
Poland	0.4%	Poland	0	Poland	-3.6%
Portugal	1.3%	Portugal	3.1%	Portugal	-0.4%
UK	1.3%	UK	2.9%	UK	0

2.50 For example, we note that France gained growth of nearly half a per cent over the 2000s because of the increase in its financial development, and 1.3 per cent more than if it had only been as developed as Poland, but 1.6 per cent less than if it had achieved the same level of financial development as the UK.

Caveats and Questions

2.51 Though the approach to estimating the effect of financial development considered discussed here is standard in the academic literature, it is worth noting that the definition of financial development is intimately connected to the degree of indebtedness (specifically, the orthodox definition of the degree of financial development is the credit by deposit money banks and other financial institutions to the private sector divided by GDP). If an economy is above its equilibrium level of indebtedness — if the private sector is "over-indebted", as may well be the case in a number of EU Member States, particularly in respect of the household sector (the corporate sector is widely regarded as having restored its leverage to a sustainable level) — then the growth in financial development, the growth in financial services business volumes, and indeed GDP growth rates might not be sustainable.

2.52 Regardless of its longer-term sustainability, for some time the EU could reasonably be characterised as a significant business opportunity for firms from outside the EU, and there was a strong case that London was used as an entry point for such firms. Such advantages, of course, had to be offset against any losses there might have been either in terms of reduced access for British financial sector firms to markets outside the EU (e.g. because of tariffs, or implicit trade barriers, or a reduced tendency to be sympathetic to arguments for reducing regulatory barriers) or in activity from within the UK being diverted into the EU, when it might better have gone elsewhere in the world.

2.53 Overall, however, during the period of rapid expansion in EU financial services, there was at least a case to be made that the benefits outweighed the costs. The question we shall ask the next section, however, is whether this remains the case. Is the EU financial services sector likely to be a significant growth area over the next decade or so, relative to financial sectors in other parts of the world? And will firms from other parts of the world regard London as as natural a launching-off point for their activities in other parts of the EU as has been the case in the past?

Remembering the Goal of this Section

2.54 We observe again that our purpose in this section has not been to contend that all EU-level financial regulation has been to the UK's benefit, or even that EU-level setting of financial regulation has, overall, been to the benefit of the UK. We have merely sought to sketch out what we regard as the key planks of the case that would be offered if one were indeed arguing that EU-level setting of regulation has been to the benefit of the UK. It is identifying what these key planks are that has been our purpose. We needed to identify these key planks because, in the next section, we shall float the thought that these key plans have now reversed — that is to say, the key factors that would, up to now, be offered by someone contending that EU-level setting of financial regulation has indeed been to the UK's benefit can be argued to be factors that, over the next decade, would suggest that EU-level setting of financial regulation will not be to the benefit of the UK.

3 THE FUTURE OUTLOOK FOR EU-LEVEL FINANCIAL SERVICES REGULATION

3.1 In the previous section, we identified the key planks upon which an argument that EU-level setting of financial regulation has, over the past couple of decades, been to the UK's benefit. In this section, we shall explore the risk that these very same factors that, in the past, might have supported the case for the UK's so benefitting, might over the next decade suggest that the UK would not benefit from EU-level setting of financial regulation.

3.2 It is in the future-gazing nature of the discussion in this section that we are unable to come to a definitive and robust conclusion. An element of judgement is necessary in assessing the materiality of the risks we identify, and in deciding how best to respond.

Change in Spirit and Thrust of Regulation

3.3 The Financial Crisis of 2007 onwards, and in particular the collapses in the banking sector of late 2008 and early 2009 led to a sea-change in attitudes to financial sector regulation across Europe and the United States. This has partly been reflected in certain specific regulatory changes in the banking sector — changes already announced and a number of changes yet to come. But more fundamentally it has driven a significant change in the thrust of financial services regulation at EU level. Whereas we have argued in previous sections that during the 1990s and 2000s the key thrust of EU-level regulation, on average across the EU (if not always in the specific case of the UK), has been liberalisation and the encouragement / facilitation of cross-border trade within the EU, the key driving force now has become the extension of the net of regulation, increasing restriction on financial services regulation, limiting the activities of financial sector firms, and empowering greater national control over the activities of the financial sector.

3.4 There are, of course, very good reasons for this change in motive force. We do not need, for our purposes here, to rule either in favour of or against all the specific measures currently being enacted or planned at EU level. But we do offer the following points for debate:

(a) The balance of EU regulatory plans has shifted from liberalising and promoting cross-border trade to extending the scope, depth, and national bite of regulation.

(b) Whereas in the 1990s and 2000s, EU-level policymakers were eager to learn from and emulate British financial regulators and regulation, Britain has become much less unambiguously influential upon the shape, objectives and detail of EU-level financial regulation.

(c) Whereas in the 1990s and 2000s, EU politicians would have felt constrained, by the culture and norms created by the Luxembourg Compromise, from imposing financial regulation upon the UK that the UK strongly resisted, that has now ceased to be the case.

(d) A number of initiatives in EU-level financial sector regulation are directed at and relevant to specific issues of the Eurozone, rather than the EU as a whole.

(e) EU-level financial regulation impinges upon and in some cases appears may impede some of the British new regulatory initiatives in response to the financial crisis (in other words, even where Britain is *increasing* its financial sector regulation, it is not always able to do so in its chosen way).

(f) The scale of financial sector trade within the EU is likely to decrease or grow much more slowly than non-EU financial sector trade over the next decade.

EU-Level Regulation as a Check / Balance upon Regulatory Over-Reaction to the Financial Crisis

3.5 Under the pressure of the financial crisis, particularly in late 2008 and early 2009, many widespread principles of regulation were overthrown. Procedures for mergers were set aside in the urgency of events (e.g. in the case of Lloyds TSB and HBOS). Rules limiting state support to particular companies (regarded as anti-competitive and protectionist) were set aside.

3.6 At the national level, such principles were simply blown away by events. But in many of these areas the ultimate authority lay with European Union institutions. It is not as widely appreciated as perhaps it deserves to be that the European Union rules were left much more intact than were national frameworks. This partly reflects the fact that the EU rules were embedded in Treaties, and so not straightforward to sweep away in one heated and hasty Parliamentary vote. Partly it reflects their international nature. And partly it reflects the fact that the European Union Single Market rules are intrinsically insulated from the day-to-day pressures of public opinion — they exist precisely to deliver liberalisation, competition, and the removal of barriers to trade between countries that either would not, for most Member States of the EU, be passed by Member State democratic institutions if left to themselves, and to resist the erection of barriers to trade and competition, and state aids, that might naturally arise as politicians respond to day-to-demands that “something must be done” and then, once in place, are only slow removed (if at all).

3.7 The European institutions, therefore, to some extent ensconced in their ivory tower and deliberately insulated from day-to-day political pressures, could not and did not abandon the principles laid out in the EU Treaties. By and large they did not seek to obstruct the neglect of merger procedures or the institution of anti-competitive state aids. Instead, they issued memoranda of forbearance, and entered into agreements with Member States about the timescales over which state aids would be unwound and more competition would once again be introduced. One example of this that has emerged during the writing of this report was the requirement for the British government to divest itself of much of Northern Rock by 2013. Other examples include the divestments required by EU competition authorities of RBS and Lloyds.

3.8 Thus, although we are about to argue that EU-level regulation will, over the next few years, be a source of de-liberalisation and reduced trade in the financial sector, this should be understood as a delicate judgement. The underlying deep structure of the Single Market is still present in the Treaties and in the institutional set-up, and this deep structure has been a pro-competitive pro-liberalising force in respect of the UK as well as elsewhere — that is to say, it has forced the UK to be more liberal and pro-competition, in certain respects, than the UK might have found it easy to choose to be for itself. It is thus not enough, to conclude that the EU is de-liberalising, to show that EU-level policy-setting will imply the introduction of de-liberalising regulation. One would also have to show that the de-liberalising regulation introduced would be more de-liberalising than the regulatory changes the UK would be likely to choose for itself, and that this more-than-offsets the liberalising character of the Treaty-embedded principles that have forced, and will probably continue to force, the UK government to be more liberal, more competitive, and more pro-trade, in certain respects, than it might find easy to choose for itself.

Extension to the Scope and Depth of Regulation

3.9 The financial sector is currently experiencing an unprecedented wave of new regulation, and regulatory and tax changes. These include:

(a) Measures that had only recently been implemented prior to the crisis, and had probably not yet been fully absorbed into behaviour, prices, demand or market structure, are already being revised in light of these events. These include the Capital Requirements Directives (implementing Basel II and now Basel III) and the Markets in Financial Instruments Directive.

(b) Measures that had been planned before the crisis but scheduled for introduction shortly afterwards. These include the Solvency II Directive and the Clearing and Settlement framework.

(c) Measures introduced at least partly in response to the banking crisis which affect the broader financial sector rather than the banks themselves. This includes in particular the Alternative Investment Fund Managers Directive and the proposed Financial Transactions Tax.

(d) Measures introduced, proposed or debated in response to the crisis affecting mainly the banking sector. These include measures requiring or effecting:

- new arrangements for cross-border supervision and crisis management
- changes to capital and liquidity requirements even under existing regulatory
- structures and new measures such as changes to trading book capital requirements
- new special administration regimes or other resolution mechanisms
- new mechanisms for the treatment of bondholders in the event of administration (e.g. “bailins” — debt-equity swaps)

- the restriction or separation of activities (e.g. as per the retail / investment banking separation / ringfencing discussed by the Vickers Commission, with proposals now to consider such separation at EU level, also)
- restrictions on remuneration or dividend policy
- caps on size, connectedness, concentration or complexity
- accounting changes
- taxes or stability fees
- macroprudential oversight

(e) Measures introduced at Member State level, in response to particular crisis, such as restrictions on the short selling of bank equities or on sovereign credit default swaps.

3.10 The central issue for our discussion here is not whether any or all of these measures are justified and appropriate regulatory improvements. It is that they are clearly not liberalising deregulatory trade- and competition-promoting measures. Their central goal is to restrict and control the activities of the financial sector.

3.11 It is also the case that a significant tendency has arisen for different Member States to enact their own new measures of financial regulation. Obvious examples of this are the various country-specific bans on the short selling of banking stocks or various trades in sovereign CDS. There have also been country-specific moves in areas such as the treatment of banking sector bonds (e.g. Denmark has taken a different approach on this question from, say, Belgium, which has in turn treated such bonds differently from Ireland).

3.12 Furthermore, the crisis has inspired the creation of a number of new EU institutions, such as ESMA, EBA and EIOPA. We note that the UK has objected to the granting to ESMA of broad-based powers (proposed on credit rating agencies, defining appropriate technical standards on equity and non-equity trading, and on product bans).[48]

3.13 Without, at this stage, committing either way on the efficacy of these measures[49], we aim to highlight that — in deep contrast to the general liberalising thrust of financial services regulation in the 1990s and 2000s — the thrust of financial services sector regulation at present is quite the reverse. And this is, at the time of writing, expected to remain the case for much of the next decade.

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[48] However, it should also be observed that, as at the time of writing, it remains uncertain what direction ESMA, etc will take. It is not impossible that in due course these may be as keen to learn from UK ways as the European Commission was before.

[49] It could, for example, be argued that it would be wrong-headed to argue that the previous “light touch” UK approach to regulation was ideal, and that the UK had a bias to under-regulating financial services, especially on the wholesale side. Some commentators have even argued that the financial services sector is intrinsically likely to be successful in “regulatory capture” of individual countries in which the sector is located. Perhaps it could even be argued that EU institutions might be less susceptible of such regulatory capture, and so intrinsically better-placed to regulate for all?

3.14 It is, however, worth observing that at least some important components of this rise in regulation originate from global institutions, rather than the EU. Examples include

(a) the revisions to the capital requirements directives (which reflect — though amplify upon — the Basel III global rules);

(b) revisions to MiFID (which have been heavily influenced by G20 initiatives in derivatives trading and transaction reporting).

Reduced Influence of the UK

3.15 In previous sections we have emphasized how influential United Kingdom regulatory models were upon EU-level financial services regulation in the 1990s and 2000s. There has now been a significant change in this area. There are three key aspects to this:

(a) Partly this reflects a reaction to the financial crisis, and its widespread characterisation (perhaps arguably caricature?) on the Continent as having been the consequence of an “Anglo-saxon” light touch, low supervision deregulatory approach to the financial services sector.

(b) Partly it is a consequence of a change in the balance of initiative in European Union institutional policy-setting, with the European Parliament gaining codecision-making powers.

(c) Partly, this reflects the fact that certain forms of financial regulatory change have been developed in response to Eurozone-specific issues, to which British concerns are regarded as peripheral at best.

Changed spirit of regulation

3.16 Of course, UK regulation has also, to some extent, shifted away from the “light-touch” concept. There is a wider re-evaluation of the approach to regulation within the UK. However, it is by no means clear that the new paradigm emerging within the UK matches that emerging at EU level.

3.17 Within the UK, two of the key foci concern the nature of supervision (and its institutional expression) and the structure of firms. An illustration of the supervision point is the switch away from FSA prudential supervisory powers to prudential regulation becoming a Bank of England competence. This is neither, per se, a matter of increased nor of resistance to increasing regulation. The Bank of England has argued, indeed, that supervisory relationship is likely to make it more feasible to enforce regulatory change than would be more detailed regulation. As Mervyn King put it, addressing the Parliamentary Joint Committee on the Draft Financial Services Bill[50]:

> I give two examples of where we think it will be important for regulators to exercise judgment and why we need to make a break from the style of regulation we have seen in the past. One is that I would like [Bank of England supervisors] to be able to say to a bank—this is a hypothetical example but is clearly relevant to what happened before the crisis—"Your leverage has gone up from 20 to one to 40 to one in the past four or five years. You have not broken any rules. Nevertheless, this is a highly risky set of activities to undertake, and we want you to reduce your leverage." The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules.
>
> Another example would be to say to a bank, "The structure of your bank is so complex and opaque, with so many offshore and onshore legal entities, that we don't understand the risks you are taking. We are not entirely confident that you do either, but certainly outside investments cannot assess it. We think that degree of opacity is inconsistent with a sensible and stable contribution to financial stability." These institutions are operating not only for themselves; they are big enough to affect the economy of the whole country. Therefore, the regulator has to be free to make a judgment about that degree of opacity, even though nothing is done that could be said to violate a specific detailed rule. That degree of judgment is vital.

3.18 This is not merely a changed style of supervision. It is a changed concept of regulation. But at EU level, though the possibility of the ECB taking some supervisory responsibility for banks has been floated, there is nothing on the table remotely of the nature of the change that is taking place in the UK.

3.19 Another central element of UK regulatory change has been proposals for changing the structure of the industry. The most visible example of this has been the Vickers commission consideration of splitting or subsidiarising retail from investment banking activities. The European Commission has recently suggested setting up its own committee to investigate the point. But as matters stand, it appears that, far from EU-level regulation following British regulation in this area, it might even be a blockage to certain of the Vickers proposals (in particular, the giving of bite to the ringfencing proposals by associating them with differences in capital requirements). During his evidence to the Parliamentary Joint Committee on the Draft Financial Services Bill, Mervyn King discussed this point with David Mowat MP:

> Q769 David Mowat: My final question is about the Capital Requirements Directive and the way we co-ordinate with Europe on that. At one time it looked as though it might make it difficult for us to impose higher capital requirements on our institutions than the Europeans would find acceptable.

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50 3 November 2011, http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/Ucjcdfsb031111ev11.pdf

Sir Mervyn King: It is still a problem. The Commission's current proposals still want to impose maximum harmonisation. I am completely baffled as to why they want to do it. I can think of no logical or economic reason why you would want to have maximum harmonisation, other than a theology of convergence for the sake of it. But the whole spirit of the agreement under Basel I, II and III was to have a level playing field in terms of common minimum requirements. No one could conceive of any reason why you would object to a country wanting to impose higher requirements, for example to protect their taxpayers. At the European Systemic Risk Board the vast majority of the people round the table were equally baffled as to why there was a case for maximum harmonisation, and I believe that an increasing number of governments in Europe will come to the same view. This is a problem.

The Commission takes the view that some of the things we want to achieve by implementation of the proposals of the Vickers Commission, or macro-prudential regulation through the Financial Policy Committee of the Bank, could be done through what is known as pillar 2 of the capital requirement. Again, that seems rather bizarre to us, because it is clear from the legal basis of pillar 2 that this is for individual institutions, but clearly that is not macro-prudential. Macro-prudential is something that applies to all banks, and that is naturally pillar 1. I cannot see any reason why anyone should object to a country using pillar 1 to have higher capital requirements. I absolutely agree there need to be common minimum capital requirements, and it is good that Europe is now taking this through the European Parliament to get European legislation. We are ahead of other countries in this respect, but I am completely baffled as to why they see any need or reason for having maximum harmonisation.

3.20 The approach at EU level and in many other Member States has reflected the concept that there was in the past, simply too much freedom, perhaps even laxness with respect to the activities of financial sector firms. Whereas in the UK the concept has been to try to re-empower market forces (through changes in structure) and re-empower supervisors (through relational supervisory oversight, rather than rules-based regulation), at EU level much of the concept has been fairly straightforwardly to write more rules. This is not altogether true — we have mentioned above the continuation of EU competition, state aid and merger rules, and it is also worth noting that the Vickers proposals in areas such as making bank debt "bail-in-able" (i.e. empowering banking administrators to convert bank debt into equity) were first proposed by the European Commission. But it does not, overall, mis-characterise the new spirit of EU regulation to say that it is consciously more sceptical of markets and actively seeks to curtail their activities.

3.21 Now we are clearly in a time of flux, and the possibility cannot yet altogether be ruled out that in due course EU and UK concepts in financial regulation might converge. But at present the UK's thought leadership in this area is much less clear than was the case in the past.

Changed institutional balance

3.22 Another, non-trivial development has been a change in the relative powers of institutions within EU-level decision-making. Traditionally, the European Commission was especially sympathetic to UK thinking across a range of economic policy areas, but especially in the financial services sector, whilst the European Parliament was much less sympathetic to UK orthodoxy.

3.23 In recent years, and especially with the Treaty of Nice, the power of the European Parliament has been enhanced. One example is the development of the "codecision procedure" whereby the European Parliament now has equal power with the Council, in its ability to amend and reject legislation.[51] Another is that, under provisions of the Treaty of Maastricht enhanced by the Lisbon Treaty, the European Parliament now has a right of legislative initiative that allows it to ask the Commission to submit a proposal.[52]

3.24 This enhanced role for the European Parliament has increased its influence over what legislation comes forward, also. An example is the Alternative Investment Fund Managers Directive (the AIFM Directive). This was a measure that the European Parliament repeatedly urged should be investigated from the mid-2000s onwards (with the European Commission repeatedly refusing), but was only finally introduced in 2009, partly as a reflection of the financial crisis but also, and crucially, as a reflection of the increased institutional role of the Parliament.

Increased relevance of needs of Eurozone

3.25 Some financial sector measures recently introduced or considered have reflected particular issues in the Eurozone. Two examples of this are restrictions on trading in sovereign CDS and proposals for a Financial Transactions Tax. Neither of these was a measure likely to be proposed within the UK. Each reflected particular issues in the Eurozone — in the case of sovereign CDS issues relating to concerns about whether assessments of sovereign creditworthiness reflected genuine analysis or were merely the result of manipulative speculation; in the case of the Financial Transactions Tax reflecting the need to obtain a revenue stream to fund future increased fiscal transfers within the Eurozone.

3.26 If Eurozone members seek to introduce regulation of particular relevance to the Eurozone, such measures are unlikely to be significantly influenced by British ideas.

Global Opportunities versus EU Opportunities

Falling EU opportunities

3.27 We have seen above that, as the Single Market developed and expanded, and as financial development advanced in many EU Member States, especially under the influence of EU-level regulation, the 1990s and 2000s saw opportunities for UK businesses within the EU, including in particular UK financial sector businesses.

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51 Previously, a measure proposed by the European Commission and supported unanimously by the Council could not be stopped by the European Parliament.

52 http://www.europarl.europa.eu/parliament/expert/staticDisplay.do?id=55&pageRank=13&language=EN

3.28 This is much less clearly likely to be the case over the next decade. In a number of Member States (e.g. Ireland, Spain), an important factor in enhanced financial development appears to have been over-indebtedness and over-expansion in banking sectors. The correction of this problem is likely to be associated with reductions in the volume and value of financial sector business. Even simply the process of deleveraging — reducing indebtedness relative to the size of the economy — is likely to have the consequence of a fall in financial sector activity, as lower debt levels means less demand for the debt to be put to work adding value, and hence passing through financial intermediaries. But beyond that there may be considerable austerity at national level, reduced function of banking sectors, reduced appetite for experimenting with new financial sector firms or new innovations — in short, these are unlikely to be as attractive growth opportunities for British financial sector firms as was the case in the past.

3.29 The financial crisis of recent years is unprecedented in the post-World War II era. It is an established empirical observation that major financial crises are followed by periods of deleveraging. The more substantial the financial crisis, other things being equal, the more substantial the deleveraging that follows.

3.30 Given the scale of the recent (and in some senses on-going) financial crisis, we would anticipate a significant phase of deleveraging. The McKinsey Global Institute analysed 45 historic episodes of deleveraging, finding that they on average last six to seven years and reduce the ratio of debt to GDP by 25 per cent.[53] This empirical finding suggests that households, businesses and governments will continue to deleverage for a number of years.

3.31 In some Member States, the key form of deleveraging will be direct reductions in household indebtedness. For example, a European Parliament study in 2010 identified Cyprus, Denmark, Ireland, Portugal, Spain and the United Kingdom as "high household indebtedness" Member States, averaging 85 per cent household debt to GDP in December 2009.[54] That compared with average household indebtedness of just 56 per cent for Belgium, Germany, Luxembourg, Austria, Finland, France, Malta, Netherland and Sweden. A reduction of 25 per cent in household debt to GDP for the high indebtedness countries (in line with McKinsey's historical analysis) would take them to 60 per cent — close to the average for the lower-indebtedness group.

3.32 In other Member States (and to some extent even in the high household indebtedness states), a key mechanism of deleveraging will be government austerity programmes. That will deleverage both by reducing government debt and by increasing household tax commitments and reducing benefits, thereby making households less attractive to lenders, reducing their creditworthiness and so reducing the amounts they borrow.

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53 http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/Debt_and_deleveraging_The_global_credit_bubble_Update
54 *Household indebtedness in the EU*, Europe Economics on behalf of the CRIS Committee of the European Parliament, 2010.

3.33 In other cases, deleveraging may take the more brutal form of default. That could be true over the next decade at household, corporate, and even sovereign level.

3.34 Just as periods of increasing leverage are both effect and cause of growth in financial services, periods of deleveraging will tend to be associated with and encourage contraction in financial services. Thus, this protracted period of deleveraging will tend to reduce financial services activity. This follows both from a reduction in credit extended by financial services firms and a consequent reduction in economic activity and growth, further restricting demand for and provision of financial services.

3.35 The Eurozone, in aggregate, is not as heavily indebted as the UK or the US, and of course there are EU Member States outside the euro, such as the Czech Republic, which offer their own unique growth opportunities. And we emphasize that the point being made here is not that there remains no scope for an expansion in financial services within the EU, or that financial services sectors had become "just too large".[55] The central point is merely that there is clearly a case to be made that, in this next-decade phase of deleveraging, relative to the recent past, opportunities for rapid growth in financial services within the EU are likely to be more limited.

Growing opportunities in emerging markets

3.36 At the same time, financial services sector opportunities outside the EU may be growing more rapidly that before. The United States may offer some opportunities, though it has very significant problems of household over-indebtedness, and deleveraging in the US might mean reduced financial sector opportunities. But at the same time financial services sector opportunities in China, India, Brazil, Russia, the Gulf region, Australia, and other countries outside the EU are expanding rapidly. Though Britain and Europe and perhaps the US may be growing only slowly at present, the world as a whole has been growing much more healthily — setting aside the terribly global contraction of 2009.

Table 3.1: GDP Growth in World, EU, and BRIC

	Real GDP Growth 2012 (IMF WEO September 2011, PPP weights)[56]	Annual Real GDP Growth to 2016 (WEO September 2011, PPP weights)	Carnegie[57] (average annual GDP Growth, percent change, y/y) 2009-50	PWC[58] (average annual real growth in GDP) 2009-50
World	4.0%	4.9%		
EU	1.4%	2.1%		

55 For example, Europe Economics' analysis for TheCityUK has suggested that, in all Member States except Ireland and the United Kingdom, the financial services sector is clearly below even fairly m inimal notions of its efficient size — see paragraphs 2.65ff in http://217.154.230.218/NR/rdonlyres/583EB1BD-3CAE-4EAD-8BEA-41B2CEC1EFD6/0/BC_RS_ValueofEUsFinancialCentres_FullReport.pdf.

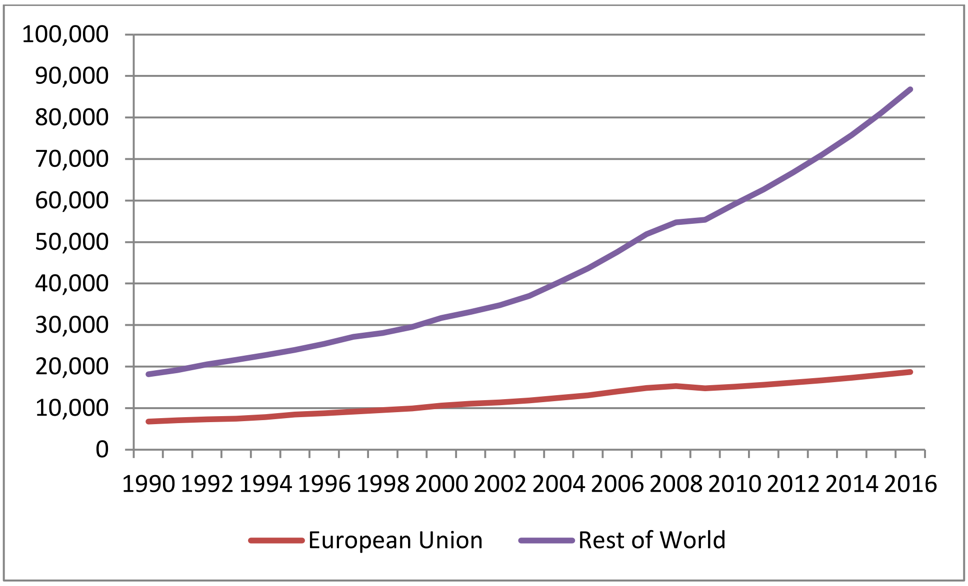
56 http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/text.pdf

57 http://carnegieendowment.org/files/World_Order_in_2050.pdf

58 http://www.pwc.com/en_GX/gx/world-2050/pdf/world-in-2050-jan-2011.pdf

	Real GDP Growth 2012 (IMF WEO September 2011, PPP weights)[56]	Annual Real GDP Growth to 2016 (WEO September 2011, PPP weights)	Carnegie[57] (average annual GDP Growth, percent change, y/y) 2009-50	PWC[58] (average annual real growth in GDP) 2009-50
Brazil	3.6%	4.2%	4.1%	4.4%
Russia	4.1%	3.8%	3.3%	4.0%
India	7.5%	8.1%	5.9%	8.1%
China	9.0%	9.5%	5.6%	5.9%

Figure 3.1: GDP at PPP, 1990-2016 ($)



3.37 In 1990, the European Union was 27 per cent of world output (in US dollars, at purchasing power parity). By 2002 the EU was still 25 per cent of world output — only a small drop. But by 2016 the EU is forecast to be just 18 per cent of world output — a dramatic and rapid relative fall.

3.38 As Chinese and Indian businesses grow, they will need capital. They will need firms to broker deals for them to obtain capital. They will need advice on their capital structures. Growing Chinese banks will require wholesale financial services. As the Chinese and Indian affluent middle classes expand, they will require savings products and pensions, share portfolios, unit trusts, and insurance.

3.39 The balance of advantage, over the next decade, could quite plausibly have shifted dramatically. Whilst EU Member States offer shrinking opportunities for UK financial sector firms, opportunities explode elsewhere.

Do the Key Threats of Regulatory Arbitrage come from within the EU, or without?

3.40 Many discussions of regulatory arbitrage in the EU financial services sector context focus upon the threat that, absent regulation providing a floor, there would be the risk of regulatory arbitrage between EU members. Perhaps some New Member State — say from Eastern Europe — might tempt business away from London to some other centre within the EU, still able to passport and trade within the EU, but subject to lower regulation.

3.41 But three important questions have arisen in the current context:

(a) Is the most important threat to London, coming from regulatory arbitrage, really from other EU Member States? Or, as a global player in financial services, should it be more concerned about international regulatory competition, from jurisdictions such as Hong Kong, Dubai, or Johannesburg?

Of course, this way of framing the question assumes that London's role as a global player can be divorced from its position within the EU. In the past, it could perhaps be contended that London was able to exercise a global role partly on the back of leveraging scale benefits it secures from its EU markets. But even if correct in the past, whether that would remain the case if EU financial services sector declines over the next decade is less clear.

(b) When the EU was a force for liberalisation, the EU itself was a device of international regulatory competition, providing pressure to drive down regulation for the EU as a whole. But if the EU is now (rightly or wrongly) to be driven by an ethos of increased regulation of financial services, does that make London (if subject to such increased EU-level regulation) more vulnerable to international regulatory competition from outside the EU?

Against this, it could be argued that the EU might, as a large and cohesive international player, be able to export its ideas internationally outside the EU (or even EEA). A new jurisdiction adopting such a common rulebook would open up an additional revenue stream for City-based firms to exploit as they would have ready-made knowhow and scale compared to local firms adjusting to the new situation.

(c) International coordination of regulation has downsides as well as upsides. When market participants become dependent upon regulators for assessing the robustness of institutions (once regulatory badging is widespread), then regulatory failure coordinates market failure — the regulator fails for the whole market at once. And if regulation is coordinated internationally, that can mean that market failure is coordinated internationally, also. Was it a coincidence that the peak of international coordination of banking regulation, with the introduction of the Basel II banking rules, coincided with the most internationally-coordinated banking crisis ever? Of course, regulatory badging and international coordination have upsides as well as these drawbacks, but the current environment of great uncertainty regarding the best way to proceed on financial regulation suggests there could be an unusually high value to regulatory competition — to different countries trying their own different paths in this new financial regulation world, learning from the successes or failures of others, and in due course adapting to the new best practice.

Caveats

3.42 In this section we have explored the risk that the very same factors that might have meant the UK benefitted from EU-level setting of financial regulation in the past, might, over the next decade, mean that the UK suffers from EU-level setting of such regulation.

3.43 It is an inevitable feature of the future-focused nature of our discussion here that we can only identify risks — we cannot come to a robust definitive conclusion about them. It is not impossible that, in fact, a consensus arises quickly as to the best form of the new phase of financial regulation, and that that consensus closely reflects British views. It also cannot be ruled out altogether that the Eurozone resolves its current difficulties fairly smoothly and the focus of EU regulation returns to EU-wide needs rather than those of the Eurozone and of particular Member States within the Eurozone. It also cannot be ruled out altogether that, having resolved these current challenges, the EU moves into a phase of rapid further integration and growth — whilst at the same time opportunities outside the EU turn out to have been exaggerated and risks under-estimated (as has happened often in the past). An element of judgement is inevitably required in interpreting the discussion of risks here.

3.44 That notwithstanding, we do not regard our discussion as idle speculation. We have offered reasons to believe that the risks we identify are material, and that although there is of course great uncertainty about the future at the time of writing, the scenarios we paint are sufficiently plausible to carry important weight in policy considerations.

4 CONCLUSION

4.1 In this report we have argued the following points:

(a) A strong case can be made that, historically, the case that Britain benefitted from EU-level setting of financial regulation rested on the views that (i) Britain had sufficient influence in the area that EU-level setting of regulation could be a device for liberalising financial sector regulation in other Member States; (ii) as well as creating opportunities for UK financial sector firms, more liberal regulation in other Member States would promote their growth, increasing opportunities for Britain to trade in other sectors, also; (iii) the risk of Britain being over-ruled in any fundamental area was limited, because the fundamental tenets of the Single Market were closely aligned to standard concepts in financial services sector regulation thinking and because the financial services sector was such an important industry for the UK, relative to other Member States, that the Luxembourg Compromise and the culture created by it (of not over-ruling a country in respect of a sector in which it was dominant) afforded considerable "soft" practical protection.

(b) Over the next decade, opportunities for financial sector trade within the EU may be more limited, as key parts of Europe undergo significant deleveraging, whilst opportunities outside the EU may grow rapidly. Also, EU-level setting of regulation is likely to be de-liberalising and not fully aligned with British thinking. Partly this reflects a lack of consensus as to what regulatory best practice should be. That itself constitutes an argument for increased regulatory competition, to help identify the new best practice.

4.2 It thus appears that key elements of the traditional case that Britain gains from EU-level setting of financial services regulation may have reversed for the next decade. If the implication is that EU-level financial regulation might not be to the UK's benefit, according to the assumptions underpinning the UK's preferred regulatory model for financial services, there are a number of potential responses:

(a) Accept that EU best practice might be better than UK thinking.

(b) Fight to convince EU partners and EU institutions to adopt UK thinking.

(c) Accept a period of disbenefit from regulation being set at the EU level, considering the "bigger picture" of broader gains from the Single Market that could be imperilled by any attempt to reverse or mitigate losses in respect of financial sector regulation.

(d) Seek a formal opt-out from certain financial services regulation.

(e) Invoke the Luxembourg Compromise in respect of certain measures.

(f) Leave the EU altogether.

4.3 It falls outside the scope of this report to consider the merits of these options or to advise upon them.

APPENDIX: QUANTIFICATION OF ADDED GROWTH IMPACT OF FINANCIAL CENTRES

A1.1 In this appendix we provide some quantification of the impact of financial centres and financial development on growth using an approach similar to that adopted in Europe Economics (2005). In that study, Europe Economics adopted the estimates eventually published in Aghion et al. (2009)[59] to assess the impact on growth of the increase in financial development that could be brought about by the MiFid Directive.

A1.2 Aghion et al. (2010) estimate a relation between the average growth rate of per capita GDP in a panel of countries, and variables such as volatility of growth in per capita GDP and the level of financial development. Different specifications were tested. The baseline estimate could be expressed as in Equation (1) below:

$$GDPg = \alpha GDPVOL + \beta FINDEV + \varphi GDPVOL * FINDEV + ... \qquad (1)$$

A1.3 where $GDPg$ is the average growth of per capita income, GDPVOL is the standard deviation of the rate of growth of per capita income, FINDEV is a measure of financial development which was computed, following Levine et al (2000), as the credit by deposit money banks and other financial institutions to the private sector over GDP. GDPVOL is the volatility of GDP measured as the standard deviation of each country GDP over the period 1995-2008 obtained from the AMECO database.

A1.4 From the equation above, the marginal effect of FINDEV on GDPg, can be expressed as in Equation (2):

$$\frac{\partial GDPg}{\partial FINDEV} = \beta + \varphi GDPVOL \qquad (2)$$

which, for small changes of FINDEV and GDPg, could be re-expressed as:

$$\Delta GDPg = \Delta FINDEV * (\beta + \varphi GDPVOL) \qquad (3)$$

A1.5 Although the AABM results are far from achieving consensus acceptance, they offer a way to model a longer-term potential impact from having an important financial centre in a country. Specifically, we might attribute the level of financial development of a country to the presence of an important financial centre. Information on two important parameters (β and φ) is taken from Table 6, column 1 of AABM (2009), which gives β and φ equal to 0.0144 and 0.52, respectively, while for GDPVOL we considered the average volatility

59 Aghion P., Angeletos M., Banerjee A. and Manova K. (2010), "Volatility and Growth: Credit Constraints and the Composition of Investment", Journal of Monetary Economics, 57, 3, pp.246-265. Actually, Europe Economics used the estimates contained in the working paper version, which are slightly different from these reported in the published version and that we use in this report.

in GDP per capita growth in each of Germany, France, UK, Italy, The Netherlands, Luxemburg, Poland, Greece, Portugal and Spain using data from 1994 to 2008 taken from the Ameco database.

A1.6 We provide two estimates of the impact of the presence of the financial centers. The first is a "within country" estimate: in other words, we assess the increase in financial development over the period 2000-2008 for each country, and we assess, using the parameter estimates of the Aghion et al. (2009) paper, the impact of the higher financial development on GDP growth rates. The second is a "between country" estimate, as we measure how much less financially developed countries have been losing in terms of GDP growth with respect to a counterfactual situation characterized by the highest level of financial development in the sample and, conversely, how much the most financially developed countries have been gaining from being more financially developed (where the counterfactual is the level of financial development of the country with the lowest private credit to GDP ratio).

A1.7 Table A1.1 below reports the levels of financial development within country as of 2000 and 2008. As we can see, the UK, Netherlands and Luxemburg are by far the countries with the highest level of financial development both in 2000 and in 2008. In terms of growth in financial development, Greece, Portugal and Poland are those with the highest increase; while France and, especially, Germany, those with the lowest.

Table A1.1: How financial development increased over the 2000s (selected EU Member States)

	Fin_dev_00	Fin_dev_08	growth-00-08
Germany	1.15	1.02	-11.3%
Greece	0.42	0.92	119%
Spain	0.65	1.72	165%
France	0.81	1.06	30.9%
Italy	0.71	1.03	45.1%
Luxembourg	0.96	2.11	120%
Netherlands	1.25	1.93	54.4%
Poland	0.25	0.41	64.0%
Portugal	1.18	1.72	45.8%
UK	1.21	1.89	56.2%

A1.8 Table A1.2 below reports the gain in GDP growth that could be ascribed to the respective increase in financial development, computed on the basis of the parameters of the Aghion et al. (2009) paper.

Table A1.2: How differences in financial development increase/decrease growth rates (selected EU Member States)

Gains from increased financial development		Gains relative to Poland		Gains (Losses) relative to UK	
Germany	-0.26%	Germany	1.2%	Germany	-1.7%
Greece	1.0%	Greece	1.1%	Greece	-2.0%
Spain	2.1%	Spain	2.6%	Spain	-0.3%
France	0.49%	France	1.3%	France	-1.6%
Italy	0.66%	Italy	1.3%	Italy	-1.8%
Lux	3.2%	Lux	4.7%	Lux	+0.6%
Neth	1.5%	Neth	3.3%	Neth	+0.1%
Poland	0.4%	Poland	0	Poland	-3.6%
Portugal	1.3%	Portugal	3.1%	Portugal	-0.4%
UK	1.3%	UK	2.9%	UK	0

A1.9 The effects of financial developments are large, reflecting the significant increases in financial development that occurred over the sample period (e.g. through Globalisation, the Financial Services Action Plan, the euro, the integration of new Member States from Eastern and Central Europe and the Mediterranean, and so on). For example, Spain would have gained 2.1 percentage of points in its average rate of growth simply for the increase in the level of financial development over the past decade; Greece and the UK about 1 percentage points, with Luxemburg an astonishing 3 percentage points. We should however bear in mind that this is going to be an upper bound, especially for the countries with high income and that were starting with an already high level of financial development (noting what has already been said about non-linear effects of financial developments). Germany might instead have lost 0.2 percentage points of growth as its degree of financial development fell over the period.

A1.10 The second column reports the gains in GDP growth that each country could achieve because of its higher level of financial development as of 2008, taken as reference point Poland, the country with the lowest level of financial development. Again, the largest gains are for countries with the highest levels of financial development, but we again should see them as upper bounds. Finally, we have the losses in terms of GDP growth that each country could have because of not having the same level of financial development of the UK.

A1.11 As we said, these estimates are likely to be upper bounds, both because these countries are all high GDP countries and therefore, if the model of Aghion et al. (2009) is correct, the level of financial development should matter less in driving GDP convergence with the US and because, for some of them, the level of financial development is already very high. In general, if one considers the estimates reported in Huang and Lin (2009) according to whom the impact of financial development on growth for low income countries could be from 1.5 to 3 times larger than in the case of high income countries, depending on the exact econometric specification, we could discount our estimates by about 2 times: even in this case, the level of financial development associated to the existence of important financial centers might still be responsible for a large share of GDP growth. For instance, the UK might still have a gain in GDP growth of about 1.4 percentage points (2.86/2=1.3) simply because it does not have the level of financial development of Poland.

A1.12 We should also bear in mind that these estimates do not take into account any gain that would derive from the presence of externalities, which however are quite likely, given the interconnection of capital markets. For instance, Guiso et al (2004a)[60] estimated that integration of the EU capital markets might have increased GDP growth by about 0.15 percentage points at year.

A1.13 We note that this analysis has not attempted to ascertain whether the growth effect estimated is due to higher capital accumulation or more innovation and therefore higher productivity growth. We have also not assessed the relative importance of the different mechanisms of effects mentioned above in driving GDP growth (e.g. maturity or risk transformation, consumption smoothing and so forth).

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[60] Guiso L., Jappelli T., Padula M. and Pagano M. (2004), "Financial market Integration and Economic Growth in the EU", Economic Policy19, 40, pp. 523-577.