



**CONTINENTAL SHIFT:
Safeguarding the UK's financial trade
in a changing Europe**

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EXECUTIVE SUMMARY

- The financial services industry is vital to the UK economy. In the 2009/10 tax year, the UK financial services sector as a whole made a total tax contribution of £53.4bn, 11.2% of the Government's total tax receipts for that year. Financial services accounted for a £35.2bn trade surplus in 2010 – the only industry sector in the UK that generated a substantial surplus apart from 'other business services', many of which are closely linked to financial services.
- In the 1990s and 2000s, the benefits to the UK of EU financial regulation rested on two premises. Firstly, while EU-wide financial rules have often increased compliance costs for firms in the UK, they generally allowed the Government to influence regulation across Europe in line with UK thinking, serving to reduce barriers to trade and creating opportunities for UK-based firms.
- Secondly, London was and is seen as an entry point to the EU's single market in financial services – a market which experienced significant growth in the 2000s as financial services developed rapidly. For example, between 2000 and 2008, France and Italy's financial sectors grew substantially and in the process contributed additional GDP growth in both countries of around 0.5%.
- However, as a result of institutional changes in the EU, the financial crash and the continuing eurozone crisis, the economic and political weather has changed. The premises from which the benefits of EU financial regulation to the UK have traditionally derived could alter fundamentally in the 2010s and onwards:
- Firstly, the UK's level of influence on new European financial rules has decreased; regulation is now less geared to financial services growth but more towards curtailing financial market activity, irrespective of whether such activity is good or bad. There are at least 49 new EU regulatory proposals potentially affecting the City of London either in the pipeline or being discussed at the EU-level – while some are justified, very few of these are aimed at promoting financial services trade.
- Not entirely without reason, the perception in many Continental capitals and in the European Parliament is that 'Anglo-Saxon' light-touch capitalism needs to be reined in. Therefore, whereas in the 1990s and early 2000s, EU politicians and policymakers generally (but not always) felt constrained from imposing financial regulation on the UK, this has now ceased to be the case.
- In the wake of the regulatory failures that led up to the crisis, more effective supervision of financial markets is needed. But while UK regulation has shifted away from the 'light-touch' concept to some extent, its new focus on regulatory 'judgement' looks set to clash with the prevailing 'rules-based' culture at the EU level. Similarly, the apparent conflict between the Vickers Commission's recommendations to impose higher capital requirements on banks and the European Commission's proposed approach of imposing maximum EU-wide standards is another example of differing approaches.
- In addition, the eurozone crisis is increasingly likely to create exceptional needs and political incentives for the euro countries to act in the interests of the eurozone 17 rather than the EU-27, with UK concerns seen as peripheral at best. This new dynamic has already been expressed in a series of new proposals, including an EU-wide financial transaction tax (FTT), possible short-selling bans and the European Central Bank's insistence that transactions in euro-denominated financial products are cleared by central counterparties within the eurozone rather than in London. These proposals represent a challenge to UK concepts of financial regulation and its access to the single market.
- These political pressures are reinforced by the structural bias in the EU's voting system against the UK's financial industry, which was more or less acceptable so long as UK influence over financial services regulation was sufficiently high and rules were broadly pro-competition. The UK accounts for 36% of the EU's wholesale finance industry and a 61% share of the EU's net exports of international transactions in financial services. However, under new voting rules coming into force in 2014, it will only possess 12% of the votes in the Council of Ministers and 10% of the votes in the European Parliament. In contrast, France accounts for 20% of the EU's market in agriculture, but enjoys a veto over the EU's long-term budget and therefore retains substantial control over the sizeable EU subsidies received by its farmers.

- Equally important, over the next decade, growth opportunities for financial services within the EU are likely to be more limited than elsewhere in the world. Many European countries are likely to undergo economic stagnation and deleveraging. In 2005, the five largest EU economies accounted for 27% of global banking assets. In 2050, that will have decreased to 12.5%. Meanwhile, the BRIC countries' share of these assets will have increased from 7.9% in 2005 to 32.9% in 2050. Therefore, the benefits to London of acting as the gateway to Europe are becoming less convincing and the need to keep the door open to emerging markets elsewhere across the globe far more important.
- The UK has two broad strategies it can pursue in response to its decreasing influence and the need to keep the City open for business in the global marketplace:
 - 1) Work with likeminded countries to seek assurances that the UK's influence over EU financial services law will be safeguarded. This could be codified in a new 'single market protocol', inserted via the first available EU Treaty change. Such a protocol could commit the EU to a pro-growth, outward looking and proportionate regulatory regime while safeguarding the UK from decisions taken solely by the eurozone for all 27 member states.
 - 2) Seek UK-specific, legally watertight safeguards that will ensure that the UK is not overruled on a vital financial measure and cement London's ability to do business and compete in global markets. Though it will be resisted by EU partners, this could include a 'double lock', acknowledging the UK's prominence in this sector and giving the Government the right to refer any disproportionate or discriminatory laws to the European Council, where it has an effective veto over regulatory proposals.
- In the list of priorities in the on-going EU negotiations that are inevitable in the wake of the eurozone crisis, safeguarding financial services should be at the very top. While the EU policies governing fishing and agriculture, for example, are in need of fundamental reform, these two industries together only account for 0.7% of UK GDP. In contrast, financial services account for at least 10% of UK GDP. It is therefore clear where the UK should concentrate its political capital.

1. THE STATE OF EU FINANCIAL LAW AND WHY IT MATTERS

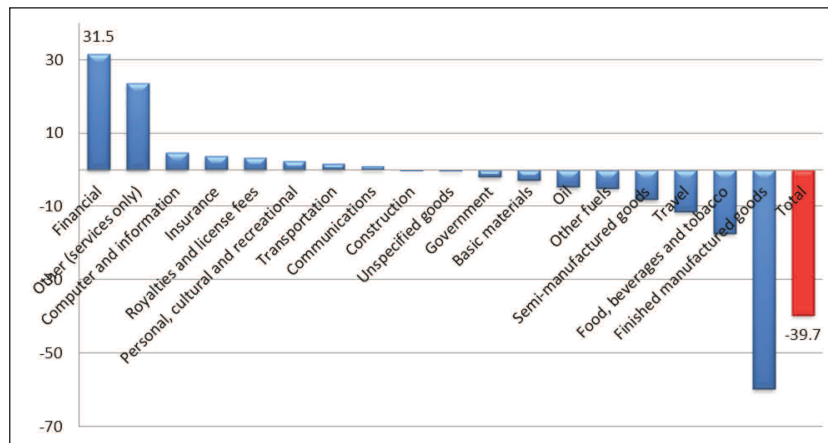
1.1. The UK is a European and global leader in financial services

The success of the financial services industry is vital to the UK economy. A report by PwC estimated that, in the tax year 2009/10, the UK financial services sector as a whole made a total tax contribution of £53.4bn, 11.2% of the Government’s total tax receipts, from all taxes, for that year.¹

In comparison to other EU member states, the UK is heavily reliant on financial and related professional services (legal & accounting services and business management & management consultancy) for its external trade, with the financial sector providing an important contribution to the UK’s balance of payments.

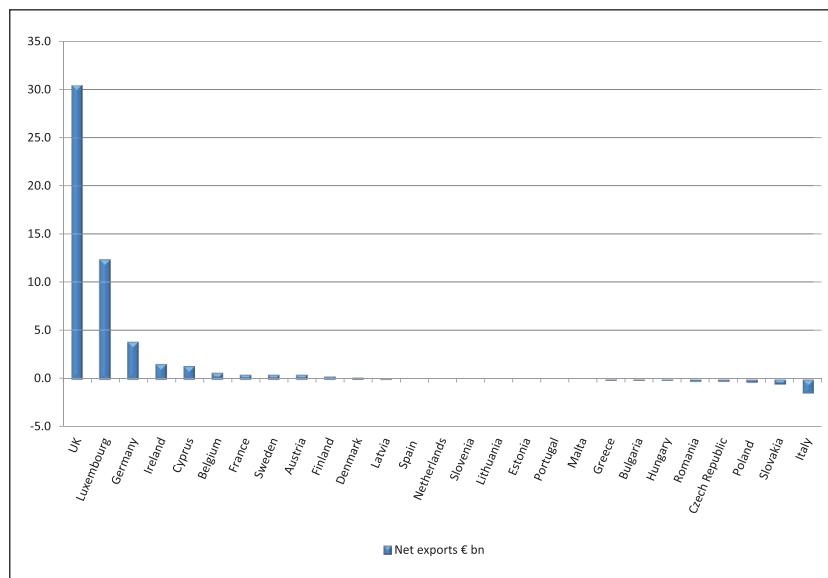
The £31.5bn trade surplus from finance, and a further £3.7bn surplus from insurance and professional services, made a substantial contribution to the UK’s balance of trade in 2010. They partially offset large deficits of £98bn in goods and £11bn in travel, although the overall UK deficit for trade in goods and services was still £39.7bn. In other words if the UK did not export financial services it would have to choose between having an overall deficit of over £70bn a year (clearly unsustainable), radically reducing its imports or creating a new world class industry.

Graph 1: UK net trade balances in goods and services 2010 £bn



Source, ONS UK Balance of Payments 2010

Graph 2: International transactions in financial services: net exports €bn (2009)



Sources: Eurostat²

1 PricewaterhouseCoopers (PwC), 'The total tax contribution of UK financial services', third edition, December 2010 (report prepared for the City of London Corporation), http://217.154.230.218/NR/rdonlyres/68F49A7E-8255-415B-99A8-1A8273D568D9/0/TotalTax3_FinalForWeb.pdf
 2 Eurostat, 'International transactions in financial services: imports, exports and balance', 2009 data, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00069&plugin=0>

The UK is not only a European but also a global market leader in many financial markets:³

International bank lending. The UK banking sector originates more cross-border bank lending than any other country – 18% of the world total in March 2011.

Foreign exchange. The foreign exchange market in the UK is the largest in the world.

Insurance. The UK insurance industry is the largest in Europe and third largest in the world with net premium income of nearly £200bn in 2009. The UK is the global market leader in marine insurance with a 21% market share in 2009.

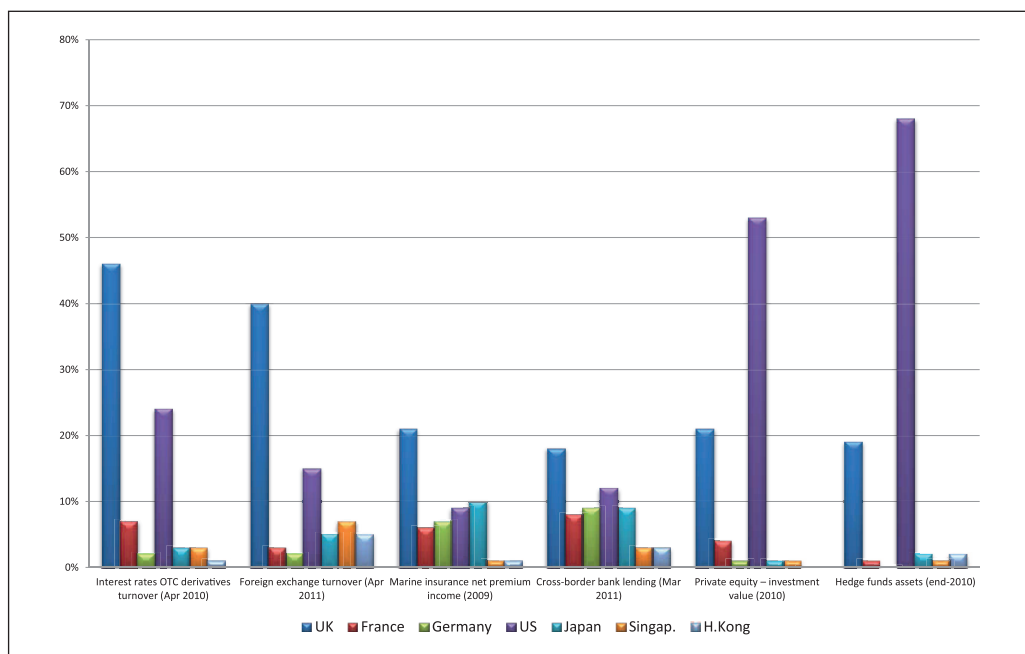
Private equity. UK-based private equity firms raised £6.6bn in 2010, one-third of the total funds raised in Europe.

Hedge funds. The hedge funds market in the UK is the largest in Europe. Around 80% of European-based hedge funds' assets are managed in the UK.

Derivatives. The UK is the biggest market in the world for over-the-counter (OTC) interest rate derivatives with 46% of global turnover in April 2010. The UK is the second largest centre for value of trading in exchange traded futures and options.

Carbon markets. The UK is one of the leading countries in the development of carbon markets. European Climate Exchange contracts, traded on the ICE Futures Europe exchange in London, have made up over 96% of futures and options trading on the EU Emissions Trading Scheme since 2009.

Graph 3: Global competition: % of world markets



Sources: TheCityUK calculations and estimates based on various sources⁴

The UK's competitiveness in financial services also makes it attractive for foreign direct investment (FDI), with the US being the UK's largest source of FDI (with a total stock of £159bn at the end of 2009), which the Government estimates provides over a million jobs in the UK. Of total FDI, financial services (other than banking) account for just over one third of US investment in the UK and manufacturing just under one third.⁵

³ TheCityUK, 'Key facts about financial and professional services', September 2011, p11-12, <http://www.thecityuk.com/assets/Uploads/Key-Facts-September-2011.pdf>

⁴ TheCityUK, 'Key facts about financial and professional services', September 2011, p12, <http://www.thecityuk.com/assets/Uploads/Key-Facts-September-2011.pdf>

⁵ Department for Business, Innovation and Skills (BIS), 'Trade and investment for growth', February 2011, p30, <http://www.bis.gov.uk/assets/biscore/international-trade-investment-and-development/docs/t/11-717-trade-investment-for-growth.pdf>

1.2 The City is a European asset

The benefits of the business activities carried out in the City are not only enjoyed 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.

Before the financial crisis, in the mid-2000s, it was estimated that London provided 41% of all City-type financial services activity in the EU, 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 16% and EU GDP would be €33bn lower in the short term, €23bn lower over the medium term, with the loss of 100,000 jobs.⁶

The benefits of the financial sector to the broader EU go far beyond the simple generation of jobs and activity in the City⁷ 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); how Governments use international financial centres to borrow to service public spending in periods when tax takes are temporarily depressed.

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. Therefore, while financial regulation impacts on the UK disproportionately, it should be in Europe's collective interest to have a vibrant and functioning financial services sector.

1.3 EU decision-making is structurally biased against UK financial services

At its most fundamental level, the EU decision-making structure does not reflect the UK's strength in financial services. The vast majority of EU financial services regulation is based on the EU Treaties' single market articles, where Qualified Majority Voting (QMV) and co-decision with the European Parliament applies, meaning that MEPs and national ministers must both agree before a proposal can become law. The European Commission's proposal for an EU FTT is an exception to this rule because decisions on taxation remain under unanimity, giving the UK a veto.⁸

As the Graphs 2 and 4 show, while the UK accounts for 36% of the EU financial wholesale market and 61% of the EU's net exports in financial services, it only has 72 out of 736 seats in the European Parliament and, from 2014 (or 2017 if a member state requests it) when new rules come into force, it will possess 12.3% of votes in the Council of Ministers (currently the UK has 8.4%, but while strengthening the UK's voting weight, the new rules will also make it harder for the UK to block a proposal as the threshold for passing a law is simultaneously lowered – see Figure 2 on page 22).

As we note in the next section, in the past, this arrangement was accepted because the UK was seen as having influence over the thrust of EU financial regulation, generally allowing it to push pro-growth, liberalising measures outside its borders, in turn creating opportunities for UK firms around Europe. But as we also set out below, these assumptions, to the extent that they were ever fully true, are now changing.

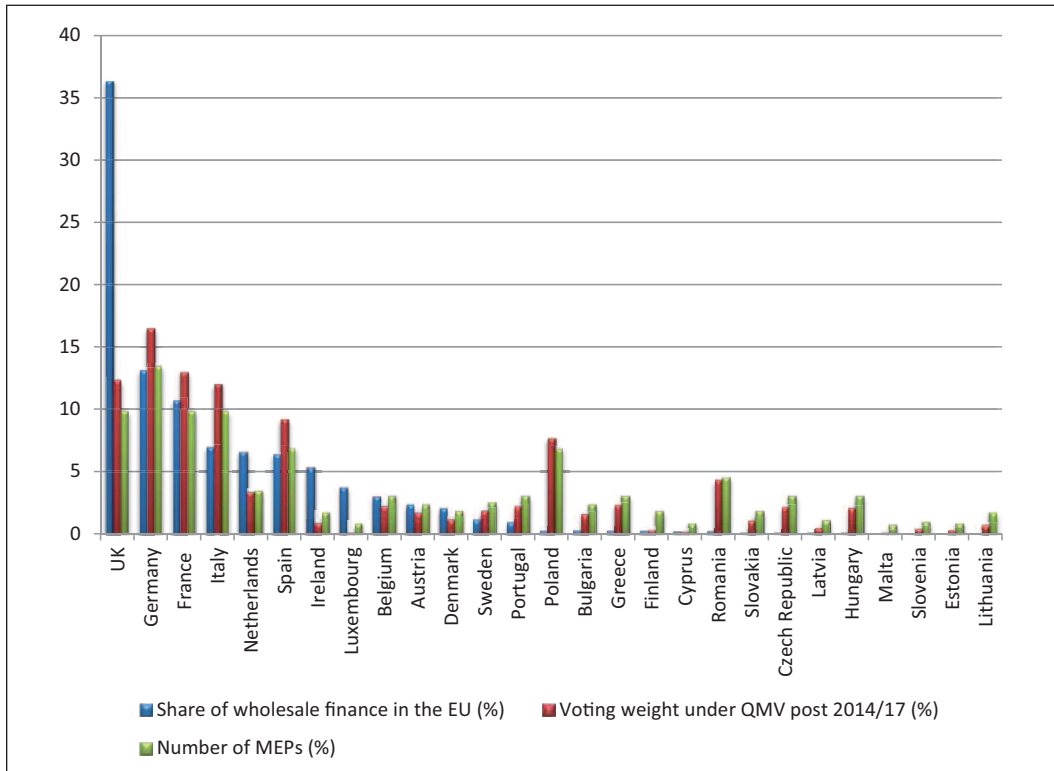
An oft-repeated point is that, while it is true that the EU decision-making structure in financial services is biased against the UK, other countries with a dominant position in a certain industry are forced to accept similar trade-offs between national control and potential economic benefits from access to the European market. However, this was only ever partly true and is becoming increasingly less so. For instance, the French have a dominant position in agriculture, the Spanish in fishing and the Germans in car manufacture. But unlike agriculture where the French have a veto over the reform of the Common Agricultural Policy – from which French farmers do exceptionally well – or fishing where Spain wields a veto over change to the Common Fisheries Policy, the UK has no comparable protection from EU financial regulation. In fact, even compared to other countries with a dominant position in certain industries, the UK's voting arrangements in financial services are, on paper, unfavourable.

6 CEBR, 'The City's importance to the EU Economy 2005', Corporation of London, February 2005

7 See, for instance, *Europe Economics*, 'The Value of Europe's International Financial Centres to the EU Economy', July 2011 (report prepared for the City of London Corporation and TheCityUK)

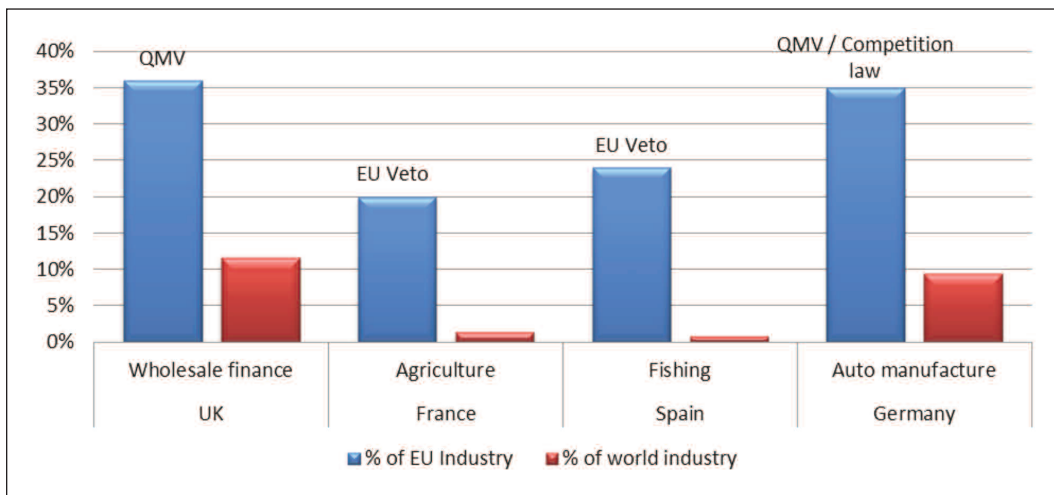
8 The European Commission's proposal for an FTT has been tabled under Article 113 TFEU, which requires unanimity

Graph 4: Share of wholesale finance in the EU-27 versus QMV voting weight and number of MEPs (%)



Source: City of London⁹

Graph 5: EU states with dominant positions in an EU policy area



Sources: IMF, German Government, Eurostat and TheCityUK

Unsurprisingly, EU states have defended their dominant positions in certain areas with great force. French efforts to block reform of the CAP are well known, as are Spain’s efforts on behalf of their fishermen. Another example would be that of Poland’s dependence on coal fired power stations and its use of a veto to protect its interests.

In June 2011, Poland was able to block plans for the Commission to look at cutting EU emissions by more than the previously agreed target of 20% in 2020 compared with 1990 levels. Poland generates 90% of its electricity from coal and Andrzej Kraszewski, Poland’s Environment Minister, said more analysis was required and the impact on particular countries should be taken into account. “We expect greater solidarity within Europe and an understanding of the situation of specific member states,” he said.¹⁰ Poland was able to block the proposal

⁹ ‘Wholesale finance’ is defined as “the provision of services by financial institutions to corporate clients, investors, institutions and public sector bodies, as well as to other financial institutions”. ‘Wholesale’ financial services contrast therefore with ‘retail’ financial services, which involve the provision of financial services to individuals, see City of London, ‘The Importance of wholesale financial services to the EU economy’, September 2009, p33, http://217.154.230.218/NR/rdonilyres/DF649F73-2F5D-4C3E-AA24-E491A280A9B5/0/BC_RS_ImportanceofWholesaleFStoEUEconomy09.pdf

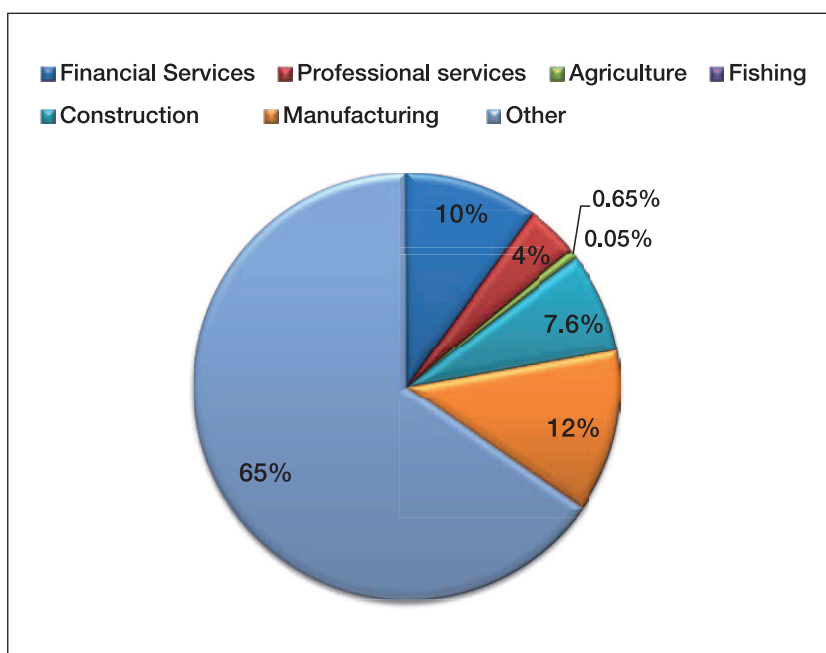
because Article 192(2)(c) TFEU states that unanimity applies to “measures significantly affecting a member state’s choice between different energy sources and the general structure of its energy supply.”

It is true that the German car industry, like UK finance, is also not fully protected with a veto, for example with regards to EU competition rules. However, unlike the City of London, the German car industry is not an area where the interests of different states diverge so sharply. It is also less mobile than the financial services industry, which is far more susceptible to regulatory competition. And in one significant area the German industry has objected to – and even ignored – EU rules. In fact, Germany has fought a protracted legal battle with the European Commission in order to preserve the ‘golden share’ in Volkswagen owned by the state of Lower Saxony.¹¹ The ‘share’, which originates from a law dating back to privatisation in 1960, allows the state to have an effective veto over the sale of the company. The European Court of Justice (ECJ) has ruled that this practice violates EU law and is threatening to levy a fine of €300,000 a day for non-compliance. When asked whether it would comply, the state premier of Lower Saxony, David McAllister simply said “Doesn’t Europe have better things to do?”¹²

1.4 Should the UK prioritise financial services in any EU negotiation?

Compared to other industries over which the EU has a strong influence, the above suggests that financial services should be a key priority in forthcoming negotiations in Europe, which are likely to involve Treaty changes as the eurozone looks to integrate further. As we note, financial services account for 10% of UK GDP, just behind manufacturing. Agriculture, another area heavily regulated by the EU, accounts for 0.65% of GDP and fishing only 0.05%. The EU’s Common Agricultural Policy and Common Fisheries Policy are both frequently cited as areas that should be subject to radical reform or even full repatriation. Though reforms of these policies clearly would be to the UK’s advantage, they do not generate the kind of economic benefits to the UK that the City does.¹³

Figure 1: Financial and professional services, agriculture, fishing and other industries as a % of UK GDP



Sources: ONS, TheCityUK, CBI¹⁴

10 Quoted in the *FT*, 'blocks' effort on emission targets', 21 June 2011, <http://www.ft.com/cms/s/0/c633d912-9c3c-11e0-acbc-00144feabdc0.html#axzz1ezklqcAD>
 11 *European Commission*, 'ECJ opposes the Volkswagen Law as a restriction on the free movement of capital', 2007, http://ec.europa.eu/internal_market/smn/smn48/docs/volkswagen_en.pdf
 12 See *AFP*, 'EU takes Germany to court over Volkswagen law', 25 November 2011, <http://www.google.com/hostednews/afp/article/ALeqM5g1x9Gwthe4bjhD1CY5fMgU6splWQ?docId=CNG.5c1b04314cb3b8eb7163ad860eac8ec1.cd1>; and Dow Jones, 'EU to sue Germany again over "Volkswagen law" case', 24 November 2011, http://online.wsj.com/article/BT-CO-20111124-704469.html?_nocache=1322731395019&user=welcomemg&mg=id-wsj
 13 The UK's net contribution to the EU budget would amount to ca. 0.5% of GDP and the cost of social and employment regulation may amount to ca. 0.85% of GDP, making these areas also important. See *Open Europe*, 'Repatriating EU social policy for jobs and growth', November 2011 <http://www.openeurope.org.uk/research/2011EUsocialpolicy.pdf>
 14 ONS, 'United Kingdom National Accounts – Blue Book', 2011 edition (2010 figures), <http://www.ons.gov.uk/ons/rel/naa1-rd/united-kingdom-national-accounts/2011-edition/index.html>; TheCityUK, 'Key Facts about UK financial and professional services', September 2011; CBI Manufacturing, 'Manufacturing in the UK', 2010, <http://www.cbi.org.uk/media/927283/2010-manufacturing-in-the-uk.pdf>

2. COSTS AND BENEFITS OF EU FINANCIAL SERVICES REGULATION

Traditionally, a number of reasons have been offered for why, up to this point, EU financial regulation could be believed to have generated benefits to the UK economy. However, the question is whether this remains the case and whether the argument for the UK accepting heavy EU involvement in financial services has weakened.

The traditional case for stating that the UK benefits from having financial services regulation set at the EU level can be summarised in five main points:

- (a) EU-level policymaking allows the UK to influence overall decision-making in Europe, and therefore regulation in other member states. Since the UK 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 UK firms and UK consumers.
- (b) When financial services regulation is improved in other member states, under British influence, those other member states grow faster, leading to opportunities for British businesses in other non-financial sectors, also.
- (c) Without EU-level regulation, some member states might set regulation below the ideal minimum level, with the objective of attracting businesses to locate away from the UK.
- (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. It is also a convenient method of implementing internationally agreed regulation to a common standard.

These potential advantages must be weighed against five potential drawbacks:

- (a) Regulation might not be set in the UK's national interest. The UK could be outvoted on some regulation, and the result is that regulation is imposed upon the UK that clashes with its regulatory model, imposing high costs.
- (b) Regulation set at EU level might be technically inferior to domestic regulation. Designing regulations that are applicable across all member states might result in one-size-fits-all compromises which lack in technical rigour.
- (c) Compliance costs might be higher for firms based in the UK, because EU-level regulations might, by the nature of applying across 27 states, have greater complexity and greater redundancy than domestically-derived 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 maintain high quality of regulation — which offsets natural bureaucratic and political tendencies to over-regulate. Furthermore, the UK 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 faster growing global markets.

Given their clear economic importance, the two most significant potential benefits are those of increased influence on EU-wide regulation and increased growth, while the most pressing potential cost is the risk of being overruled on a fundamental issue of difference with other member states, which in turn could have a negative impact on the UK economy.

Below we consider, first the traditional case for why having financial regulation set at EU level might be beneficial, including the claim that UK influence has promoted EU liberalisation, growth and trade opportunities for UK firms. Second, we will consider whether the main elements of the case for EU-setting of financial regulation have in fact now reversed.

2.1. The benefits of UK influence and impacts on growth

i) The benefits of influence

The stated ambition of EU directives and regulation and judgements of EU competition authorities and the ECJ has often, but not always, been “liberalisation” across financial and economic services. More specifically, it has been to strip away Government subsidies, Government-created monopoly power, and legal barriers to trade and competition (both explicit and implicit).

It is far from clear how effective or complete EU-level regulation has been in delivering these objectives. However, EU directives and regulations have quite often increased the level of regulation in the UK, but in return, served to lower regulatory barriers in many other member states which, in an ideal world, makes it easier for UK firms to do cross-border business within the EU. Those who contend this to be the case often point to the financial services action plan of 1998-2006, which sought to create / deepen the single market in financial services.

The financial services action plan (FSAP)

The potential benefits of developing a single market in financial services were explored by the Lamfalussy group of “Wise Men”, who identified the necessity of improved allocation of capital and more efficient intermediation between savers and investors as potential drivers of growth in the European economy.¹⁵ While the FSAP clearly increased compliance costs¹⁶ for UK firms in a number of ways (see Annex 2), a number of these directives were influenced by UK thinking. At the very least, in many respects they sought to conform regulation in other member states to pre-existing UK regulations.

UK influence: the example of MiFID

A clear illustration of UK influence upon directives in the FSAP can be seen in arguably the single most important component of the FSAP: the Markets in Financial Instruments Directive (MiFID).¹⁷ 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: MiFID requires firms to categorise clients into three groups. The MiFID groups were not precisely the same as the pre-existing – Financial Services Authority (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.¹⁸

Permitted forms of trading: 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 their behalf that order could only be carried out on a “regulated market” – which in practice meant the main exchange.¹⁹ MiFID required all countries to be like the UK, 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.²⁰

¹⁵ See *City of London*, “Creating a Single Market for financial services – A discussion paper”, http://www.cityoflondon.gov.uk/NR/rdonlyres/E32604AB-75F1-4399-B807-80F119D21706/0/single_market.pdf

¹⁶ See, *Open Europe*, “Selling the City short? A review of the EU’s Financial Services Action Plan”, 4 December 2006, <http://www.openeurope.org.uk/research/fsap.pdf>

¹⁷ MiFID is a directive that sets out how member states must regulate ‘investment services’. This includes 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.

¹⁸ The MiFID categories were ‘eligible counterparties’, ‘professional clients’, and ‘retail clients’. As one might expect, the level of consumer protection is greater for professional clients than eligible counterparties, and greater still for retail clients. Before regulation had required firms to categorise clients into three very similar groups: ‘market counterparties’, ‘intermediate customers’, and ‘private customers’

¹⁹ This 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. The UK, by contrast, had for some time permitted certain firms to act as ‘systematic internalisers’.

²⁰ Furthermore, even in some member states where there was some systematic internalising (e.g. Germany), it was much less widespread than in the UK.

In terms of the FSAP more widely, the main European Parliament evaluation found that its impact on the new member states and Italy was particularly significant, leading to enhanced competition in banking, insurance, securities services and in relation to financial conglomerates, while it increased competitiveness in the banking sectors of Italy, Poland and Spain.²¹

Table 1: Illustrative impacts of FSAP on Italy, Poland and Spain

	Italy	Poland	Spain
Key liberalising effects	<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • Increase in competition in banking, insurance and securities services • Increase in competitiveness in banking • Increase in consumer protection in banking and securities services 	<ul style="list-style-type: none"> • Increase in competition in banking • Increase in competitiveness in banking

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

The City of London as an entry point to the EU single market

Traditionally, it has been thought that the EU would be a zone in which financial services would have strong growth opportunities, and that international financial 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 sector was a significant growth area.

Volumes of business increased, also. By the mid-2000s, EU business supported 22% of London’s City-type activities and EU companies owned about one third of the foreign banks operating in London.²² In comparison, about 15% of UK GDP is exported to the EU across all sectors.²³

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.²⁴ 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. Increased leverage, in turn, tends to support increased household spending and business investment, which boost towards economic growth, encouraging further provision of financial services. However, this is not to say that we endorse over-leveraging – which clearly was a problem leading up to the 2008 crash (see below).

ii) Impacts on growth

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. Based on analysis by Europe Economics, the table below quantifies how much financial development increased over the 2000s in selected member states (see Annex 4 for methodology).

21 The term ‘competitiveness’ is used here in relation to the relative efficiency and attractiveness of the output of domestic firms, compared with foreign firms.

22 See, www.uktradeinfo.com

23 Ibidem

24 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 integration 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 eleven out of fifteen categories of financial services the trading and activity increased in the EU relative to the US between 1998 and 2004, see *International Financial Services London*, ‘Financial markets trends – Europe vs US 2005’, October 2005, <http://www.thecityuk.com/assets/Uploads/EuropevsUS2005.pdf>

Table 2: How financial development increased over the 2000s (selected member states)

	Index of financial development in 2000	Index of financial development in 2008	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%

Table 3 looks at how much of 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 the 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 3: 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

Interestingly, France gained growth of nearly 0.5% over the 2000s because of the increase in its financial development, and 1.3% more than if it had only been as developed as Poland, but 1.6% less than if it had achieved the same level of financial development as the UK.

Despite the fact that this methodology for estimating the effect of financial development is standard in the academic literature, as we note above, financial development is intimately connected to levels of debt and indebtedness.²⁵ 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 the household sector – then the growth in financial development, the growth in financial services business volumes, and overall GDP growth rates might not be sustainable. However, regardless of the longer-term sustainability of EU consumption of financial services, for some time Europe could be seen as a good business opportunity for global firms, and in many cases London was used as the entry point for these firms.²⁶

²⁵ 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.

²⁶ These advantages, of course, had to be offset against any losses there might be 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 in UK firms' activity being diverted into the EU, when it might better have gone elsewhere in the world. So, overall, 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. However, the question is whether this remains the case (see next section for a broader discussion on this point).

2.2. The costs: decreasing UK influence and limited EU growth opportunities

In addition to higher compliance costs – which we have discussed in detail elsewhere²⁷ – one of the potential drawbacks of heavy EU involvement in setting regulation is the risk that the UK is overruled in some fundamental aspect of financial services rules when its preferred approach differs to that of other member states.

Despite the unfavourable voting system (see Section 1), in the 1990s and early 2000s, this risk was arguably limited in financial services for the following broad reasons:

- (a) Though with several exceptions, a significant chunk of EU financial regulation has been pro-trade, and pro-competition. While the UK might have preferred the details of certain regulations to be different, some compromise provided the opportunity to extend UK thinking at the EU level, in turn promoting trade opportunities in what was a promising market.
- (b) EU policymakers at, in particular, the European Commission have been influenced by British thinking to a certain extent and regarded UK financial regulation as international best practice – though again not without exceptions.
- (c) It was often, but not always, understood that financial services, particularly at the wholesale level, were an industry in which the UK had both a particular interest and was much the leading player in the EU. There was at least some reluctance at EU level to overrule the UK.

This has now changed fundamentally, for three main reasons that we set out below:

i) The changed spirit and thrust of regulation

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 regulatory changes in the banking sector, some of which have clearly been justified. But more fundamentally it has driven a significant change in the thrust of financial services regulation at the EU level.

For example, French President Nicolas Sarkozy described the appointment of a Frenchman, Michel Barnier, to the post of EU Commissioner for the Internal Market and Financial Services, as a “defeat for Anglo Saxon capitalism.”²⁸ German Finance Minister Wolfgang Schäuble recently said, “We have to fight the causes of this crisis, and the main reasons of the crisis are a lack of financial market regulation and an abundance of Government deficits and debt.”²⁹

In practice, this has meant that:

- EU regulatory plans are gradually becoming less focussed on liberalising and promoting cross-border trade and more on extending the scope, depth, and bite of regulation.
- In contrast to the 1990s and 2000s, the UK has become much less influential upon the shape, objectives and detail of EU financial regulation.
- EU politicians no longer feel constrained from imposing financial regulation upon the UK against British wishes.

There are very good and understandable reasons for this change in motive force. The American and British regulatory systems suffered from clear weaknesses leading up to the financial crisis, as did other national systems. However, in reality, the increasingly uncomfortable relationship between the EU and UK regulatory cultures cannot be confined to a debate between the desirability or otherwise of stricter regulation – it is far more complicated than that.

²⁷ See for example, Open Europe, “The EU’s AIFM Directive: Likely impact and best way forward”, 21 September 2009, <http://www.openeurope.org.uk/research/aifmd.pdf> and Open Europe, “Still out of control? Measuring eleven years of EU regulation”, 30 March 2010, <http://www.openeurope.org.uk/research/stilloutofcontrol.pdf>

²⁸ As quoted in the Telegraph, “Sarkozy will use Michel Barnier to advance French interests”, 21 December 2009, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6861065/Sarkozy-will-use-Michel-Barnier-to-advance-French-interests.html>

²⁹ Quoted by Bloomberg, “Merkel says reluctance on financial transactions tax “not acceptable”, 15 October 2011, <http://www.bloomberg.com/news/2011-10-15/merkel-says-won-t-accept-u-s-balking-at-finance-transaction-tax.html>

UK regulation has also, to some extent, shifted away from the “light-touch” concept. Within the UK, two of the key debates concern the nature of supervision and the structure of firms. An illustration is the switch away from FSA prudential supervisory powers to prudential regulation becoming a Bank of England competence. This is neither a matter of increased nor of resistance to increasing regulation. The Bank of England has argued that a relationship-based model is likely to make it easier to enforce regulatory change than would be the case under a detailed rules-based model. As Mervyn King put it:³⁰

“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 investors 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.”

This is not merely a changed style of supervision – it is a changed concept of regulation. But at the EU level, there is nothing on the table resembling the change that is taking place in the UK.³¹ Similarly, a key part of UK regulatory change has been the proposal for altering the structure of the industry - the Vickers Commission consideration of splitting or subsidiarising retail from investment banking activities (see below). This now means that even when the UK wants to go further in its regulatory approach than the norm it could potentially clash with EU rules (i.e. Vickers).

The approach at the EU level and in many other member states has reflected the notion that, in the past, financial firms simply enjoyed too much freedom. 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 the EU level much of the concept has been fairly simply to write more rules (though 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).

³⁰ From Sir Mervyn King’s oral evidence to the Parliament’s Joint Committee on the Draft Financial Services Bill, 3 November 2011, p3, <http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/Ucjcdfsb031111ev11.pdf>

³¹ Though the possibility of the ECB taking some supervisory responsibility for banks has been floated.

Box 1: Are the interests of the City and wider economy always the same?

Any assessment of the merits of new financial services regulation – domestic or EU – involves balancing two sets of interests: those of the financial services sector and those of the wider UK economy and taxpayer. Though these sets of interests are often synonymous, there are clearly instances where they differ.

For example, the proposal for an EU FTT has been rejected by the Government not only because it would hurt the UK's financial services sector but because it would also lead to wider losses to the UK economy through lower tax revenue due to the likely relocation of transactions elsewhere.

Capital requirements for banks is an example where policymakers have to weigh the benefits of a more robust banking sector against extra costs for banks and the potential knock-on effects this might have in terms of reduced lending to businesses in the wider economy. However, as the size of the UK's banking sector is hugely valuable but also leaves the UK vulnerable – total banking assets represent roughly 700% of UK GDP – there may be an overriding economic interest in ensuring that taxpayer-backed bailouts are avoided in future by tougher capital standards than elsewhere. There is a strong argument for such an interest taking precedence over narrower commercial interest, short-term lending levels and EU-wide standards.

	Size of banking sector (ratio of total assets to GDP, 2010)
Belgium	3.2
Germany	3.4
France	3.2
Italy	1.6
Japan	2.0
Canada	2.2
Netherlands	4.4
Sweden	3.5
Switzerland	6.6
United States	1.1
United Kingdom	7.0

Sources: Bank of Canada, Bank of Japan, Bankscope, EZB, FFIEC, FINMA, Japanese Bankers Association, OECD, SNB³²

We are clearly in a time of flux, and it may be that in due course EU and UK concepts in financial regulation might converge. However, for the moment, EU regulation is consciously more sceptical of markets and actively seeks to curtail their activities.

A wave of new regulations

The financial sector is currently experiencing an unprecedented wave of new regulation, and regulatory and tax changes – much of which stems from the EU-level. We estimate that there are currently 49 items of EU-level financial services regulation that have been either adopted but not implemented, proposed but not yet adopted, or are currently being discussed without a formal proposal (See Annex 1). These include:

- 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.
- 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 Directive³³ and the proposed FTT.
- Measures introduced, proposed or debated in response to the crisis affecting mainly the banking sector.³⁴

32 See the speech given by Thomas J. Jordan, Vice-Chairman of the Governing Board of the Swiss National Bank, 'Approaching the finishing line: The too big to fail project in ', 17 May 2011, Chart 2, http://www.snb.ch/en/mmr/speeches/id/ref_20110517_tjn/source/ref_20110517_tjn.en.pdf

33 For a detailed discussion about the AIFMD, see Open Europe, "The EU's AIFM Directive: Likely impact and best way forward", 21 September 2009, <http://www.openeurope.org.uk/research/aifmd.pdf>

34 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/ring-fencing 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 macro-prudential oversight

Other measures have been introduced at member state level, in response to particular crises, such as restrictions on the short selling of bank equities or on sovereign credit default swaps.³⁵ The key issue here is not whether all these measures are justified but that they are clearly not promoting trade and competition. Driven by a range of different motives, their central goal is to restrict and control the activities of the financial sector.

Examples of proposed regulation and measures illustrating this trend include:

The ECB calling for London clearing houses to relocate to the eurozone

The most conspicuous example of a change in the eurozone vs EU-wide relationship – discussed in detail below – is the ECB's insistence that clearing houses that handle "sizeable amounts" of euro-denominated business be located within the eurozone. This risks not only undermining the City of London, home to more clearing houses than any other EU capital, but also blatantly undercuts the single market.

The ECB's November 2011 policy briefing stated that central counterparties (CCPs) should comply with the eurosystem's location policy, noting that "infrastructures clearing and settling sizeable amounts of euro-denominated securities and derivatives should be located in the euro area."³⁶ A previous ECB policy document issued in July 2011 said, "The location policy is applied to all CCPs that hold on average more than 5% of the aggregated daily net credit exposure of all CCPs for one of the main euro-denominated product categories."³⁷

In September, the Government launched legal proceedings against the ECB at the ECJ in addition to seeking a negotiated settlement. HM Treasury has said,

*"This decision contravenes European law and fundamental single market principles by preventing the clearing of some financial products outside the euro area. That is why we have begun proceedings against the ECB through the European court of justice. The Government wants to see this resolved swiftly and without involving the courts but, if necessary, will not shy away from continuing legal action to make sure there is a level playing field across the EU for British businesses."*³⁸

The main concern for the UK is that several clearing houses based in the City – including LCH.Clearnet, the world's largest clearing house – could be forced to relocate to Frankfurt or Paris. The City is home, for example, to 40% of the world's trading in OTC derivatives,³⁹ meaning that several City-based clearing houses easily exceed the 5% limit for euro-denominated business.

Market participants also warn that the ECB's policy would spell the end for multi-currency clearing in general, fragmenting CCPs among national jurisdictions and raising costs for users, as they would lose the benefits of clearing in a central venue.⁴⁰ Some also believe the policy could actually increase systemic risk, with a wide array of institutions in different countries setting up clearing services without the required risk management expertise.⁴¹

An EU-wide FTT: "a bullet aimed at the heart of London"

An EU-wide FTT is potentially one of the most harmful proposals for the City of London ever to come out of Brussels. Last June, the Commission proposed introducing an EU FTT as a way to raise money to directly fund the EU budget.⁴² A more detailed draft directive followed in September, but did not change the substance of the plan. The Commission has proposed a 0.01% levy on financial transactions involving derivatives agreements and a 0.1% levy on all other types of financial transactions.⁴³

35 It is, however, worth noting that at least some important components of this rise in regulation originate from global institutions, rather than the EU. Examples include the revisions to the EU's Capital Requirements Directives (which reflect the Basel III global rules) and the revisions to MiFID (which have been heavily influenced by G20 initiatives in derivatives trading and transaction reporting), although the proposed version of the latter differ substantially from that proposed in the US

36 ECB, 'Standards for the use of Central Counterparties in Eurosystem foreign reserve management operations', November 2011, p11, <http://www.ecb.int/pub/pdf/other/standards201111en.pdf> – The Eurosystem comprises the ECB and the national central banks of eurozone countries, see <http://www.ecb.int/ecb/orga/escb/html/index.en.html>

37 ECB, 'Eurosystem oversight policy framework', July 2011, p10, <http://www.ecb.eu/pub/pdf/other/eurosystemoversightpolicyframework2011en.pdf>

38 Quoted in the *Guardian*, 'takes ECB to court to save City's euro trading', 14 September 2011, <http://www.guardian.co.uk/business/2011/sep/14/european-central-bank-treasury-court-action>

39 See Financial Secretary to the Treasury Mark Hoban MP's speech at the Markit Conference, 12 May 2011, http://www.hm-treasury.gov.uk/speech_fst_120511.htm

40 In negotiations on new EU regulation, known as EMIR, for OTC derivatives, the UK won a concession which inserted language in that specific regulation taking into account its concerns about different regulatory treatment of clearinghouses in different jurisdictions by the EU's 'supervisory colleges' – on which the ECB sits. See Article 13(2b) of the draft text adopted as a general approach by the Council of Ministers on 4 October 2011, p60, <http://register.consilium.europa.eu/pdf/en/11/st15/st15148.en11.pdf>

41 *Risk.net*, 'Risk.net poll – UK Treasury is right over ECB lawsuit', 28 September 2011, <http://www.risk.net/risk-magazine/news/2112350/risknet-poll-uk-treasury-ecb-lawsuit>

42 European Commission, 'Financing the EU budget: Report on the operation of the own resources system', 27 October 2011, p29-31, http://ec.europa.eu/budget/library/biblio/documents/fin_fw1420/proposal_council_own_resources_annex_en.pdf

43 European Commission, 'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC', 28 September 2011, p20, http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/com%282011%29594_en.pdf

The Government is opposed to anything short of a global FTT, for at least two reasons. Firstly, an EU-only levy would trigger a relocation of transactions to non-EU markets which are not covered by the FTT – a process which would have a disproportionate impact on the UK economy, given that the City of London is by far Europe's largest financial hub. The Commission estimates that turnover on derivatives markets is "expected to decline by up to 90% in some market segments".⁴⁴

Based on his own country's previous experience, Swedish Prime Minister Frederik Reinfeldt pointed out earlier this year,

*"Sweden is interesting because we are the only country with any real experience on this type of transaction tax. If it is only imposed on one part of a market, our experience is that it brings small amounts of income, but transactions move away."*⁴⁵

Secondly, without a sensible burden-sharing agreement between EU member states, a huge proportion of any FTT revenue would come from the UK (between 62% and 72%, according to recent European Commission estimates).⁴⁶ The Commission estimates that an FTT would generate EU-wide revenue of €57bn a year.⁴⁷

Based on data from the World Federation of Exchanges (WFE) on the level of financial transactions in the EU in 2010,⁴⁸ Open Europe estimates that, using the Commission's 0.1% rate for bonds and shares and the 0.01% rate for derivatives, the potential economic impact of an FTT across the EU-27 would be between €24.3 billion and €80.9 billion.⁴⁹ Therefore, in the absence of a burden-sharing arrangement, the impact on the UK alone would be between €17.5 billion and €58.2 billion (£15bn and £49.9bn).⁵⁰

As Chancellor George Osborne put it,

*"Proposals for a Europe-only financial transactions tax are a bullet aimed at the heart of London. Even the European Commission admits that it would cost hundreds of thousands of jobs. This Government is all for making the financial sector pay more in tax...But the ideas of a tax on mobile financial transactions that did not include America or China would be economic suicide for Britain and for Europe."*⁵¹

The Government has also pointed out that, according to the Commission's impact assessment, an EU-wide FTT could lead to the loss of half a million jobs across Europe.⁵² Contrary to popular belief, costs from this tax would not only hit bankers but would ultimately be passed onto small businesses and individual consumers, particularly through higher borrowing costs and end prices. An FTT would be levied on every transaction involved in a given financial product, further increasing the impact for final consumers. This is why most Governments now use VAT rather than turnover taxes to raise funds.⁵³

In light of UK opposition to an EU FTT, the possibility of a eurozone 17 financial tax has been repeatedly suggested, not least by German Finance Minister Wolfgang Schäuble.⁵⁴ It remains unclear whether a eurozone-only FTT would give the UK a competitive advantage or not. However, in an interview with the Financial Times, EU Taxation Commissioner Algirdas Šemeta suggested that such a tax would be

44 European Commission presentation, 'The Commission proposal for a Council Directive on a common system of FTT', 28 September 2011, p17 http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/ftt_proposal_en.pdf

45 Quoted in the *Guardian*, 'After this crisis, may get the kind of EU it wants', op-ed written by Open Europe's Director Mats Persson, 20 August 2011, <http://www.guardian.co.uk/commentisfree/2011/aug/20/britain-germany-economic-plans>

46 Jean-Pierre De Laet, Head of Unit, Economic Analysis, DG Taxation and Customs Union, European Commission, put the UK's share at 72% (based on 2007 data) in his June 2010 presentation to the OECD SEE Working Group, see <http://www.oecd.org/dataoecd/24/62/45467598.pdf>; The Commission's latest FTT impact assessment gives a figure of 62%, see http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm

47 European Commission, 'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC', p11

48 The WFE put the level of financial transactions in the EU as a whole at \$830 trillion in 2010. To estimate the total value of financial transactions in the EU, we looked at the annual total value of shares, bonds and derivatives traded on European markets based on the WFE statistics, see <http://www.worldexchanges.org/statistics/annual/2010>

49 Our lower bound estimate assumes relocation and evasion of 10% in bonds and shares, and 90% in derivatives. For the higher bound we assume that the volume of trades remains constant for simplicity and to show the notional revenue on gross transactions. This helps to highlight the uncertainty surrounding the tax as well as its potential for substantially impacting on financial markets. We use a share of revenue of 72%

50 The broad range is due to uncertainty regarding the degree of relocation and evasion of the FTT. For more details on methodology, see *Open Europe*, 'Ten ways to introduce an EU tax (and why none of them will work)', August 2011, <http://www.openeurope.org.uk/research/tenEUtax.pdf>

51 Writing in the *Evening Standard*, 'Fix this euro crisis with the smack of firm Government', 14 November 2011, <http://www.thisislondon.co.uk/standard/article-24009665-fix-this-euro-crisis-with-the-smack-of-firm-Government.do>

52 See the *FT*, 'attacks "fanciful" EU transactions tax push', 8 November 2011, <http://www.ft.com/cms/s/0/9adeec5a-0a2f-11e1-92b5-00144feabdc0.html#axzz1ezm6NPD3>

53 See Tuan Minh Le, 'Value added taxation: Mechanism, design and policy issues', 2003 (paper prepared for the World Bank's course on 'Practical issues of tax policy in developing countries'), <http://siteresources.worldbank.org/INTTPA/Resources/TuanPaper.pdf>

54 Quoted by *Bloomberg*, 'EU transactions tax debate highlights euro area disagreement', 8 November 2011, <http://www.bloomberg.com/news/2011-11-08/eu-transaction-tax-debate-highlights-euro-area-disagreement.html>

designed so that when any eurozone-based counterparty is involved, the FTT will still leave British institutions paying the levy to continental tax collectors, even for London-based trades. "The tax is designed in such a way that it doesn't matter where transactions are taking place," he said. "I think that London will lose out."⁵⁵

A eurozone-only FTT would essentially act as a disincentive to trade with eurozone countries (firms may decide there are better places to allocate resources). Since London has been seen as an entry point to the EU's financial market it could lose business because of this effect. This applies to foreign firms looking into the EU. The counter point is that for firms looking outward from the eurozone, London would become more attractive as would unregulated access to global financial markets. So it could cause eurozone firms to relocate to London.

It is not clear which impact would be bigger, but the effect of lost trade from non-EU firms has the potential to be much larger than the benefits of eurozone firms relocating to London – the eurozone, however, would lose out on both counts.

Solvency II rules on insurance and pension funds could deprive the real economy of investment

Traditionally, insurance companies and pension funds have been major providers of long-term investment that supports the real economy. However, the proposed Solvency II rules give preferential treatment to investments with shorter maturities and Government bonds over corporate and bank bonds. Deutsche Bank Research notes that, "One fear, for example, is that insurers might respond to Solvency II by scaling back their investment in corporate and bank bonds. This might deprive banks and companies of one of their main sources of funding."⁵⁶

CBI Director-General John Cridland has warned that the Solvency II proposals "are shockingly bad" and "would have a major impact on insurance companies and pension funds as potential providers of the long-term investment capital." He continued:

*"As drafted, the proposals promote an investment strategy of punting on supposedly 'risk-free' EU sovereign debt and shortening the duration of corporate debt investments. This suggests that money is better spent on Government bonds than being put to work funding energy, road and air infrastructure projects."*⁵⁷

EU rules that could conflict with the UK's Vickers Commission on capital requirements

The most visible example of how the changing thrust of UK financial regulation can clash with the prevailing regulatory culture in the EU, is the Vickers Commission on banking reforms. As matters stand, far from the EU regulation following British regulation in this area, it might even be an impediment to the Vickers proposals.

While internationally agreed Basel III requirements on additional capital for systemically important banks are minimum standards, the European Commission's desire to create a 'single rule book' for financial services in the EU has led it to propose new regulations, known as CRD IV, based on the approach of 'maximum harmonisation'. So, although the draft EU regulation implementing Basel III allows some limited degree of flexibility, one of its principles is that EU countries may not go beyond the common minimum standard and make their banks safer.

The UK's Independent Banking Commission, chaired by Sir John Vickers, which has proposed additional requirements beyond the Basel III minimum standards, noted in its final report that such a system of maximum harmonisation "lacks economic logic":

"In stopping countries making their banks safer than under the minimum standard, it stops them from benefiting other EU member states and Europe as a whole. The financial stability problem to be addressed, like pollution control, is one of negative cross-border externalities. It would be a strange environmental policy that required countries not to control pollution more than some centrally set amount..."

⁵⁵ Interview with the FT, 'EU taxman has in his sights', 28 November 2011, <http://www.ft.com/cms/s/0/5ed9458e-1880-11e1-b16b-00144feabdc0.html#axzz1ezKTXPSD>

⁵⁶ Deutsche Bank research, 'Solvency II and Basel III: Reciprocal effects should not be ignored', 22 September 2011, http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000278734.PDF

⁵⁷ From his speech to CBI annual dinner, 13 October 2011, http://www.cbi.org.uk/media/1106165/20111013_john_cridland_london_annual_dinner1.pdf

...There are perfectly good reasons why some EU member states wish to go beyond international minimum capital standards. Their banking systems, including exposures to global financial markets, are by no means the same. Moreover, national taxpayers bear the fiscal consequences if banks fail with inadequate loss-absorbing capacity (and will continue to do so indirectly even if suggestions to shift this burden onto a European bail-out fund gain any traction).⁵⁸

Commissioner Barnier has suggested that the EU's regulations on capital requirements do offer the UK flexibility to implement the Vickers Commission's proposals on ring-fencing banks' retail operations and requiring them to hold additional capital, via so-called 'Pillar 2'.⁵⁹ This would allow national regulators to apply additional discretionary requirements on particular firms or groups of firms that are exposed to similar risks. However, the Treasury says that the flexibility in question "is not designed to be applied to all firms at a systemic level and if used in that way may be subject to legal challenge,"⁶⁰ which could see the Vickers Commission's proposals dismantled at the ECJ.

The Vickers Commission has itself expressed reservations as to whether its proposals to apply additional loss-absorbing capital standards to ring-fenced banks will be compatible with the new EU regulations:

*"The [Vickers] Commission is satisfied that its structural reform proposals are compatible with current European Union law, although a number of issues including the ability of the UK authorities to apply capital and liquidity standards to ring-fenced banks will need to be clarified in relation to the ongoing consultation on CRD IV."*⁶¹

In October 2011, the IMF warned that the Commission's CRD IV proposals were "less ambitious" than the internationally agreed Basel III rules, which could lead to regulatory arbitrage and a "race to the bottom":

*"The draft legislation recently presented by the European Commission that aims to translate the Basel III framework into binding rules for EU banks, nonbank lenders, and most investment firms (also known as CRD4) is in certain areas less prescriptive/ambitious than the Basel III framework. This could trigger a race to the bottom in Basel III implementation, or else risky activities could shift to less well-regulated jurisdictions."*⁶²

Without commenting on the specific provisions in the Vickers' recommendations – many of which are clearly controversial – this is a clear example of how diverging regulatory philosophies can lead to problems in future. And as we note in Box 1, there may be reasons for the UK to want to do things differently. This could also be seen as an example of a clash that is driven, in part, by eurozone politics. Several countries in the eurozone are reluctant to substantially recapitalise their banks – fearing a backlash from both voters and the banking lobby.

MiFID II: one size fits all means regulation that does not fit the UK

The Commission is currently reviewing and updating MiFID as part of a new package called MiFID II. The current proposals – though these are only under consultation at the moment – include measures aimed at increasing the transparency of trading systems, new restrictions on high frequency trading, and forcing derivative contracts on to exchanges and rules on commissions.⁶³ These proposals are complex but there are a number of examples of where MiFID II, as currently proposed, could clash with the UK's national characteristics in the different finance industries. Irrespective of the merits, unlike its predecessor, the proposal is not primarily aimed at facilitating trade.

The UK's quote driven stock exchange v. the Continental order driven exchange: The London Stock Exchange is a "quote driven" stock exchange where designated market makers produce a buy price and a sell price and ensure liquidity by dealing at those prices. Most continental stock exchanges are by contrast "order driven" where the market seeks simply to match buy orders with sell orders.

58 *Independent Commission on Banking*, 'Final report recommendations', September 2011, p97, <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>

59 The existing Capital Requirements Directives will be replaced by a new Directive and a new Regulation. The Regulation implements Pillar 1 of the rules, while the Directive implements Pillars 2 and 3. See *European Commission*, 'Proposal for a regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms', 20 July 2011, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52011PC0452:EN:NOT>; and *European Commission*, 'Proposals for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate', 20 July 2011, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0453:FIN:EN:PDF>; see also FSA, 'Amendments to Capital Requirements Directive', 27 September 2011, [http://www.fsa.gov.uk/pages/About/What/International/pdf/CRD%20\(PL\).pdf](http://www.fsa.gov.uk/pages/About/What/International/pdf/CRD%20(PL).pdf)

60 *City AM*, 'EU in bid to veto UK bank reform', 31 October 2011, <http://www.cityam.com/news-and-analysis/eu-bid-veto-uk-bank-reform>

61 *Independent Commission on Banking*, 'Final report recommendations', p149, <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>

62 *IMF*, 'The multilateral aspects of policies affecting capital flows', 13 October 2011, p18, <http://www.imf.org/external/np/pp/eng/2011/101311.pdf>

63 See the European Commission's website, http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

The proposals for MiFID II include requirements for 'best execution' and transparency that are designed around the continental system where actual orders are easily recordable. In the London exchange, governed by a market maker, there is no such information on pre-trade prices making it difficult to comply unless dispensations are gained.

The Continental "bancassurance" model v. the UK system: The continental banking world is dominated by "bancassurance" companies where a combined bank and insurance company uses its network of sales outlets to sell fund management and life insurance products. The UK model is very different being made up of separate insurance companies, banks and independent financial advisors. In this case people wishing to purchase life assurance or fund management products tend to go to an independent firm or advisor.

Under the proposed MiFID II and the UK's Retail Distribution Review (RDR) there will be a ban on independent advisors accepting commissions from firms whose products they sell. Under the continental model the distributors are not 'independent' and so do not fall under the ban (however, under the UK's RDR all commissions are banned, independent or otherwise). The requirement to fulfil all the regulation under MiFID are based around a single "bancassurance" model where one big company complies, in the UK system the regulatory cost is multiplied as all independent parts right the way down to small fund management companies need to comply. In addition there is a risk of competing regulations with the FSA imposing an outright ban, while the EU's regulation would only impose the ban on independent advisors.

ii) Loss of UK influence and institutional change

As outlined above, compared to the 1990s and early 2000s, the balance of initiative in EU policy-setting is changing, which risks radically reducing the UK's influence. In addition to the broadly hostile perception in several national capitals of UK-style financial services, discussed above, there are at least three additional drivers:

The rise of co-decision: In recent years, and especially with the Treaty of Nice, the power of the European Parliament has been enhanced. Under co-decision MEPs now effectively have equal power with the Council, in their ability to amend and reject legislation.⁶⁴ In addition, under provisions of the Treaty of Maastricht enhanced by the Lisbon Treaty, the EP now has a right of legislative initiative that allows it to ask the Commission to submit a proposal.⁶⁵

An example of the boosted influence of the EP was the AIFM Directive, which MEPs repeatedly urged the Commission to table from the mid-2000s onwards (with the European Commission repeatedly refusing). It was finally introduced in 2009, partly as a reflection of the financial crisis but also, and crucially, as a result of the increased institutional role of the EP.⁶⁶

A separate eurozone agenda and caucusing: In addition to the greater political pressure for regulation, the eurozone's sovereign debt crisis has revealed the high degree of financial interconnectedness and interdependence among the euro countries – although the crisis has clearly had effects on financial institutions outside the eurozone too. As the eurozone looks for solutions to its current crisis, financial measures are increasingly likely to be developed in response to eurozone-specific issues, to which British concerns are regarded as peripheral at best. André Sapir, an economic advisor to Commission President Jose Manuel Barroso, has suggested that for the eurozone to become economically sustainable in the long-term its financial sector must be regulated by a common regulator and backed by a common fiscal authority.⁶⁷ It is also hard to envision how eurobonds could work without some sort of banking resolution fund at the eurozone level to backstop the banking system. As we note above, in restrictions on CDS and eurozone-only counterparties, we already see this risk of a separate eurozone agenda materialising.

Although there remain differences among the eurozone nations, particularly between North and South, as the UK Government itself has pointed out, there is a genuine risk that the eurozone starts to act and

⁶⁴ Previously, a measure proposed by the European Commission and supported unanimously by the Council could not be stopped by the European Parliament

⁶⁵ See the European Parliament's website, <http://www.europarl.europa.eu/parliament/expert/staticDisplay.do?id=55&pageRank=13&language=EN>

⁶⁶ Martin Power, head of cabinet for the then Internal Market Commissioner Charlie McCreevy, said of the AIFMD that "the raison d'être for this proposal came very much from a political initiative taken in the European Parliament", see *House of Lords European Union Committee*, 'Directive on Alternative Investment Fund Managers', Volume 1, p10, <http://www.publications.parliament.uk/pa/ld200910/ldselect/ld/ld/48/48i.pdf>

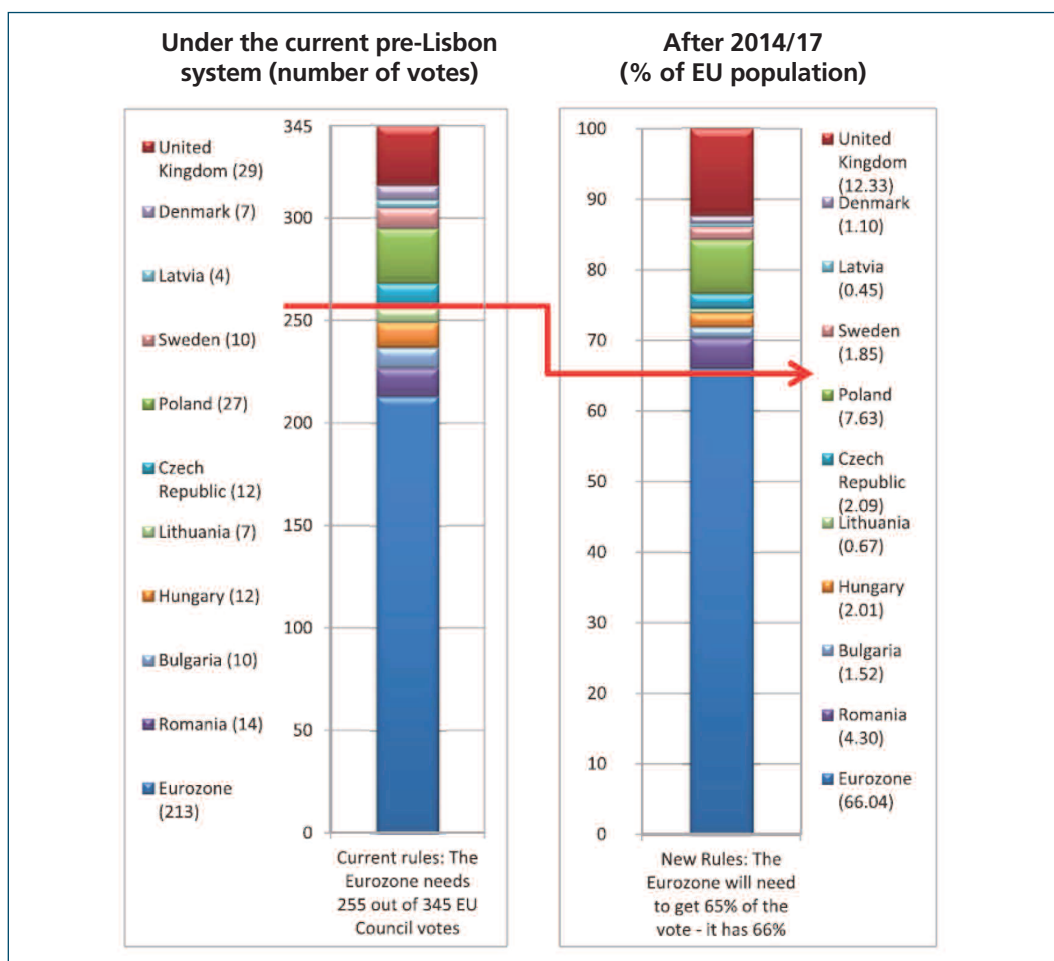
⁶⁷ Quoted in the *FT*, 'To the eurozone: advance or risk ruin', 22 November 2011, <http://www.ft.com/cms/s/0/4dc988ca-14fd-11e1-a2a6-00144feabdc0.html#axzz1ed2wQmPQ>

vote as a 'caucus', particularly on financial services regulation.⁶⁸ This could leave the UK consistently outvoted on measures with a profound impact on its economy and the City of London, simply because it is outside this new inner core.

Though in practice, ministers rarely actually vote – preferring instead to operate by consensus – the voting weight of individual countries very much determines the bargaining strength individual ministers. Crucially, future changes to QMV rules in the Council will exacerbate the risk of caucusing. Under current rules the UK can, with difficulty, form a blocking minority. However, when new voting rules enshrined in the Lisbon Treaty, and based on population size, come into force after 2014 (or 2017 if a member state requests it), the UK and other non-euro countries will never be able to form a blocking minority if the eurozone votes as a caucus.

Below, the chart on the left shows how the eurozone, under the current rules, falls short of a qualified majority (255 votes) on its own. Although with the help of a few non-eurozone states such as Romania and Bulgaria it could still push through EU laws. The chart on the right shows that, after 2014/17, if the eurozone votes as a caucus, the eurozone reaches the threshold - 65% of the EU's population – needed to pass a law.⁶⁹

Figure 2: How the UK can be outvoted by a 'eurozone caucus'



The rise of the EU's financial supervisors: Since 1 January 2011, three new financial supervisory authorities (ESAs) have been in place to oversee the banking, insurance and securities markets in the EU. These are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority

⁶⁸ An early example of the potential for eurozone dominance was the decision leading to the creation of the EU's European Financial Stabilisation Mechanism (EFSM) bailout fund, used to aid Ireland and Portugal. Unlike the European Financial Stability Facility, which is guaranteed solely by eurozone states (EFSF), the EFSM is jointly guaranteed by all 27 EU member states via the EU budget. The decision, in May 2010, to create this fund was hugely controversial because it used Article 122 of the EU Treaties, previously reserved for providing financial assistance only in times of natural disaster, to overrule the Treaties' 'no bailout clause'. Although the decision was formally approved under QMV at a meeting of the EU-27 finance ministers on 9 May 2010, eurozone leaders had already outlined the creation of the EFSF at their own meeting two days earlier. The statement of the heads of state or Government of the euro area (7 May 2010) is available here, <http://in.mobile.reuters.com/article/businessNews/idINIndia-48328620100507>

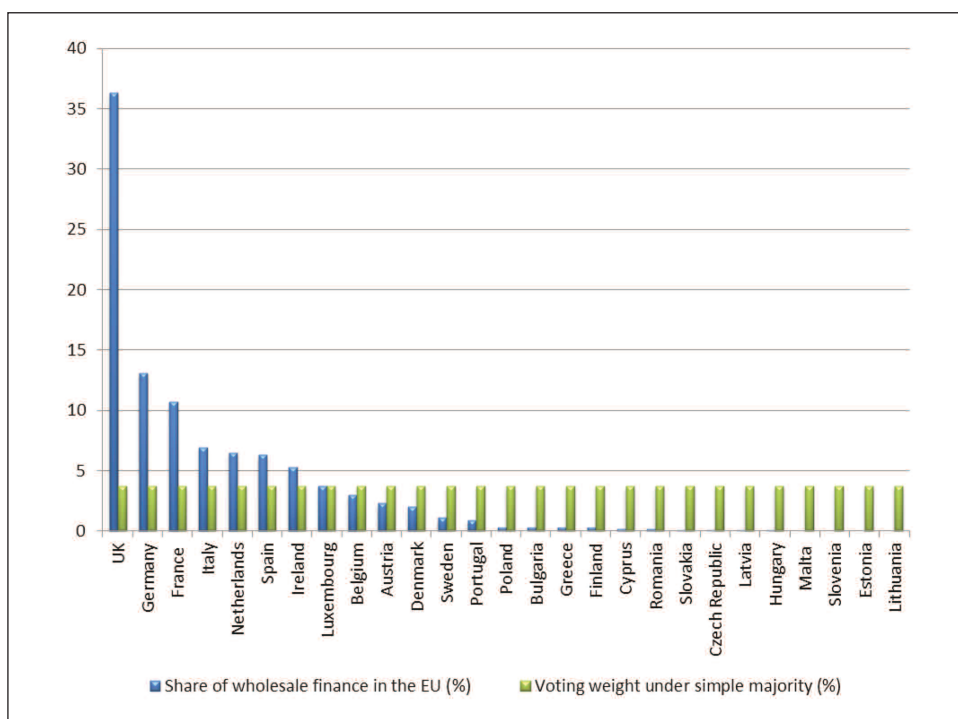
⁶⁹ In other words, under the current rules, the eurozone has 213 Council votes out of 345 – just short of a qualified majority. Under the Lisbon Treaty rules, that come into force in 2014/17, the eurozone needs votes from states representing 65% of the EU population to push through an EU law – they currently have 66% on their own giving them a permanent in-built majority.

(EIOPA), and the European Securities and Markets Authority (ESMA). The European Systemic Risk Board (ESRB) was also created to provide macro-level risk analysis, but does not have any powers to impose measures on member states.

The three EU watchdogs have powers over national supervisors in several areas – and the supervisors have the power to address individual firms directly and overrule national regulators in three instances.⁷⁰

As a rule, decisions within the ESAs are taken by simple majority, meaning that the UK has exactly the same voting weight as all other EU member states, despite being home to the bulk of the bloc’s financial sector. The exception is that, for decisions on technical standards, QMV is used.

Graph 6: Share of wholesale finance in the EU-27 versus simple majority voting weight in the EU financial supervisors (%)



Source: City of London⁷¹

The ESAs are the perfect illustration of the potential economic benefits of a ‘single rulebook’ pitted against the potential drawbacks for the UK of loss of control over its key economic sector. Clearly, the ESAs can benefit the City and the UK economy by stamping out protectionist or diverging implementation of EU financial services regulation, and drafting sharp technical standards. At the moment, it is unclear in what direction the ESAs will go, but it is likely that they will take on more powers over time.⁷²

However, the UK could already be on course to lose influence at the hands of these new supervisors. In November 2011, MEPs approved a new regulation on short-selling and credit default swaps. Article 24 of the Regulation,⁷³ yet to be formally approved by ministers but expected to enter into force in November

⁷⁰ The specific powers include: to collect relevant information on the performance of the industry and undertake investigation into activities of financial institutions to determine the level of risk they pose; to coordinate peer reviews between national supervisors; to initiate and conduct stress tests at the EU level; to draft binding technical standards; to ban or restrict financial products which may weaken EU economic stability. Furthermore, ESAs are empowered to address individual firms directly (if national regulators do not comply with a decision): in the settlement of disputes between national regulators; in case of breaches of EU law; in ‘emergency situations’. Currently, only member states can declare an ‘emergency situation’ in the Council of Ministers. However, the European Parliament is ‘formally empowered’ to request an individual European Government to do so. For a broader discussion, see *Open Europe*, ‘Shifting powers: What the EU’s financial supervisors will mean for the City of London’, October 2010, <http://www.openeurope.org.uk/research/EUSupervisors.pdf>, p6; see also *Lloyd’s*, ‘EU financial supervisory structure’, <http://www.lloyds.com/The-Market/Operating-at-Lloyds/Regulation/Government-Policy-and-Affairs/European-Union/EU-Financial-Supervision-Structure>

⁷¹ *City of London*, ‘The importance of wholesale financial services to the EU economy’, p33

⁷² Firstly, there are ‘review clauses’ in the legislation establishing the supervisors envisioning their evolution. Secondly, the legislation is designed so that at any given time, additional responsibilities can be granted to the ESAs through amendments or the introduction of new directives. This opens up the possibility of the being outvoted on a future proposal to grant the new bodies additional powers (as such decisions will be taken by QMV)

⁷³ See *Council of the European Union*, ‘Proposal for a Regulation of the European Parliament and of the Council on short selling and certain aspects of Credit Default Swaps (text provisionally agreed with the European Parliament)’, 4 November 2011, <http://register.consilium.europa.eu/pdf/en/11/st16/st16338.en11.pdf>

2012, will give ESMA the power to impose temporary EU-wide restrictions on short-selling of certain financial products under exceptional circumstances.

In addition to disagreeing with the proposal on substance, the UK Government has also said it has “significant concerns” that the plans to grant ESMA powers to ban short selling “would be unlawful” because they would breach rules on the tasks that can be handed to such agencies⁷⁴ under the ECJ’s so-called Meroni ruling.⁷⁵ However, the UK’s position is made difficult by the fact that the legislation establishing ESMA, approved in 2010, already provides it with the power to “temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets.”⁷⁶

iii) Global opportunities versus EU opportunities

Declining EU opportunities

As we note above, as the single market developed and expanded, and as financial development advanced in many EU member states, the 1990s and 2000s saw opportunities for UK businesses within the EU, including in particular UK financial businesses.

The need for several countries around the EU to de-leverage in the wake of the debt crisis in addition to considerable austerity at national level, reduced function of banking sectors, reduced appetite for experimenting with new financial sector firms or new innovations, in combination, are likely to reduce the growth opportunities for British financial firms, compared to the opportunities of the past.

In particular, given the scale of the recent (and in some senses on-going) financial crisis, the level of deleveraging could be particularly severe. 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%.⁷⁷ This suggests that households, businesses and Governments will continue to deleverage for a number of years.⁷⁸ 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.

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. The eurozone, in aggregate, is not as heavily indebted as the UK or the US, and there are EU member states outside the euro, such as the Czech Republic, which offer their own growth opportunities. There still remains scope for an expansion in financial services within the EU⁷⁹ but Europe is likely to go through a severe phase of deleveraging which, in comparison to the past, will limit the opportunities for growth in financial services.

Growing opportunities in emerging markets

At the same time, financial services sector opportunities outside the EU may be growing more rapidly than before – opportunities in Brazil, Russia, India, China (BRIC), the Gulf region, Australia, and other countries outside the EU are now expanding quickly (see Graph 8). The United States may offer some opportunities,

74 The Government argues that, “The UK continues to have significant concerns that as drafted, Article 24 [ESMA intervention powers in exceptional situations] would be unlawful and contravene the principle set out in the judgment of the Court of Justice of the European Union in the case of Meroni. The UK Government cannot therefore support the text in Article 24 and will be considering how best to ensure legal certainty is provided.” See Council of the European Union, ‘Proposal for a Regulation of the European Parliament and of the Council on short selling and certain aspects of Credit Default Swaps - Letter to the European Parliament’, 11 November 2011, <http://register.consilium.europa.eu/pdf/en/11/st16/st16336-re01co01.en11.pdf>

75 The ruling established that the delegation of powers from EU institutions to other bodies and agencies cannot concern ‘discretionary’ powers because this would undermine the balance of power between the various EU institutions, see *ECJ*, Case 9/56 (Meroni vs ECSC High Authority), Judgement of 13 June 1958, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61956CJ0009:EN:PDF>

76 Article 9(5) of Regulation (EU) No 1095/2010 states that, “The Authority [ESMA] may temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union in the cases specified and under the conditions laid down in the legislative acts referred to in Article 1(2) or if so required in the case of an emergency situation in accordance with and under the conditions laid down in Article 18”, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:01:EN:HTML>

77 See *McKinsey Global Institute*, ‘Debt and deleveraging: The global credit bubble and its economic consequences (Updated analysis)’, January 2010, http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/Debt_and_deleveraging_The_global_credit_bubble_Update

78 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 UK as ‘high household indebtedness’ member states, averaging 85% household debt to GDP in December 2009. That compared with average household indebtedness of just 56% for Belgium, Germany, Luxembourg, Austria, Finland, France, Malta, Netherland and Sweden. A reduction of 25% in household debt to GDP for the high indebtedness countries (in line with McKinsey’s historical analysis) would take them to 60% - close to the average for the lower-indebtedness group. 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. See *Europe Economics*, ‘Household indebtedness in the EU’, 2010 (report for the Directorate-General for Internal Policies of the European Parliament), <http://www.europarl.europa.eu/document/activities/cont/201103/20110324ATT16330/20110324ATT16330EN.pdf>

79 For example, *Europe Economics*’ analysis for TheCityUK has suggested that, in all member states except Ireland and the UK, the financial services sector is clearly below even fairly minimal notions of its efficient size, see *Europe Economics*, ‘The Value of Europe’s International Financial Centres to the EU Economy’

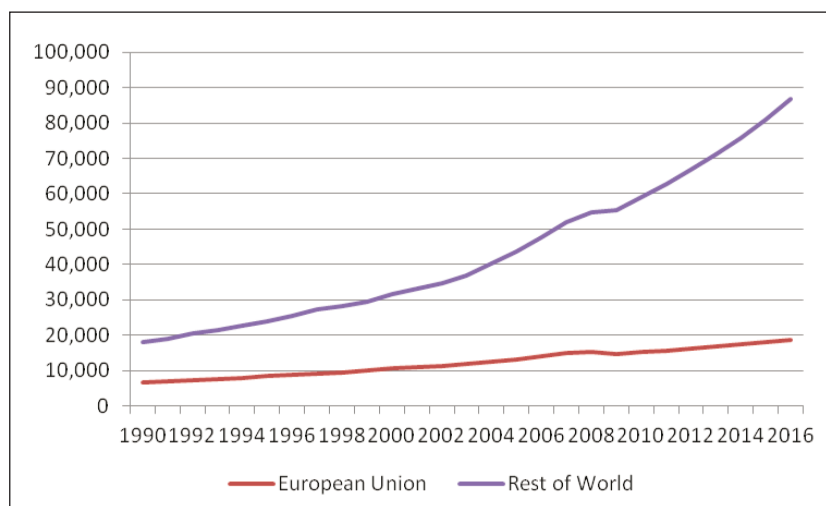
though it has very significant problems of household over-indebtedness, and deleveraging in the US might mean reduced financial sector opportunities there too. In contrast to the slow growth in the UK, Europe and the US, the world as a whole has been growing much more healthily – setting aside the terribly global contraction of 2009 (see Graph 7).

Table 4: GDP Growth in the World, EU, and BRIC

	Real GDP Growth 2012 (IMF WEO September 2011, PPP weights) ⁸⁰	Annual Real GDP Growth to 2016 (WEO September 2011, PPP weights)	Carnegie ⁸¹ (average annual GDP Growth, percent change, y/y) 2009-50	PwC ⁸² (average annual real growth in GDP) 2009-50
World	4.0%	4.9%		
EU	1.4%	2.1%		
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%

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

Graph 7: European Union and Rest of the World GDP at PPP, 1990-2016 (\$ bn)



Source: *Europe Economics*

As Chinese and Indian businesses grow, they will need capital. They will need firms to broker deals for them to obtain capital and 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.

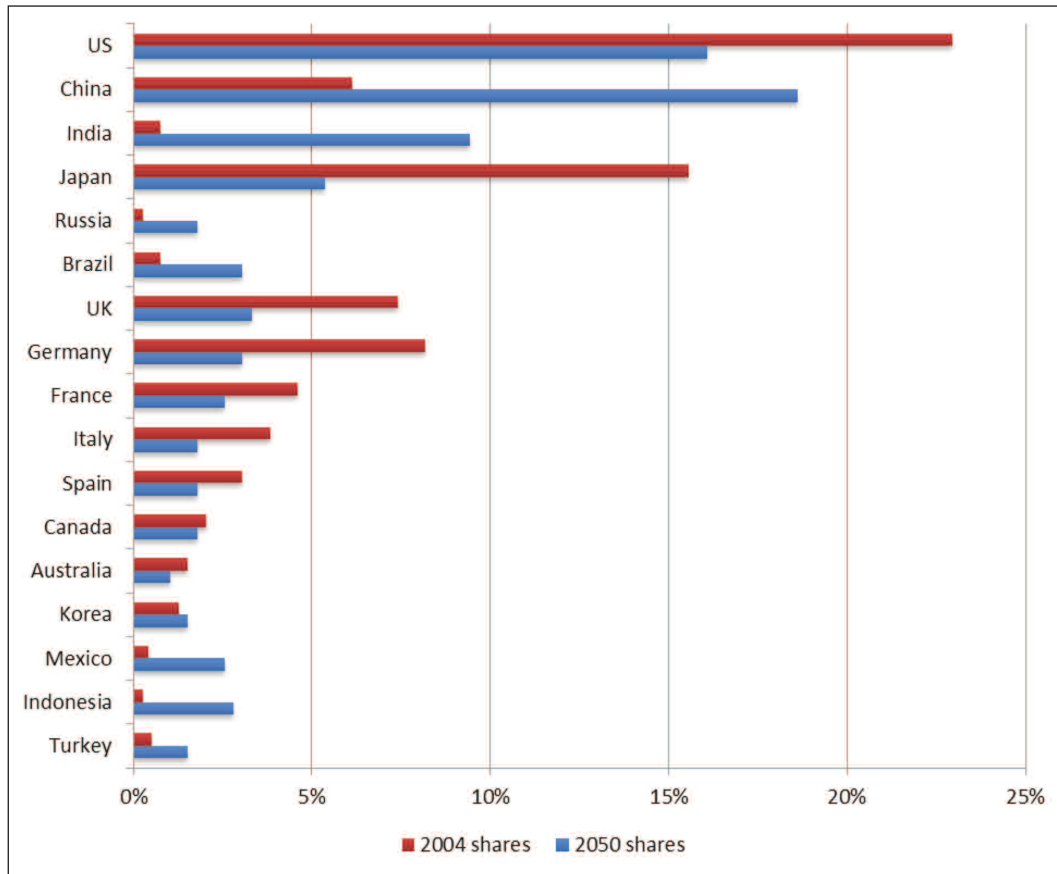
So whilst EU member states offer limited new opportunities for UK financial sector firms, opportunities are exploding elsewhere. Graph 8 illustrates this point.

⁸⁰ See IMF, 'World Economic Outlook – Slowing growth, rising risks', September 2011, <http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/text.pdf>

⁸¹ See Uri Dadush and Bennet Stancil, 'The World Order in 2050', *Carnegie Endowment for International Peace policy outlook*, April 2010, http://carnegieendowment.org/files/World_Order_in_2050.pdf

⁸² See PwC, 'The world in 2050 – The accelerating shift of global economic power: challenges and opportunities', January 2011, http://www.pwc.com/en_GX/gx/world-2050/pdf/world-in-2050-jan-2011.pdf

Graph 8: Shifts in share in of global banking assets, 2005 to 2050



Source: PricewaterhouseCoopers baseline scenario projections

It is interesting to note that in 2005, the five largest EU economies – UK, Germany, France, Spain and Italy – accounted for 27% of global banking assets. In 2050, that will have decreased to 12.5% under these projections. Meanwhile, the BRIC countries will see their share of these assets go from 7.9% in 2005 to 32.9% in 2050, illustrating the potential of financial services activities in these countries.

2.3. Conclusions

Historically, the case that the UK benefitted from EU-level financial regulation rested on the assumptions that (i) the UK had sufficient influence (ii) the risk of the UK being overruled in any fundamental area, although present, was limited, (iii) the single market created beneficial trading opportunities for UK financial sector firms.

Over the next decade, some or all of these key elements of the traditional case that the UK gains from EU financial regulation are likely to be reversed. If EU financial regulation might no longer be to the UK’s benefit, according to the assumptions that have underpinned it in the past, there are a number of potential actions that the UK can take to secure continued growth and trade in its key industry. We will look at them in more detail in the next section.

3. WHAT ARE THE OPTIONS FOR THE UK?

The table below sets out three specific strategies that the UK can pursue to safeguard its financial services industry and the extent to which these strategies meet three basic aims that the Government has set itself in negotiations with EU partners. These – at times contradictory – aims are to protect the UK’s economic interests (primarily protecting financial services but could also include avoiding a financial meltdown in the eurozone), protect the single market, and maintain good relations with EU partners.

The first strategy would essentially be to engage with the status quo, seeking political assurances among EU allies and partners that the UK will not risk further loss of influence over financial services as the eurozone integrates further. This would be the path of least political resistance but would involve few firm safeguards.

The second strategy could involve protecting the interests of the UK as part of a wider strategy to strengthen the influence of the 10 non-eurozone member states (sometimes referred to as the E10). While this approach would be an effective means of ensuring that decisions over the single market continue to be taken at the level of the 27, it would still leave the UK in a position to be outvoted on key proposals.

The third strategy would be to seek UK-specific guarantees on financial services, which could be legally rooted in the EU Treaties. This would offer the most watertight safeguard, but would also be likely to meet fierce political opposition among the other EU member states.

In addition, the UK can simply refuse to implement individual measures – an option that we will consider at the end of this section. Taking everything into account, of the options we set out below, we consider a ‘single market protocol’ to be the absolute minimum that the UK Government should be pushing for to counter the trends that we describe in Section 2. However, the option with the most certainty of safeguarding the UK’s economic interests would be a UK ‘emergency brake’, giving London the right to block disproportionate or protectionist EU financial regulation. These need not be contradictory to efforts aimed at avoiding a meltdown in the eurozone (which would clearly hurt the UK economy). In fact, by virtue of promoting growth and trade, such measures could in fact give a much needed boost to the eurozone as well.

Box 2: Potential strategies to safeguard UK-based financial services			
	Aim 1: Protect UK’s economic interests	Aim 2: Maintain integrity of the single market	Aim 3: Good political relations
Strategy 1: Path of least political resistance <i>Option 1) Status quo</i> <i>Option 2) A far more pro-active approach</i> <i>Option 3) Seek political assurances</i>	Very similar to the status quo UK could be increasingly exposed to unwanted measures, but would not stand in the way of further eurozone integration (seen by some as necessary to avoid a euro meltdown)	Without firm guarantees, the single market could become dominated by eurozone caucus	As it does not involve any major changes, it would go down well with other member states, particularly those in the eurozone
Strategy 2: Guarantees for the non-euro group <i>Option 4) A single market protocol (Treaty change)</i> <i>Option 5) Establishing a non-euro group (Treaty change)</i> <i>Option 6) Formal safeguards for the non-euro group (Treaty change)</i>	Could limit risk of eurozone caucusing With backing from the more liberal non-euro states, UK could potentially block damaging financial rules As protection, this route is far more unpredictable than a UK-specific safeguard	Could ensure that decisions relating to the single market are not to be imposed on the 27 by the 17 eurozone states	Likely to win support from some non-eurozone countries Could serve as a quid pro quo for greater eurozone integration
Strategy 3: UK safeguards and opt-outs <i>Option 7) UK specific guarantees (Treaty change):</i> a) UK emergency brake b) UK opt-out from financial services	Would enable the Government to regulate one of its key industries in the manner it thinks is best Could act as a watertight safeguard against growth-destroying EU regulation	Potentially leading to fragmentation of the single market. Other countries may demand similar guarantees or opt-outs to protect their favoured industries	Likely to be resisted by other member states. However, refusal to engage with the UK’s concerns could push UK closer to EU exit door

3.1 OPTIONS NOT REQUIRING TREATY CHANGE

Option 1) Status quo

There may be reasons for the Government to leave this policy area untouched, due to fears of losing political capital that may be needed for a wider renegotiation, of allowing protectionist EU states the opportunity to subvert the single market, or that any ambitious re-negotiation may cause problems for the stability of the Coalition Government at home.

Drawbacks: As we point out throughout this paper, the status quo may not actually be an option as the eurozone moves towards further integration and the economic environment changes.

Option 2) A far more pro-active approach

There remain a number of political options open to the UK that it can pursue even without major changes to the EU Treaties. In fact, many of these should be pursued irrespective of what the UK chooses to do on other fronts.

Both Commission officials and officials from finance ministries across Europe frequently point out that, despite accounting for by far the largest share of financial services in the EU, the UK has over recent years often been absent or aloof at the key stages of negotiations over financial services regulation.

A new long-term strategy should involve:⁸³

- (a) *Exploiting national networks in Brussels and around Europe:* The UK does very little to exploit the natural and potential loyalties and interests of British staff in Brussels, in stark contrast to other EU countries which systematically exploit their national networks, liaising regularly with staff who are working there. The UK must develop a game plan for Brussels lobbying and cultivating national capitals, including parliaments.
- (b) *Getting in early:* related to the above point, it is also a poorly kept secret that the UK does not get in early enough in the decision-making process to properly influence the agenda, and is therefore frequently forced to play catch-up. The previous Labour Government was particularly bad at this in the wake of the financial crisis – in part understandable, given the push for regulation that followed the crisis.⁸⁴ But the Coalition Government has suffered from this as well. For example, George Osborne appeared absent from the early stages of the debate surrounding an FTT – instead it was primarily Swedish Finance Minister Anders Borg that continuously spoke up against the FTT. While the proposal is protected by a UK veto, arguably, early pressure from Cameron and Osborne could have prevented Barroso from tabling it in the first place and would not force the UK Government to spend so much political capital.⁸⁵

Again, the contrast to other countries is stark. For example, in July 2009 France and Germany set up a 'working group' charged with hammering out common proposals on the shape of the EU's Common Agricultural Policy (CAP) after 2013, touring EU capitals including London, Madrid, Rome, Bucharest and Warsaw.⁸⁶

- (c) *Gaining appointments to the economic portfolios in the Commission:* European Commissioners are meant to act independently of national interest, but in practice, this is rarely the case. One of the UK's biggest strategic mistakes in recent years was former Prime Minister Gordon Brown's decision in 2009 to go for the position of High Representative in Foreign Affairs as the UK's representative in the Commission, while Michel Barnier – a Frenchman with a manifestly very different approach to how financial markets should be regulated – was given the vital internal market portfolio (which includes financial services).⁸⁷ In future, the UK should a) always go for one of the Commission's economic positions (enterprise, internal market, trade or competition) b) if the internal market brief

⁸³ For more, see Browne, Anthony and Persson, Mats "The case for European localism", 12 September 2011, <http://www.openeurope.org.uk/research/EUlocalism.pdf>

⁸⁴ For example, on proposals such as the AIFMD and the EU financial supervisors the could arguably have avoided some of the very uncomfortable negotiations that followed had it only made the right calls at an early stage in the process. *House of Lords EU Committee* press release, 'Lords criticise European Commission's financial regulation proposals for ignoring its own better regulation principles', 17 June 2009, http://www.law.qmul.ac.uk/news/docs/lastra_lords_17June09.pdf

⁸⁵ *WSJ*, 'EU finance ministers clash on financial transaction tax', 8 November 2011, <http://online.wsj.com/article/BT-CO-20111108-708596.html>

⁸⁶ *Euractiv*, 'France Germany join forces on CAP reform', 6 July 2009, <http://www.euractiv.com/cap/france-germany-join-forces-cap-reform/article-183751>

⁸⁷ This clearly could have been avoided by, for example, splitting up the internal market portfolio with financial services put under a separate responsibility under a free market minded Commissioner

is blocked from the UK (which is likely), the UK should push for a Swede, Czech or, if a eurozone representative is required, a Dutch, Irish or Finnish candidate.

The second leg of this strategy would be to place more British officials inside the Commission – the Government has already taken positive steps by launching a programme aimed at encouraging British civil servants to work for the Commission.⁸⁸

- (d) *Properly equipping UKREP*: The UK Government should staff the UK's Permanent Representation to the EU and also nominate to the European Commission to a level and grade comparable to those of other EU countries, with particular focus on officials with experience from and knowledge of the financial sector. The UK has less than half the EU staff you would expect given its population.
- (e) *More UK use of the ECJ*: The UK could become more active in its use of the ECJ in order to police the single market and strike down any mission creep regarding financial services. This could involve bringing more cases in two areas to:
- *Challenge use of Treaty articles for ends they were not designed for*: It is an often quoted criticism of the development of the EU, seen in its most overt form in EU employment law,⁸⁹ that the Commission can be very creative in stretching Treaty articles in order to give itself 'competence' to regulate. One hypothetical example would be for the UK to challenge any attempt to introduce a FTT on the basis that the EU has no competence – indeed, the Swedish Parliament has already objected to the proposal for an FTT on the basis that it violates the EU's subsidiarity principle.
 - *Litigate to prevent eurozone protectionism*: Similarly, as discussed above, the UK Government has already taken the ECB to court over proposed eurozone securities clearing – similar cases could well arise in future as the eurozone moves towards fiscal union. The UK must be prepared to continue to challenge such measures on all fronts, including the ECJ.⁹⁰
- (f) *Working on image*: the UK should accompany any move to seek allies with a sophisticated public relations drive in the rest of the EU to explain how London is a European asset which brings benefits to all EU states – which must also involve the City of London itself.
- (g) *Seeking 'better regulation'*: There are a number of better practices the EU should promote and the UK should push for when enacting regulations – known as the 'better regulation' agenda. Elsewhere, we have outlined a programme of reforms that should be pursued at the UK and EU level to achieve better targeted and more proportionate regulation.⁹¹

Drawbacks: While all these aims and objectives are worthy, and again, should be pursued regardless, they do not alter the basic EU decision-making structure. Political support is valuable but will be difficult to come by. Even if the UK took all the above measures, it could still easily be outvoted in the Council and the European Parliament. Action at the ECJ could have potential, as the UK and the EU institutions could find themselves on the same side in wanting to uphold the principle that that decisions are made at the level of all 27 member states, rather than by a eurozone caucus.

Option 3) Seek political assurances and mobilise the E10

While the E10 is far from a unified entity and will take different positions on a range of proposals, the non-eurozone countries are all likely to agree that decisions in the EU should remain, as much as possible, at the level of all 27 states. On both sides of the eurozone divide, the eurozone 17 and the non-eurozone 10, countries are concerned about the potential fragmentation of the single market and a shift in the balance of power to the southern – often more protectionist – member states. In addition to the UK, Sweden, Denmark, Poland and indeed Germany have all expressed strong concerns about such a possible development.

To counter this, the UK and other eurozone 'outs' can seek various forms of political assurances that decisions impacting on the single market, and financial services, continue to be made by all 27 member

⁸⁸ See *Foreign and Commonwealth Office*, 'Careers in the EU: Opportunities for graduates', <http://www.fco.gov.uk/en/news/latest-news/?view=News&id=23049891>

⁸⁹ See *Open Europe*, 'Repatriating EU social policy: the best choice for jobs and growth?', November 2011

⁹⁰ *Guardian*, 'takes ECB to court to save City's euro trading', 14 September 2011

⁹¹ See, *Open Europe*, "Still out of control? Measuring eleven years of EU regulation", 20 March 2011, <http://www.openeurope.org.uk/research/stilloutofcontrol.pdf>

states and the European Parliament in future, rather than a eurozone ‘caucus’ (see Section 2). Such assurances could take a number of forms:

- (a) *A gentlemen’s agreement*: The UK could ask that EU leaders give an assurance that the eurozone will not take decisions as a bloc where they have an impact on the non-euro members. This should include a commitment from France and Germany that they will not seek to undercut the wider EU-structure through far-reaching backroom deals. In the past, the so-called “Luxembourg compromise” was a political agreement, whereby EU states agreed that if a member state was disproportionately affected by a specific EU law or measure, the other member states should refrain from pressing ahead with it.

Box 3: The Luxembourg compromise

Shortly after QMV was introduced, General de Gaulle came to power in France. He regarded 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”.

The Luxembourg Compromise was never formally accepted by the European Commission or the ECJ, 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 overruled in agriculture,⁹² 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, many of the options we discuss here are in the same spirit as the original Luxembourg Compromise.

- (b) *A declaration*: Similarly, the UK could ask for a political ‘declaration’ stating that single market legislation remains a matter for all member states. One example of the UK achieving a declaration in a different area was to state that the EU’s European Financial Stability Mechanism (EFSM) bailout fund, used to aid Ireland and Portugal, would come to an end in 2013.⁹³
- (c) *Being present at negotiations*: In addition, the UK can take other measures such as insisting on always sitting at the table during key negotiations, even when those may involve only eurozone member states.
- (d) *Make the non-euro area an economic success*: One factor that will undoubtedly have an impact on the future development of the eurozone is its relative success compared to non-euro states. If once the current eurocrisis has subsided the non-euro states demonstrate that they have a relative advantage in terms of the dynamism of their economies in the EU their relative standing will increase and they may find an audience more receptive to arguments concerning economic reform. This argument has been made by the Foreign and Finance Ministers of Sweden.⁹⁴

Drawbacks: Neither political guarantees nor a declaration – unlike a protocol attached to the EU Treaties – are actually legally binding, even if inserted into EU summit conclusions. Similarly, the theoretical existence of the Luxembourg Compromise has proven ineffective in preventing the UK being outvoted in practice. In fact, over the last decade, it has not served as a real deterrent to member states or the Commission in pressing ahead with measures that clearly have asymmetrical impacts across Europe, for example the proposed FTT.

92 Indeed, the UK Government position is that the Compromise is still in place, and the possibility of the UK applying the Luxembourg Compromise to financial services regulation was floated by the Financial Secretary to the Treasury Mark Hoban MP, see *Reuters*, ‘UK threatens veto over financial regulation’, 8 November 2011, <http://uk.reuters.com/article/2011/11/08/uk-britain-financial-hoban-idUKTRE7A74WO20111108>

93 Although a previous declaration, attached to the Nice Treaty, had already asserted that Article 122 on which the EFSM was based should not be used for bailouts and remain limited to EU countries in cases of natural disasters or occurrences ‘beyond the control’ of the country in question .

94 Sweden’s Foreign Minister Carl Bildt and Finance Minister Anders Borg argued, “What might emerge is hardly the old concept of a core moving ahead with greater integration at greater speed, with a periphery gradually being dragged along. Rather, we would see the reverse when it comes to growth and competitiveness.” See their op-ed in the *Frankfurter Allgemeine Zeitung*, ‘The dangers of two-speed Europe’, 15 September 2011, <http://www.sweden.gov.se/sb/d/12393/a/175113> (English translation).

3.2 OPTIONS INVOLVING TREATY CHANGE

Option 4) A single market protocol

To ensure that all matters relating to the single market continue to be regulated at the level of all 27 member states, the UK could aim to secure a new 'single market protocol'. This could set out a commitment that a more integrated eurozone bloc cannot infringe or alter the mandate and right of the Council of Ministers, most importantly ECOFIN – the forum of national finance ministers – to decide on proposals.

In addition to securing influence, the UK could also use such a protocol to:

- Re-state the importance of the single market.⁹⁵
- Include a possible timetable for seeking to reduce barriers to trade in areas such as services, the digital economy, telecoms and energy.
- Codify the 'better regulation' objectives including a commitment to robust impact assessments.
- Establish a one-in one-out system to limit the amount of new regulation.
- Ensure that all regulations, including financial ones, are proportional, consistent with subsidiarity and related to a known risk.
- Re-state the need for pro-growth measures at the EU-level, including a need to make labour markets more dynamic. This could even include the EU's own commitments to exercise greater flexibility in the aspects of labour market law that it is involved in, including the Working Time Directive and the Agency Workers Directive.

Drawbacks: The single market and the aim to ensure a level playing field are already cemented in the EU Treaties, likewise proportionality, so, while very attractive in theory, this measure could prove ineffective in practice. Amid resistance from France and others, trying to reinforce competition and an EU-wide single market could involve a lot of political capital for uncertain gain.

Option 5) Establishing a non-euro group

Again, the UK is not alone in worrying about a more formalised eurogroup, where eurozone finance ministers currently meet, with more power to influence regulations in a whole range of areas, including financial services. In order to counter such a risk, former UK Foreign Secretary Lord Owen and others have argued in favour of strengthening the bloc of non-euro states.⁹⁶ The E10 could be mobilised in the following ways:

- (a) Non-euro group meetings:* Giving non-euro states the same right as the euro states to have an informal meeting chaired by the President of the Council, currently Herman van Rompuy, within the EU secretariat. This would legitimise the group and by requiring both the non-euro group and eurogroup to be permanently chaired by the President would ensure that the euro group does not develop into an institution separate or superior to the EU. The creation of the eurogroup finance minister's meeting is governed by Protocol 14 attached to the EU Treaties.⁹⁷ By amending this protocol and adding a new one for the non-euro group the equality of the two could be maintained.
- (b) Permanent opt-outs for all non-euro states:* Granting all non-euro states the right to stay out of the euro, would give the group greater political legitimacy within the EU and allow for the creation of a platform for non-euro states to discuss the impact of the eurozone on the EU 27. This could be achieved by giving all the non-euro states the option of a euro opt-out protocol, which is currently only enjoyed by Denmark and the UK.

⁹⁵ During the negotiation of the Lisbon Treaty, French President Nicolas Sarkozy managed to remove the words "a system ensuring that competition in the internal market is not distorted" from the main text of the Treaty. The wording that replaced it was a "social market economy aiming at full employment". A protocol would be a good opportunity to inject new life into the single market. See Professor Alan Riley, 'The EU Reform Treaty and the Competition Protocol: Undermining EC Competition Law', *Centre for European Policy Studies policy briefs*, 24 September 2007, www.ceps.eu/ceps/download/1370

⁹⁶ Writing in the *Guardian*, 'The eurozone isn't Europe', 7 November 2011, <http://www.guardian.co.uk/commentisfree/2011/nov/07/Eurozone-is-not-europe?newsfeed=true>

⁹⁷ See the Council of the European Union's website, <http://www.consilium.europa.eu/policies/the-Eurogroup/about-the-Eurogroup.aspx>

Option 6) Formal safeguards for the non-euro group

There are also a number of formal safeguards that the E10 could pursue. All of the below could exist in a 'light' version merely involving a declaration or a political agreement, or they could be made legally binding through formal Treaty changes. For example:

- (a) *Double QMV to give the non-euro group a veto:* To counter the new voting system coming in to force in 2014/17, which gives the eurozone bloc a qualified majority in the Council for the first time, if a decision is deemed to have been decided by the 17 with a clear impact on the 27, then one or several member states could have the right to request that a separate vote is taken amongst the ten non-members. Under such a mechanism, for a proposal to pass, it would first need a qualified majority amongst the 17 eurozone countries, and then a separate qualified majority amongst the 10.⁹⁸
- (b) *A new "Ioannina" compromise:* The new voting rules outlined above will come into force in 2014 but a state can request a reversion to the original rules until 2017. It could be proposed that this dispensation is made permanent giving the smaller non-euro states some extra ability to block eurozone measures. There is a precedent for this. In 1994, when the voting weight within the Council of Ministers changed ahead of the 1995 enlargement (Sweden, Finland and Austria were joining) EU leaders agreed (at Ioannina) that the previous rules could continue to be used if a state requested it, with no time limit on the old voting arrangements.
- (c) *A non-euro red card:* A mechanism, introduced by the Lisbon Treaty, allows for a so-called yellow card procedure, whereby if one-third of all national parliaments object to a Commission proposal within eight weeks of it being tabled, then the Commission needs to re-consider that proposal. While the yellow card has never led to a proposal being dropped, a purpose built, beefed up version could be used to counter a eurozone caucus.⁹⁹

Drawbacks: While each of these options could give the UK a further avenue to strike down misdirected financial laws it is unclear whether the UK would manage to mobilise the other euro 'outs' to vote with it. At the end of the day, the E10 is not a united bloc. This is particularly true since it is only the UK and Denmark which currently have formal 'opt outs' from the euro – the other eight member states are considered 'pre-ins' and are legally obliged to join at an undetermined moment (no matter how distant).

Option 7) UK-specific guarantees

Every one of the above options is more or less designed to ensure that all decisions on the single market, and therefore financial services, are decided by QMV in the Council involving all member states, and co-decision with the European Parliament. None of them address the UK's unique position as a global financial hub, nor the risk of the UK being outvoted on damaging laws. For that the UK would need a specific guarantee. There are two ways this could be done.

- (a) *A UK emergency brake:* A watertight safeguard could be achieved through an emergency brake or 'double lock', embodied in a legally binding protocol attached to the Treaties.

Lock one – right to get the Commission to think again. Lock one would assert the UK's special circumstances in financial services and give it the right to force the Commission to re-consider proposals with a disproportionate impact on the UK before they go to a vote in the Council of Ministers and the European Parliament. To counter accusations that such a carve-out would fragment the single market, the protocol could also state that the UK would be required to exercise the protocol with responsibility, doing its utmost to ensure the integrity of single market – in similar terms to the 'single market protocol' set out above.

Lock two – a veto if lock one fails. Lock two would give the UK the right to appeal any proposal at any stage during the decision-making process (i.e. before the proposal has been agreed by the Council and the EP) kicking it up to the level of the European Council, where unanimity applies and the UK therefore has a veto. This emergency brake could be pulled if a proposal contained, or in negotiations developed, unwarranted costs or disproportionate impacts on the UK.

⁹⁸ This new safeguard could be added to a new non-euro Protocol and would have the benefit of securing the non-euro bloc's influence as countries enter (or leave) the single currency

⁹⁹ For example, if one or more (a certain threshold may be necessary) non-euro states object to a decision pushed through the Council of Ministers on the basis that it is a measure designed specifically by the eurozone, then the proposal could be referred to the European Council, where heads of state and Government meet and where unanimity applies. The very existence of such a mechanism could act to deter eurozone countries from taking decisions at 17 with an impact on the 27.

Should the UK decide to appeal the proposal to the European Council, along with the suspension of QMV, the jurisdiction of the ECJ to review the application of the veto would also be suspended, which would avoid a scenario whereby the ECJ gradually chipped away at the UK protocol through case law – something to be feared having regard to the past record of the ECJ.¹⁰⁰

The use of (or threat to use) the emergency brake would have the added benefit of giving the UK the negotiating leverage to ensure that measures are of high quality and can go ahead with UK involvement.

Box 4: Ensuring Parliamentary scrutiny of Government decisions

In order to ensure that a UK Government could not waive or use its rights within the new protocol without Parliamentary oversight, Parliament might want to create a mechanism by which it can oversee Government decisions on proposed directives or decisions.

Drawbacks: Inserting a legally binding protocol in the Treaties would clearly require the UK Government to spend a lot of political capital in EU negotiations. Other member states may ask for carve-outs of their own, some of which may be damaging to UK interests, such as exemptions for subsidies to state-owned companies, in areas such as energy and telecoms, which would undermine competition around Europe – though this could be mitigated by World Trade Organisation rules.

(b) A full UK opt-out from financial services: An alternative to a veto would be a full opt-out from EU financial services, with an opportunity for the UK to opt in to individual measures on a case-by-case basis. The UK already has a similar opt-in arrangement in EU justice and home affairs. This differs from a veto in that it would allow other EU countries to press ahead with a measure even if the UK did not give its approval. In contrast, a veto would effectively block the entire EU proposal, forcing other Governments and the Commission back to the drawing board.

Drawbacks: As with an emergency brake and veto, this option would require a lot of political capital and risks retaliation from EU partners. It would also be perceived as a blow to the single market as it would effectively mean extracting a specific industry from the overall single market framework. There would also be a risk that some UK-based firms would relocate elsewhere in the EU in order to take full advantage of the single market.¹⁰¹

3.3 WHAT IF AN AGREEMENT IS NOT POSSIBLE?

Option 8) Refuse to implement

The UK could simply refuse to implement a given EU law, if it had been outvoted on a proposal that it deemed particularly objectionable. The legal repercussions of this option are relatively simple. However, the political implications are hugely uncertain and impossible to predict.

A further alternative would be for Parliament – its sovereign role re-affirmed in the recently passed European Union Act¹⁰² – to pass a law stating that the powers previously delegated to the EU over financial regulation are now to be determined solely by Parliament, not by the EU institutions. This would mean that Parliament would decide whether or not to apply EU financial regulations and could decide to ignore rulings from the ECJ. It would also be free to dis-apply any existing EU derived financial regulation. An alternative to an indefinite withdrawal from EU financial regulation could be a temporary suspension of EU financial regulation, effectively giving the City a temporary break from burdensome regulation to cope with the tough economic climate.

Legally, refusing to implement or dis-applying a law would almost certainly lead to infraction procedures being launched against the UK either by the Commission, under Article 258 TFEU, or another member state, under Article 259 TFEU.

¹⁰⁰ In part, there is a precedent for this kind of “emergency brake” in the EU Treaties, which could serve as a model. For example, Article 82(3) TFEU, dealing with criminal justice law, states that if a proposal impacts on the “fundamental aspects” of a country’s criminal justice system, the concerned country may ask the proposal to be referred to the European Council, meaning an effective veto over the entire proposal.

¹⁰¹ One complication of both this approach and that of the ‘emergency brake’ could be the risk that the Commission could frame measures more broadly than financial regulation in order to avoid a UK Protocol. This practice is already seen in the re-classification of the Working Time Directive as a ‘health and safety’ measure.

¹⁰² Section 18 of the European Union Act 2011 states, “Directly applicable or directly effective EU law (that is, the rights, powers, liabilities, obligations, restrictions, remedies and procedures referred to in section 2(1) of the European Communities Act 1972) falls to be recognised and available in law in the United Kingdom only by virtue of that Act or where it is required to be recognised and available in law by virtue of any other Act”, see <http://www.legislation.gov.uk/ukpga/2011/12/section/18>

This infraction process would involve the following stages:

- 1) The Commission delivers a “reasoned opinion” to the UK deeming it to be in breach of the treaties, demanding that it change its relevant laws in order to comply with the Treaties within a given time frame.
- 2) If the UK maintained its non-compliance the matter would be taken to the ECJ, which would make an initial ruling. The UK could contest the case.
- 3) In the month following the initial ECJ judgement, the Commission would send a letter requesting information on the measures taken to end the infringement.
- 4) The UK’s failure to comply with the ECJ ruling would result in the Commission taking the UK back to court and asking the ECJ to impose a lump sum or penalty payment on the UK in the shape of a fine. The maximum fine that can currently be imposed on the UK is €703,104 a day or €256.6m (£225.6m) a year.¹⁰³
- 5) It is unclear what would happen if the UK refused to pay the fines.

In the past, infringement procedures of this kind have taken years and it has never led to any fines close to the maximum. However, given that no country has unilaterally opted out of an important policy area before, it is very difficult to predict the timescale and intensity of the legal infringement process that would follow. The Commission may take firm action and the ECJ also has an “accelerated procedure” at its disposal that it can use to deal with cases of an urgent nature.

Politically, the consequences would be far more unpredictable. Unilateral withdrawal from parts of EU financial regulation would certainly result in a massive political row with the EU and the other member states. Despite a likely political fall-out and however unlikely, it might be possible to come to a negotiated settlement (perhaps along the lines of the proposed protocol above) following a messy, unilateral UK withdrawal, if the alternative was seen to be the UK leaving the EU altogether.

Option 9) A unilateral opposition to regulation justified under EU law?

Article 4(2) TEU of the EU Treaties explicitly specifies that the EU will respect the “fundamental structures” and “state functions” of the member states. EU law Professor Damian Chalmers at the London School of Economics has argued that this Treaty Article could be used to assert the UK’s right to protect its financial services industry. Due to its predominance and importance to the UK economy – in terms of trade, tax revenue, job creation and growth (see Section 1) – the City could be considered a “fundamental structure” in both a “political” and “constitutional” sense.

The UK could assert and then inform the Council of its intention not to be bound by a piece of regulation as it would alter the “fundamental structures” of its economy and society, defined under Article 4 (2) of TEU

Box 5: Article 4(2) Treaty on European Union guarantees a member state’s ‘fundamental structures’

“The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-Government. It shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each member state.”

The leading German scholar in EU law, Armin von Bogdandy, in a recent article¹⁰⁴ with Stephan Schill, has noted that Article 4(2) can only mean that national law takes precedence over EU law when that is demonstrably the case. The question is who the arbiter is. Von Bogdandy and Schill suggest that if there

¹⁰³ The ECJ can either impose a daily penalty payment or a lump sum penalty. The basic flat-rate penalty payment is €640 a day. This is multiplied by a coefficient for seriousness (ranging between 1 and 20) and a coefficient for duration (a multiplier of between 1 and 3, calculated at a rate of 0.10 per month from the date of the first ECJ ruling). This is then multiplied by a country specific coefficient (currently 18.31 for the UK). See European Commission, ‘Application of Article 228 of the EC Treaty’, http://ec.europa.eu/eu_law/docs/docs_infringements/sec_2005_1658_en.pdf; and ‘Application of Article 260 of the Treaty on the Functioning of the European Union. Up-dating of data used to calculate lump sum and penalty payments to be proposed by the Commission to the Court of Justice in infringement proceedings’, http://ec.europa.eu/eu_law/docs/docs_infringements/sec_2010_923_en.pdf

¹⁰⁴ Von Bogdandy and Schill, ‘Overcoming absolute primacy: Respect for national identity under the Lisbon Treaty’, *Common Market Law Review*, Vol. 48 No. 5, October 2011, <http://www.law.leiden.edu/journals/commonmarketlawreview/contents/cml-rev-october-2011.html>

have been national hearings – in Parliament for example – to determine that national law should take precedence, it would be almost impossible for any EU Institution to contradict them.¹⁰⁵

In order to do this the UK should set up a process through which to establish that an EU measure could be opposed under Article 4(2). At the initiative of the Cabinet, the UK could set up a constitutional committee, or an independent “European Treaties Committee,” consisting of MPs from the Treasury, Constitutional and EU committees in Parliament, in addition to a selection of lawyers.

Drawbacks: This would be completely uncharted territory and it is far from clear whether such a unilateral approach, although based on an interpretation of the EU Treaties, would be supported by other member states or the EU institutions. The result could be that the UK would be subject to EU infraction procedures (see above).

Box 6: How EU Treaty changes can be achieved to accommodate UK concerns?

The ordinary revision procedure (Article 48 (2-5)).

If a proposed Treaty change is significant, the European Council will convene a Convention (composed of representatives of the member states’ national parliaments, Heads of State or Government of the member states, the European Parliament and the European Commission) prior to a decision being taken by an InterGovernmental Conference. If the European Council decides (after obtaining consent from the European Parliament) that the proposed Treaty changes are not significant an InterGovernmental Conference will examine the proposals directly. Changes if agreed unanimously will then need to be ratified by all member states.

The simplified revision procedure (Article 48 (6)).

A proposed Treaty change under this mechanism must only change the internal policies and action of the EU including economic and monetary policy [Part Three of the TFEU]. The European Council has the power to approve by unanimity the necessary amendments in these areas, after consultation with the European Parliament. Member states will then need to ratify these measures.

The flexibility clause (Article 352)

If action by the Union should prove necessary, within the framework of the policies defined by the Treaties, to attain one of the objectives set out in the Treaties, and the

Treaties have not provided the necessary powers, the Council, acting unanimously on a proposal from the European Commission and after obtaining the consent of the European Parliament shall adopt the appropriate measures.¹⁰⁶

¹⁰⁵ In Germany, for example, the Federal Court indicated that a key requirement for the constitutionality of the Lisbon Treaty was that the EU could not adopt for itself significant fiscal powers. If the transaction tax affected as significantly as it would affect the it is an open question whether it would be lawful there. See the judgment of the Second Senate of the German Federal Constitutional Court, 30 June 2009, http://www.bundesverfassungsgericht.de/entscheidungen/es20090630_2bve000208en.html; see also FT, ‘Berlin has dealt a blow to European unity’, 12 July 2009, <http://cachef.ft.com/cms/s/0/48bbec78-6f10-11de-9109-00144feabdc0.html#axzz1fPc3eFdm>

¹⁰⁶ This is not technically a treaty change

ANNEX 1: EU FINANCIAL REGULATION IN THE PIPELINE

EU legislation adopted but not yet transposed into national law		Current status	Deadline for transposition/Entry into force
EU legislation			
Alternative Investment Fund Managers (AIFM) Directive – <i>Directive 2011/61/EU</i>	Adopted on 8 June 2011		Deadline for transposition is 22 July 2013
Solvency II – Directive 2009/138/EC	Adopted on 25 November 2009		Transposition will have to be complete by 1 January 2013, but the new requirements will enter into force on 1 January 2014 ¹⁰⁷
Financial Conglomerates Directive (upgraded version) ¹⁰⁸	Adopted by the Council of Ministers on 8 November 2011, awaiting publication on the EU's Official Journal		To be added in when the Directive is published in the EU's Official Journal – it is temporarily fixed at 18 months after the entry into force of the Directive ¹⁰⁹
Access to basic banking services (part of the European Commission's Single Market Act initiative)	Recommendation adopted by the European Commission on 18 July 2011		EU member states are <i>invited</i> to take the necessary measures by at the latest six months after the publication of the Recommendation (i.e. first quarter of 2012)
Short-selling and CDS Regulation	Adopted by the European Parliament on 15 November 2011, awaiting final (formal) approval by the Council of Ministers		The Regulation will enter into force after its publication in the EU's Official Journal, but will apply from 1 November 2012 ¹¹⁰
Regulation on wholesale energy market integrity and transparency	Adopted by the Council of Ministers on 10 October 2011, ¹¹¹ awaiting publication in the EU's Official Journal		After its publication in the EU's Official Journal
Prospectus Directive (upgraded version) – <i>Directive 2010/73/EU</i>	Adopted on 24 November 2010 ¹¹²		Deadline for transposition is 1 July 2012 ¹¹³
Location of clearing houses	ECB communicated its decision to change the Eurosystem's location policy for clearing houses in July 2011. The UK started legal action against the decision in September, timeline remains uncertain at the moment		Unclear
EU legislation proposed but not yet adopted			
Proposal	Current status	Deadline for transposition/Entry into force	
Draft Directive introducing a Financial Transactions Tax (FTT) ¹¹⁴	European Commission proposal published on 28 September 2011		The Commission proposes 31 December 2013, with the new provisions entering into force on 1 January 2014
Draft Omnibus II Directive ¹¹⁵	European Commission proposal published in January 2011		The Commission proposes 31 December 2012, with the new provisions entering into force on 1 January 2013

¹⁰⁷ See the FSA website, <http://www.fsa.gov.uk/pages/About/What/International/solvency/implementation/index.shtml>

¹⁰⁸ Due to amend Directives 98/78/EC, 2002/87/EC, 2006/48/EC and 2009/138/EC (Solvency II) as regards the supplementary supervision of financial entities in a financial conglomerate

¹⁰⁹ Some provisions must be transposed by 22 July 2013, see http://register.consilium.europa.eu/pdf/en/11/pe00/pe00039_en11.pdf

¹¹⁰ See *European Parliament* press release, 'Parliament seals ban on sovereign debt speculation and short-selling limitations', 15 November 2011, <http://www.europarl.europa.eu/en/pressroom/content/20111115IPR31525/html/Parliament-seals-ban-on-sovereign-debt-speculation-and-short-selling-limitations>

¹¹¹ See *Council of the European Union* press release, 'New framework for monitoring of energy markets adopted', 10 October 2011, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/trans/124995.pdf

¹¹² This Directive also amends Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (aka Transparency Directive), see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:327:0001:0012:EN:PDF>

¹¹³ The UK has already transposed the upgraded version of the Prospectus Directive with the Prospectus Regulations 2011, <http://www.legislation.gov.uk/uk/si/2011/1668/mtrroduction/made>

¹¹⁴ Also due to amend Directive 2008/7/EC concerning indirect taxes on the raising of capital, see http://ec.europa.eu/taxation_customs/resources/documents/sector/com%282011%29594_en.pdf

¹¹⁵ Due to amend the existing Prospectus Directive (Directive 2003/71/EC) and Solvency II in respect of the powers of EIOPA and ESMA, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0008:FIN:EN:PDF>

EU legislation adopted but not yet transposed into national law		
Proposal	Current status	Deadline for transposition/Entry into force
Draft Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (part of the CRD IV package) ¹¹⁶	European Commission proposal published on 20 July 2011	The Commission proposes 31 December 2012, with the new provisions entering into force on 1 January 2013 ¹¹⁷
Draft Regulation on prudential requirements for credit institutions and investment firms (part of the CRD IV package)	European Commission proposal published on 20 July 2011	The Commission proposes applying the new provisions from 1 January 2013 ¹¹⁸
Draft Credit Rating Agencies Regulation (CRA III)	European Commission proposal published on 15 November 2011 ¹¹⁹	After its publication in the EU's Official Journal ¹²⁰
Draft Directive amending UCITS IV and AIFMD in respect of the excessive reliance on credit rating agencies (part of the CRA III package)	European Commission proposal published on 15 November 2011 ¹²¹	The Commission proposes applying the new provisions from 12 months after the entry into force of the Directive
Draft Investors Compensation Schemes Directive (upgraded version)	European Commission proposal published on 12 July 2010. Compromise proposal drafted by the Polish Presidency endorsed by the Committee of EU member states' Permanent Representatives to the EU (COREPER) on 23 November 2011 ¹²²	The Commission proposes applying the new rules from 12 months after the entry into force of the Directive, the FSA notes that the proposals are anticipated to come into effect by the end of 2012 ¹²³
Draft Bank Deposit Guarantee Schemes Directive (recast)	European Commission proposal published on 12 July 2010	The Commission proposes 31 December 2012 ¹²⁴
Draft Regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation, EMIR)	Negotiations between member states and the European Parliament are still under way, EU finance ministers agreed on a common negotiating position on 4 October 2011 ¹²⁵	After its publication in the EU's Official Journal
Draft Markets in Financial Instruments Directive (MiFID II, upgraded version)	European Commission proposal published on 20 October 2011	Not specified in the Commission's draft
Draft Regulation amending EMIR (part of the MiFID II package)	European Commission proposal published on 20 October 2011	The Commission proposes applying the new rules from 24 months after the entry into force of the Regulation ¹²⁶
Draft Market Abuse Regulation ¹²⁷	European Commission proposal published on 20 October 2011	After its publication in the EU's Official Journal, although the existing Market Abuse Directive (MAD) would be repealed 24 months after the entry into force of the new Regulation

¹¹⁶ Also due to amend the existing Financial Conglomerates Directive (Directive 2002/87/EC)

¹¹⁷ Chapter 4 (on capital buffers) would apply from 1 January 2016, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0453:FIN:EN:PDF>

¹¹⁸ Article 436(1) would apply from 1 January 2015, see http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/20110720_regulation_proposal_part3_en.pdf, p153

¹¹⁹ Final text of the proposal is not yet available, a provisional version is available here, http://ec.europa.eu/internal_market/securities/docs/agencies/COM_2011_747_en.pdf

¹²⁰ Some provisions would enter into force from 1 June 2014, see http://ec.europa.eu/internal_market/securities/docs/agencies/COM_2011_747_en.pdf, p35

¹²¹ Final text of the proposal is not yet available, a provisional version is available here, http://ec.europa.eu/internal_market/securities/docs/agencies/COM_2011_746_en.pdf

¹²² See http://consilium.europa.eu/uedocs/cms_Data/docs/pressData/en/ec/inf126385.pdf, p7

¹²³ See <http://www.fsa.gov.uk/pages/About/What/International/pdf/ICSD.pdf>

¹²⁴ Transitional measures have been proposed for deposits paid in before 30 June 2010, which would be applied until 31 December 2014, see http://ec.europa.eu/internal_market/bank/docs/guarantee/comm_pdf_com_2010_0368_proposition_de_directive_en.pdf, p42

¹²⁵ See *Council of the European Union* press release, 'Council reaches agreement on measures to regulate derivatives market', 4 October 2011, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/inf124903.pdf

¹²⁶ Some articles would apply immediately after the entry into force of the Regulation. Existing third country firms would be allowed to continue to provide services and activities in EU member states in accordance with national regimes until four years after the entry into force of the Regulation, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0652:FIN:EN:PDF>, p60

¹²⁷ Due to replace the existing Market Abuse Directive (Directive 2003/6/EC), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0651:FIN:EN:PDF>

EU legislation adopted but not yet transposed into national law		
Proposal	Current status	Deadline for transposition/Entry into force
Draft Directive on criminal sanctions for insider dealing and market manipulation (part of the Market Abuse Directive review package)	European Commission proposal published on 20 October 2011	The Commission proposes applying the new provisions from 24 months after the entry into force of the Directive ¹²⁸
Draft new rules on corporate governance in financial institutions	Proposed as part of MIFID II and CRD IV ¹²⁹	See above
Draft Transparency Directive (upgraded version)	European Commission proposal published on 25 October 2011	Not specified in the Commission's draft
Draft Savings Taxation Directive (upgraded version)	European Commission proposal published on 13 November 2008, negotiations between member states and the European Parliament are still under way	Deadline for transposition is not specified, the Commission proposes applying the new rules from the first day of the third calendar year following the calendar year in which the Directive enters into force ¹³⁰
Draft Regulation on Single Euro Payments Area (SEPA) migration end-date(s) ¹³¹	European Commission proposal published on 16 December 2010	Various, depending on the different provisions ¹³²
Draft Directive on credit agreements relating to residential property (mortgages)	European Commission proposal published on 31 March 2011, the latest compromise text by the Polish Presidency was published on 28 November 2011 ¹³³	The Commission proposes applying the new provisions from two years after the entry into force of the Directive ¹³⁴
Draft Regulation on a common European sales law	European Commission proposal published on 11 October 2011	The Commission proposes applying the new rules from six months after the entry into force of the Regulation ¹³⁵
Draft Statutory Audit Directive (upgraded version) ¹³⁶	European Commission proposal published on 30 November 2011	Not specified in the Commission's draft
Draft Regulation on specific requirements regarding statutory audits of public-interest entities (part of the audit reform package)	European Commission proposal published on 30 November 2011	The Commission proposes applying the new provisions from two years after the entry into force of the Regulation ¹³⁷
Draft Directive replacing the EU's Accounting Directives ¹³⁸	European Commission proposal published on 25 October 2011	The Commission proposes 1 July 2014 ¹³⁹
Draft Regulation creating a European Account Preservation Order to facilitate cross-border debt recovery in civil and commercial matters	European Commission proposal published on 25 July 2011	The Commission proposes applying the new rules from 24 months after the entry into force of the Regulation ¹⁴⁰

128 See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0654:FIN:EN:PDF>, p13

129 See *Clifford Chance*, 'European regulatory reform progress report', 3 November 2011, http://www.cliffordchance.com/publicationviews/publications/2011/11/european_regulatoryreformprogressreport-.html

130 See http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_directive_review/com%282008%292727_en.pdf, p27

131 Due to amend Regulation (EC) No 924/2009 on cross-border payments in the Community

132 See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0775:FIN:EN:PDF>, p23-24

133 The compromise proposal is available here, <http://register.consilium.europa.eu/pdf/en/11/st17/st17608.en11.pdf>

134 See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0142:FIN:EN:PDF>, p44

135 See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0635:FIN:EN:PDF>, p29

136 To amend Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, see http://ec.europa.eu/internal_market/auditing/docs/reform/COM_2011_778_en.pdf (provisional version)

137 Transitional provisions are set out for audit contracts concluded within a certain timeframe, see http://ec.europa.eu/internal_market/auditing/docs/reform/COM_2011_779_en.pdf, p82-83 (provisional version)

138 Directives 78/660/EEC and 83/349/EEC

139 See http://ec.europa.eu/internal_market/accounting/docs/sme_accounting/review_directives/20111025-legislative-proposal_en.pdf, p67

140 With the sole exception of Article 48, which would apply from 12 months after the entry into force of the Regulation, see http://ec.europa.eu/justice/civil/files/comm-2011-445_en.pdf, p36

EU legislation adopted but not yet transposed into national law		
Proposal	Current status	Deadline for transposition/Entry into force
Draft Directive on Alternative Dispute Resolution (ADR) for consumer disputes ¹⁴¹	European Commission proposal published on 29 November 2011	The Commission proposes that transposition be completed by 18 months after the entry into force of the Directive ¹⁴² and estimates that out-of-court ADRs should be available everywhere in the EU in the second half of 2014 ¹⁴³
Draft Regulation on Online Dispute Resolution (ODR) for consumer disputes	European Commission proposal published on 29 November 2011	The Commission proposes 6 months after implementation deadline for the draft ADR Directive, i.e. presumably early 2015
Target-2 Securities programme ¹⁴⁴	Framework agreement endorsed by the ECB's Governing Council on 17 November 2011 ¹⁴⁵	The ECB's Governing Council decided to push back the go-live date to June 2015 (it was initially planned for September 2014) ¹⁴⁶
EU legislation in the pipeline but without a formal proposal		
Potential proposal	Current status	Deadline for transposition/Entry into force
Insurance Guarantee Schemes (IGS)	A task force on IGS was set up by EIOPA in May 2011 ¹⁴⁷ . The Commission may present a proposal next year, but the exact timeline is unclear at the moment	Unclear
Harmonisation of Securities Law	European Commission proposal was due in the first semester of 2011, ¹⁴⁸ but has been delayed (presumably to next year)	Unclear
Central Securities Depositories	European Commission consultation launched on 13 January 2011 ¹⁴⁹ . A proposal was due during the summer, ¹⁵⁰ but has been delayed and may be put forward by the end of the year ¹⁵¹	Unclear
UCITS V	European Commission proposal expected in early 2012, according to the FSA ¹⁵²	Unclear
Insurance Mediation Directive (upgrade)	European Commission still working on a proposal, which might be published next year ¹⁵³	Unclear
Corporate governance framework	European Commission consultation launched on 5 April 2011, with responses due by 22 July 2011 ¹⁵⁴	Unclear

141 Due to amend Regulation (EC) No 2006/2004 on cooperation between national authorities responsible for the enforcement of consumer protection laws and Directive 2009/22/EC on injunctions for the protection of consumers' interests (codified version)
142 See http://ec.europa.eu/consumers/redirectress_cons/docs/directive_adr_en.pdf, p22

143 *European Commission* press release, 'Consumers: Commission puts forward proposals for faster, easier and cheaper solutions to disputes with traders', 29 November 2011, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/17461&format=HTML&aged=0&language=EN&guiLanguage=en>

144 Target-2 Securities is the name of the Eurosystem project to harmonise securities settlement in central bank money, see http://www.bundesbank.de/zahlungsverkehr/zahlungsverkehr_t2securities.en.php

145 See the ECB's website, <http://www.ecb.europa.eu/press/govdec/otherdec/2011/html/gc111118.en.html>

146 See the ECB's website, <http://www.ecb.int/press/govdec/otherdec/2011/html/gc111021.en.html>

147 See EIOPA website, <https://eiopa.europa.eu/about-eiopa/organisation/new-working-groups/task-forces/task-force-on-insurance-guarantee-schemes/index.html>

148 See the European Commission's website, http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm#timetable

149 See *European Commission* press release, 'Enhancing safety of European financial markets: Common rules for Central Securities Depositories (CSDs) and securities settlement', 13 January 2011, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/29&format=HTML&aged=0&language=EN&guiLanguage=en>

150 See *European Commission*, 'Planned Commission initiatives until end of 2011', p6, http://ec.europa.eu/atwork/programmes/docs/forward_programming_2011.pdf

151 See http://www.hm-treasury.gov.uk/fin_euimtl_dossier_ucits.htm

152 See the Commission's website, http://ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework_en.htm

153 See *European Commission* communication, 'Commission Work Programme 2012 - Delivering European renewal', COM(2011)777, 15 November 2011, p4, http://ec.europa.eu/atwork/programmes/docs/cwp2012_en.pdf

154 See the Commission's website, http://ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework_en.htm

EU legislation in the pipeline but without a formal proposal		
Potential proposal	Current status	Deadline for transposition/Entry into force
Packaged Retail Investment Products (PRIPIs)	Part of the new rules on disclosure proposed as part of MiFID II, the rest to be included in the new draft Insurance Mediation Directive. New rules on distribution to be proposed in a specific piece of legislation, maybe next year ¹⁵⁵	Unclear
EU framework on bank resolution	European Commission working on a proposal. Internal Market Commissioner Michel Barnier said on 16 November that he expected the proposal to be unveiled "in the coming weeks" ¹⁵⁶	Unclear
Collective redress	European Commission consultation launched on 4 February 2011, with responses due by 30 April 2011 ¹⁵⁷	Unclear
Venture capital	European Commission consultation launched on 15 June 2011, with responses due by 10 August 2011. The Commission aims to publish a proposal by the end of 2011 ¹⁵⁸	Unclear
Card, internet and mobile payments	European Commission Green Paper due to be published on 7 December 2011, with follow-up measures to be considered by 2013 ¹⁵⁹	Unclear
Payment Services Directive (upgrade)	European Commission could put forward a proposal for revision by 1 November 2012 ¹⁶⁰	Unclear
Institutions for Occupational Retirement Provisions Directive (upgrade)	EIOPA launched a second consultation on 25 October 2011, with responses due by 2 January 2012. ¹⁶¹ Based on EIOPA advice, the Commission will consider putting forward a proposal, presumably by the end of 2012	Unclear
Raw materials and commodity markets	European Commission Communication published on 2 February 2011. Although partly covered by other initiatives (e.g. MiFID II), a specific proposal on raw materials and commodity markets could still be presented, maybe next year ¹⁶²	Unclear
Financial Activities Tax (FAT)	European Commission included FAT in a list of potential sources of revenue to fund the EU budget directly. ¹⁶³ It is unclear when (and if) the Commission will put forward a formal proposal, as the FAT remains the preferred option at the moment	Unclear

155 See *European Commission communication*, 'Commission Work Programme 2012 – Delivering European renewal', COM(2011)777, 15 November 2011, p4156 November 2011, <http://www.reuters.com/article/2011/11/16/euro-zone-barnier-idU5WEA351120111116>

157 See http://ec.europa.eu/dgs/health_consumer/dgs_consultations/ca/docs/cr_consultation_paper_en.pdf

158 See http://ec.europa.eu/internal_market/consultations/docs/2011/venture_capital/consultation_paper_en.pdf, p17

159 See http://ec.europa.eu/governance/impact/planned_ia/docs/2013_market_005_integrated_european_market_en.pdf

160 See the European Commission's Roadmap for 2012, http://ec.europa.eu/governance/impact/planned_ia/docs/2013_market_007_psd_en.pdf

161 See EIOPA website, <https://eiopa.europa.eu/en/newsletters/news-alerts/eiopa-launches-second-consultation-on-draft-response-to-call-for-advice/index.html>

162 See, 'European regulatory reform progress report', 3 November 2011

163 European Commission, 'Financing the EU budget: Report on the operation of the own resources system', 29 June 2011, p31-32, http://ec.europa.eu/budget/library/biblio/documents/fin_fw1420/proposal_council_own_resources_annex_en.pdf

Quoted by Reuters, 'EU to unveil bank crisis toolbox in coming weeks - Barnier', 16

ANNEX 2: COSTS AND BENEFITS OF KEY FINANCIAL SERVICES ACTION PLAN MEASURES

Most material FSAP measures	FSAP cost estimate	FSAP benefit estimates	Other cost estimates	Other benefit estimates
Third Money Laundering Directive	HM Treasury undertook the consultation exercise £25 – 52 million ¹⁶⁴ (£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 ¹⁶⁵ £10 million over 5 years (other simplifying measures) ¹⁶⁶ Enhanced risk management Greater financial stability Market confidence and consumer protection	One-off: 0.16 – 0.29% operating expenses Ongoing: 0.05 – 0.13% operating expenses ¹⁶⁷ Other estimates Ongoing: £66-87 million ¹⁶⁸	To provide a common EU basis for implementing the revised Financial Action Task Force Recommendations on Money Laundering.
Capital Requirements Directive	Ongoing compliance costs: Securities and futures firms: £0.2 million per firm per year; Investment managers: reduction of £3 million ¹⁶⁹	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 ¹⁷⁰ 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) ¹⁷¹	
Insurance Mediation Directive	One-off: £56.23 – 58.89 million (authorisation related requirements for firms and individuals); Ongoing: £71.65 – 205.89 million ¹⁷²	Increase in the quality of the 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 ¹⁷³	Ongoing: £400 million (ex-post estimate of costs to industry and consumers of UK General Insurance Regulations which include DMD and IMD) ¹⁷⁴	

164 HM Treasury, 'The Money Laundering Regulations 2007 – Regulatory Impact Assessment', 2007, http://www.legislation.gov.uk/ukSI/2007/2157/pdfs/ukSIem_20072157_en.pdf

165 Ibidem

166 Ibidem

167 See *Europe Economics*, 'Study on the cost of compliance with selected FSAP measures', January 2009 (report prepared for the Internal Market and Services Directorate-General of the European Commission), http://ec.europa.eu/internal_market/finances/docs/actionplan/index090707_cost_of_compliance_en.pdf

168 See *Open Europe*, 'Selling the City short? A review of the EU's Financial Services Action Plan', November 2006, http://www.openeurope.org.uk/research/fsap_summary.pdf

169 See FSA, 'Strengthening Capital Standards 2', Consultation Paper CP06/3, February 2006, http://www.fsa.gov.uk/pages/Library/Policy/CP2006/06_03.shtml

170 See *Europe Economics*, 'Study on the cost of compliance with selected FSAP measures'

171 See *Open Europe*, 'Selling the City short? A review of the EU's Financial Services Action Plan'

172 See FSA, 'Prudential and other requirements for mortgage firms and insurance intermediaries', September 2003, <http://www.fsa.gov.uk/pubs/policy/ps174.pdf>

173 Ibidem

174 See *Open Europe*, '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
Solvency I framework	N/A	N/A	N/A	N/A
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) ¹⁷⁵ because of aggregation benefits)	£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) ¹⁷⁶	One-off: 0.52-1.46% operating expenses ¹⁷⁷ Ongoing: 0.08-1.09% operating expenses ¹⁷⁸ Other estimates £1.2 billion (IT costs) ¹⁷⁹	£100 million per annum (reduced costs of complying with regulation) £20 billion to £500 million per annum additional turnover (improved access) £0.1 – 1 billion per annum (reductions in transactions costs) £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 ¹⁸⁰
UCITS III	Ongoing: £11 million per year (increased capital requirements, maximum extra cost of capital) ¹⁸¹ 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. ¹⁸²	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		

175 See FSA, 'The overall impact of MiFID', November 2006, http://www.fsa.gov.uk/pubs/international/mifid_impact.pdf

176 Ibidem

177 See Europe Economics, 'Study on the cost of compliance with selected FSAP measures', January 2009 (report prepared for the Internal Market and Services Directorate-General of the European Commission)

178 Ibidem

179 See Open Europe, 'Selling the City short? A review of the EU's Financial Services Action Plan'

180 See Europe Economics, 'The benefits of MiFID', 2006 (report prepared for the Financial Services Authority)

181 See Open Europe, 'Selling the City short? A review of the EU's Financial Services Action Plan'

182 See FSA, 'Implementation of the Simplified Prospectus requirements in the UCITS Management Company Directive', November 2004, http://www.fsa.gov.uk/pubs/cp/cp04_18.pdf

Most material FSAP measures	FSA cost estimate	FSA benefit estimates	Other cost estimates	Other benefit estimates
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 ¹⁸³	One-off: 0.48% – 1.46% operating expenses ¹⁸⁴ Ongoing: (-)0.15% – 0.16% of operating expenses ¹⁸⁵ Other estimates 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). ¹⁸⁶	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. ¹⁸⁷
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 Annual compliance costs: £134 million – £200 million ¹⁸⁸	Prudential soundness and financial stability Coordination between supervisors promotes consistency of treatment of firms and standards of regulation across the EU, encouraging competition 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. ¹⁸⁹	One-off 0.00% - 0.01% of operating expenses On-going: 0.00% - 0.01% of operating expenses ¹⁹⁰	

183 See FSA, 'The Listing Review and implementation of the Prospectus Directive – Draft rules and feedback on CP203', 2005, Annex 3, http://www.fsa.gov.uk/pubs/cp/cp04_16_annexes1-5.pdf

184 See *Europe Economics*, 'Study on the cost of compliance with selected FSAP measures', January 2009 (report prepared for the Internal Market and Services Directorate-General of the European Commission)

185 Ibidem

186 *HM Treasury*, 'Final Regulatory Impact Assessment', 2005

187 Ibidem

188 See FSA, 'Financial Groups', 2003 (CBA focused on four key policy lines developed to implement the requirements of the FGD and the changes to the insurance group risk regime)

189 See FSA, 'Financial Groups', 2003

190 See *Europe Economics*, 'Study on the cost of compliance with selected FSAP measures', January 2009 (report prepared for the Internal Market and Services Directorate-General of the European Commission)

ANNEX 3: POTENTIAL WORDING OF THE PROTOCOLS

Wording of a potential single market protocol

PROTOCOL ON THE SINGLE MARKET

THE HIGH CONTRACTING PARTIES,

RECOGNISING the importance of maintaining the single market for the prosperity of the Union;

DESIRING to reduce barriers to trade in areas such as the digital economy, services, telecoms and energy by 20XX;

DESIRING to allow for a competitive flexible and responsive labour market;

HAVE AGREED upon the following provision, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

Article 1

So as to ensure that competition in the internal market is not distorted, all decisions relating to the internal market are to be decided by the Council of Ministers by the ordinary legislative procedure and that all decisions relating to the operation of the euro-area are compatible with the internal market of all member states.

Article 2

No provision will be introduced unless it has been subject to a rigorous impact assessment, is matched by the cancelation of a current measure, is proportional, consistent with the principle of subsidiarity and is demonstrably related to a known risk.

Article 3

No provision relating financial services will be introduced unless it is proportional, related to and seeks to remedy a known and demonstrated risk, and does not impose maximum standards on the sector, if a member state demonstrates the need to safeguard its own industry.

Article 4

That a Code on Better Regulation will be considered before any proposal is brought forward and an assessment made as to whether measures will improve growth and competitiveness of the Union economy.

Wording of a potential UK Protocol:

PROTOCOL ON THE FINANCIAL SERVICES INDUSTRY IN THE UNITED KINGDOM

THE HIGH CONTRACTING PARTIES,

RECOGNISING the importance of the financial services industry to the United Kingdom;

DESIRING to allow the United Kingdom to maintain control over the regulation of its financial services industry;

WHILST wishing to allow the United Kingdom to retain the ability to participate in regulations and measures;

ACKNOWLEDGING the United Kingdom's responsibility to act responsibly and preserve the Single Market;

HAVE AGREED upon the following provision, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

Article 1

Notwithstanding the provisions of the Treaties, where the United Kingdom indicates to the Council that it believes that a proposed regulation or directive or an amendment to an existing regulation or directive is or would in its judgement adversely and disproportionately affect its financial services industry it may request that the proposal is referred back to the European Commission, that additional assessments are made of the proposal and that suggested amendments are considered.

Article 2

Notwithstanding the provisions of the Treaties, where the United Kingdom indicates to the Council that it believes that an existing directive or regulation, a proposed regulation or directive or an amendment to an existing regulation or directive is or would in its judgement adversely affect its financial services industry it may request that the proposal is suspended and referred back to the Council. In that case, the ordinary legislative procedure shall be suspended and the validity of such a request shall not be called into question whether by the ECJ or in any other way.

Wording of a potential amended Euro Group Protocol:

Amended Protocol no 14: ON THE EURO GROUP

THE HIGH CONTRACTING PARTIES,

DESIRING to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,

CONSCIOUS of the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro,

HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

Article 1

The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is the euro and of the Commission.

Article 2

The Ministers of the Member States whose currency is the euro shall appoint the president of the European Union Council to chair their meetings.

Article 3

Member States whose currency is the euro shall not take any decisions that may restrict their ability to vote in decisions taken by all member states of the Union and not take any decisions that would adversely affect the ability of non-euro states to run their economies.

Article 4

Member States whose currency is the euro may after consultation between euro area Member States, the ECB and the European Commission join the Non-Euro Group, as established in Protocol 15.

Wording of a potential Non-Euro Group Protocol:

New Protocol no 15: ON THE NON-EURO GROUP

Article 1

The Ministers of the Member States whose currencies are not the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to their position with regards to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currencies are not the euro and of the Commission.

Article 2

The Ministers of the Member States whose currencies are not the euro shall elect a president for two and a half years, by a majority of those Member States.

Article 3

Member States whose currencies are not the Euro shall be under no obligation to join the Euro and will have the same status as that pertaining to the United Kingdom in the "Protocol on certain provisions relating to the United Kingdom of Great the UK and Northern Ireland".

ANNEX 4: QUANTIFICATION OF ADDED GROWTH IMPACT OF FINANCIAL CENTRES

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)¹⁹¹ to assess the impact on growth of the increase in financial development that could be brought about by the MiFID Directive.

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:

$$(1) \quad GDPg = \alpha GDPVOL + \beta FINDEV + \phi GDPVOL * FINDEV + \dots$$

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.

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

$$(2) \quad \frac{\partial GDPg}{\partial FINDEV} = \beta + \phi GDPVOL$$

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

$$(3) \quad \Delta GDPg = \Delta FINDEV * (\beta + \phi GDPVOL)$$

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 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.

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).

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.

¹⁹¹ See Aghion et al., ‘Volatility and growth: Credit constraints and the composition of investment’, *Journal of Monetary Economics* (2010), Vol. 57 No 3, p246-265. Note that 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.

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

	Financial development in 2000	Financial development in 2008	Growth 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%

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%
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

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% 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%, with Luxemburg an astonishing 3%. 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% of growth as its degree of financial development fell over the period.

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.

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% ($2.86/2=1.3$) simply because it does not have the level of financial development of Poland.

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)¹⁹² estimated that integration of the EU capital markets might have increased GDP growth by about 0.15% a year.

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).

¹⁹² See Guiso et al., 'Financial market integration and economic growth in the EU', *Economic Policy* (2004), Vol. 19 No 40, p523-577