The primary purpose of the House of Lords European Union Select Committee is to scrutinise EU law in draft before the Government take a position on it in the EU Council of Ministers. This scrutiny is frequently carried out through correspondence with Ministers. Such correspondence, including Ministerial replies and other materials, is published where appropriate.

This edition includes correspondence from 5 June - 4 December 2014

ECONOMIC AND FINANCIAL AFFAIRS
(SUB-COMMITTEE A)

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Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury

Thank you for EM 10197/14, dated 12 June 2014, on the Commission Communication A reformed financial sector for Europe. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 15 July 2014.

We note this overview of the regulatory reforms that have been agreed since the financial crisis erupted in 2008. We agree with your conclusions that the analysis lacks rigour due to the insufficient quantitative data available, coupled with the fact that certain reforms have not yet been implemented, and thus cannot be analysed in the review.

In that context we have chosen to focus a new inquiry into the EU financial sector regulatory framework. Our inquiry will draw attention to some of the areas where conflicting and overlapping regulation give cause for concern, and shall seek to build on the Commission’s work by identifying and highlighting any gaps or inconsistencies in the regulatory framework. We will focus on issues that have been identified by the Commission’s review such as: the resolution of interconnected and systemically large financial institutions as well as ensuring an effective and coordinated approach to supervision and implementation of the regulations. We will also gather evidence on the following areas:

— Which elements of the reforms have been most and least effective in addressing: consumer protection; market efficiency, transparency and integrity; and financial stability?
How effective are individual pieces of legislation such as the Alternative Investment Fund Managers Directive? What will the impact be of such legislation on the UK?

How effective has the legislative process been over the course of the financial crisis? Which EU institutions have been most or least effective?

How can the ‘growth agenda’ and support of alternative financing sources best be promoted by the EU with respect to regulation?

Are there any overlaps, contradictions or inconsistencies when assessing and comparing individual pieces of the regulatory agenda?

How can it be ensured that there is an effective and coordinated approach to supervision and implementation of the regulatory agenda?

Do areas of the regulatory agenda need immediate revision/reform? If so, how might the effectiveness of the review clauses which apply to the new measures be best ensured?

Whether the Commission is correct in asserting that new and/or forthcoming proposals on Bank Structural Reform, Shadow Banking, Benchmark Regulation and Non-bank Resolution will complete the financial sector reform agenda, and if not, which policy gaps remain?

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

Has the ‘too big to fail’ problem been addressed?

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

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

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

What is your assessment of the impact of the new Rulebook on third-country actor access to the EU and of the approach taken to ‘equivalence’?

Is there a danger of ‘multiple jeopardy’ arising from the multiplicity of regulatory regimes across the EU and beyond?

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

What are the challenges of the regulatory reform agenda for non-eurozone Member States? In particular, which specific challenges does the UK face?

Were financial regulatory proposals improved or weakened by the input of the Council and the European Parliament?

How can it be ensured that there are mechanisms in place to fine-tune the regulatory system where necessary without disrupting financial stability and predictability for financial users? Should there be a period of calm before further reforms are introduced?

How has the UK’s approach to the regulatory reform agenda compared with that of other non-eurozone Member States such as Poland and Sweden?

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

Finally, the Commission document cites the forthcoming review of the European System of Financial Supervision. We are aware of media reports of a leaked draft of the report. Given that the report
was due to be published in late 2013, can you shed any light on why it has been delayed? When do you anticipate that it will be published?

The Call for Evidence for this inquiry has been launched today, and we invite HM Treasury to respond to that consultation. In the meantime we now clear the document from scrutiny.

16 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter dated 16 July 2014, on the Commission Communication *A reformed financial sector for Europe*, the Committee’s new inquiry into the EU financial sector regulatory framework and the Commission’s review of the European System of Financial Supervision.

We welcome your inquiry into the EU financial sector regulatory framework. Many of the areas that this will focus on were raised in the call for evidence to the HM Treasury-led report on financial services and the free movement of capital, which has just been published and forms part of the broader Government review of the Balance of Competences between the UK and the EU. We received around 70 pieces of evidence, including from banks, insurers and other financial services companies, industry groups, consumer organisations, and a number of individuals including MP/MEPs and academics.

The evidence base was also informed and extended through 15 engagement events with around 200 organisations and individuals in the UK and the rest of Europe. A copy of the final report is attached [not printed] to this letter and copies have been placed in the House. I hope that the report and all the evidence submitted, which has been published alongside, provide a useful source for the Committee’s inquiry. I would especially like to draw your attention to the volume of responses and evidence from stakeholders reflecting concerns about the quality and appropriateness of the EU policy-making process on financial services since the crisis. Concerns raised by stakeholders covered many aspects of the process and the HMT report sets out a number of possible ways to improve the standard of financial services regulation going forward.

You also raised some questions regarding the publication of the Commission’s review of the European System of Financial Supervision. It is not clear why this has been delayed, although the cross-cutting nature of the European Supervisory Authorities and the European Systemic Risk Board and the ongoing development of key pieces of financial services regulation in recent months may have contributed to the delay. As to the likely publication date, we expect this to be in July or August 2014.

18 July 2014

**AUTOMATIC EXCHANGE OF INFORMATION IN THE FIELD OF TAX (10243/13)**

Letter from David Gauke MP, Financial Secretary, HM Treasury, to the Chairman

With sincere apologies for the lateness of the hour I am writing to inform you about a unanimity dossier – the amending proposal to the Directive on Administrative Cooperation - that is on the agenda for political agreement at the ECOFIN meeting on 14 October. This Directive, which brings into EU law the new global standard for automatic exchange of tax information, is a political priority for the UK. The last time that your Committee was updated on the Directive was in September 2013. Little has happened on the Directive between then and the final agreement of the new global standard and its detailed commentaries in July of this year following the consensus of OECD countries. This was because the purpose of the Directive was simply to implement the global standard into EU law and until that standard was agreed no real progress could be made in EU negotiations. Since the agreement of the global standard the Italian Presidency has proceeded at great speed with the intention of adoption of the Directive by the end of this year in line with the mandate from the May European Council.

While this dossier has moved very quickly and there has been a limited window between the summer and conference recess, I fully acknowledge that we should have updated the Committee earlier based on our expectation for the final shape of the Directive. I apologise sincerely for that.

As said above, this is an important Directive for the UK. The UK has led on the development of the new global standard on automatic exchange of tax information, including through our G8 Presidency where this was the first of the ten commitments in the Lough Erne Declaration. Global implementation of this standard will largely put an end to offshore tax evasion except by the most
determined criminals with important implications for revenue protection and for maintaining the confidence of honest taxpayers in the fairness and effectiveness of our tax system. The main features of the new standard are that it will require the reporting of account balances and account holder details of foreign tax residents, both individuals and entities, for both new accounts and for pre-existing accounts to the country in which the account holder is tax resident. It is largely based on US FATCA but contains important simplifications as a result of the reporting on the basis of tax residency rather than citizenship (which allows the account holder’s address to be the main indicator of tax residency). While we have yet to finalise the impact assessment for domestic implementation we expect the costs to industry to be a small proportion of the FATCA implementation costs. This is based on our experience with our bilateral agreements with the Crown Dependencies and the reduction in burden that will come from the repeal of the EU Savings Directive as explained below.

In addition to our G8 Presidency, the UK has been in the forefront of the development and implementation of this standard on multiple fronts. In April 2013, together with France, Germany, Italy and Spain we launched an initiative aimed at early adoption of the new standard once agreed. Many other countries and jurisdictions have joined this initiative over the past eighteen months. In February of this year we took the further step of announcing a concrete timetable for implementation which will see the standard implemented from the end of 2015 with the first exchange of information between the early adopter countries in 2017. A total of 48 countries and jurisdictions have agreed to implement to this timetable, including 26 EU Member States. The full list and the implementation timetable can be found at: http://www.oecd.org/tax/transparency/AEOI-early-adopters-statement.pdf

While not yet fully public, as a direct result of the lead shown by the early adopter group launched by the UK, almost all major financial centres have now signed up to this timetable or have agreed to exchange one year later. This includes all of the G20 countries which agreed at their September meeting to begin exchanging information automatically in 2017 or by 2018. Switzerland and Hong Kong have also recently publicly announced their intention to begin exchanging information under the new standard from 2018. Two years ago it was unthinkable that we would have made such progress.

The global standard is now being brought into EU law by amendments to the existing Directive on Administrative Cooperation (DAC) - 2011/16/EU. We are fully supportive of this, although our negotiating aim has always been to ensure full alignment of EU law with the global standard. This is something we have also pressed at European Council level and is reflected in the May 2014 Conclusions of the European Council. If we had a situation where there were different, competing standards then this could rapidly lead to fragmentation, increasing the difficulty of agreeing any further improvements over time on a global basis, and would lead to significant and unnecessary burdens on business. We have been successful in this aim and the Directive simply imports the standard into EU law. The one area where there has been some discussion of the standard with the industry is on a provision in the global standard which exempts the reporting of certain insurance contracts in some situations where a sale is effectively prevented by law. Member States, the Commission and the Council Legal Services did not agree with the industry’s interpretation in the EU context and this is reflected in the final Directive text.

The Directive does not raise any issues of competence (although we had to work hard to remove a provision for comitology in the final meeting last week which had been pushed by the Presidency and supported by other Member States but which would have crossed UK red lines). The Directive is also fully in line with EU data protection law, something we have discussed at length with the Information Commissioner’s Office and which has been considered in depth by the relevant EU Committee.

Following political agreement of the Directive the intention is to give a mandate to the Commission to repeal the EU Savings Directive which overlaps with but is inferior to the new standard and relatively easy to avoid. Repeal of the EUSD and the removing of the unnecessary burdens it would occasion following agreement of the DAC will be welcomed by the UK financial services industry. While the Commission accept the need to repeal the EUSD, this is time critical as unless the DAC is agreed now and the EUSD switched off, we and the financial services industry will have to begin implementation of the amended EUSD which was agreed earlier this year but has not yet been implemented. This would lead to a significant wasted cost. Agreeing the Directive now is also important as regards ensuring implementation to the agreed timetable by all EU Member States. In order to give financial services firms sufficient time to make necessary administrative and IT system changes, they need the certainty of legislative requirements which the Directive brings. Agreement will also send a clear message globally of the need to move quickly from political commitments to legislative implementation.

The one outstanding issue on the Directive which we expect to agree at the ECOFIN is the date of implementation. The 26 Member States which have signed up to our early adopters initiative wish to
exchange under the directive from 2017 in line with the early adopter timetable. However two
member states which do not currently exchange under the EU Savings Directive (using an option of
withholding tax instead) are arguing for an additional year for implementation. Discussions are
ongoing but a compromise is very likely to be reached at the ECOFIN which may result in two
different implementation dates, one year apart. While this is not our preference this is a unanimity
dossier and this may be a necessary compromise to reach agreement. Different dates for two
Member States will, however, make little difference to the impact of the Directive given the truly
global take up of the standard which removes hiding places and therefore the incentive to move
money between countries.

With apologies again for the lateness of this letter, I would be very grateful in the light of the
explanation above if your Committee would be able to waive or clear this dossier from scrutiny in
time for the 14th October ECOFIN. The officials who lead on this policy area in the Treasury stand
ready to provide any further information which would be helpful in your consideration. If it is not
possible to obtain clearance to that timetable then I hope that the Committee will understand the
reasons why I believe it is important for UK objectives and for the UK’s reputation as the leader in
tackling tax evasion for us to give support to political agreement on this dossier at the October
ECOFIN.

13 October 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 13 October 2014, on EM 10243/13: European Commission proposal
for a Council Directive amending directive 2011/16/EU with regards to the mandatory exchange of
information in the field of taxation. The House of Lords European Union Sub-Committee on
Economic and Financial Affairs considered this document at its meeting on 21 October 2014.

It is highly regrettable that this letter was only received immediately before political agreement was
sought at the ECOFIN meeting on 14 October 2014. As you yourself state, this is an important
Directive that seeks to implement the new global standard on automatic exchange of tax information.
We acknowledge the leading role played by the UK in these global discussions, and well recognise
why the file is, in your words, a political priority for the UK. Yet this fact makes your failure to update
the Committee sooner all the more disappointing. For your obligations to a Committee of the House
of Lords to be overlooked in such a high-profile case gives the impression that HM Treasury does not
take the parliamentary scrutiny process seriously. While we note your apology, what reassurance can
you give us that all necessary steps are being taken to ensure that such an error is not repeated?

We understand that a General Approach was indeed reached at the 14 October ECOFIN. We would
be grateful for a full account of the outcome of negotiations, as well as clarification of the following
points.

You state that you have yet to finalise the impact assessment for domestic implementation but that
you expect the costs to industry to be a small proportion of the FATCA implementation costs. Can
you be more specific? When do you anticipate the full impact assessment to be finalised?

You state that two Member States were arguing for an additional year for implementation. We
understand that Austria and Luxembourg are the two Member States in question. What was the
reason for their reticence? We would be grateful for details on the outcome of the discussions at
ECOFIN on the date of implementation. We understand that Luxembourg agreed to a 2017
implementation date, whereas Austria requested an extension to 2018 on the grounds that it needed
to create a new reporting system. Can you confirm this? While we note your statement that this will
make little difference to the impact of the Directive, can you be more specific about the practical
implications of this discrepancy?

You state that the one area where there has been some discussion of the standard with the industry
was on the provision in the global standard which exempts the reporting of certain insurance
contracts in some situations where a sale is effectively prevented by law. Can you be more specific
about the nature of the disagreement between the Commission and Member States on the one hand,
and the industry on the other? Can you clarify if the final Directive text is in line with the global
standard in this case?

You will be aware that the Sub-Committee agreed on 13 October 2014 to grant a scrutiny waiver.
Nevertheless we continue to hold the document under scrutiny pending your response to this letter.
We would be grateful for a reply by 4 November 2014.

21 October 2014
Letter from David Gauke MP to the Chairman

May I begin by thanking you for the flexibility of the House of Lords EU Select Committee and its Sub-Committee in giving such rapid consideration to my letter of 13 October seeking a waiver for the UK joining the political agreement at the 14 October ECOFIN on the proposed amendment to the Directive on Administrative Cooperation. As set out in my earlier letter these amendments bring the new single global standard on automatic exchange of taxpayer information into EU law and move us closer to the implementation of the new standard on a global basis.

I have attempted to address the further points you raise in your reply of 21 October below and hope the information provided will enable your Committee to clear the dossier from scrutiny which is now expected to be put on the agenda for adoption at the 9 December ECOFIN.

I am pleased to report that political agreement by all Member States was reached at the ECOFIN. In a very welcome development Luxembourg agreed in the final negotiations to the implementation of the amending Directive to the same timetable as had already been agreed by 26 other Member States, removing any need for delayed implementation in its case. This timetable will see the first exchange of information in 2017 in respect of accounts that are open at the end of 2015 and new accounts opened from 1 January 2016.

It was, however, agreed that Austria could have up to a year more for implementation. Austria argued that it needed additional time in order to create “links” between Austrian financial institutions and the Austrian Tax Authority since they do not currently exchange information under the Savings Directive (but have withholding arrangements instead). This is not something that we have ever understood and my officials have engaged with the Austrian Finance Ministry on this on a number of occasions. There is no need for new infrastructure. The information can pass in encrypted form through ordinary secure internet links as we would expect to be the case between Austrian financial institutions and the US tax authorities under FATCA. However, in order to reach agreement by the end of the year, as asked for by the Heads of State at the European Council in May, this compromise was agreed. As you may know, the Austrian Finance Minister stated at the ECOFIN that he would make all efforts to try and meet the 2017 exchange timetable and we are hopeful that as they examine implementation issues further that they will be able to do so.

As I said in my earlier letter, our view is that a difference of one year in implementation will make little practical difference. The main risk that we have been concerned with in our wider and highly successful diplomatic efforts to get all financial centres on a 2017 or 2018 first exchange timetable is the possibility of evaders simply moving their assets between jurisdictions that have announced implementation plans and those that have not. We judge this risk to be minimal where the difference in timetable is just one year. In the meantime, of course, Austria will continue to withhold under the EU Savings Directive in respect of UK taxpayers. (As regards the success of our wider efforts, I have attached an annex [not printed] which sets out the jurisdictions which have made commitments to implement the global standard to a 2017 or 2018 timetable. As you will see this includes virtually all financial centres.)

Finally as regards the ECOFIN, as foreseen in my letter Finance Ministers also agreed to give a mandate to the Commission to repeal the Savings Directive, subject to appropriate transitional arrangements to ensure there is no gap in coverage for Austria or the five EU third countries (Switzerland, Liechtenstein, Monaco, Andorra and San Marino). This will avoid any duplication which would result in increased and unnecessary burdens and costs for the financial services industry. Ministers also called for the existing Savings Agreements with the third countries to be brought into line with the new global standard. The Commission expressed optimism that such agreements would be reached in a very short time frame.

Turning to your other points, the draft impact assessment for domestic implementation will accompany draft legislation to give effect to the new Directive (which will be in line with our planned implementation of the global standard on which HMRC has been consulting). We are aiming to consult on draft legislation by the end of the year.

We expect the costs of implementation of the Directive to be a small proportion of the FATCA implementation costs based on our experience with the bilateral agreements that we reached with the Crown Dependencies and Gibraltar. These agreement were based on FATCA but with some changes to reflect the different circumstances, in particular taxation on the basis of residency. The impact assessment that we published with the regulations for the agreements can be found at:

As you will see, the estimate for costs on business were £50 million to £110 million. This contrasts with the estimated costs of FATCA implementation of between £1,100 million to £2,000 million:


We would expect the implementation of the Directive to result in costs closer to the agreements with the Crown Dependencies and Gibraltar than the estimated FATCA costs. This is because industry will already have made many of the necessary IT and administrative changes in implementing FATCA and the CD/Gibraltar agreements and because of further simplifications to the due diligence process under the global standard. In addition, the switching off of the EU Savings Directive when the Directive comes into force will result in as yet unquantified savings. We will also continue working very closely with industry to minimise costs.

On the question of the discussion of the standard with representatives of the insurance industry I can confirm that the Directive is in line with the global standard. There was difference in interpretation of the commentary to the new standard (a form of guidance) between the Member States and representatives of the insurance industry. The global standard does not require reporting of insurance or annuity contracts where this is “effectively prohibited by law”. The commentary stated that “where the applicable law does not prohibit Reporting Financial Institutions from selling insurance or annuity contracts outright, but requires them to fulfil certain conditions prior to being able to sell such contracts to residents of the Reportable Jurisdiction (such as obtaining a license and registering the contracts), a Reporting Financial Institution that has not fulfilled the required conditions under the applicable law will be considered to be “effectively prevented by law” from selling such contracts to residents of such Reportable Jurisdictions”.

Representatives of the insurance industry had taken this to mean that where an insurance company had not undertaken the administrative steps required under European legislation (Directive 2002/83/EC) then they were effectively prevented by law. This was not an interpretation shared by the EU Member States which negotiated the commentaries in the OECD and which would not have agreed the commentary on the interpretation given to it by industry representatives. A number of Member States have said that they experience significant numbers of sales to the residents of other EU Member States by insurance companies that have not undertaken the administrative steps and they wish this to be the subject of reporting (as it is in our agreements with the Crown Dependencies). The Commission and the Council Legal Service were also of the view in the negotiations that the administrative steps required by EU law did not amount to sales “effectively being prevented by law”.

I should be clear, though, that HMRC are working closely with all industry representatives on UK guidance on the Directive which should clear up what seem to be a number of misunderstandings about the due diligence required for pre-existing accounts which will hopefully reduce industry concerns about the burdens.

Finally, I apologise again for the delay in keeping the Committee informed and the urgency with which we sought scrutiny clearance. While not excusing it in any way, in this particular instance a number of factors came together which contributed to the oversight. As you kindly acknowledged in our recent meeting, HMT’s record on scrutiny has improved markedly over the last while, and I hope you would appreciate that this was an isolated incident. However, let me assure that we are putting in place further measures on top of our existing systems and guidance (which have held us in good stead for the last two years) to help ensure that this is an incident that is not repeated.

I hope the above answers your questions and that your Committee will be able to clear this dossier from scrutiny. As set out above, we are currently expecting formal agreement to be sought at the ECOFIN meeting on 9 December.

Thank you again for such quick consideration of my earlier request.

26 November 2014

Letter from the Chairman to David Gauke MP


We are grateful to you for this comprehensive response to our letter of 21 October 2014. Nevertheless there are two points on which we would be grateful for further details.
First, you state that the costs of implementation will be closer to that in respect to the Crown Dependencies/ Gibraltar bilateral agreement than the FATCA implementation costs. However this does not provide any useful estimate of the costs given the vast gulf between the costs that you cite. Can you be more precise about the broad range of costs that are expected? We note the draft impact assessment will be brought forward alongside draft legislation, and that you aim to consult on this by the end of the year. We would be grateful to you to keep us updated on the publication of the draft impact assessment and legislation and the launch of the consultation process.

Second, with regard to the problems with the scrutiny process in relation to this legislative file, you state that “we are putting in place further measures on top of our existing systems and guidance … to help ensure that this is an incident that is not repeated”. Can you give more details about the steps you are taking?

We would be grateful for a response to this letter by 16 December 2014. In the meantime we now clear the document from scrutiny.

2 December 2014

BANK RECOVERY AND RESOLUTION (11066/12 12386/10)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury


We are grateful to you for your update on developments regarding your attempt to clarify the articles relating to the writedown of capital instruments at the point of non-viability. However we would be grateful for clarification on a number of points. First, why was the oversight not spotted until such a late stage in the negotiating process? What steps are you taking to ensure that such an oversight does not occur again in the future?

Media reports state that the Netherlands, Finland and the Czech Republic all formally objected the UK’s proposal, and that Germany also expressed concerns. What was the specific nature of these objections? Did those Member States share any concerns about the implications for mutual support for failing institutions, in particular in the context of the Single Currency?

Given that the Government’s proposed amendment was not accepted, are you working with the Bank of England to identify a solution to address the issue? What form will such a solution take?

We would be grateful for a response to this letter by 24 June 2014.

10 June 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter, dated 10 June 2014, on the Bank Recovery and Resolution Directive (BRRD).

As you will be aware, negotiations on European Directives can be extremely fast-moving, with new texts arriving on a regular basis. It is of course regrettable that this issue was not spotted until a late stage, making it difficult to address. Now that the Directive has been adopted and published, the Treasury will, in keeping with standard practice, be reviewing the file and assessing lessons learned. That process will include considering how this oversight occurred, and if necessary ensuring procedures are in place to prevent similar incidents in the future.

It is not appropriate to discuss the views which other Member States expressed during Council meetings, and I regret that it is not possible to provide detail beyond what has been suggested in media reports.

Following the agreement of the BRRD, we are now focused on transposition of the Directive. The Government is engaging with the Bank of England to consider any implications for the provision of state-indemnified Emergency Liquidity Assistance and are optimistic that the issue will be effectively addressed as part of the transposition process.
In July, the Government intends to publish a consultation on transposition of the BRRD. I would be happy to update you at that point.

27 June 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 27 June 2014, on EM 11066/12, the Bank Recovery and Resolution Directive. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 8 July 2014.

We welcome your statement that HM Treasury will be reviewing the lessons learned from this file in order to ensure that similar mistakes are not repeated in the future.

You state that it is not appropriate to discuss the views which other Member States expressed during Council meetings. However our question is justified given that media accounts suggest that the discussion in Council was more contentious than your letter of 11 May 2014 implied, when you stated that “the speed of the process, number of stakeholders and level of technicality and complexity meant that it was difficult to secure sufficient focus on the substance of our proposal”.

While we appreciate that the negotiating positions of other Member States remain confidential, we would be concerned if you were to rely on this principle to refuse to inform us of the different views within the Council on a proposal. As you will know from past experience, this can be done in general terms; it does not require disclosure of details which would compromise a Member State’s negotiating position or undermine the decision-making process of the Council. If the Government now refuses to do so, it will severely restrict our ability to scrutinise these policies effectively, and we will wish to pursue the matter further. So we ask you again to provide us with an outline of the different views in the Council on the amendment proposed by the UK.

We welcome your commitment to update the Committee when the Government publish their consultation on transposition of the BRRD. We would be grateful if this update could address in more detail how the provision of state-indemnified Emergency Liquidity Assistance will be addressed in the transposition process. We would be grateful for a response to this letter by 28 July 2014 at the latest.

9 July 2014

Letter from Andrea Leadsom MP to the Chairman


In my letter of 11 May I wrote to you about the Jurist Linguist process on the BRRD, to clarify the Government’s position in the context of media reports. You responded on 10 June asking questions on the specific positions expressed in private negotiations and on 9 July you asked for broader information on positions and asked again about the specifics of negotiations.

Let me first say that in my 11 May letter, I reflected on the use of state-indemnified Emergency Liquidity Assistance (ELA) across the EU and stated that our view had gained support in technical discussions. More broadly my letter made clear that the changes we requested merely sought alignment with the trigger conditions for bail-in that had already been agreed by Council and with the Basel 3 agreement which requires that capital instruments are written down or converted when a non-viable firm accesses public finances. Secondly, as a number of members of your Committee who have been involved in these types of negotiations are fully aware, the Jurist Linguist process is conducted at a rapid pace, with Member States putting forward technical suggestions and then being asked to take immediate positions on the suggestions of others. Amendments are only accepted when there is unanimous support for them. As stated in that letter, the reason the amendment was not accepted was due to the nature of the decision making process, including its speed, which prevented sufficient focus on the substance of our suggestion.

In your letter, you also ask for an update on how the provision of state-indemnified ELA will be addressed in the transposition process. The Government’s consultation on the transposition of the BRRD has now been published and is available at:


The section on Emergency Liquidity Assistance (ELA) is on p.47. Here, the Government sets out its interpretation of what the BRRD requires in relation to the provision of state-indemnified ELA. In our view, the requirement in the BRRD to write-down or convert relevant capital instruments
following the provision of State aid only applies in circumstances where there are losses to absorb, since the BRRD requires that the instruments are written down “in proportion to the losses”. Therefore, when state-indemnified ELA is provided to a solvent bank that does not need to absorb losses or be recapitalised, then write-down is not required.

In cases where a bank is failing to meet its capital requirements, under the State aid guidelines, state-indemnified ELA may be provided for up to two months before burden sharing is required. During this time the bank could be attempting to recover its capital position for example by divesting assets or undertaking a liability management exercise. In such cases, ELA provides the bank with liquidity to enable it to keep operating while it attempts to recover its capital position. ELA does not provide additional capital to the bank. The Government considers that the BRRD should be interpreted similarly where a bank fails to meet its capital requirements but has a recovery plan underway and repays the ELA within two months. If the ELA is not repaid within two months, then burden sharing will be required.

The Government therefore does not consider that it is necessary to place any requirement in legislation for write-down to occur immediately upon the receipt of state-indemnified ELA, and the existing arrangements in the UK can be maintained.

The amendment we sought during the Jurist Linguist process would have made this position clearer. However, we believe that it is still the most reasonable interpretation of the text.

8 August 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 8 August 2014, on EM 11066/12 on the Bank Recovery and Resolution Directive. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 9 September 2014.

While we note your explanation of the Jurist-Linguist process, we remain concerned that such a significant issue was not spotted until such a late stage when the likelihood of amendments being accepted is so slim. In reply to our query as to why the problem was not spotted earlier, you wrote on 27 June 2014 stating that negotiations can be fast-moving and expressing regret that the issue was not spotted until such a late stage. You also said that HM Treasury would “be reviewing the file and assessing lessons learned. That process will include considering how this oversight occurred, and if necessary ensuring procedures are in place to prevent similar incidents in the future.” Has this review now been conducted? What further details can you give us as to why this oversight occurred, and the steps you have taken to prevent similar incidents in the future?

We may seek to address this point at your appearance before the Sub-Committee on 4 November 2014. We would therefore be grateful for a response to this point by 13 October 2014.

10 September 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter, dated 10 September 2014, on the Bank Recovery and Resolution Directive (BRRD). You requested an update on the “lessons learned” review following the conclusion of the BRRD negotiations.

Our review of lessons learnt has concluded. The problems which occurred in this instance can be summarised as a mixture of human error – the issue was missed during the busy stages of a complex and fast moving process; and political sensitivities which meant that the issue became difficult to resolve due to the sensitive nature of the file, the late stage in the process, and the fact that the issue had been picked up by the media.

Sessions have been held with staff from all relevant parts of Treasury highlighting this example, and it is also reflected in the written guidance issued to staff in relation to managing EU legislative files, to help ensure issues of this nature are minimised in future.

As outlined in my previous letter, the Government believes that existing arrangements for the provision of emergency liquidity assistance can be maintained. Overall, the outcome of the BRRD negotiations was very positive for the UK.

20 October 2014
Letter from the Chairman to Nicky Morgan MP, Financial Secretary to the Treasury, HM Treasury


We are grateful to you for this update, and in particular for helpful sight of the joint letter from the UK, German and Dutch Finance Ministers to the Greek Presidency, expressing your concerns. Having previously exhorted the Government to maximise their efforts to work with other Member States in common cause, we congratulate you on this positive and innovative approach.

We note that the Greek Presidency has suspended article-by-article discussion of the proposal, but that the Commission is nevertheless seeking further discussion. We would be grateful for further updates once the next steps become clear. In the meantime we will continue to hold the document under scrutiny.

10 June 2014

EU BUDGET FOR 2014/2015 (DAB3/2014) (10340/14, 15444/14)

Letter from the Chairman to Nicky Morgan MP, Financial Secretary, HM Treasury

I am writing with regard to COM (2014) 329 FINAL, Draft Amending Budget No 3 (DAB 3) to the General Budget 2014. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 10 June 2014.

We understand that your EM on this proposal is shortly to be received. However, given the importance of the document we have taken the decision to write to you at the earliest opportunity.

The Commission defends this proposal on the grounds that budgetary pressures make recourse to further funds unavoidable. In light of the significant figures involved, we would be grateful for your detailed response to the Commission’s assertions, as follows.

What is the principal cause of such a large amendment being proposed? Is it the backlog of unpaid payments from the previous MFF period, the front-loading of the current MFF, unforeseen circumstances, or a combination of all three?

Given that the Contingency Margin is defined as “a last-resort instrument to react to unforeseen circumstances”, is the Commission’s proposal to resort to it as “the only available instrument to react to the budgetary impact of unforeseen circumstances” justified? Is it justified in seeking to mobilise the Contingency Margin for 2014 in full? Can you confirm reports that the UK and seven other Member States have written to assert that “a proposal for the mobilisation of the contingency margin in 2014 would not only be legally questionable but also unnecessary, premature and not a ‘last resort’ option”? What is the basis for this assessment, and in particular your argument that recourse to the contingency margin is legally questionable?

The Commission repeatedly cites a major shortage of payment appropriations as a justification for the proposal. It notes that shortages of payment appropriations are visible across all headings, and that there is a sizeable backlog of unpaid payment claims for 2007-13 programmes, amounting to €23.4 billion in Heading 1b (Economic, Social and Territorial Cohesion). Is the Commission correct to identify this as a problem? Why has it occurred on such a scale? What can be done to provide a long-term solution that would avoid recourse to such significant budgetary revisions as this? If funds have already been committed, for instance to ERDF recipients in Member States including the UK, where do the Government believe such funds should be drawn from, if not from the Contingency Margin?

The Commission notes six sets of unforeseen circumstances which it argues justifies calling on the Contingency Margin, including frontloading of various programmes; a top-up for the Fund for European Aid to the Most Deprived (FEAD); a large number of outstanding cohesion policy payment claims; rural development; European Fisheries Fund; and the financial package of support for Ukraine. While we accept that the ramifications of recent events in Ukraine could not have been anticipated, do you share our scepticism that all the other circumstances cited by the Commission were entirely unforeseen? If our scepticism is justified, why were such problems not taken into account in previous budgetary negotiations?
The Commission states that it has taken into account the “extremely limited” possible sources for redeployment. However it appears only to have identified €65 million from the reserve for Sustainable Fisheries Partnerships Account that can be reallocated. Do you share our view that it is unlikely that all possibilities for redeployment have been exhausted? If so, which other areas would you identify as potential targets for redeployment?

Do you share our concern about the Commission’s warning that it may also have to propose the mobilisation of the Contingency Margin for 2015 at a later stage? Is the Commission’s warning that offsetting the Contingency Margin in 2016 “would be imprudent” a tacit admission that it will also need to be mobilised in 2016? In light of this, is it realistic, as the Commission asserts, to expect the offsetting to be distributed over the years 2018-2020, because such additional payment needs “are to a significant extent compensated by lower payment needs in later years of the 2014-2020 MFF”? What will happen if this does not prove to be the case?

In our letter to the former Financial Secretary to the Treasury, Rt Hon Greg Clark MP, on 24 July 2013, we asked if he could give any guarantee that the 2014 Draft Budget would not be subject to significant further amendment. We expressed concern about the effect on budgetary discipline of the decision to provide flexibility between years. We also warned that the relationship between payment and commitment appropriations had broken down. At his appearance before the Committee the previous day, we warned that in the deal secured on the MFF, there may be the potential for problems in the future in terms of front-end loading, which would increase the pressure on the budget. In our 15 October 2013 letter to his successor, Rt Hon Sajid Javid MP, we drew attention to the potential for, and consequences of, front-loading of annual budgets under the MFF, and suggested that the headline deal achieved in 2013 was therefore not as good as at first sight and had not addressed fundamental problems.

Noting that the Commission specifically cites front-loading as one of the “unforeseen circumstances” that have necessitated this budgetary amendment, do you agree that this proposal has borne out our predictions? What do such apparently intractable problems indicate about the efficacy of the EU budgetary process? Do they demonstrate that the mechanics of the process are no longer fit for purpose and need to be significantly overhauled? If so, how can the process be reformed to ensure that the budgetary process does not repeatedly and irretrievably break down?

We would be grateful for a response to these questions, as well as a full account of the timetable for negotiations on the proposal, by 24 June 2014. We also look forward to discussing these issues both with yourself and the Commission in the context of our forthcoming scrutiny of the Draft Annual Budget for 2015. In the meantime we will hold this document under scrutiny.

10 June 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter asking detailed questions on the Draft Amending Budget No.3 to the General Budget 2014 (DAB3/2014). As you acknowledge in your letter, you wrote in advance of receiving the Government’s Explanatory Memorandum on DAB3/2014 – and this EM, which has subsequently been sent, sets out the Government’s overall position.

The current timetable of negotiations has not changed since the submission of the EM. It remains unclear when the Presidency will return the proposal to Budget Committee for further discussion. The negotiation on DAB 3/2014 may be taken forward in parallel with the wider discussions on the draft annual budget for 2015, which will follow the usual timetable over the second half of 2014.

In your letter, you begin by asking the cause of the size of the Commission’s proposed amendment. The Commission’s argument is based on all the points you suggest in your letter. The Commission cite the unpaid payments from the previous MFF period and frontloading of the current MFF as reasons for why they need more money now. They also make the claim that both of these were “unforeseen” at the time of the agreement to the MFF ceilings. In addition, they present some other elements of the request as purely “unforeseen”, such as the funding for Ukraine.

You ask whether we accept the Commission’s rationale for requesting mobilisation of the Contingency Margin (“CM”), and also about the joint statement issued on the CM with other Member States. The Government does not agree with the Commission that the CM is “the only available instrument to react to the budgetary impact of unforeseen circumstances”. As set out in the Government’s EM on DAB3/2014, the Government’s view is that the Commission should always look first to reallocate funds from within existing agreed budgets to meet emerging in-year pressures, rather than coming to Member States with requests for additional money.
The UK signed a joint statement along with seven other Member States – Germany, Sweden, Denmark, Netherlands, Finland, Austria and France – and it is included in an annex [not printed] which sets out the jurisdictions which have made commitments to implement the global to this letter for your information. This was prepared in advance of the publication of DAB3/2014, and as such addressed expectations (namely the mobilisation of the CM to meet commitments dating from before this MFF) rather than the actual content of DAB3/2014. Having said this, the sentence which you highlight in your letter is fully in line with the Government’s current position on DAB3/2014, as expressed in the EM, and is based on the same assessment – i.e. that the Commission should always look first to reallocate funds from within existing agreed budgets.

In terms of the specific point you make around the argument that the mobilisation is “legally questionable”, the Government does not have a definitive legal position on this issue. One potential argument could say that, given the CM may only be mobilized “as a last-resort instrument to react to unforeseen circumstances”, payments for pre-2014 commitments by definition cannot be considered as “unforeseen circumstances” and thereby are not a legitimate premise for mobilisation of the CM.

The inclusion of this argument in the joint statement reflects that this was one of several issues being considered by the signatory Member States in questioning whether the Commission should be mobilising the CM at this stage. The Government’s primary position on DAB3/2014 is not a legal one but the principled position set out in the EM and reiterated above.

You ask several questions about the backlog of unpaid payment claims under heading 1b, and what the Government feels should be done about this. First, the Government recognises that this is an issue that has to be addressed, insofar as it represents a pressure on the EU budget in this and in future years. The Commission states that it has arisen as a result of Member States submitting claims in 2013 around €10bn (£8bn) above those from 2012.

In terms of a long-term solution, the Government does not accept that significant budgetary revisions are required. These claims represent one pressure which has to be managed by the Commission alongside many other pressures. This should be done in a manner which sees real budgetary restraint, in this and in future years, and the solution need not be higher budgets. The Government has not given the Commission specific instructions as to where in the budget these funds should be drawn from, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money if re-allocation is required.

You also ask why these problems were not taken into account in past budget negotiations. The Commission should have made better provision for them in compiling the detail of the 2014 budget, insofar as they were aware of these pressures. I do not think that the emergence of these pressures indicates that the Government should have taken a different approach to the budget negotiations, which were informed by our commitment to payment restraint.

You express scepticism that the Commission have exhausted all possibilities for redeployment as alternatives to bringing forward DAB3/2014. The Government shares this view, in particular given that, as you point out, the Commission have found only €65m in potential reallocations. In terms of where such funds should be found, as stated above, the Government has not given the Commission specific instructions, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money.

The Government has put its views on DAB3/2014 clearly and repeatedly to the Commission and other Member States, initially via the joint statement and subsequently in the official-level Council Budget Committee and other meetings. In doing so, we have been supported by the other Member States which signed up to the joint statement.

You then express a longer-term concern that the Commission are planning to mobilise the CM repeatedly in future years, raising questions about whether these funds could be offset at the end of the MFF period. You refer to previous letters and comments made by the Committee raising concerns that the scope for “front-loading” annual budgets via the use of the CM rendered the MFF “not as good as at first sight”. Finally, you ask whether these issues demonstrate that the mechanics of the EU budget process are no longer “fit for purpose” and are therefore in need of significant reform.

I agree, in a general sense, that the Commission are likely to continue to come forward with significant requests for funds in future years – their recently published draft budget for 2015, an EM on which you will be receiving alongside this letter, is evidence of this trend. It is clear that significant
front-loading into the first few years of the MFF (i.e. via multiple annual budgets at the payment ceilings and mobilisations of the CM) would impose pressure on later years of the deal.

The Government does not accept, however, that these recent developments have in any way demonstrated that the MFF is "not as good as at first sight". The MFF agreed last year delivered the first ever real terms cut to the EU budget. The MFF deal included provision for the CM to operate as a mechanism to move expenditure between years but within the overall MFF ceiling. The fact that the Commission have chosen to request the mobilisation of the CM in the first year does not in itself indicate that the MFF and the mechanics of the EU budget specified within in are unfit for purpose.

The Government is very clear in its support for budgetary restraint in the EU, and is mindful of the importance of a continued strong position to ensure the successful delivery of the historic MFF deal. This is why the Government has taken a clear stance in the annual budget 2015 negotiations that there should be a significant margin between the budget and the annual ceiling, and more generally takes the view that, when in year pressures emerge such as the current DAB3/2014 request, the Commission should always look first to reallocate funds from within existing agreed budgets rather than coming to Member States with requests for additional money.

It is also worth recalling that Commission proposals can be blocked on a qualified majority vote basis, and that initial Commission proposals, such as draft annual budgets, are invariably reduced through negotiations with Members States ahead of final budgets being agreed.

The initial responses given to the Commission by the Government and by other Member States on the draft annual budget 2015, in addition to DAB3/2014, demonstrate that such large requests from the Commission are not something that will be accepted as usual practice. I intervened at Ecofin last Friday to set out the Government's objections to the Commission's annual budget proposal, and was supported by a number of other Member States including Germany, the Netherlands and Sweden.

25 June 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your EM, dated 25 June 2014, on the 2015 Draft Budget, EM 10340/14 & 10341/14, dated 16 June 2014, on Draft Amending Budget 3 (DAB3) to the 2014 Budget, and your letter, dated 25 June 2014, on the same. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 8 July 2014. In doing so we took account of the evidence heard on 24 June 2014 from Nadia Calviño, Director General, DG Budget (BUDG), and Silvano Presa, Director, DG Budget (BUDG), European Commission, and your own evidence before the Sub-Committee on 1 July 2014, for which we are grateful. We are also grateful to you for ensuring that the Committee had sight of the EM on the 2015 Draft Budget in advance of the evidence session.

THE DRAFT 2015 BUDGET

The Commission states that it is proposing a 2.1% increase in commitments (to €145.6 billion) and a 1.4% increase in payments (to €142.1 billion) for 2015. We agree with you that, in doing so, the Commission is not comparing like with like, since its comparison assumes that DAB3 will be agreed as proposed. In comparison with the 2014 Budget as agreed, the Commission is, as you state, proposing a 4.9% increase in payment appropriations.

We also agree with you that in any sound budgetary process there should be a margin between the agreed budget and the annual ceiling. As you state, unforeseen pressures can and will emerge, and we note your view that past precedent suggests that the margin needs to be several billions of euros. As we explore below, the absence of such a margin is one indicator of the immense strain that the budgetary process is now under.

Having said that, your observation that the proposed level of payments expenditure “is too high” over-simplifies the problem. You state that you do not intend to plan the Commission’s budget in detail for them. While we agree with you that the Commission has a responsibility to explain why such an increase is proposed, in making your assertions it is more convincing for the Government and the like-minded Member States (you cite Germany, the Netherlands and Sweden) to make concrete proposals as to how the 2015 Draft Budget can be trimmed. In your EM and in your evidence before us, you suggested that savings could be made under Heading 1a (Competitiveness for Growth and Jobs), Heading 1b (Economic, Social and Territorial Cohesion), Heading 2 (Sustainable Growth: Natural Resources), Heading 3 (Security and Citizenship) and Heading 5 (Administration). In your evidence before us, you identified the school fruit scheme under Heading 2, the Marco Polo II 15
programme and cuts to the administration budget, but were unable to give precise details as to the amounts involved. In the absence of such information we remain doubtful as to the scale of the reduction in payments that such cuts would amount to. We would therefore be grateful for clarification as to the specific ways and amounts in which payment appropriations in the 2015 Draft Budget can be cut. Is your statement that savings can be made under Heading 1a compatible with your assertion that greater focus on this heading is a positive step? Overall, how much of the 4.9% increase can realistically be trimmed?

Nadia Calviño observed that the new MFF focuses “as much as possible [on] the headings that contribute more to growth and jobs: innovation, infrastructure and all the things to do with setting the basis for the future of Europe.” We agree with you that the increase in funding in Heading 1a (Competitiveness for Growth and Jobs) is a step in the right direction. It is regrettable that the constraints of the agreed Multiannual Financial Framework for 2014-2020 mean that it is only a small step. As we set out in our 2011 and 2012 reports on the MFF, reform of the Common Agricultural Policy (CAP) is imperative, and far greater efforts must be made to reduce the CAP’s budget and to begin phasing out direct payment to farmers. A further reduction in the CAP’s budget would allow the MFF to focus funding on areas that will support growth and encourage innovation. Notwithstanding the fall in CAP spending in the new MFF overall, we regret that Heading 2 (Sustainable Growth: Natural Resources) remains as much as 40% of the overall Budget. The size of the CAP budget means that the capacity for the EU to promote growth, jobs and competitiveness, which many would argue is more important, will continue to be hamstrung.

Taking into account the constraints of the MFF deal, in which specific ways do you believe that the EU Budget should be targeted in this and future years to ensure that economic recovery and growth is sustained in the years ahead? Is enough being done to focus spending on Heading 1a (Competitiveness for Growth and Jobs), or are we at the limit of what is realistically achievable under the current MFF deal?

DRAFT AMENDING BUDGET 3 (DAB3) TO THE 2014 BUDGET

In addition to the 2015 Draft Budget, the Commission has made a request for additional payments of €4.7 billion, albeit it argues that this will be offset to some extent by increased revenue and by transferring the remnants of last year’s budget. As such, the Commission argues that, in terms of its absolute size, it is a relatively small draft amending budget. For our part, we fear that the size of DAB3 calls into question the overall effectiveness of the budget-making process and that there is a significant cash flow problem. Do you share this analysis?

We note that the Commission justifies the request on three grounds: first (and most significantly), the backlog of bills for programmes and projects that have been pre-financed by Member States, including a backlog of cohesion policy payments amounting to €23 billion; second, the frontloading of programmes; and third, unexpected events such as the EU’s actions in Ukraine. Like you, we are sympathetic to the Commission’s actions in the latter case, although we note your observation that the Commission has already found the resources for disbursal of €250 million for Ukraine. However the key questions of the acceleration of payments and the frontloading of programmes deserve to be analysed in more detail.

BACKLOG OF PAYMENTS

On the backlog of payments, the Commission states that the problem has arisen because of the speed of expenditure, and in particular because the rhythm with which bills have come in has been unexpected. Silvano Presa told us that “the forecast for Member States turned out to be much more accurate than before”, in part because Member States sought to spend money quickly because of the automatic decommitment of funds after two or three years. Nadia Calviño added that the UK Government had announced that €1.3 billion of bills would be coming from the UK to be paid. Does the Commission’s explanation tally with your own understanding of why such a massive backlog has built up? What is the explanation for such a large payment request being made by the UK? You state that it is unclear why the Commission did not anticipate many of these pressures and that the Commission should have made better provision for them in compiling the detail of the 2014 Budget, insofar as it was aware of them. To your knowledge, did anyone within the EU institutions or Member States anticipate these problems or urge the Commission to adjust the Budget at the time? Is the fact that the scale of this problem appeared not to have been anticipated an indictment not only of the Commission, but also of the Council and the European Parliament, as well as the budget-making process as a whole?
We welcome your statement that the growing backlog of payments is an issue that needs to be addressed. However, when we asked you to identify a long-term solution to the problem, you stated only that “the solution need not be higher budgets. The Government has not given the Commission specific instructions as to where in the budget these funds should be drawn from, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money if re-allocation is required.” As set out below, we share your view that the Commission should look first to redeployment, and that further sources for redeployment other than the €65 million thus far pinpointed by the Commission need to be identified. However, the sheer scale of the problem cannot be tackled by redeployment alone. Is your own statement that the Commission should look first to redeployment to meet some of the commitments a tacit admission of this fact?

In light of this, is it not incumbent upon the UK and like-minded Member States to assist the Commission in identifying a long-term solution to the issue, not least given that €1.3 billion of bills pertaining to the UK remain outstanding? In seeking to identify solutions, will you need to move from generalities to specifics? Do you agree that the EU budgetary process is groaning under the weight of such seemingly intractable problems? In light of this, what assurances can you give us about the efforts that the UK and like-minded Member States are making to tackle this growing problem? Can the issue really be addressed without resort to significant budgetary revisions?

FRONTLOADING

On the frontloading of programmes, the Commission told us that there was a political decision to advance the payment of programmes that would boost growth and employment, and that this decision was supported by the UK. You confirmed that this was the case, and that the Government continue to support the frontloading of such programmes as Erasmus, the youth employment initiative, COSME and Horizon 2020 in the MFF as a reflection of the Government’s priorities in supporting growth and competitiveness. You state that “it is clear that significant front-loading into the first few years of the MFF … would impose pressure on later years of the deal”, and that the Prime Minister was well aware of the implications of the decision to frontload. Yet at the same time you point out that “when the Council negotiated the seven-year multi-annual financial framework it did not specify the detail of how it would work.” This was surely a mistake on the Council’s part, adding weight to our view that the UK and other Member States took insufficient account of the pressures that frontloading would create on the budgetary framework at the time the decision was made. Silvano Presa told us that if estimates do not prove as accurate as they should be between now and 2020, “the difficulties will lie with other programmes and adjustments will need to be made. The risk has, in a way, been transferred to other programmes within the general framework.” Are you confident that it will be possible to offset such spending in future years? Will it be possible to return to a more orthodox understanding of the purpose of a contingency margin in the future? What will be the outcome for the overall MFF if the pressure on the later years of the budgetary framework becomes untenable? Is there a danger that the overall MFF deal will unravel?

THE CONTINGENCY MARGIN

The Commission has asserted that it is proposing resort to the Contingency Margin only as a last resort, and that it will continue to seek opportunities for redeployment within the existing budget proposals. While we welcome the Commission’s commitment to “continue this effort for the remainder of the year”, we are disappointed that the message from the directors-general is that “it does not look as if there is going to be a big margin for other reallocations in the remainder of the year”. We urge the Commission to redouble its endeavours to locate further sources of redeployment, and welcome your efforts to encourage the Commission to do so. However, we reiterate that redeployment on its own will not deal with the magnitude of the problem. Thus the question of the Contingency Margin inevitably comes into play.

Nadia Calviño told us that “all the parties were aware of the challenges of these budgets, but the European Commission said at the time … that the budget can be implemented if we are able to use the margin of flexibility that has been embedded in it. If we are able to use the contingency margin and advance the payments, and if we are able to use the special instruments et cetera, then we can implement the tasks that are entrusted to the European budget. They knew the consequences. That is why the European Council also signed up to the need for flexibility when implementing the yearly budget within the ceilings of the multiannual financial framework.” Is this an accurate description of the MFF negotiations? If so, should the Council not have foreseen the inevitability of the Commission’s recourse to the Contingency Margin? Is this another example of a failure of the budgetary process?
The Joint Statement by eight Member States, including the UK, stated that “a proposal for the mobilisation of the Contingency Margin in 2014 would … be legally questionable”. However the Commission maintains that the proposal is legal, stating that “the existence of ‘unforeseen circumstances’ that may justify the mobilisation of the Contingency Margin to cover additional payment needs has … to be assessed against the state of play in February 2013 when the MFF payment ceilings were first established.” Your own letter of 25 June 2014 appears to cast doubt on the strength of the joint statement’s argument when you state that “the Government does not have a definitive legal position on this issue”, that “this was one of several issues being considered by the signatory Member States in questioning whether the Commission should be mobilising the CM at this stage”, and that “the Government’s primary position on DAB3/2014 is not a legal one but [a] principled position”. In your evidence to us, you went further, stating that “‘legally questionable’ does not mean ‘illegal’; it means that there is a form of words in relation to ‘unforeseen’ and ‘as a last resort’, and we are not convinced that what is proposed meets that definition. That does not necessarily mean that it is ‘illegal’”.

In our view, to counter the Commission’s assertion that recourse to the Contingency Margin is a last resort because the Global Margin for Payments is not available, you would have to demonstrate the availability of a viable alternative to the Contingency Margin for the sum requested. Without this there is no basis on which the Court of Justice could impugn the Commission’s justification that using the Contingency Margin is a last resort. The argument employed in the Joint Statement, and repeated in your letter, that “payments for pre-2014 commitments … cannot by definition be considered as unforeseen circumstances” is not credible in our view. There is nothing in the term “unforeseen circumstances” in paragraph 1 of Article 13 of the MFF Regulation that could be construed to preclude such circumstances arising in the year before the additional appropriations need to be paid, so long as they were unforeseen. It is quite possible for pre-2014 commitments to lead to further expenditure than foreseen in 2014, such as the under-estimation of the backlog of payments under the Cohesion policy.

In light of this, do you stand by the Joint Statement’s assertion that resort to the Contingency Margin would be legally questionable? How would you respond to the suggestion made at the evidence session that a more effective approach would be to make sure that the inevitable increase in the budget is recognised as the result of a cash-flow problem, so that a clear statement is written into the minutes that reinforces the supremacy of the MFF and its seven-year numbers and makes clear that you expect compensating reductions in later years for the money that is brought forward to deal with the backlog of payments and frontloading of the MFF?

FUTURE YEARS

When we asked the Commission whether the scale of the problem meant that the Contingency Margin would be called upon in 2015 and 2016, Nadia Calviño told us that “we anticipate that by 2016 the payment appropriations situation should be eased … because we will have finished the payments of the past and the new programmes will be small in terms of pre-commitment by the European budget.” Nevertheless, she conceded that “it is almost impossible to say what is going to happen in 2016. If Member States are suddenly much more efficient, and launch the programmes much faster, we may have a problem in 2016. But … it would not be a responsible budgeting approach now to say that we are now going to activate the contingency margin in 2015 and 2016.”

In light of this uncertainty, we share your concern that the Commission is likely to continue to come forward with significant requests for funds in future years. While we urge you to continue your efforts to ensure that the Commission only turns to the Contingency Margin as a last resort once all opportunities for redeployment have been exhausted, the scale of the problem again illustrates the need to identify a long-term solution to the problem.

THE BUDGETARY PROCESS

All these issues feed into our broader concerns that the budgetary process itself is unsatisfactory. While we note your observation that the gap between payments and commitments has fallen from 7% to 5% and the Prime Minister has described that gap as perfectly safe, we repeat our view that a disjuncture between the two has occurred. Is the Commission correct in stating that the underbudgeting of payments has arisen because of “the economic crisis and the obligations of budgetary restraint”? Is it therefore a temporary problem or has the disconnect in the relationship between payments and commitments become a permanent structural feature of the budgetary process? You state that part of the problem lies in adjusting to “a new budget era” of fiscal constraint.
Can you elaborate on this? What in your view is the cause of this disjuncture, and how can it be corrected?

Both you and Nadia Calviño deny that the budgetary process is no longer fit for purpose. We disagree. In our view the strains in the budgetary process that the 2015 Draft Budget and DAB3 have brought to light show that the budgetary process needs radical modernisation. It is a highly complex mechanism with insufficient flexibility to take account of the real world and how a budgeting process works in practice. Aside from the wider reforms to the MFF that we advocated in our past reports, we believe that the time has come to give serious thought to a review of the budgetary process itself. Ideally, this would complement the current review of Own Resources, as how the forward plans and budgets are set and managed and how they are funded are all part of the same system. To continue in the present vein risks bringing the entire exercise into disrepute. It is therefore incumbent on all sides urgently to identify a solution to these problems. You state that “there are question marks around the budgetary system, particularly on the balance between payments and commitments”, that “it is certainly fair to raise the issue of whether the budget should be calculated in a different way” than this “very unusual system”, and that “there may be broader scope to look at how the whole picture of the way the budget works”. However you also state that this is not your primary focus at the present time. While we appreciate the urgency of reaching a satisfactory deal on negotiations on the 2015 Budget and DAB3, this is a nettle that needs to be grasped. What reassurances can you give us that the Government are taking these issues seriously and are seeking to work alongside the Commission, the European Parliament and other Member States to address them? For our part, we stand ready to provide any assistance to your efforts that we can.

We note your statement that a formal position in Council is expected in early September. We would be grateful if you could ensure that we are able to undertake effective scrutiny of the proposals before Council adoption of its initial position. What further discussions do you anticipate taking place before the end of July? Is there any likelihood that Council will reach an initial position by then? In light of this, we would be grateful for a response to this letter by 22 July 2014, or sooner if significant progress is expected in Council in the meantime.

At your appearance before the Committee on 1 July, the Committee invited you to respond in writing to a number of points directly relevant to the issues raised in this letter, as follows:

— Further details of the programmes that you identified as candidates for cuts, and the amounts involved (Q20);
— Your response to the Committee’s questioning of the Joint Statement’s claim that resort to the Contingency Margin is “legally questionable” (Q22);
— Further information on the position of other Member States on the 2015 Draft Budget and DAB3 (Q25);
— A response to the Committee’s question as to how the budgetary process can be improved (Q27);
— Providing information, ideally in tabular or graphic form, setting out the relationship between payments and commitments over the past ten years and explaining the reason why it has changed (Q29).

We would be grateful if your response to this letter could also respond to these points. Pending receipt of your reply we will continue to hold the documents under scrutiny.

9 July 2014

Letter from David Gauke MP, Financial Secretary, HM Treasury, to the Chairman

Thank you for the letter on these matters sent to my predecessor as Financial Secretary. First, I wanted to offer an update on progress in the budget negotiations since my predecessor appeared in front of the Committee on 1 July.

On 15 July, Coreper reached an agreed Council position on the 2015 budget, calling for a budget of €140.0bn (£112.2bn). This represents a €2.1bn (£1.7bn) cut to the Commission’s draft budget, and provides for a margin of €1.9bn (£1.5bn) between the budget and the 2015 annual ceiling set out in the MFF.

In Coreper, there was no formal vote as it was clear that a qualified majority was in place to support the Council position. Our Permanent Representative indicated that had there been a vote, the UK would have abstained on both Parliamentary scrutiny and substantive grounds, and regretted that
greater cuts were not found. We do, however, welcome the fact that this position does support the overall delivery of the PM’s deal on the Multiannual Financial Framework.

As we suggested to you in the recent evidence session, we will have to vote formally via Council written procedure in early September. We will be abstaining in this vote. If the annual budget were to clear scrutiny by the time of the vote, we would still abstain on substantive grounds.

In terms of DAB3/2014, there has been no further progress since we last updated the Committee. We continue to expect that DAB3/2014 will be discussed alongside the negotiations on the 2015 annual budget in the autumn.

In your letter, you ask for our views on how the Commission’s draft budget could be cut. The press release from the Council, which sets out the revised breakdown by heading, is available at the following address:


As noted above, we felt that further cuts could have been found beyond these €2.1bn (£1.7bn). In particular, we would have been keen to see further cuts in administration, Heading 5 of the budget, where the Council proposal still represents a 2.1 per cent increase on the 2014 agreed budget.

You asked about how the budget could be targeted in 2015 and future years to ensure that growth and economic recovery is sustained across the EU. The MFF deal done by the Prime Minister secured a commitment to increase spending on high-value research and development, universities, and other pro-growth investment via Heading 1a of the budget. Pleasingly, we have seen the reorientation of expenditure to these areas, provided for by the MFF deal, play out in the 2015 annual budget negotiations. The agreed Council position ensures a 24.5 per cent increase in Heading 1a compared with the 2014 budget.

At the hearing with my predecessor, you asked for further details of how we plan to find sufficient cuts to the existing 2014 budget so as to avoid the need for additional expenditure on DAB3/2014.

I should reiterate our overall approach to negotiations on the budget. We start from the fundamental principle of the importance of budgetary discipline, and this determines our stance in negotiations. As my predecessor made clear in her previous letter on DAB3/2014 and at the hearing, we do not provide a line-by-line breakdown of cuts or savings to the Commission. This is because we see the role of Member States as setting the overall parameters of spending, and the role of the Commission as managing the detail of the budget so as to ensure that the EU lives within its means.

You ask whether the Government stands by the assertion in the Joint Statement that the use of the contingency margin is “legally questionable”. On this, I do not have anything more to add to the reasoning set out in our previous letter to the Committee. As we set out in this letter, the Government does not have a definitive legal position on this issue – this explains the use of the term “legally questionable”. The Government’s primary position on DAB3/2014 is not a legal one but the principled position set out in the original Explanatory Memorandum and reiterated in the letter sent and the hearing held since that EM was sent.

You ask several questions asking why scale of the problems caused by the pressures included in DAB3/2014 were not anticipated, and whether these represent an indictment of the budgetary process. As my predecessor made clear in the last letter on this subject, it is unclear why many of these pressures should not have been anticipated by the Commission. The Government does not agree, however, that this is an indictment of the budgetary process. In-year pressures of some sort will always emerge. The challenge is to ensure that there is sufficient flexibility built into budgets and in-year margins below the annual ceilings to allow resources to be re-allocated to meet genuinely unforeseen pressures.

You ask some more general questions about risks of the MFF becoming untenable as a result of the mobilisation of the contingency margin. As we said in our last letter to the Committee on this subject, it is clear that significant front-loading into the first few years of the MFF would impose pressure on later years of the deal. This is one of the reasons behind the Government’s view that the Commission should always look first to reallocate funds from within existing agreed budgets to meet emerging in-year pressures. Having said this, the MFF deal did include provision for the contingency margin to operate as a mechanism to move expenditure between years but within the overall MFF ceiling. The fact that the Commission have chosen to request the mobilisation of the contingency margin in the first year does not in itself indicate that the MFF is in some way untenable.

You ask several questions about the relationship between payments and commitments, and how it may have changed in recent years. As my predecessor made clear at the evidence session, the Government does not accept that the relationship has broken down. Indeed the gap between
payment and commitment ceilings has fallen from 7 per cent during the last MFF to 5 per cent over the current MFF. The Prime Minister has described this gap as “perfectly safe”. The Government finds this downward trend encouraging as it contributes to mitigating the steady build-up of unpaid commitments.

You requested a table comparing payment and commitment appropriations over recent years. This is set out in an annex [not printed]. As it makes clear, the gap between payments and commitments is significantly tighter in 2014 than any of the previous four years. The gap between payments and commitments in the Council position represents a further tightening at just 3.6 per cent. This is evidence of the value of the 2014-20 MFF deal in bearing down upon the build-up of commitments, and should help to address the current backlog.

Finally, you ask for a response to the Committee’s questions as to how the budgetary process can be improved. As my predecessor said in giving evidence to the Committee, it is certainly fair to raise the issue of whether the budget should be calculated in a different way. She made it clear, however, that rather than focusing on potential reform of the system, the Government’s energies for now are fully focused on the amount of money that the UK is going to be expected to find in 2014 and 2015 – and more generally on the successful implementation of the 2014-20 MFF deal, where the Prime Minister delivered the first ever real-terms cut to the EU budget. This is where my focus too will be as Financial Secretary.

23 July 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 23 July 2014, on the 2015 Draft Budget and on Draft Amending Budget 3 (DAB3) to the 2014 Budget. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.

We are pleased to welcome you to your new post as Financial Secretary. However we regret to state that we are disappointed by the standard of this response to our detailed letter of 9 July 2014. The letter provides scant information beyond the position set out by your predecessor at her appearance before the Committee on 1 July 2014.

We are particularly disappointed by the lack of detail on the further cuts that the Government would have wished to have seen. You cite only further cuts in administration, and provide no further details. You state that “we do not provide a line-by-line breakdown of cuts or savings to the Commission. This is because we see the role of Member States as setting the overall parameters of spending, and the role of the Commission as managing the detail of the budget so as to ensure that the EU lives within its means.” We find this attitude to be both complacent and counterproductive. The Government’s failure to pinpoint specific areas for cuts makes it all the harder for an effective case for reductions to be made. As we said in our 9 July 2014 letter, it is more convincing if the Government and like-minded Member States make concrete proposals as to how the Draft Budget can be trimmed. Your failure to do so tends to give weight to the Commission’s argument that there is little room for further cuts or for reallocation within the existing budgetary framework. The fact that Coreper has agreed a position not to the UK’s satisfaction suggests that you have been equally unable to convince other Member States of your case.

Likewise, we regret your failure to engage with our concerns about the efficacy of the budgetary process. You state that the fact that the Commission has chosen to request the mobilisation of the contingency margin does not in itself indicate that the MFF is in some way untenable. Yet you give us little cause for optimism that this will not ultimately prove to be the case. You do not agree that the fact that the scale of the problems lying behind DAB3 were not identified is an indictment of the budgetary process. Yet you give us little comfort that the underlying issues are being addressed in any systematic manner. You state that it is fair to raise the issue of whether the budget should be calculated in a different way, but that the Government will nevertheless not be focussing on such issues. Once again, we find this to be a complacent attitude. If the UK and like-minded Member States do not lead the way in seeking sensible reforms to the budgetary process then it will not be surprising if the flaws in the system persist for years to come, to the detriment of all.

We note the table attached to the letter setting out the gap between commitments and payments since 2008. You state that the gap is significantly tighter in 2014. Can you clarify if the 2014 figure takes into account the DAB3 proposal? Given that payments exceed commitments in each of the years, and continue to do so for 2015 even if at a reduced level, we question your assertion that “this is evidence of the value of the 2014-2020 MFF deal in bearing down upon the build-up of commitments, and should help to address the current backlog.” Can you explain the rationale behind...
this claim? Is it true to say that the high gap in 2010-2013 was a temporary phenomenon arising from the financial crisis and EU-wide recession? Should we expect a small gap to persist in the future? Or should we expect a budget where commitments are lower than payments in the future? Is this not the only way in which the build-up of commitments can be reduced? You repeat that in the 2014-2020 MFF deal “the Prime Minister delivered the first ever real-terms cut to the EU budget.” Do you take as the basis for this claim the agreed level of payments or commitments?

Given that a general approach on the 2015 Draft Budget has now been reached, we now clear that document from scrutiny. However we will continue to hold DAB3 to the 2014 Budget under scrutiny pending the progress of negotiations. We would be grateful for an update on both when negotiations resume in the autumn, and by 30 September 2014 at the latest.

29 July 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter on the 2015 EU budget and DAB3/2014 sent just before the summer recess. You requested an update on progress on these matters by the end of September.

Regarding the 2015 budget, you will be aware the Budget Committee of the European Parliament (“BUDG”) are currently holding their hearings on the subject. This process will culminate in a vote on the European Parliament’s position on the 2015 budget at a plenary session. We expect this to occur around 22 October. Following this, a 21 day period of “conciliation” will begin for the Council’s and European Parliament’s positions to be reconciled. This will culminate at a Budget ECOFIN session on 14 November, where final agreement on the 2015 budget should be reached.

The Government’s position on the 2015 budget remains unchanged from the one I set out in my most recent letter to you. As I suggested in this letter, we abstained on the Council’s position on the 2015 budget in the Council written procedure that concluded at the beginning of September.

For DAB3/2014, there has been no progress. As was the case before the summer, DAB3/2014 remains on the table, but as yet the Presidency have not returned to the Council with either the original or an amended proposal. We continue to anticipate that it will be resolved as part of the wider negotiations this autumn on the 2015 budget, although we do not know the timetable over which this will take place. As with the 2015 budget negotiations, the Government’s position on DAB3/2014 has not changed since we last communicated it to you.

You also asked some questions about the balance between payments and commitments in the EU budget.

In response to your first factual question, the figure for 2014 does not include DAB3/2014, as this has not been approved by the Council. Even without DAB3/2014, however, there is a marked narrowing of the gap between payments and commitments in 2014 compared with previous years – and this gap should be narrowed further in 2015 if the Council position is adopted. Annual budgets containing a smaller gap between payments and commitments should naturally be a key factor addressing the backlog of commitments that has been allowed to build up.

You ask whether this trend will persist in the future, and suggest that annual budgets where payments exceed commitments will be required to address the backlog. The Government does not consider that the latter situation will be necessary. The EU budget has always worked on the basis that not every commitment will be translated into a payment. This is why the Prime Minister was able to describe the gap of 5 per cent in this current MFF as “perfectly safe”.

In response to your final question, I can confirm that the Prime Minister’s 2014-20 MFF deal represents a real-terms cut to both payments and commitments compared to the previous MFF.

29 September 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 29 September 2014, on the 2015 Draft Budget and on Draft Amending Budget 3 (DAB3) to the 2014 Budget. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 21 October 2014.

While we note your response to our specific questions, your letter did not respond to our criticisms of the lack of detail about the budgetary cuts you wish to see, and your failure to engage with our wider concerns about the efficacy of the budgetary process. We raised these and other points in
evidence sessions that we held in Brussels with three prominent MEPs: Richard Ashworth MEP, UK Conservative/ECR member of the Committees on the Budget (BUDG) and on Budgetary Control (CONT); Jean Arthuis MEP, Chair of the BUDG Committee; and Dr Ingeborg Grässle MEP, Chair of the CONT Committee. We would be grateful for your reflections on the evidence they provided.

On the growing budgetary pressures which DAB3 bears witness to, Mr Ashworth told us that, while the budget had been cut, there had been no provision for a reduction in spending: “Consequently, we find ourselves continually squeezing 6.5 into 6 … and as a result any exceptional item is likely to result in a draft amending budget being submitted by the Commission. … Therefore, because there is no margin, draft amending budgets are going to be a feature we will have to live with.” Mr Arthuis noted that there was “substantial inertia” and “a lack of confidence” in the system that meant that it was not easy to respond to the current situation. Dr Grässle argued that “we should have the courage to redo the whole budgetary procedure, which will become more and more ridiculous.” Do you share this assessment? Do you agree with us that it is yet another indictment of the failures and weaknesses of the budgetary process, which, regretfully, no-one is taking the initiative to resolve? Mr Ashworth argued that the Commissioner for Budgets needs to undertake a mid-term strategic review within the budget to ensure that the EU keeps within fiscal limits. Mr Arthuis agreed that a review was necessary. Do you support the case for a mid-term review? Is it not essential that Member States are closely engaged with such a process if any positive outcome is to be delivered?

On the relationship between payments and commitments, Mr Arthuis said that new procedures for dealing with outstanding payments were needed. Mr Ashworth told us that the problem had “got out of control”, in particular since 2008: “Once the recession and the economic difficulties began to squeeze economies, member states realised that the money was there to be spent, that it is very often on a ‘use it or lose it’ basis and they had better start using it. That is when the problems really started to arise”. Dr Grässle agreed that “the commitments of today are the payments of tomorrow. There is always a gap of €50 billion in the MFF. Annually, every single euro that is foreseen but that we do not achieve in the negotiations for the annual budget means that the gap broadens.” This chimes with our own analysis in our letter to you of 29 July 2014, when we asked you if the growing gap between payments and commitments had arisen from the financial crisis, and whether payments would need to exceed commitments in future budgets to address the issue. In response, you stated that a smaller gap between payments and commitments would naturally be a key factor in addressing the backlog of commitments that has built up. Nevertheless the Government do not consider that annual budgets where payments exceed commitments will be required to address the backlog, since the EU budget has always worked on the basis that not every commitment will be translated into a payment. Given the scale of the problem, we do not believe that this will be sufficient to deal with the issue. Do you agree with us that drastic steps now need to be taken if the backlog is to be addressed and the relationship between payments and commitments is to be restored to an even keel?

With respect to the Commission’s decision to request resort to the Contingency Margin, Mr Ashworth told us that the Commission’s proposal to reduce payment ceilings in 2018, 2019 and 2020 may simply be “kicking the can up the road and storing up another problem”. We made the same point in our 9 July 2014 letter to your predecessor, when we asked what the outcome would be for the overall MFF if the pressure on the later years of the budgetary framework became untenable, and whether there was a danger that the overall MFF deal would unravel. In your reply of 23 July 2014, you stated that “the fact that the Commission have chosen to request the mobilisation of the contingency margin in the first year does not in itself indicate that the MFF is in some way untenable.” In light of Mr Ashworth’s observations, is there not a real and present danger that the MFF deal will unravel? If so, what steps need to be taken to address the problem before the situation becomes untenable?

On the budgetary process itself, our witnesses told us that a major weakness was the lack of an effective means of ensuring fiscal discipline. Mr Ashworth bemoaned the failure to appoint an office of budgetary control or Commissioner for budgetary control. The current flawed system was “the son of the original proposals from way back in 1957 with the Treaty of Rome and it has never changed because nobody ever thought to change it.” Mr Ashworth also told us that, while the European Parliament had a very active role in drawing up the expenditure budget, it had virtually no role in scrutinising outturn and delivery, for instance in questioning Commissioners or heads if departments on the effectiveness of delivery of the budget. It was therefore difficult for MEPs to form a judgment whether there was a danger that the overall MFF deal would unravel. As a result, EU spending planning was determined by political considerations rather than fiscal or outturn considerations. Dr Grässle also said that there should be more effective cooperation between the European Parliament Committees on Budgets and Budgetary Control, and with those Committees responsible for spending, to ensure a more joined-up process of accountability.
Mr Ashworth was also critical of the generalised nature of European Court of Auditors’ reports, which failed to name and shame. Dr Grässle said that the delay in the start of the discharge procedure, marked by the publication of the ECA’s report, was a problem. She did point out that the ECA would, for the first time this year, provide country-specific error rates, making it possible to name and shame. However she bemoaned the lack of effective powers of sanction against countries with significant error rates because of Member State opposition to their introduction. She pointed out that the situation in the UK was getting worse in relation to regional policy and agriculture. Other Member States were suffering from similar problems. Mr Arthuis said that “Europe has created monstrous complexity and bureaucracy. We lose a lot of time on peanuts and nonsense. … We have to evaluate current expenditure, but we have to review our organisation and our bureaucracy. It is very expensive, and there is a lack of comprehension between the territorial actors and the European Union.”

Do you share such concerns about the system of budgetary control? If so, what steps can be taken to improve the scrutiny of the Budget within the EU institutions, whether it be the Commission, the European Parliament or the European Court of Auditors? What confidence do you have that Mr Juncker will seek to address these issues in his term as President of the Commission? Do you agree that there would be value in appointing a Commissioner for Budgetary Control? What steps will you take to ensure that positive examples from the UK system of budgetary control and scrutiny can be applied in the EU context? How would you respond to the assertion that the budgetary control situation in the UK is getting worse in relation to regional policy and agriculture? What steps is the Government taking to address these problems?

In our 29 July letter, we expressed disappointment at the lack of detail you provided on the further cuts that the Government would have wished to have seen. We also criticised as counterproductive and complacent the Government’s position that “we do not provide a line-by-line breakdown of cuts or savings to the Commission. This is because we see the role of Member States as setting the overall parameters of spending, and the role of the Commission as managing the detail of the budget so as to ensure that the EU lives within its means.” Mr Ashworth told us that, “concerning the attitude of the United Kingdom Government and the Treasury, I find it very difficult to get them to become engaged at all. They will certainly get excited about the sort of headline that will make news in the Daily Mail or something like that, but it is hard to get them to drill down into the detail. I find it very difficult to get appointments at the Treasury. I find it very difficult to get them to take the subject seriously. … I feel I need to remind them that, ‘You, the member states, through the Council have input into the size of the budget’. To say, ‘We are hands-off on this’, is absolute nonsense. Unless or until we start to drill down into this and get people to accept responsibility, we will have the ongoing embarrassment of a qualified statement of assurance every year. That is never going to change unless the member states do something about it.” We wholeheartedly agree with Mr Ashworth’s assessment, and regret to say that his criticism of the Government mirrors our own experience. How would you respond? In light of Mr Ashworth’s comments, do you consider that a structural relationship between HM Treasury and UK MEPs on the Budgets and Budgetary Control Committees could be mutually beneficial?

In that regard, we also draw to your attention the views of Mr Ashworth in relation to the High-Level Group on Own Resources. He stated that “it is important that we maintain a position and attitude that we are open to proposals – we are not going to say a flat no to any … it is vital that if we are the only voice speaking out against a financial transaction tax and various Own resources we should have a seat at the table to say so and that we have the opportunity to say publicly what our position is. We may lose the argument, but if we do not engage in the battle, we know that we will lose.” This chimes with our own views expressed to you in previous correspondence about the importance of engaging in the debate on Own Resources. How would you respond?

We would be grateful for a response to these questions, as well as an update on negotiations on the 2015 Draft Budget and DAB3, by 4 November 2014 at the latest. We would however advise you that the Sub-Committee’s final meeting before the 14 November Budget ECOFIN session will take place on 4 November 2014. Any request for clearance of DAB3 ahead of Budget ECOFIN would therefore need to be received in advance of the 4 November meeting. In the meantime we will continue to hold DAB3 under scrutiny.

22 October 2014

Letter from the Chairman to David Gauke MP

I am writing to you to seek urgent clarification of reports on 24 October 2014 that the Commission has told the UK to pay an extra €2.1 billion into the EU Budget on 1 December 2014. We would be
grateful for a full account of the Commission’s request, and in particular for clarification of the following points:

THE COMMISSION’S REQUEST:

— Can you provide a full account of the means by which this calculation has been arrived at and the statistics on which it is based? Can you confirm the legal basis for the request?

— Is it correct that the figure derives from a one-off recalculation of VAT and GNI figures undertaken by Eurostat dating back to 1995? Are we correct in our understanding that 1995 has been chosen because this was the year that the GNI/GNP resource came into operation?

— On what other occasions since 1995 did Eurostat also undertake recalculations of VAT and GNI figures? On what previous occasions in that period were Member States requested to provide payment or notified of reimbursements? Was 2010 one such occasion?

— When was the decision taken to recalculate VAT and GNI balances? In the event that this was more recent than 1995, what is the Commission’s justification for seeking retrospective readjustment as far back as this date rather than from the date of agreement?

— How does this one-off recalculation differ in form from the regular readjustments in the budgetary process?

— How does the question of VAT and GNI balances relate to Draft Amending Budget No 6/2014? When can we expect to receive an Explanatory Memorandum on the latter?

THE REQUEST TO THE UK COMPARED TO OTHER MEMBER STATES

— Why is the UK adjustment so much larger than for any other Member State?

— Can you confirm the figures for other Member States? Why are some required to make a payment while others will be reimbursed? Can you confirm that the amount, in total, to be reimbursed to some Member States outweighs that to be paid by others? What is the reason for this imbalance?

— How is the Commission dealing with Member States that acceded to the EU after 1995?

THE GOVERNMENT’S POSITION:

— Can you clarify when the Government were first made aware: a) of the likelihood of the UK being asked to make an additional payment; and b) the precise scale of the amounts involved? To what extent were you taking account of the full ramifications of the European System of National and Regional Accounts (ESA 2010)?

— What was the nature of the UK statistical authorities’ interaction with Eurostat in relation to this recalculation?

— What is the UK Government’s position on this request? Do you regard the request as justified or unjustified? If so, on what grounds? We note that the Prime Minister demanded a meeting of all EU finance ministers to discuss the issue. What update can you give us on these discussions? What discussions are you having with other Member States on the issue? Do you intend to make the payment? Will you ask for the date of payment to be put back or for payment to be staggered?

— Can you confirm the statement by the EU Budgetary Commissioner that the UK will be liable for interest if the payment is not made on time? What is the legal base for charging interest and has it always been rigorously applied?

— In December 2013 and February 2014, we wrote to the then Economic Secretary to the Treasury, Nicky Morgan MP in relation to the European
Court of Auditors' Annual Report on the Implementation of the EU Budget in 2012. That report had highlighted 11 GNI reservations outstanding in relation to the UK, the most of any Member State. We asked the Minister what was the nature of the problem, what had caused such a high number of reservations and how confident she was that the Commission would judge the UK to have sufficiently addressed these issues. In her reply of 11 March 2014, the then Minister stated that outstanding GNI reservations had been introduced over several years but that “the Government continues to give high priority to addressing these reservations in the National Accounts work plan. In addition, the ONS has agreed priorities with stakeholders and publicly set out commitments via the published plan.” How does this statement relate to the matter at hand?

We would be grateful for a response to this letter by 11 November 2014.

29 October 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter dated 22 October on the draft EU budget for 2015 and the outstanding DABs proposed for 2014. In your letter the Committee sought the Government’s reflections on evidence provided by three MEPs on a series of issues and I have set out our response to the points raised below:

WEAKNESSES IN THE BUDGETARY PROCESS

The Committee raises fair questions regarding the EU budget process. The manner in which the EU budget is managed, including the use of payment and commitment appropriations, is an unusual system and not one applied here in the UK.

However, as set out by the then FST when she appeared before the Committee on 1 July 2014, the Government’s immediate focus remains delivering the tough but fair 2014-2020 MFF deal rather than reform of the budgetary system. Nevertheless, the Government would actively engage in the consideration of any formal proposals to improve EU budget processes.

MID-TERM REVIEW FOR ANNUAL BUDGETS

The Government notes Mr Ashworth MEP’s suggestion that a mid-term review, similar to the process provided for within the seven year MFF, be introduced for annual budgets. The Government is open to considering any formal proposals that seek to improve the Commission’s management of the EU budget and allow for better monitoring of annual budget expenditure.

Further, I agree with the Committee that the successful introduction of any reforms to EU budget processes would need the active engagement of Member States to ensure that they are representative and that funds are managed and implemented in a manner that offers the best possible outcome for taxpayers across Europe.

PAYMENTS AND COMMITMENTS

The Government recognises that the payments backlog represents an ongoing pressure on the EU budget that must be addressed. We have been consistently clear that effective and sustainable steps must be taken to mitigate the risk of this issue being replicated in future years.

The Government also remains of the view that the EU budget as a whole must reflect the prevailing fiscal circumstance across the EU. As such, we recognise that the budgetary restraint the UK seeks in the payment ceiling for the EU budget should be reflected in the accompanying commitment ceilings.

IMPACT OF THE CONTINGENCY MARGIN ON THE MFF

The Government notes the Committee’s concerns that the Commission’s proposed use of the Contingency Margin presents a risk to the MFF deal. It is important to be clear that the Contingency Margin was specifically designed to accommodate unforeseen spending pressures without breaching the overall MFF deal. In other words, although it is an emergency measure, it should not pose a threat to the overall MFF deal.
To ensure that the MFF deal is respected, we have joined other like-minded, budget-disciplinarian Member States in pushing for all proposals to access the Contingency Margin to be accompanied by clear and realistic assurances that this expenditure will be off-set in future MFF years. We are disappointed that the Commission offered no such plan when issuing their proposal to mobilise the Contingency Margin for 2014.

**BUDGETARY CONTROL AND SCRUTINY**

Your letter also highlights the Committees concerns in relation to scrutiny of the EU budget and the annual assessments conducted by the European Court of Auditors ("ECA"). Given the imminent arrival of the ECA's report and the associated scrutiny considerations, I will commit to addressing these valid points in subsequent and associated correspondence.

**HMG ENGAGEMENT**

It is regrettable that Mr Ashworth MEP and the Committee feel that they have experienced difficulty in their engagement with the Government on the EU budget. I would like to reassure the Committee that the EU budget remains a priority for this Government and we take a very active approach to engaging on this important issue both at a domestic and EU level. This Government has adopted a consistent and budget-disciplinarian stance on the EU budget maintaining that Governments across the EU have a responsibility to their taxpayers to ensure that the Commission effectively deploys EU budget funds.

The Government will therefore continue to press for savings in areas of expenditure which represent poor value for money, such as administration and the Common Agricultural Policy, and encourage the prioritisation of expenditure that offers high added value, such as research and development, and innovation. The Commission possess the detail on programme disbursement and must exercise financial discipline in reallocating between budget lines.

Further, the Government is open to taking appropriate steps to improve engagement on this key issue in all areas, including in our engagement with UK MEPs.

**HIGH-LEVEL GROUP ON OWN RESOURCES**

As set out in the then FST's letter of 4 June, the High-Level Group on Own Resources has yet to publicly set out a specific plan on how it intends to conduct its work. It is not yet clear at this stage whether or how the Group will seek input from national governments. Once this becomes clearer, the Government will consider its engagement strategy with the Group.

It is important to note that the Group's conclusions will not be legally binding. Any change to the current system requires the unanimous agreement of all Member States and approval by national parliaments. This means that the UK has a double-lock on any proposals to change to the EU's financing system.

**UPDATE ON NEGOTIATIONS FOR AB2015 AND DAB3**

In your letter the Committee also sought an update on Draft Amending Budget no.3 ("DAB3") and negotiations on the annual budget for 2015. As we are now approaching the end of negotiations on both the 2015 budget and the outstanding Draft Amending Budgets for 2014, I have consolidated my responses to the questions posed in this and other letters on these issues into one comprehensive response.

As in previous years, the 2015 annual budget will be discussed and agreed at Budget ECOFIN which will be held on 14 October. The Presidency has presented its compromise proposal for the 2014 DABs, which includes a €350m reduction in DAB3 payment requests, and we expect this package to be discussed concurrently.

While I am unable to offer a definitive stance on these ongoing EU negotiations at this stage, I can confirm that at ECOFIN on 14 October, I intervened strongly to urge the Commission to pursue fiscal prudence in negotiations at November's Budget ECOFIN stressing the importance of the EU budget reflecting the fiscal restraint demonstrated by domestic Governments across the EU. I also highlighted the disappointment shared by a number of Member States that the Commission had not done more to identify necessary savings and raised concerns over the consideration of MFF ceilings.
as being the 'minimum level of expenditure' which has contributed to the challenges the EU budget now faces.

Over the coming weeks, the UK will continue to work with like-minded Member States to pursue this budget-disciplinarian and sustainable approach to EU budget negotiations.

AMENDING LETTER 1 TO ANNUAL BUDGET 2015

Amending Letter No 1 ("AL1") was issued by the Commission on 15 October 2014. It amends the Commission's draft budget proposal to account for the most recent developments in agricultural markets, recent forecasts of Member States on the execution of the 2014 budget and legislative changes since the Commission's original proposal.

The net impact of these changes is a reduction of €448.5m in commitment appropriations with no overall change to the level of payment appropriations.

AL1 provides two main adjustments to Draft Budget 2015. First, the redeployment of €448.5m of expenditure from Heading 2 and Heading 5 to Headings 1a, 2, 3 and 4 in 2015. This is made possible by: the €448m increase in assigned revenues available for the European Agricultural Guarantee Fund (EAGF) in 2015; and, a conversion of Commission posts which yields a saving of €0.5m.

Second, the use of the 'crisis reserve' in Heading 2 of Draft Budget 2015 to finance "temporary emergency measures" in response to the Russian ban on certain EU agricultural imports. The cost of these measures is currently estimated at €344m. This will not require additional appropriations as the Draft Budget 2015 already included €433 million appropriations for 'crisis reserve', intended to support the agricultural sector in crisis situations. Any mobilisation of the 'crisis reserve' would require a budget transfer to be agreed by Council after the adoption of the EU Budget 2015.

The Government welcomes that AL1 is budget neutral on payments and reduces commitments. We are also pleased to see that the Commission have identified savings in agricultural and administrative expenditure. However, we do not think that the Commission should seek to use the savings to increase expenditure in other headings on top of the draft budget 2015 proposed by the Commission. Instead, these savings should be used to help reach an agreement on the 2015 annual budget which is in line with the Council position.

We note that AL1 will be part of wider negotiations at ECOFIN where we will be clear in our objective to push for a 2015 annual budget which sets expenditure at a level that provides a significant margin below the MFF ceiling.

AMENDING LETTER 1 TO DRAFT AMENDING BUDGET NO.4 ("DAB4")

On 16 October, the Commission submitted Amending Letter 1 to DAB 4. This Amending Letter includes additional fines and interest on late payments as well as interest on fines which adds to 'miscellaneous revenue'. As these changes serve to reduce Member State contributions, our position on DAB4 remains unchanged.

DRAFT AMENDING BUDGETS 6 & 7

EMs on DAB6 and DAB7 will be with the Committee shortly.

I would like to reassure the Committee that, taking into account ongoing EU negotiations and the fact that the UK's final position will be dictated by the shape of negotiations, I have provided as much information as possible. I hope that I have now provided sufficient information to allow the Committee to clear these documents from scrutiny.

3 November 2014

Letter from David Gauke MP to the Chairman

I am writing to the Committee alongside the Explanatory Memorandum on Draft Amending Budget 6 2014 (DAB6) to request a waiver of Parliamentary Scrutiny in this instance.

I believe this is necessary given the fast-moving pace of wider negotiations on the adjustment payment, on which DAB6 is entirely dependent. As the Prime Minister stated to the House in his post-Council statement the Government is seeking changes to these underlying adjustments. Therefore, the Government's position on DAB6 will depend on the outcome of the negotiations.
If the negotiations reach an acceptable outcome, the Government will support DAB6 as a means of returning the additional contributions requested as a result of the data revisions. To retain flexibility for the negotiations, and in order to obtain the best overall outcome for the UK, the Government requests, exceptionally in this case, a waiver of Parliamentary Scrutiny. I will, of course, update committees following any further developments.

3 November 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 3 November 2014, on the 2015 Draft Budget and on Draft Amending Budget 3 (DAB3) to the 2014 Budget. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 4 November 2014.

While we note your response to our specific questions, we regret the Government’s failure to take steps to respond to the concerns that we have raised. We highlight in particular your statement that “the payments backlog represents an ongoing pressure on the EU budget that must be addressed” without setting out the means by which this pressure can be alleviated. It is not enough to be “open” to reforms – if the EU budget is, as you state, a priority for the Government, then it needs to take the initiative to promote reform where it is needed. Otherwise the problems that we have identified in this year’s process will inevitably recur in the future.

You state that the Presidency has presented a compromise proposal, including a €350 million reduction in DAB3 payment requests. Can you provide more details about the Presidency’s proposals? You state that you are unable to offer a definitive stance on these ongoing EU negotiations. Do you anticipate being able to inform the Committee of your stance ahead of Budget ECOFIN on 14 November? We would be grateful for a response to these questions before that meeting, as well as an update on the outcome of negotiations as soon as possible afterwards.

We would be grateful for a response to this letter by 11 November 2014. Pending a response to these questions we will continue to hold DAB3 under scrutiny.

4 November 2014

Letter from the Chairman to David Gauke MP

Thank you for your EM 14442/14 and accompanying letter, both dated 3 November 2014, on Draft Amending Budget 6 (DAB6) to the 2014 EU Budget, including reference to the adjustment to past VAT and GNI-based contributions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 4 November 2014.

We note your explanation of why the payment adjustment has been requested at this time. We also note your statement that DAB6 is “a mechanistic procedure which is a direct consequence of and entirely dependent upon the gross adjustments”. Can you clarify what would happen in the event that DAB6 were not agreed on 15 November? Would the UK be required to pay the full adjustment of £2,873 million? Can you also clarify why the GNI and VAT changes date back to 2002 rather than 1995 in the UK’s case?

You state that the UK’s position on DAB6 is dependent on negotiations on the payment adjustments, and that the UK is seeking changes to these underlying adjustments. What is the basis of your argument for change in the underlying adjustments? We understand that the issue is scheduled to be discussed at the 7 November ECOFIN meeting. We would be grateful for an update on these negotiations.

You will be aware that we wrote to you in relation to these issues on 29 October 2014. We trust that your response to that letter, due on 11 November, will explore many of the issues raised in the EM in more detail. We would be grateful if responses to the questions contained in this letter could also be dealt with in that reply. In the meantime, we will continue to hold DAB6 under scrutiny.

4 November 2014

Letter from David Gauke MP to the Chairman

Thank you for your letters of 29 October and 4 November on the EU budget.

The ECOFIN meeting which the Chancellor attended in Brussels on Friday 7 November is relevant in the context of your questions regarding DAB6. On 10 November, the Chancellor updated
Parliament on the discussions with the new Commission and at the ECOFIN meeting, and this was repeated by Lord Deighton in the House of Lords.

At the ECOFIN meeting, a deal was reached to make a permanent change to European law. As set out in the attached [not printed] Presidency conclusions, the Council agreed to invite the Commission to come forward with a proposal for an amendment to Council Regulation No 1150/2000 to take account of exceptional circumstances, to allow the Member State concerned to defer the required payment over a reasonable period of time. The Government will ensure that this proposal, when made, is submitted for Parliamentary scrutiny in the usual way.

Your letter of 4 November 2014 also sought an update on the Government’s approach to Draft Amending Budget no.3 (“DAB3”) and the draft annual budget for 2015. At Friday’s ECOFIN, the Council agreed to work constructively to adopt a position on DABs for 2014 in a timely manner, while recalling Council’s position on the draft budget for 2015. As requested, I will provide the Committee with an update on the outcome of negotiations once they have concluded.

11 November 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 11 November 2014, on the Draft EU Budget for 2015, Draft Amending Budgets 3 (DAB3) and 6 (DAB6) to the 2014 Budget, and the request to the UK for €2.1 Billion payment to the EU Budget. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 18 November 2014.

We note the deal reached at the 7 November ECOFIN on the request to the UK for a €2.1 billion payment. You refer the Committee to the Chancellor’s statement and the Presidency conclusions. Given the cursory nature of your letter, we look forward to a full account of the deal, together with details of the proposal to amend European law to take account of exceptional circumstances, in your reply. We also expect that this letter will provide a substantive response to the specific questions contained in our letters of 29 October and 4 November 2014.

We note that on 17 November 2014, Coreper agreed its position on a package covering the 2015 EU Budget and Draft Amending Budgets for 2014. Nevertheless agreement with the European Parliament was not reached before expiry of the conciliation deadline the same day. We would be grateful for a full account of these negotiations, as well as full details of the next steps as the Commission is required to propose a new draft budget. We would also be grateful for an account of the UK’s position on the 2015 Budget and the various Draft Amending Budgets for 2014, notably DAB3 and DAB6. Can you confirm that the UK abstained? What was the justification for abstention rather than voting against the proposals? We also seek clarification of the statement in the Council Press Release that "the Council’s position seeks to put the development of commitments and payments on a more sustainable path to avoid similar situations in the future.” What are the practical implications of this statement?

DAB3 and DAB6 remain formally under scrutiny pending a response to this letter. We would be grateful for a reply by 25 November 2014.

18 November 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 18 November which seeks an update on discussions of the annual budgets for 2014 and 2015. I am sorry that you did not consider my letter of 11 November to be sufficiently detailed and hope that this letter provides the Committee with the information required.

As you note, my letter of 11 November and the accompanying Presidency conclusions set out the deal reached at ECOFIN on 7 November. This deal included agreement to a targeted amendment to Regulation (EC, Euratom) No. 1150/2000 to take account of exceptional circumstances and allow Member States to defer required payment over a reasonable period of time. Following the publication of a formal proposal for this amendment, I submitted EM no.15444/14 for the Committee’s consideration which sets out the detail of this proposal and the Government’s approach.

Your letter also sought an update on EU level discussions of the budgets for 2014 and 2015. Since last writing to you, I have attended two Budget ECOFIN meetings aimed at finalising the package of Draft Amending Budget (“DAB”) requests for the 2014 annual budget and the proposed annual budget for 2015. These discussions were, as you know, unsuccessful and we now expect the Commission to issue a new proposal in the coming days.

18 November 2014
To explain in a bit more detail these developments, the Council had already, as you know, agreed in July a position on the annual budget for 2015 (a position which the UK had been unable to support). During Budget ECOFIN on Friday 14 November the Council was unable to agree a position on the package of DABs for 2014. The UK, alongside the majority of other Member States, was unable to support a compromise proposal from the Presidency resulting in no agreed Council position on the DABs package for 2014. As such, negotiations with the European Parliament (“EP”) could not take place.

Consequently, on Saturday 15 November and Monday 17 November COREPER met to discuss and ultimately agree a Council position. Conciliation with the EP then began on the afternoon of Monday 17 November, at a second Budget ECOFIN meeting which I attended. During this meeting, the Council and the EP were unable to agree a position ahead of the midnight deadline although there was no formal vote. The conciliation period therefore expired with no budget agreed.

In light of these developments, we now expect the Commission to release a new draft budget in the coming days with a view to discussing and securing agreement by mid-December. This proposal will be subject to the usual scrutiny procedure, and I will submit an EM for the Committee’s consideration once the new draft budget for 2015 is published.

Finally, your letter sought clarification of the practical implications of the reference in Council’s Press Release to achieving a more sustainable level of commitments and payments to avoid similar situations in the future. This statement recognises the issues presented by the historic gap between commitments and payments and Member States have taken this into consideration when adopting a position on proposed packages.

The gap between payments and commitments is significantly tighter in 2014 than in previous years and was tightened even further in the Council’s agreed position of July 2014. This is encouraging evidence of the value of the 2014-2020 Multiannual Financial Framework in bearing down upon the build-up of commitments and should help to address the current backlog. It is clear that the EU budget has to reflect the fiscal circumstances of Member States across the EU and the UK will continue to work with like-minded Member States to press for this type of budgetary restraint to be reflected across both the commitment and payments ceilings of the EU budget.

As you are aware, negotiations on the EU budget are live and developing quickly. As such, I will seek to keep you and the Committee up to date as discussions develop, and would be happy to speak by phone if helpful.

27 November 2014

Letter from the Chairman to David Gauke MP


We welcome this proposal as a simple yet sensible adjustment of the rules pertaining to the annual adjustment of Member States’ national contributions based on VAT and GNI. It is a pragmatic recognition that exceptional circumstances may from time to time arise where the figures involved are of such a high level as to, in the Commission’s words, “put Member States in a difficult budgetary situation and may even imply a significant risk for their economic or financial stability.” What are the implications of the agreement for Member States due to be reimbursed in 2014, and in any given year in the future? In the event that one of the two conditions for delayed payment is met, will there be a consequential delay in reimbursing Member States whose national contribution has been revised downwards?

Given the unusual circumstances, we would be grateful for further clarification of your statement that “the proposal has been considered by the Council and opinions are being sought from the European Parliament and the European Court of Auditors.” It would be particularly helpful to know:

— Whether there has been, or whether there will be, any discussion in Council subsequent to the 7 November 2014 ECOFIN discussions and to the adoption of the document on 12 November;

— What is the timetable for formal agreement of the proposal by the Council;
When the European Parliament and the European Court of Auditors are expected to present their views, and what sense, if any, there is of their likely positions;

How the agreement will be applied in relation to agreement on the revised regulation on Own Resources, and whether you anticipate any difficulty in this regard;

The meaning and basis for the Chancellor’s assertion before the House of Commons that “we can examine the numbers, and if there are errors we will get money repaid to us at the end of next year.”

You cite the Chancellor’s statement that the UK correction will apply in full. It is our view that the rebate was never in question, and thus the Chancellor’s assertion that “we have halved the bill” is factually questionable. We would therefore be grateful for a full account of negotiations and how they justify this assertion, as well as an explanation of the Chancellor’s statement that “it had not been clear that we would receive a rebate, let alone such a large one”. Can you also clarify his remarks that “it was agreed that a full rebate would apply to the British payment, that the rebate would be specific, that it would be in addition to any other rebate that we might expect next year, and that, for the first time ever, it would be paid at the same time as any money owed”? What will be the practical impact on the rebate process for 2014 and 2015?

You note your letter of 27 November 2014. While we acknowledge that a number of our questions on the Government’s position and the implications of a failure to reach agreement on the UK payment have been superseded by events, we are disappointed to have still not received a response to our questions of factual clarification on the original request, as set out in our letters of 29 October 2014 and 4 November 2014. We again invite you to address the following points:

**THE COMMISSION’S REQUEST:**

— Can you provide a full account of the means by which this calculation has been arrived at and the statistics on which it is based? Can you confirm the legal basis for the request?

— Is it correct that the figure derives from a one-off recalculation of VAT and GNI figures undertaken by Eurostat dating back to 1995? Are we correct in our understanding that 1995 has been chosen because this was the year that the GNI/GNP resource came into operation?

— On what other occasions since 1995 did Eurostat also undertake recalculations of VAT and GNI figures? On what previous occasions in that period were Member States requested to provide payment or notified of reimbursements? Was 2010 one such occasion?

— When was the decision taken to recalculate VAT and GNI balances? In the event that this was more recent than 1995, what is the Commission’s justification for seeking retrospective readjustment as far back as this date rather than from the date of agreement?

— Can you also clarify why the GNI and VAT changes date back to 2002 rather than 1995 in the UK’s case?

**THE GOVERNMENT’S POSITION:**

— Can you clarify when the Government were first made aware: a) of the likelihood of the UK being asked to make an additional payment; and b) the precise scale of the amounts involved? To what extent were you taking account of the full ramifications of the European System of National and Regional Accounts (ESA 2010)?

— What was the nature of the UK statistical authorities’ interaction with Eurostat in relation to this recalculation?

— In December 2013 and February 2014, we wrote to the then Economic Secretary to the Treasury, Nicky Morgan MP in relation to the European Court of Auditors’ Annual Report on the Implementation of the EU Budget in 2012. That report had highlighted 11 GNI reservations outstanding in relation to the UK, the most of any Member State. We asked the Minister
what was the nature of the problem, what had caused such a high number of reservations and how confident she was that the Commission would judge the UK to have sufficiently addressed these issues. In her reply of 11 March 2014, the then Minister stated that outstanding GNI reservations had been introduced over several years but that “the Government continues to give high priority to addressing these reservations in the National Accounts work plan. In addition, the ONS has agreed priorities with stakeholders and publically set out commitments via the published plan.” How does this statement relate to the matter at hand?

Finally, we would point out that this episode demonstrates that reform of the budgetary process is possible when the Government and other Member States demonstrate the necessary political commitment.

We again draw your attention to our broader concerns about the budgetary process expressed in recent correspondence on the 2015 Draft Budget. You have repeatedly stated that “rather than focusing on potential reform of the system, the Government’s energies for now are fully focused on the amount of money that the UK is going to be expected to find in 2014 and 2015”. We once again call on you to reconsider this facile position.

In order to allow the Committee an opportunity to consider your response before the Christmas recess we would be grateful for a reply to this letter by 11 December 2014. In the meantime we will continue to hold the document under scrutiny.

We will write separately regarding the issues raised in your 27 November 2014 letter pertaining to the 2015 Draft Annual Budget and the 2014 Draft Amending Budgets.

3 December 2014

EUROPEAN COURT OF AUDITORS’ ANNUAL REPORT ON THE IMPLEMENTATION OF THE EU BUDGET FOR 2013 (UNNUMBERED)

Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury


We are glad to see that the ECA again conclude and indeed approve that the EU accounts are reliable and fairly represent the financial position of the EU, the results of its operations and its cash flows for the year. In noting that the ECA has granted a qualified Statement of Assurance for the twentieth year in a row, we observe that there has been next to no improvement in the headline estimated error rate. It is regrettable that this figure does not point to any significant improvements in control of the budgetary process. The ECA report does highlight however that had the Commission and Member States not applied corrective measures to transactions, the Court, based on its reviewed sample of transactions, would have estimated the level of error to be 1.6% higher than the current level, which is of course welcomed. We are concerned that new challenges in presenting reliable financial information of the EU budget will be increasingly burdensome in managing the EU budget. These challenges arise due to ongoing financial developments, particularly the growing use of net financial corrections and financial instruments. How is the UK Government intending to respond to the ECA’s recommendation that the Commission put in place sound procedures for Member States to work with the Commission to confirm timings, origins and amounts of corrective measures, in order to give greater assurance to the accuracy of the figures presented in the accounts?

Paragraph 58 of your Explanatory Memorandum implies that the governments of the Member States are not responsible for the problems to which the Court of Auditors draws attention. Yet it is clear that governments are, and indeed the Court of Auditors draw attention to failings in this country. Paragraph 59 of your EM implies resistance to Commission efforts to oblige the Member States to tackle such problems. As such you fail to address the persistent problems that exist at Member State level. You will find attached [not printed] to this letter an Annex produced by the European Court of Auditors detailing references to the UK in the Court’s Annual Report. We would be grateful for full details and explanations of the various reservations and weaknesses that have contributed to the error rate in the UK.

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We are disappointed at the Government’s continued lack of initiative in suggesting improvements in the way the budget is run. While an increased focus on added value is welcomed, this does not alleviate the short and medium term persistent problems of inaccuracy or errors due to inadequate shared management processes at the Member State level. The information in the Evaluation Reports by the Commission are deemed inadequate to be used as a basis for discharge of the budget. The Court of Auditors also state that new performance arrangements may indeed encourage an increased focus on results, but the impact is likely to be marginal as there are still no financial incentive or sanctions in the 2014-2020 framework relating to the results achieved with EU funding. We ask again why sanctions should not be introduced. What specific proposals for sanctions have been proposed by the Commission? How would they be applied? What effective solutions are there to address the weak incentives in the management of the EU budget, other than performance measures? Which of the ECA’s recommendations do you find particularly helpful in restoring trust in operations of shared management?

In light of the mechanism of checks to assess the regularity, reliability and legality of transactions by the EU, we would be interested to know how the 4.7% error rate compares to the error rate for the UK budget. Can you estimate what this level would be? We note that in 2006, Sir John Bourn, the then Comptroller and Auditor General at the UK’s National Audit Office, told this Committee in the context of its report on ‘Financial Management and Fraud in the European Union: Perceptions, Facts and Proposals’¹, that were he required to issue a single Statement of Assurance on the UK’s Government’s accounts in the same way as the Court of Auditors does for the European Union’s accounts, he, like the Court, would be unable to do so. This was because the previous year he issued a qualified opinion on 13 of the 500 accounts of the British Government which he audited. Does such a situation continue to hold true today?

Finally, we note that the Prime Minister has promoted a reform agenda for the EU. Why is reform of the budgetary system not a prominent part of this agenda?

We would be grateful for a response to this letter by 16 December 2014. In the meantime we will continue to hold the document under scrutiny.

2 December 2014

EUROPEAN FINANCIAL REPORTING ADVISORY GROUP (EFRAG) (11690/14, 5213/14)

Letter from Jo Swinson MP, Minister for Employment Relations and Consumer Affairs, Department for Business, Innovation and Skills, to the Chairman

Following my letter of 15 March 2014, I am writing to confirm the final agreement.

I recently sent you EM 11690/14 covering a report from the Commission on the progress achieved in the implementation of the reform of the European Financial Reporting Advisory Group (EFRAG).

The Maystadt recommendations are an important element of the agreement of the funding programme for the international financial reporting and audit bodies.

Commitments to fund these bodies was related to these reforms, although the Commission’s proposal to provide funding support to three accounting and audit organisations was agreed on 3 April 2014 and published as Regulation (EU) No. 258/2014.

We had anticipated that the Commission’s report on progress with the reforms would be published early in April, but it did not take place until 8 July 2014. I am now following with details of the funding programme in the context of the satisfactory progress made on the reform of EFRAG, as described in the report.

The funding will be for the period 2014 – 2020. It will be provided in the form of operating grants awarded on an annual basis relating to:

- International Financial Reporting Standards Foundation (IFRS Foundation) EUR 31,632,000 (£25,002,408)
- The European Financial Reporting Advisory Group (EFRAG) EUR 9,303,000 (£7,354,213)
- The Public Interest Oversight Board (PIOB) EUR 2,241,000 (£1,771,417)

¹ http://www.publications.parliament.uk/pa/ld200506/ldselect/ldeucom/270/270i.pdf
The UK supports the contribution these organisations make to a single and transparent set of global accounting standards.

31 July 2014

Letter from the Chairman to Jo Swinson MP

Thank you for EM 11690/14, dated 21 July 2014, on the Report from the Commission on the progress achieved in the implementation of the reform of EFRAG following the Maystadt report recommendations. Thank you also for your letter, dated 31 July 2014, on EM 5213/13, the Proposal for a Regulation in the field of Financial Reporting and Auditing for the Period 2014-2020. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 9 September 2014.

We welcome the progress in implementation of the Maystadt review recommendations. However we note that your EM does not comment on the departures from the Maystadt recommendations set out in the Commission document, including granting an additional seat to smaller Member States, the decision of the ESAs and the ECB to take only observer status, the addition of three additional seats to private stakeholders, and provision for a full-back mechanism of a qualified majority of two-thirds of Members to make a decision. What is the Government’s view of these adjustments?

You state that the UK will monitor progress with the reforms recommended by the Maystadt report. We also note that Philippe Maystadt will supervise the implementation of the reform of EFRAG. In that light we would be grateful for further updates on the progress of implementation in the months ahead.

We would be grateful for a response to our questions by 6 October 2014. In the meantime we now clear EM 11690/14 from scrutiny.

10 September 2014

Letter from Jo Swinson MP to the Chairman

I am writing in response to your letter of 10 September 2014 regarding a European Commission report on progress achieved in the implementation of the reform of the European Financial Reporting Advisory Group (EFRAG) that was summarised in EM 11690/14. Your letter welcomed the progress in the implementation of the Maystadt review recommendations and cleared the EM. You also noted a number of areas where the EFRAG’s reforms have departed from the Maystadt review recommendations and requested information on the Government’s view of these.

EFRAG plays an important role in the EU’s decision making processes in relation to the adoption of international accounting standards. As such it is essential that the body’s own governance arrangements provide confidence in the legitimacy of the advice it gives to the Commission. In this context, we are pleased with the decision to reform EFRAG and with the progress that has been made. The departures from the recommendations represent a pragmatic response to issues emerging during the implementation phase. Taking each of your points in turn:

— **Granting of an additional seat to the smaller Member States** - Although some smaller Member States do not have a national standard setter it is important that they have the opportunity to participate fully in the endorsement process. The granting of an additional seat to the smaller Member States recognises this and enhances EFRAG’s institutional legitimacy.

— **Decision of the three European Supervisory Agencies (ESAs) and the European Central Bank (ECB) to take only observer status** - The ESAs and the ECB would have preferred a decision-making process centred around public authorities. As this is not the model proposed, they feel unable to participate as voting members of EFRAG’s board. Both the ESAs and ECB have a strong interest in the accounting framework applied to companies listed on the EU’s regulated exchanges. In view of this, we believe it is appropriate that they participate as observers.

— **Provision of three additional seats to private stakeholders** - The increase in seats for private stakeholders is necessary to maintain the balance of EFRAG’s board. This increase in seats should also ensure that concerns expressed after publication of Mr Maystadt’s recommendations about the
capacity of board members to reflect the wide spectrum of stakeholder interests can be addressed.

Qualified majority voting - It is essential that EFRAG is able to provide timely, high-quality advice to the Commission in support of the endorsement process. It would not be acceptable for the endorsement process to stall merely because consensus proved impossible to achieve. The proposal for advice to be agreed by a qualified majority, with the fall back of allowing the President to present his conclusions based on an indicative vote where a qualified majority view was not achievable, presents a practical way forward. We do not consider this undermines the Maystadt recommendation for consensus decision making.

Since the publication of the progress report the Commission has advertised for candidates for the role of President of EFRAG with a closing date of 15 September. The text of the notice was:

“The European Commission is looking for suitable candidates to fill in the post of President of the Board of the European Financial Reporting Advisory Group (EFRAG). The President of the EFRAG Board will be nominated by the European Commission after having heard the Council and the European Parliament and will be appointed by the EFRAG General Assembly.”

I will write again when I have news of the outcome from this exercise.

1 October 2014

EUROPEAN LONG TERM INVESTMENT FUNDS (12044/13)

Letter from Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury, to the Chairman

Thank you for your letter of 10 December 2013 on the European Long Term Investment Fund Proposal (ELTIF), following our Explanatory Memorandum of 26 June.

The Council have met at working level to discuss this proposal on a number of occasions over the last few months, and the draft text is currently in a positive place. The Greek Presidency is planning on holding further meetings in June and has indicated that it hopes to reach a General Approach before the end of its term.

RETAIL PARTICIPATION

The major contentious issue has been whether or not such a long term product can be suitable for retail investors. The Commission’s rationale for creating a retail scheme is that there are many institutional investors whose investment mandate requires that they may only invest in retail suitable products, including many defined contribution pension funds. The Government broadly agrees with this view. A majority of Member States have argued, however, that a long term fund with no redemptions can never be suitable for retail investors. Whilst the compromise still allows marketing to retail investors, it is likely that future iterations will restrict this to certain semi-professional or high net worth investors defined by those able to make a minimum subscription of a certain amount, similar to European Venture Capital Funds (Regulation (EU) No 345/2013) or European Social Entrepreneurship Funds (Regulation (EU) No 346/2013).

We have spoken with UK firms that are interested in the opportunities that ELTIF could offer. They agree with the Commission’s proposition of a retail product with institutional investors in mind. Some believe that it would still be possible for them to make a workable product if the investor base were restricted by a minimum investment threshold though the benefits would be diminished as it would be a clear statement that it is not genuinely a retail suitable product.

In our view, the compromise that has been reached is acceptable due to the limited impact it would have in practice. A closed ended fund with no redemptions can be suitable for some retail investors as part of a diversified portfolio in the context of an advised sale – particularly where the fund is structured as an investment company admitted to trading on a regulated market. In this case funds will operate similarly to an investment trust or a venture capital trust where secondary trading can compensate for a lack of redemption, or where investment is being made as part of a self invested pension where there would be no redemptions in any case.
CROSS BORDER SUPERVISION AND ENFORCEMENT

With regard to cross border supervision and enforcement where an ELTIF is authorised in one jurisdiction and the manager in another, the Commission has stated that its intention is that this should follow the same model as exists for funds authorised under the Undertakings for Collective Investment in Transferable Securities Directive, as we had hoped. We expect to be added to the text.

ELIGIBLE INVESTMENTS

Eligible investment rules have changed little from the original proposal.

A number of Member States argued that ELTIFs should not be able to make loans, which they are permitted to do under the proposal and state that this represents shadow banking. The Government does not agree with this assessment. ELTIFs as they are envisaged are established for a fixed life with no redemption and may not make loans that exceed their lifecycle. Therefore there is no maturity transformation. Furthermore ELTIFs would be restricted from using leverage and would be lending their own capital. As such we do not agree that there would be any shadow banking risk. Restricting the ability of ELTIFs to lend would be very damaging as well as the majority of investment in infrastructure is made by way of loans. The text therefore currently still allows for an ELTIF to make 100% of investment by way of loans.

In order to ensure investment on infrastructure, whilst excluding certain speculative investments such as wine, art, or vintage cars, there is general agreement in the Council to include a suitable definition of “real asset” as an eligible investment however the precise formulation of this definition is yet to be determined.

The text currently still does not allow for a fund of fund structure. Some firms interested in establishing ELTIFs have argued that it could be more efficient to structure themselves as a fund of funds when looking to invest in a range of assets across different markets, however on further discussion they agree that this is a secondary issue and the Government agrees.

UK TAX TREATMENT OF ELTIFS

In the UK tax rules operate independently of the Regulation or Directive under which a fund may be authorised. Therefore the vehicles which are used to facilitate investment in ELTIFs would continue to be subject to the tax rules that are currently in place. So if, for example, an ELTIF were to be set up as an investment company or as a limited Partnership then it would use the tax rules currently in place for such vehicles. Broadly, the Government does not hold any concerns and expects these rules to be effective as they stand.

As stated above, the Greek Presidency is looking to confirm the formal Council position on this dossier by the end of the month. The Government would look to support the Regulation as currently drafted, however if things move substantially I will write to you as a matter of urgency.

7 June 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 7 June 2014, on EM 12044/13: the Regulation on European long Term Investment Funds (ELTIFs). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 June 2014.

We are grateful for this useful update, and welcome the progress towards an acceptable compromise text. In light of our previous concerns, we note in particular that the proposal for a fund of fund structure looks unlikely to be pursued. We also note the sensible emerging compromise on retail participation, and support your position in relation to cross-border supervision and eligible investments. You state that firms and the Government agree that allowing for a fund of fund structure is a secondary issue. Does this mean that the idea has been dropped and will not feature in the final text of the proposal?

Noting that the Greek presidency is shortly expected to seek agreement to a General Approach, we are now content to clear the document from scrutiny. However we would be grateful for further update on the outcome of negotiations, in particular with regard to elements of the proposal yet to be determined. We would be grateful for receipt of such an update by 18 July 2014.

18 June 2014
Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 18 June on the European Long Term Investment Fund Regulation proposal. General Approach for this proposal was agreed by the Council in Coreper on 25 June. As requested I am writing to clarify the position on funds of funds and other items that were unresolved at the time of my previous letter.

FUNDS OF FUNDS

Regarding the possibility of a fund of funds, this is expressly prevented in the final Council text. A European Long Term Investment Fund (ELTIF) would not be able to invest more than 20% of its capital in other investment funds. In turn, those investee funds would not be able to invest more than 10% of their capital in other funds in order to prevent a proliferation of fees or dilution of investment. Investee funds must also adhere to the same overall investment requirements as an ELTIF although they do not necessarily need to be authorised as an ELTIF themselves.

RETAIL PARTICIPATION

Retail participation is still permitted in the final Council text with certain restrictions. Managers or agents acting on behalf of managers must sell to retail investors through an advised process that takes into account the suitability of the life cycle of the fund and its risk profile for the circumstances of the prospective investor. Retail investors must be able to commit to a minimum subscription of €10,000 and any investment must not exceed 10 per cent of their net investible assets.

These restrictions do not apply to retail investors with net investible assets exceeding €500,000.

DEFINITION OF REAL ASSETS

The final text defines a real asset as a physical or tangible asset that has value due to its substance and properties and can be expected to provide returns. The text is open as to whether this could be in the form of capital growth, an income stream, or a combination of the two. The text also provides a non-exhaustive list of examples.

16 July 2014

Letter from Nicky Morgan MP, Financial Secretary, HM Treasury, to the Chairman

Thank you for your letter dated 13th May concerning Explanatory Memorandum 7413/14: European Semester: Prevention and correction of macroeconomic imbalances.

In your letter you welcome the Commission’s acknowledgment of the challenges that remain, and ask whether the EU Institutions have done enough to respond to the identified weaknesses. As you are aware, structural reform is ongoing across the EU, and much has already been achieved. The Government considers that this process needs to continue, notably by increasing the flexibility of labour markets, and strengthening the single market, for instance by fully implementing the Services Directive.

Your letter also refers to a growing deflationary threat. You will be aware specific euro area monetary policy decisions are a matter for the ECB, which will continue to monitor developments in the euro area closely to ensure price stability as defined in its mandate. More broadly, the Government considers that all Member States need to comprehensively address Europe’s growth challenge and tackle overall low productivity, lack of economic dynamism and flexibility. The UK has long argued for a pro-business, pro-growth agenda completing the single market and fostering greater competition throughout Europe. There needs to be a step change in structural reforms across Europe, and high-deficit, low-competitiveness countries in the periphery must continue to tackle their problems.
In terms of the Commission’s assessment of the UK, the Government recognises that in accordance to the thresholds set out in the Macroeconomic Imbalances Procedure (MIP) scoreboard, the UK is in breach of the following three indicators: export market share, private sector debt and public sector debt. The Government’s long-term economy strategy, set out in the June 2010 Budget, was designed to address these imbalances from developing further. To date, the government has taken substantial steps to correct these imbalances. For instance, the household debt-to-income ratio has fallen by nearly 30 percentage points since its peak in 2008 and exports of goods and services grew by 1.9 per cent in 2013. Growth is expected to pick up to around 5 per cent a year from 2015 onwards according to the independent Office for Budgetary Responsibility. Moreover, the Government has introduced a new system of macro-prudential regulation, with the Financial Policy Committee (FPC) at the centre, to monitor risks and take action where appropriate.

You also ask about the practical effect of the UK’s participation in the European Semester process, given that the UK is not subject to sanctions under the MIP or at any point of the Semester. The Government supports the objectives of the Semester to share best practice on economic policies, to help strengthen the resolve of all Member States to move forward with structural reform and to support responsible fiscal policies.

4 June 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your letter, dated 4 June 2014, on EM 7413/14 on the European Semester: Prevention and Correction of Macroeconomic Imbalances. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 10 June 2014. At that meeting we also considered the Commission Recommendation, dated 2 June 2014, for a Council Recommendation on the United Kingdom’s 2014 National Reform Programme and delivering a Council Opinion on the United Kingdom’s 2014 convergence programme. We understand that the Government EMs on these documents and on the country-specific recommendations for other Member States are expected to be received shortly. However, given that the documents are due to be discussed in Council on 19/20 June, we took the decision to write to you at the earliest opportunity.

We would stress the responsibility of each Member State to take account of and respond appropriately to the Commission’s recommendations in each case, so as to encourage growth and economic prosperity across the EU. What more can the Government do to encourage this mutually beneficial process across the EU in order to secure the aims of the Single Market in securing enhanced growth and prosperity?

We note that the Commission has made a number of specific recommendations in relation to the UK. In light of the comment in your letter that “the Government supports the objectives of the Semester to share best practice on economic policies, to help strengthen the resolve of all Member States to move forward with structural reform and to support responsible fiscal policies”, what practical steps will the Government take in response to the Commission’s recommendations? What action will you take to ensure that best practice is indeed shared across the EU?

We look forward to receiving the EMs on these important documents, and in addition would be grateful for a response to this letter by 24 June 2014. In the meantime we will hold the country-specific recommendation documents under scrutiny.

10 June 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter dated 10 June concerning European Semester documents.

I refer to the Government’s recent Explanatory Memorandums on the Country Specific Recommendations addressed to the UK and to other Member States and the euro area.

You also asked specifically what steps could be taken to encourage a culture of mutual learning across the EU, and to ensure that best practice is shared. The Government considers that the Semester process is a constructive one, my officials and those of other interested departments are engaged in in-depth, open and frank discussions throughout the year in order to share best practice across the full range of policy areas. Key elements of the resulting analysis are considered at Council. However, the government notes that the policy areas covered by the Semester fall primarily within the competence of individual Member States, and considers that strong national ownership is essential for
structural reform to be successful. In this context, the government does not formally comment on the economic policies of other Member States.

You also asked what steps the Government will take in response to the Commission’s recommendations. The European Commission addressed recommendations to the UK on 2nd June in the following areas: reducing the deficit, reforming the housing market, improving skills and tackling youth unemployment, combating worklessness, improving access to credit, and investing in infrastructure.

As set out in the Explanatory Memorandum, these areas are broadly in line with the government’s policies. We will take full account of the detailed analysis and recommendations in considering the most effective way for the government to meet our objectives on growth, as we do with the advice from other international institutions, such as the IMF or the OECD. The government nevertheless disagrees with the Commission’s assessment of the Help to Buy: mortgage guarantee scheme and notes that latest figures show that the scheme is having the desired effect. The government also disagrees with the Commission’s assessment that the Council Tax regime creates distortions in the wider housing market.

I look forward to participating fully in the Commission’s review of the Europe 2020 Strategy, and to exchanging ideas with you about how to further refine EU-level surveillance with a view to strengthening Member State implementation of growth-enhancing structural reforms.

16 June 2014

Letter from the Chairman to Nicky Morgan MP


The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 18 June 2014. You will also be aware that EM 10501/14 et al on recommendations for a Council Decision abrogating decisions on the existence of an excessive deficit in various Member States was cleared at the sift on the same day.

Further to our 10 June letter on the Semester, we are now content to clear these documents from scrutiny. However we would repeat our regret that, in the 9 April 2014 debate on the Convergence Programme, it again did not prove possible for the debate to also cover the National Reform Programme. We would also be grateful for further detail on your comment in EM 10679/14 and 10522/14 that “the devolved administrations have been consulted in the preparation of this EM”. What was the nature of this consultation?

We would be grateful for a response on these points by 2 July 2014.

18 June 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter of 18 June concerning the European Semester documents and in follow up to my letter of 16 June.

In your letter you asked about the nature of the consultations with the devolved administrations in the preparation of the Explanatory Memorandum 10679/14 & 10522/14 on the UK’s Country Specific Recommendations. It is standard practice for the Government to consult the Devolved Administrations when drafting EMs which concern either devolved functions or reserved functions with a particular impact on devolved functions, and to give careful consideration to any drafting proposals submitted by the Devolved Authorities. Given that the Country Specific Recommendations cover both reserved and devolved matters, the government consulted all Devolved Administrations in the preparation of this EM.

30 June 2014
Thank you for EM 12446/14 on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS) and EM 12447/14 on the mission and organisation of the European Systemic Risk Board (ESRB), dated 1 September 2014. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 9 September 2014.

It is clear from the Commission report that the ESAs have focussed to a large extent on fulfilling more effectively their regulatory mandate than fulfilling their supervisory responsibilities. We understand that this is partly due to the demands of the intense regulatory climate which instructs the ESAs to draft rules. We agree with the short term amendments proposed in the Report that the ESAs should make more use of peer reviews. We would like you to explain in more detail your assessment of the effectiveness of peer reviews and your suggestion that the peer reviews should provide second opinions on the discharge of supervisory responsibilities.

We agree with a number of the non-legislative amendments in the Commission Report. We particularly welcome the emphasis on enhancing the transparency process for preparing technical standards and advising the Commission. It is also clear from the Commission report that it will empower technical standards in future legislative proposals to have deadlines relative to the entry into force of the basic legal act. This will effectively allow the ESAs to have adequate time to produce and consult on level 2 rules, which we believe will make a significant difference to the experience of stakeholders in participating in consultations. However we are concerned that the ESAs have an insufficient ability to make quick and decisive changes to alter regulation. Evidence put to us in the context of our current inquiry into the EU financial regulatory framework has suggested that the vast volume and pace of agreed legislation has produced unintended drafting errors. Yet the ESAs lack the power to rectify legislation promptly, with potentially harmful consequences for European financial markets. How would you respond to this argument?

A number of suggestions were set out in the Report to enhance the internal governance of the ESAs and ESRB. You disagree with the Report’s assessment that the Board of Supervisors within the ESAs has not acted in the European interest. What are the reasons behind your belief that the Board of Supervisors has acted in the European interest?

You make clear that you believe no legislative changes are necessary at this point and that the ESAs are well equipped to fulfil their existing mandate. You may recall that our 2011 Report evaluating the EU Financial Supervisory Framework stressed that national supervisors should be responsible for micro-prudential regulation and information. It however remains clear that an ongoing tension exists as to how much information sharing should be permitted between the ESAs and individual financial institutions. Is there a danger of unnecessary and excessive bureaucracy being created if such competences are not transferred to ESAs? Given that it has been suggested that the ESAs could in future carry out roles such as stronger oversight of internal model valuations, shadow banking and IFRS enforcement, do you consider the medium term legislative changes in the level of information sharing appropriate? You state that transparency, efficiency and independence can be enhanced to improve the ESAs’ accountability using expertise from the national level. Can you provide more detail in terms of this suggestion, and in particular whether some level of direct access to data would help to improve transparency and the ESAs’ duty to carry out its economic analysis?

The recent decision by the European Court of Justice to dismiss the UK’s challenge in relation to the short selling regulation, handed down a judgment that could arguably encourage the EU to transfer further powers to EU bodies. How would you respond? What is the Government’s policy response to this judgment?

In light of the inauguration of the Single Supervisory Mechanism, you note that the ESRB will need to ensure it can manage any tensions that arise in terms of the ECB’s supervision of the SSM and the ESRB’s role in assessing risks across the whole of the EU. We take note of this concern and ask you to provide more details on the nature of the tension between the two institutional bodies and indeed any structural changes that may be necessary.

We take note of the expiration of the mandate of the first Chair of the ESRB in December 2015. Do you have any concerns on the Regulation that needs to be revised? Furthermore, in recognising the
operations of the ESRB do you support the new function of a Managing Director, and whether the composition of the two advisory committees should be reviewed?

We would be grateful for a response to this letter by 6 October 2014. In the meantime we will continue to hold EMs 12446/14 and EM 12447/14 under scrutiny.

10 September 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter dated 10 September 2014 on the operation of the European Supervisory Authorities (ESAs), the European System of Financial Supervision (ESFS) and the European Systemic Risk Board (ESRB).

You asked for the Government’s view of ESA peer reviews. One of the core tasks of the ESAs in their role as strategic level regulators, as opposed to day-to-day supervision which remains a task for national competent authorities, is to help raise the standards of supervision across the EU. As you noted, the UK Government considers this an area that has been relatively neglected since the inception of the ESAs due, in part, to the volume of rules that the ESAs have been required to draft. It is now important that the ESAs improve their ability to help raise supervisory standards, ensure that regulation is implemented consistently and share best practice across Member States. Peer review is one approach that has been demonstrated to be effective – for instance, in other international financial organisations such as the International Monetary Fund and the Financial Stability Board – in helping to enhance standards across member countries. To date, the ESAs have only conducted a limited number of peer reviews and so it is too early to provide a robust assessment of their impact and effectiveness. However, the UK Government is of the view that a greater future focus in the ESAs on peer review and a sufficiently clear and strategic approach, while still focusing on specific issues that support improved outcomes – for example, in the area of enforcement – would support higher standards of supervision.

You raised the issue as to whether the ESAs should have powers to rectify legislation promptly, in light of evidence to your inquiry that the volume and pace of agreed legislation has produced unintended drafting errors. The quality of the rule-making process on financial services issues, both at the legislative and “delegated” level, since the global financial crisis was also called into question by a large number of respondents to the Government’s Balance of Competences report on Financial Services and the Free Movement of Capital. However, any ex post powers to the ESAs to rectify errors would need to be considered carefully, not least as these could reduce the incentives for the quality of legislative drafting to be high from the outset and could impinge on the role of the co-legislature under the Treaty on the Functioning of the EU. It is arguable that there should instead be a stronger focus on preventing the creation of such errors in the first instance. In situations of urgency, the ESAs may already submit draft technical standards to the Commission for adoption without public consultation. For this reason, the UK Government is keen to see reforms to the quality of the policy-making process on financial services legislation, including through steps to improve the quality of the drafting of legislation in the first instance.

In your letter, you noted the Government’s disagreement with the contention in the Commission’s reports that the Boards of Supervisors of the ESAs do not act in the European interest. First, the National Competent Authorities (NCAs) that comprise the Board of Supervisors are very aware of their independence obligations under the ESA Regulations. The UK Government believes that the NCA representatives on the Boards of Supervisors generally act according to these obligations, seeking effective and practical outcomes that will improve EU markets and promote the interests of EU citizens and economic actors. Indeed, other NCAs are well-placed to identify when individual members are not acting in the European interest. It is also worth noting that NCAs are independent from national parliaments and finance ministries and that their objectives are aligned with the European interest. In addition, it is important to note the expertise and insights that the NCAs are able to provide which allow them collectively to identify the best course of action. They provide accountability, technical knowledge and understanding of domestic markets, all of which help to ensure that the ESAs’ actions are both legitimate and informed.

It is important for their functioning that the ESAs have adequate access, subject to legal limits, to firm-specific data via NCAs. It is equally important that the ESAs make effective use of data, in order to enhance their ability to conduct peer group analysis and both identify risks and enhance supervisory activity at a sectoral level. It is, however, necessary that the ESAs have sufficiently strengthened processes in order to demonstrate compliance with their confidentiality obligations and to ensure that they have adequate security systems in place. As you noted, the UK Government believes that any reforms to the ESAs should be based around supporting the ESAs so that they can perform their
existing tasks and mandate and use their existing powers more fully. The Government, therefore, views the medium- to longer term options in this light. Furthermore, information sharing is not the key obstacle to achieving the goals of more transparent ESAs and a greater focus on economic analysis. The ESAs could improve their transparency by, for instance, being more open about communications with the Commission and decisions taken by the Board of Supervisors. A greater focus on economic analysis could be achieved through, for instance, a review of the prioritisation of work within the ESAs going forward.

With regard to the decision by the European Court of Justice on the short selling regulation, the UK Government has consistently stated that any powers conferred on EU agencies must be in conformity with EU Law to ensure legal certainty and institutional balance. The ECJ’s judgment in this case confirms that the Meroni principle continues to apply as to the nature of powers which may be vested with EU agencies and provides clarity as to how one is to apply the principle in the context of vesting powers concerning financial services regulation in the ESAs. Any proposal to vest powers in the ESAs will need to ensure that it adheres to this judgement.

You concluded your letter with a number of questions regarding the European Systemic Risk Board (ESRB). The UK Government considers the ESRB to have performed well since its inception. Key factors in its performance include the authority and expertise it derives from its comprehensive membership of central bank governors and financial supervisors, its independence from Member States and EU institutions, and its macroprudential oversight across all financial services sectors and the EU as a whole. It is important that the benefits of these elements are retained. This includes ensuring that the European Central Bank’s supervision of banking union countries is subject to the ESRB’s macroprudential monitoring, in line with supervisors from non-banking union countries. To date, the ESRB has benefited from its close relationship with the ECB, including through the sharing of information and expertise. Such benefits should not be lost; but care should also be taken to ensure the ESRB’s independence is not undermined. You also refer to the Commission’s proposal for a Managing Director and the two advisory committees. The UK Government is prepared to explore options to improve the effectiveness, efficiency and visibility of the ESRB. Subject to its mandate, the creation of a Managing Director post could help to support these goals. Similarly, the composition of the advisory committees could be considered as part of the broader review. However, care should be taken to ensure that the benefits of the existing membership and separate groups are not lost.

6 October 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 6 October 2014, on EM 12446/14 on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS) and EM 12447/14 on the mission and organisation of the European Systemic Risk Board (ESRB). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 21 October 2014.

Your response provides a helpful level of detail on many of the points raised in our letter sent on 10 September 2014. Read in conjunction with your separate correspondence on the unnumbered EM on the European Court of Auditors’ report on the European Banking Authority, it is clear that you do not support extending the mandates to the ESAs at the current time, but will consider other non-legislative changes to improve their functioning. We agree with the Government’s support for measures to improve the functioning of the level 1 process and transparency of decision making in the level 2 process.

We are however still concerned that you show no concrete long term vision for the ESAs as they continue to evolve in the medium term. The recent legislative period has showed the weaknesses of the ESAs in operating with limited resources and powers, which has ultimately lead to sub-optimal outcomes especially in terms of supervisory consistency and convergence. Whilst it is important that the ESAs fulfil their existing mandate, we urge you to be proactive in engaging in the medium term and potential legislative changes that can improve the functioning of the ESAs’ regulatory and supervisory responsibilities.

We would be grateful for any update as to further discussions on the proposed amendments to the ESAs. In the meantime we now clear the document from scrutiny.

21 October 2014
Thank you for your two recent letters on the operation of the European Supervisory Authorities (ESAs) and the European Court of Auditors’ report on the European banking Authority (EBA), and for clearing the relevant documents from scrutiny. I am responding to some of your further comments, as I want to ensure you are fully appraised of the government’s position on the ESAs review and will update you as the agenda progresses.

First of all, I wanted to clarify that the Government has a clear, long-term vision for the ESAs, which we have elaborated since their inception and most notably at some length in our response to the European Commission’s consultation last year. The Government wants to see each of the ESAs develop into strong and expert organisations that sit at the heart of financial supervision in the EU. Our vision is of the ESAs as strategic organisations that manage the overall system of supervision, ensuring there is a uniformly high standard of outcomes across the EU, which in turn will help to ensure a safe and stable single financial market as well as a level playing field that is fair and prevents arbitrage between different countries. The ESAs have a critical role in helping to design regulations, especially the detailed technical standards, raising standards of supervision across all 28 Member States and undertaking financial market analysis to help safeguard financial stability, as well as underpin the quality of regulation and supervision. I strongly believe that the key added value of the ESAs is that they provide a unique and strategic EU-level approach that helps to enhance standards of supervision and regulation.

For this reason, I feel it is undesirable for the ESAs to take on more direct supervision. To date, they have only directly supervised entities (credit ratings agencies and trade repositories) that are ancillary to financial markets. However, if they undertake more supervision, which is best left to national regulators with their expertise and proximity to local markets, then the benefit of that second, additional EU layer of protection will begin to disappear.

Indeed, there is a conflict of interest between the ESAs’ mandated role as a second layer of supervisory authorities that shares best practice and highlights inadequacy in national-level approaches, while also undertaking national level supervision themselves. For example, who will undertake a peer review of how the ESAs are supervising credit ratings agencies and trade repositories? Who would hold them to account in the same way that they are meant to hold national supervisors to account? The question of direct supervision also raises important questions of subsidiarity and ensuring that national regulators are able to meet their financial stability mandates and mitigate the risk to taxpayers posed by financial sector failure.

To date, the ESAs have only partially delivered on their mandate, primarily on the single rulebook aspect, and so they have much further to go if they are to deliver in full. To some extent, the ESAs could be considered to be approaching the end of their first development phase, which has been on writing new rules, and to now be entering the next phase, which is to help ensure rules are implemented and enforced appropriately.

The Government wants to see the ESAs succeed in taking forward the various tasks and activities they are already being asked to deliver. In this regard, the Government is engaging proactively in Council discussions to help improve the functioning and efficiency of the ESAs. For instance, we support the majority of the short-term improvements proposed in the Commission’s report from August 2014, including better use of peer reviews, greater transparency in drafting technical standards, and enhancements to internal governance within the existing Regulations. We should work to enhance ESA functioning within the existing Regulations, where much can be achieved, before considering more challenging options that would entail legislative change. I do not agree that they will become more efficient by being given more tasks or responsibilities – these may serve only to distract them from their core focus. Nor do I agree that they should be given additional powers when they have not exercised in full those they already have today. There would need to be clear evidence that there are obstacles or uncertainties in delivering their current mandate before changes and additional powers could be proposed.

You specifically raised the issues of binding mediation and supervisory convergence. On the first of these, Article 17 in the ESA founding Regulations sets out the instances and process whereby the ESA can adopt binding decisions on competent authorities in the event of disagreements between competent authorities in cross-border situations. The ESAs have not yet availed themselves of these powers. This is due, in part, to the successful use of non-binding tools and the threat of binding action which has helped to secure resolution of such issues when they have emerged. As such, it is not clear that the lack of use of binding mediation means that there is any need to strengthen these powers.
Indeed, to do so would risk infringing on the rights of national authorities to exercise supervisory judgement as well as the principle of subsidiarity and could lead to more interventionist ESA powers that would undermine the ESAs’ roles as system managers, as noted above.

In principle, I am not opposed to clarifications or modifications, however there is as yet no clear evidence that this is necessary. Furthermore, I do not believe that the current system of switching on binding powers on a case by case basis will lead to a piecemeal and disjointed approach to powers. Rather, I consider this to be an appropriately tailored approach that ensures the accountability, transparency and due process through the co-legislature that is necessary for the application of such significant powers.

As noted above, I believe the ESAs should focus more on supervisory convergence in the next few years and I welcome the steps they are beginning to take to deliver on this important part of their mandate. However, again there is little, if any, evidence that there is a need for enhanced powers, given that they have not yet fully used their existing peer review powers. Indeed, up until the end of 2013, the ESAs had collectively conducted only 11 reviews between them in the three years since their inception, and the EBA alone had conducted just one. Therefore, there is a clear need for the ESAs to use these existing powers much further – and the Government is keen to see them do this – before any consideration is given to the need for greater powers. As with binding mediation, I am not opposed in principle to clarifications or modifications to support supervisory convergence if needed, but there is no evidence as of yet that this is the case. In large part, this lack of focus on supervisory convergence is due to the ESAs focusing on drafting technical standards in the last few years. But this points to a change in focus and reallocation of resources, and not to any new powers, as the ESAs’ work on Level 2 issues begins to ease.

You also made reference in your correspondence to the possible greater involvement of the EBA in Level 1. Overall, the Government believes that there should be benefits in involving the ESAs more closely across various parts of the legislative process, on the basis that their expertise and understanding of the impact of rules on firms should help to improve the quality and coherence of the rules that emerge from the process. Steps to improve their engagement could include: ensuring the Commission consults with the ESAs at the start of Level 1 on their ability to deliver, the timing of review clauses, and the mandates and priority order of Level 2; a requirement for the ESAs to publish an assessment of all new proposals, covering the quality of evidence and analysis in Commission impact assessments, the implementation timetable, and any issues with Level 2 delegating provisions; requiring the ESAs to publish ex post assessments of the extent to which legislation is meeting its regulatory objectives; and ensuring the ESAs have adequate time to produce and consult on Level 2 rules. However, significant care will need to be taken to ensure that any change in the roles of the ESAs is appropriate and commensurate with their roles as set out in their governing Regulations and is not an unnecessary distraction from other aspects of their existing mandate.

I hope that the above information is useful and I will keep you informed on developments regarding the ESAs review.

27 November 2014

FINANCIAL MANAGEMENT - EVALUATION OF THE UNION’S FINANCES BASED ON THE RESULTS ACHIEVED (11473/14)

Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury

Thank you for EM 11473/14, dated 21 July 2014 on the European Commission’s Communication on Long-Term Financing of the European Economy. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 9 September 2014.

We agree with you that the report does not provide adequate evidence of the extent to which the EU’s objectives have been achieved. Do you agree with us that it suffers from an overemphasis on how money was spent as opposed to what the end result of such spending was? What steps do you believe can be taken to further improve the quality of the report in the future, and what will the Government do to help ensure that such improvements are made?

We note that you provide little analysis of the policy implications of the Commission document. While you comment that the report itself is essential in ensuring accountability and transparency of the EU budget and welcome the improvement to the quality of the reports since the previous year, we nevertheless wish to stress the importance of a number of the interim conclusions, particularly...
where programmes have fallen behind or achieved early on their targets. Given the Government’s position and watchful eye on all areas of the expenditure under the new Multiannual Financial Framework, we would be grateful if you could expand your analysis further to account for example on areas of poor performance such as the Cohesion Fund and ERDF Infrastructure investments to date, or the early evaluation success of FP7 programmes designed to meet research needs of businesses.

We note that this document also follows up on key recommendations that the Commission has made further to the request of the Court of Auditors. Do you believe that enough has been done to address the ECA’s recommendations?

We would therefore request that you provide us with deeper analysis of the areas of evaluation. We would be grateful for a response to this letter by 6 October 2014. In the meantime we will continue to hold EM 11473/14 under scrutiny.

10 September 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 10 September on the above named explanatory memorandum. Your letter seeks further information on several issues which are considered below.

FOCUS OF THE REPORT

Your letters sought HMG’s views on the quality and focus of the Commission’s report. The Government believes that monitoring the way in which EU budget funds are spent and managed should remain a priority. However, we support the Committee’s view that the Commission’s report should seek to place greater focus on the end result of such expenditure. For example, in this year’s joint counter-statement on the discharge of the EU budget for 2012, the UK (joined by Sweden and the Netherlands) called for further steps to be taken to monitor and enhance the European added value of interventions financed from EU funds.

Adjusting the focus of this report would support this and other calls from the European Court of Auditors (ECA) and the European Parliament for EU budget expenditure to be considered and assessed in light of its value for money. The Government will continue to engage closely with like-minded Member States in Council and the Commission to encourage all institutions to begin to incorporate value for money in their consideration of the use of EU budget funds, including in this report.

REPORT’S CONCLUSIONS

Your letter also asked for further analysis of poor and positive performance in specific areas.

It is encouraging that the Commission has acted reactively to improve poor performance in areas such as the Cohesion Fund and ERDF infrastructure investment.

The Government is pleased to note the successful implementation of FP7 and particularly welcomes the steps taken to improve business participation, including the introduction of public-private partnerships which has been successful in generating increased business investment in associated R&D and innovation.

For less successful programmes, such as Cohesion Funds and the ERDF, the Government recognises that the slow start up of the 2007-2013 programmes was exacerbated by the economic crisis. As a result, many programmes have found their results and outputs falling behind their original profiled targets. With regard to infrastructure projects in particular, the report indicates that the below target outputs relate mainly to the EU12 which suffered more from the impact of the economic and financial crisis than the EU15.

Further, the results and impact of Cohesion fund and ERDF projects are often best reported after the projects have been completed. We expect the development of performance frameworks for the 2014-2020 programmes, and a more results oriented approach to outputs and indicators, to produce more transparent and efficient monitoring of implementation in the future.

EUROPEAN COURT OF AUDITORS’ (ECA) RECOMMENDATIONS

Finally, your letter asked for the Government’s views on the follow up to the ECA’s recommendations. The Government welcomes the ECA’s Special Reports and recommendations
which encourage the Commission and Member States to continue to improve their management and financial controls systems to optimise the value for money of investments.

The Government considers that the Commission has made a good start in addressing the shortcomings identified by the ECA, however, it is clear that more needs to be done to maintain the progress made and tackle outstanding issues.

It is worth noting that the Government continues to oppose the use of coupled payments which distort the market and require additional layers of bureaucracy. However, the Government supports the ECA’s recommendation that there should be improved monitoring of Member States’ use of coupled support and we therefore welcome the Commission’s commitment to make improvements in this regard for the new CAP period.

The Commission emphasised that they will apply some of the ECA’s key recommendations to the 2014-2020 programmes. These include a stronger results oriented focus, partnership agreements that include an analysis of disparities and development needs, ex ante conditionalities and annual reporting of output indicators based on a common set of indicators.

3 October 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter dated 3 October 2014 on EM 11473/14, Evaluation of the Union’s Finances based on the results achieved. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 November 2014.

We are grateful for your short analysis of the performance of the programme implementations, addressing in particular the problems seen in relation to the Cohesion Fund and the ERDF Infrastructure investments to date. We note that the Government has been active in vocalising the need to strengthen the focus of the report on Union finances to incorporate European added value. Do you believe there is any momentum behind persuading the Commission to incorporate such focus to the reports? Are there further obstructions to achieve such arrangements?

You note that you are dissatisfied with the coupled payment system currently in operation, which adds an additional layer of bureaucracy to the process. We note that this system has largely been phased out in the CAP reform in 2013, and should no longer pose additional burdens in the future. In raising this issue, do you believe that these reforms will not effectively achieve their goals?

We would be grateful for a response to this letter by 2 December 2014. In the meantime we now clear EM 11473/14 under scrutiny.

18 November 2014

FINANCIAL MANAGEMENT - INTERNAL AUDITS CARRIED OUT IN 2013 (13921/14)

Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury

Thank you for EM 13921/14, dated 27 October 2014, an Annual Report to the Discharge Authority on the Internal Audits carried out in 2012 and accompanying Commission Staff Working Document. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 November 2014. I apologise for the delay in sending you this letter.

You note that you found the Annual report useful and take the management of Union funds very seriously. However, you provide little analysis of the report’s findings. We would therefore be grateful for further elaboration on how you see the internal control systems developing from previous years across the DGs?

Overall, the story emerging from the IAS mirrors that of EM 13681/14: Follow up to discharge of the 2012 EU Budget. Both reports raise concern over the control and audit strategies for DG REGIO and DG AGRI. Again, we understand that the problem lies in the fact that the Commission relies heavily on the control statistics reported by Member States which the IAS assess to be unreliable. While the recommendations go some way to reinforce the work of the Certifying Body and strengthen the assessment of the Paying Agency, further improvements or re-design will not take place quickly. The fact that there is a weakness in the sanctioning system, as well as the need to respect the principles of shared management means there will inevitably be a continued level of inertia in ensuring reliability of
statistics. What confidence do you have that the problems in these DGs will be rectified, taking into account best practice from other DGs?

While the European Social Fund represents 8% of the EU Budget, and efforts have been made by DG EMPL to reduce the error rates, the audit concludes there are significant issues regarding the effective functioning of management and control systems for 27 Operational Programmes in a number of Member States, of which the UK is one. Can you provide any clarity on the nature of these issues and how they are being resolved, with particular reference to the UK?

Although we have raised issues of internal controls and systems in relation to the EU Budget, the IAS recommendations underscore the fact that ‘critical’ and ‘very important’ recommendations across the Commission warrant significant attention.

We would be grateful for a response to this letter by 16 December 2014. In the meantime we will continue to hold the document under scrutiny.

2 December 2014

FINANCIAL TRANSACTION TAX (6442/13)

Letter from Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury, to the Chairman

Thank you for your letter of 13 May, responding to mine of 11 May about the recent ruling by the ECJ on the UK’s precautionary legal challenge and the 6 May ECOFIN meeting.

You ask what more I can tell you about the implications of the ECJ’s ruling for negotiations, and for any future challenge against an FTT directive. Negotiations will proceed as usual until a compromise text is adopted by the participating Member States. It would be at that stage that the Government would look to lodge a new legal challenge, if necessary. In the meantime we continue to participate in discussions, ensuring that UK concerns are heard.

I note the 10 April response by the Commission to your report Financial Transaction Tax: Alive and deadly. The arguments in that letter are similar to those contained in a paper circulated by the Commission to the FTT working group last November. The Government’s position on these points, as set out in the paper accompanying my predecessor’s letter of 25 May 2013, remains unchanged: in particular, we continue to consider that the counterparty principle in its current form breaches Article 327 TFEU and is inconsistent with established international tax law. It would in due course be for the Court to consider the views of the litigating parties and decide whose interpretation is correct, should the Government decide to challenge any final FTT directive.

You ask about the level of information provided to Member States about the draft FTT proposal in advance of the Authorising Decision. On 26 November 2012, in response to requests for more detail from the UK and others, the Commission delivered a presentation at a Council Working group. The slides briefly set out potential options for amending the original proposal, and included a bullet point relating to the possible extension of the residence principle to guard against relocation. The Commission explained at the meeting that they were considering introducing the issuance principle. The UK welcomed this information but continued to call on the Commission to make available the full draft proposal, accompanied by a full impact assessment, before Council was asked to authorise enhanced cooperation on an FTT. A further note was circulated by the Commission prior to a meeting of fiscal attaches on 7 January 2013, providing some additional detail on possible changes to the original proposal, including on the possible introduction of the issuance principle, but no draft proposal was made available. I take full note of the Committee’s views on the Government’s approach to the Authorising Decision. However, I believe the decision to abstain from the Authorising Decision was appropriate and I refer you to previous correspondence with my predecessors on this.

You also mention the joint statement by ministers of the participating Member States at ECOFIN on 6 May, and ask about its implications and the next step in negotiations. Since my last letter, there has been one further Council working group, on 28 May. At that meeting, Member States had a preliminary discussion about how to tax derivatives under the FTT, including whether in principle to seek to adopt a custom list of in-scope instruments, or instead to refer to financial instruments contained in the annex to the Markets in Financial Instruments Directive (MiFID); and whether in principle to select derivatives by instrument type (e.g. futures, options) or instead by type of “underlying” (e.g. shares, interest rates). The UK emphasised that before any process of selecting which derivatives to tax could be started, clarity was needed on the territorial limits of the proposal.
The discussion did not cover in any detail which particular derivatives or classes of derivatives should be covered. Officials also discussed legislative options for structuring any “step by step” approach.

At the meeting, UK officials highlighted the concerns expressed at the 6 May ECOFIN by the Chancellor and other non-participating countries’ finance ministers about process and transparency. I am pleased to note that at the working group there was an open discussion involving both participating and non-participating Member States. This was in contrast to recent experience. We understand there will be no more meetings under the current presidency, but expect Council working groups to resume in July.

On whether the UK could accept a UK-style stamp duty, the answer is yes, in principle. The UK tax is, broadly, limited to UK shares (ensuring a proper territorial link is established) and contains suitable exemptions to preserve market liquidity. Something designed along these lines and put into effect in the FTT area should not adversely affect the UK, though further analysis to confirm this position would be needed if such an approach is proposed. However, the statement issued by the participating countries indicates that they intend to capture certain derivatives. We share your concerns about the lack of detail in this statement and believe it reflects a current lack of consensus among the 11 about which derivatives to tax and on what basis.

You ask about Slovenia’s position given that they did not sign the joint statement from the participating Member States at May ECOFIN. The reasons for this are unclear at this time. Slovenia remains a participating Member State in the enhanced cooperation group.

The UK continues to raise its concerns around the proposal at Council working group and through a variety of other channels. A key priority is to ensure the territorial basis of any compromise addresses our legal concerns. The Chancellor has been clear that we will not hesitate to launch a further legal challenge to any final implementing directive, if required. However, there is still much to be discussed before any final FTT can be agreed, and we stand ready to engage with other Member States on any emerging compromise.

6 June 2014

Letter from the Chairman to Andrea Leadsom MP


We are grateful to you for this informative response. We welcome the fact that in the most recent Council working group there was an open discussion involving participating and non-participating Member States. We note the lack of consensus among the 11 participants about which derivatives to tax and on what basis, and would be grateful for further updates on the scope of the tax and more generally as negotiations progress. We also welcome the clarity you provide on the UK’s likely approach to a stamp duty-type model. However we are surprised to learn that a Stamp Duty model may be deemed unacceptable to the UK if it applies to derivatives as this could create a competitive advantage for the City of London.

We note your account of the information provided to Member States on the draft FTT proposal in advance of the Authorising Decision in late 2012 and early 2013. However, we regret that this information has only come to light now. We also find it odd that we only became aware of this following receipt of the Commission’s response to our December 2013 report, rather than being told as much by the Government at the time. While we wholly accept that it was unacceptable on the Commission’s part not to publish the draft proposal in full before the authorising decision was made, we are disappointed that the then Financial Secretary did not share with us the information that had been revealed on 26 November 2012 and 7 January 2013. We wrote to the then Minister on three separate occasions between October and December 2012 asking him to provide the Committee with information on the proposed scope of the revised proposal. The Minister’s reply, written one month after the 26 November 2012 briefing took place, stated that “in the absence of a substantive proposal by the Commission, my officials are unable to provide the analysis or the information that the Committees have requested.” The Government’s failure to keep us apprised of such information on the scope of the proposal as was available inhibited this Committee’s ability to scrutinise the proposals and the proposed authorising decision. Now that we know what the Government knew at the time about the likely scope of the proposal under enhanced cooperation, we are even more puzzled that the Government made no attempt to muster a blocking minority against the Authorising Decision.
You will also recall that our December 2013 report concluded that there was no Treaty impediment to the Commission bringing forward at the same time its proposal for a Decision authorising enhanced cooperation and its proposal for the substantive legislation implementing enhanced cooperation. The Government’s response to our report expressed sympathy with the Committee’s conclusions, and stated that “it is crucial that the right precedents are set at the early stages of [the use of the enhanced cooperation procedure] in order to provide all Member States with confidence if the procedure is to be used effectively in future.” In light of this, we would be grateful if you could inform us as to the efforts you are making to gain support amongst EU colleagues for ensuring that the precedent is adopted and followed of ensuring that a substantive proposal is brought forward at the same time as any proposal for an Authorising Decision for enhanced cooperation.

We note the Government’s willingness to launch a further legal challenge if necessary. We would be grateful for the Government’s assessment of the strength of the safeguard contained in Article 20(4) TEU that enhanced cooperation should not bind non-participating Member States, and the extent to which you would seek to rely on it in any legal challenge. At the same time we welcome your commitment to engage with other Member States on any emerging compromise.

We would be grateful for response to this letter, including an update on negotiations in the Council working groups scheduled for July, by 21 July 2014 at the latest, and sooner should there be any significant developments in the meantime. We continue to hold the document under scrutiny.

18 June 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 18 June.

Since then, there has been one Council working group, on 15 July. This mainly focused on how to define the scope of the commitment by participating Member States to apply the tax (in its first phase) to “shares and some derivatives”.

On shares, the discussion centred on which types of instruments to include beyond ordinary shares (such as preference shares, rights and warrants, and depositary receipts). On derivatives – the more controversial element, where the negotiation remains wide open – various approaches to selecting which instruments to cover were discussed. One option proposed was to tax derivatives which are linked to equities, another idea was to tax derivatives most closely associated with speculation, another was to target those derivatives whose taxation would be expected to raise substantial revenue, and the final option was to tax derivatives according to which could successfully be captured by the issuance principle.

These options have very different implications and the discussion was inconclusive. Our prior judgement, that there is considerable work to do before any revised proposal begins to take shape, remains unchanged – and we do not currently expect another working group before September.

In your letter you proposed that a tax on equity-linked derivatives could benefit the UK through relocation effects. We agree that, in certain scenarios, this might create a competitive advantage for the City of London. However, it is also possible that the participants would seek to design the tax in a way which prevents the migration of trading activity to London and financial centres in non-participating countries as much as possible. This could possibly be done by recourse to extraterritorial provisions to which we may have objections of principle. We continue to ensure that our legal and other concerns are taken on board in discussions of the options.

In relation to the provision of information to the Committee in the lead up to the authorising decision, I would note that until 7 January 2013, we had received nothing in writing about the potential inclusion of the issuance principle other than the single bullet point in the Commission’s informal presentation. Indeed, when a draft paper was circulated on 7 January, after the correspondence with the Committee to which you refer, it was described as an indication of thinking rather than a definitive proposal. It was only when the Commission published its draft implementing proposal on 14 February 2013 that the inclusion of the issuance principle was formally confirmed. My predecessor outlined the scope of the proposal in his explanatory memorandum of 19 March 2013. I note also that the potential inclusion or combined use of the issuance principle was, for us, not the offensive element of the tax as such. As you know, UK stamp duty takes this approach and we do not object to it in principle. Our main concern was general – that in order to properly analyse the impacts of a tax, which would inevitably be very sensitive to the details of the proposal, we would need to see its detailed provisions. My predecessor made this point very strongly at the ECOFIN meeting in December 2012.
On the enhanced cooperation procedure, the Treasury will continue to work to ensure that appropriate precedents are established during this negotiation. We will also ensure that any appropriate lessons from the use of enhanced cooperation on the FTT are used to inform wider work in Government on the future of Europe.

On Article 20(4) TEU, this says that acts adopted under enhanced cooperation do not bind non-participating Member States. In the case of FTT, however, our concern has not been with acts which would bind the UK directly. Rather, it has been with acts which would apply ostensibly only to the participating Member States but which would nevertheless have indirect or extraterritorial effects on entities in non-participating Member States, as well as third countries. Article 20(4) does not address this situation in terms, and was not referred to in the UK’s legal challenge to the Council’s decision authorising enhanced cooperation. We will of course keep it in mind should it be relevant for any future proceedings.

18 July 2014

Letter from the Chairman to Andrea Leadsom MP


We are grateful to you for your update on discussions at the 15 July 2014 working group. You state that four options for taxation of derivatives were discussed at that meeting. Although we note that the discussion was inconclusive, can you provide any further details? Were any of these options deemed preferable compared to the others? What were the views of their relative strengths and weaknesses? Were any ruled out as unviable, or do they all remain on the table for future discussion? Is there momentum behind any of the proposals? You state that each of the options have very different implications. Can you provide a more detailed analysis of each of them? Which of these options is most and least preferable from the UK’s point of view, and why?

On the enhanced cooperation procedure, you state that “the Treasury will continue to work to ensure that appropriate precedents are established during this negotiation. We will also ensure that any appropriate lessons from the use of enhanced cooperation on the FTT are used to inform wider work in Government on the future of Europe.” However, you do not provide a specific response to our question as to the efforts that you are making to gain support among EU colleagues to ensure that a substantive proposal is brought forward at the same time as any proposal for an Authorising Decision for enhanced cooperation at the very latest. Are you taking practical steps to make the case to fellow Member States that there is no Treaty impediment to such practice being followed in the future?

We note your statement that there is considerable work to do before any revised proposal begins to take shape. We also note that no further Working Groups are expected until September. We would therefore be grateful for a response to this letter, together with an update on discussions at the next working group, by 30 September 2014, or sooner if significant progress is made before then. In the meantime we will continue to hold the document under scrutiny.

29 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 29 July.

You asked for an update on discussions following any further working group meetings, of which there has been one since my last letter, on 7 October.

Discussions at the meeting focused on three room documents issued by the Presidency.

The first proposed which instruments should come under the definition of “shares”. Discussion focused mainly on whether to provide options for participants to exempt shares in smaller and unlisted companies from the scope of the tax, and on whether to tax secondary trading (as opposed to redemptions and subscriptions, which were proposed to be exempt) of shares and units in funds. While there was widespread support for optionality on smaller and unlisted companies, there was no agreement on details such as the design of any size threshold or the definition of “unlisted”. Several Member States opposed the inclusion of fund units and some called for special treatment for pension funds. It was clear from the meeting that there was no consensus on the drafting, and that more work
needed to be done on specifying the range and definitions of shares to be covered. Some Member States pointed out that it was difficult to consider these issues before agreement had been reached on the territorial basis of the tax.

The second document highlighted various risks associated with the residence principle, including potential relocation effects and the difficulties of identifying counterparties to a transaction when a trade was centrally cleared. The Commission was invited to comment on these risks, and argued that on the limited data available it did not expect widespread relocation of activity outside the FTT-zone. It was for participating Member States to develop a solution for the identification of counterparties and they could, if necessary, make use of the joint and several liability provision in Article 10 of the Commission’s proposal.

The third document outlined potential options for the allocation of FTT revenues among the participating Member States in the event that an issuance principle was adopted as the sole determinant of liability for the tax. In most options, the residence of the counterparties to a transaction would partially determine to which Member States the FTT revenue associated with that transaction was distributed. Some options foresaw revenue being allocated to relevant Member States on an immediate transaction-by-transaction basis, and others assumed a periodic disbursement based on a formula. While certain participating Member States appeared to welcome the paper as a step towards a potential compromise, it was clear that several smaller participating Member States were sceptical about the proposals.

There was no further discussion of the approach to taxing derivatives which had been discussed at the previous working group. The Presidency indicated that this would be raised again at a future working group. The UK position on derivatives will largely depend on the basis on which these derivative instruments are proposed to be taxed – i.e. the residence or issuance principle. We have consistently expressed our preference for the Commission’s version of the issuance principle as the exclusive territorial basis for the tax, recognising this would substantially limit the application of the tax to derivatives traded in the UK.

Thank you for your further thoughts on the process around the enhanced cooperation procedure. We share a number of your concerns about how the FTT enhanced cooperation procedure has been handled, which has not always given non-participating Member States the certainty they need, and lessons need to be learned. However, the enhanced cooperation procedure has rarely been used, each case has been different, and there is unlikely to be a single solution that fits all future cases well. We are therefore continuing to discuss with other Member States, and with the EU institutions, how the process might be improved, respecting the framework set out in the Treaties, particularly with an eye to any future proceedings where the approach you set out may be an appropriate course of action to pursue.

At the time of writing there are no further working groups scheduled.

14 October 2014

Letter from the Chairman to Andrea Leadsom MP


We are grateful to you for your update on discussions at the 7 October 2014 working group. We would invite you to provide the Committee with further updates on future working groups as soon as practicable after they take place. In light of the evident disagreements between participating Member States, do you still consider it likely that they will reach agreement on the form of the tax by their end-2014 deadline? How satisfied are you with the extent to which non-participating Member States are being kept informed of the progress of discussions?

We note that no further working groups are currently scheduled. Accordingly we would be grateful for a response to this letter by 21 November 2014 at the latest, and sooner should a further working group be held in the meantime. In the meantime we will continue to hold the document under scrutiny.

28 October 2014
Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury

Thank you for EM 13681/14, dated 15 October 2014, a Report from the Commission on the follow-up to the discharge for the 2012 financial year. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 28 October 2014.

You state that “the Government welcomes the Commission’s report which highlights efforts to address the concerns raised by Council in their discharge recommendations”. However the rest of the EM tends to undermine this assertion. For instance we detect little detailed analysis of the Commission’s responses, and in particular whether its rationale for disagreeing with 40 of the recommendations of the European Parliament or the Council is justified. We also note that, while the report is presented to the Council and the European Parliament for consideration, no ministerial discussion is anticipated. That being the case, can you illuminate us as to the practical purpose that this report serves? Is it an effective means by which the Commission and Member States alike can improve management of the EU Budget? Given that the document appears to respond to a greater extent to recommendations from the European Parliament than the Council, what reassurance can you give us that the Council’s recommendations are taken seriously by the Commission, and that the Commission’s response is taken seriously by Member States? In support of your arguments, can you clarify what mechanisms are in place to take forward discussions with the Commission in order to, in your words, “satisfy the recommendations put forward by the EP and Council”?

We also wish to highlight a number of specific points which arise from the report.

In relation to addressing problems raised in the DGs’ Annual Activity Reports, how would you respond to the Commission’s assertion that the Parliament’s request to audit all operational programmes at least once in the course of the programming period is not in line with the single audit approach proposed by the ECA, and also conflicts with the EP’s request to enhance cost-efficiency? Do you agree that DG AGRI and DG REGIO are in particular need of stronger control and audit strategies? Why is this? What systemic issues affect those two DGs? Would you highlight any DGs in terms of best practice of effective management of EU resources, from which others can learn?

We note your statement that, in relation to stronger control and audit strategies for 2014-2020, the Commission assessed that the EP’s recommendations fell outside the Commission’s remit, being the responsibility of Member States. We note in particular the Commission’s arguments that “it is the MS that has to assume the primary responsibility for ensuring that actions financed by the budget are implemented correctly in accordance with the rules. The role of the Commission consists rather in an overall supervision by verifying the effective functioning of MS’s management and control systems”. Do you share this perception of the division of responsibility between Commission and Member State? In previous correspondence we have criticised your predecessors for not doing enough to acknowledge Member State responsibility for effective management of EU spending. In our view, effective management is a shared responsibility between Commission and Member State, and the two must work together. It is therefore regrettable to perceive a tendency by both parties to seek to place the primary onus on the other. This appears to us to be symptomatic of a wider problem, that no-one is willing to grasp the nettle and seek to effect meaningful reform of a budgetary process that is patently no longer fit for purpose. How would you respond?

With regard to the European Parliament’s request for the application of progressively increasing payment reductions and administrative sanctions where eligibility criteria have not been respected, the Commission states that the current regulatory framework already provides for such a system when there is sufficient evidence that the persistence of the deficiencies is increasing the financial risk to the EU Budget. However, in recent evidence to us, Dr Ingeborg Grässle MEP, Chair of the European Parliament Budgetary Control Committee, argued that it had not proved possible to implement an effective sanctions regime because of the unwillingness of Member States to countenance such a paradigm shift. How would you respond? Do you agree that an effective sanctions regime is urgently needed to ensure effective management of EU funds?

In his recent evidence to us, Richard Ashworth MEP told us that the use of RAL (reste à liquider) was getting out of hand. Yet the Commission defends it on the grounds that “the pre-financing is a tool meant to provide the beneficiaries with a float and to enable them to run the projects they have committed to. If the period covered by pre-financing were to be shorter than the period of the project, then the beneficiary would sooner or later run out of resources and the project in question could eventually fail.” How would you respond? What practical steps need to be taken to bring RAL under control?
We would be grateful for a response to this letter by 11 November 2014. In the meantime we will continue to hold the document under scrutiny.

28 October 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 28 October on the above named EM.

Your letter queries the purpose of the Commission’s report which the Committee notes is not subject to ministerial discussion. As part of the discharge process for the 2013 budget Council will consider the Commission’s actions as set out in this and other reports to assess whether sufficient progress has been made on management of the EU budget and where further improvements are required.

As the Committee is aware, this Government has adopted a consistently robust approach to discharge of the EU budget as a process for holding the Commission to account. For the past three years, we have joined Sweden and the Netherlands in voting against discharge and issued a joint counter-statement calling on the Commission to do better. The findings of this report will feed into the UK and other Member States’ approach to discharge of the 2013 EU budget.

With regard to the Annual Activity Reports (“AARs”) from Directorates-General, Member States now carry out an annual audit of the legality and regularity of programme expenditure. The Government believes that the Commission and the European Court of Auditors (“ECA”) should, in line with the single audit approach, rely on the information provided by Member States. Further, they should seek to reduce the number of audits conducted which will reduce duplication of effort and the overall cost of financial controls.

The control regime for the 2014-2020 programme period already includes annual control reports, management declarations, annual clearance of accounts, certification of expenditure and annual summaries of audits. As such, the Government does not support the European Parliament’s proposal which undermines the current single audit approach.

Your letter asked about the performance of two Directorates-General. The management and implementation of Agricultural and Cohesion Funds, which fall within the remit of DGs AGRI and REGIO, continues to present a challenge for both Member States and EU institutions. The UK has taken a leading role in pressing for the simplification of the complex rules and legislation governing these areas of the EU budget to secure rules that are universally both accessible and capable of being consistently applied by all.

Your letter also raises questions regarding the division of responsibility for the implementation of EU budget funds. It is clear that, as 80 percent of the EU budget is spent under the system of shared management, Member States must put in place effective and efficient control mechanisms for the receipt and management of EU budget funds.

However, as evidenced by the discharge process, the Commission is accountable for the implementation of the EU budget as a whole. I agree that Member States and the Commission must work together to address systematic concerns and ensure that EU budget expenditure is effective and represents value for money for taxpayers. This must include working to simplify the regulatory framework to enhance compliance and facilitate a universal interpretation of the rules and legislation governing EU budget expenditure - a key UK objective.

The Government does not support the idea that Member States should accept the implementation of progressively increasing payment reductions and administrative sanctions at this stage. Before this can be considered, eligibility criteria and control requirements must be significantly simplified and the application of financial corrections adjusted to better reflect the actual risk to EU budget funds.

On the overall budgetary system and the management of EU budget funds, the Government believes that the clearest route for addressing the issues you raise is to narrow the gap between payments and commitments. This gap was significantly tightened in 2014 compared with previous years, which is evidence of the value of the 2014-2020 MFF deal in bearing down on commitments.

17 November 2014

Letter from the Chairman to David Gauke MP

Thank you for your letter, dated 17 November 2014, on the Report from the Commission on the follow-up to the discharge for the 2012 financial year. The House of Lords European Union Sub-
Committee on Economic and Financial Affairs considered this document at its meeting on 25 November 2014.

You state that the Government has adopted a consistently robust approach to discharge of the EU budget as a process for holding the Commission to account. Notwithstanding this, we repeat the concerns expressed in our 29 July and 22 October 2014 letters to you on the Draft Budget for 2015, when we criticised the Government’s complacent and counterproductive attitude to efforts to reform the EU budgetary process. We would point out that administrative sanctions and payment reductions would be one means of making the process more effective.

We would be grateful for further clarification of the Government’s position with regard to these issues. You state that you do not support proposals for sanctions and payment reductions at this stage, and that eligibility criteria and control requirements must be significantly simplified before they can be considered. By what criteria will you judge whether eligibility criteria and control mechanisms have been “significantly simplified”? How much progress has been made to this end at this stage? In the event that you are satisfied that such simplification has been achieved, would you then support the introduction of a sanctions regime? We would also be grateful for clarification of the third criterion that you cite, that the application of financial corrections needs to be adjusted to better reflect the actual risk to EU budget funds. We note the explanation of the issue contained in your 18 November 2014 letter on EM 13781/14: the Communication on protection of the EU Budget to end 2013. In addition, can you give some specific examples of the sorts of problems that are arising and need to be addressed?

We would be grateful for a response to this letter by 9 December 2014. In the meantime we now clear the document from scrutiny.

25 November 2014

HIGH LEVEL GROUP ON OWN RESOURCES (UNNUMBERED)

Letter from Nicky Morgan MP, Financial Secretary, HM Treasury, to the Chairman

I am writing in response to your letter dated 13 May. As the Committee knows, the High Level Group held its first meeting in Brussels on 3 April 2014, following the announcement by the European Parliament, Council and Commission in Strasbourg on 25 February 2014 of Mario Monti as the Group’s Chair. The Group, the establishment of which was agreed as part of the 2014-2020 Multiannual Financial Framework, will undertake a general review of the current Own Resources system, and issue a first assessment by the end of 2014.

We understand that the Group will take into account all existing and forthcoming input from the three European institutions and national parliaments, and that the intention is for national parliaments to be provided an opportunity to assess the outcome of the work through an inter-parliamentary conference in 2016. The UK was instrumental in securing a voice for national parliaments in this process. This Government is committed to ensuring that Parliament has its say and we will keep you updated as further details become available.

The Group is still in its infancy and it has yet to set out a specific plan on how it intends to conduct its work, either before the first assessment is made at the end of this year or ahead of its final assessment. One aspect of the Group’s work that is not yet clear is whether and how they may seek input from national governments. Once that becomes clearer the Government will consider its engagement strategy with the Group.

You ask in your letter about HM Treasury’s current thinking on the future of Own Resources. The Government’s view on the system of Own Resources is clear. As set out in Explanatory Memoranda and correspondence relating to the MFF and the Own Resources legislative proposals over recent years, the Government’s overriding, and continuing, priorities have been to protect the UK abatement, and to oppose any new EU-wide taxes to finance the EU budget. This means the Government opposes any new own resources, and in particular any new EU taxes or changes to the existing Own Resources system that increase UK’s contributions or pose a threat to our position in the long term.

The Joint Declaration on Own Resources states that the Council shall unanimously adopt a decision on the system of Own Resources and that the Council may establish new categories of Own Resources or abolish an existing category. This makes it clear that the UK retains a veto on any Own Resources proposals. Moreover, Article 311 of the Treaty on the Functioning of the European Union confirms that any Council decision on own resources shall not enter into force until it is approved by
the Member States in accordance with their respective constitutional requirements. This means that
the UK Parliament will be asked to approve any Own Resources decision of the Council.

4 June 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your letter, dated 4 June 2014, on the High-Level Group on Own Resources. The
House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this
document at its meeting on 18 June 2014. We note that the Group is still in its infancy and has yet to
set out a specific plan for how it intends to conduct its work. It is imperative that Parliament is kept
updated on these important issues, and we are therefore grateful to you for committing to keep the
Committee updates as further details become available, and in particular as it becomes clear how the
input of national parliaments and national governments will be sought.

While we note the Government's clear position on Own Resources, nevertheless this should not rule
out the Government undertaking contingency planning in case circumstances change. In our 2012
report on The Multiannual Financial Framework 2014-2020, we concluded that “the complexity of the
VAT-based own resource, and the Commission's own statement that it offers no European Added
Value over the GNI-based resource, may make it preferable for it to be removed entirely, which
could bring relatively small, although welcome, savings by reducing the administrative costs of
collection. This need not necessarily prejudice the UK abatement, although we acknowledge that
determining a new base for calculating the abatement might require a difficult negotiation. We
nevertheless urge the Government to give further thought to this possibility as part of their response
to the own resources proposals.” We may seek to bring this proposal to the attention of the High-
Level Group when it begins its engagement with national parliaments, and would therefore be grateful
for your own view. We would also be grateful for your assessment of the most appropriate effect on
the level of Own Resources of the expansion of the EU in recent years.

Once the Group makes clear how it will engage with national governments, we would be grateful for
greater clarity on how you intend to engage with its work.

We look forward to discussing these issues with you at your forthcoming appearance before the
Committee to discuss the 2015 Draft Annual Budget on 1 July. We would therefore be particularly
grateful to receive any updates before then.

18 June 2014

INDICES USED AS BENCHMARKS (13985/13)

Letter from Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury,
to the Chairman

Following the end of the Greek Presidency, I thought it timely to provide an update on the
negotiations of the European Commission proposal for a Regulation on indices used as benchmarks in
financial instruments and contracts (Benchmarks Regulation).

The Greek Presidency held five Council working group meetings to discuss the benchmarks proposal.
These focused predominantly on the scope of the proposal, as without knowing how broad the scope
will be, it is not possible to effectively develop rules and provisions that will apply. Given the range of
views amongst delegations on the question of scope, progress has been relatively slow.

Council discussions have also focused on how best to ensure appropriate proportionality in the
proposal. During discussions delegations have considered a range of options. Some were based on
sector specific approaches, others potentially considering the usage of the benchmark as a threshold,
whilst some support an approach that considers the vulnerability of a benchmark. Council has yet to
settle on a specific approach and discussions continue.

The Government favours an approach in which regulatory intensity is calibrated according to the
significance of benchmarks and the potential impacts of their failure on markets across the EU. Under
this approach, the focus of regulatory intensity would be on critical benchmarks. However there
would be appropriate proportionality introduced for non-critical benchmarks to ensure proper
governance, but in a manner that appreciates the differences in the broad universe of benchmarks, is
not unnecessarily burdensome, and is in line with internationally agreed principles.
The incoming Italian Presidency hopes to make significant progress with this file. However they are aware that a number of major issues remain outstanding and the nature of discussions on these issues will determine how much progress is made.

15 August 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 15 August 2014, on EM 13985/14, the proposal for a regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 9 September 2014.

We are grateful for this update. We note that negotiations have yet to proceed beyond first principles, although the Italian Presidency will seek to make progress in the weeks and months ahead. That being the case, we would be grateful to be kept updated as negotiations progress, and in particular to learn whether there is any support among other Member States for the UK’s preferred approach of focussing the most intensive regulation on critical benchmarks while ensuring a proportionate and yet not unduly burdensome approach to non-critical benchmarks. In anticipation of such an update we will continue to hold the document under scrutiny.

10 September 2014

Letter from Andrea Leadsom MP to the Chairman

I am writing to update you with regard to negotiations on the European Commission proposal for a Regulation on indices used as benchmarks in financial instruments and contracts (Benchmarks Regulation).

The Italian Presidency has made good progress over the last few months, including circulating two Presidency compromise texts. The Government has been satisfied with the direction of travel in some of the amendments made by the Presidency, which introduces a more relative and proportionate approach. This considers the specific characteristics of benchmarks when determining the regulatory regime to be applied to them, with some administrators required to be authorised and some just having to register with their regulator. We are seeking to expand upon this approach in negotiations, in order to ensure that regulators are able to concentrate their resources on the administrators of more important benchmarks.

Also discussed in some detail is the issue of benchmarks from outside the EU, and whether firms in the EU will be able to utilise them once the Regulation is in force. We have argued in favour of finding a solution that allows use within the EU for benchmarks that can prove they are administered in line with internationally agreed International Organization of Securities Commissions (IOSCO) standards. This line of argument has been well received amongst other delegations and the general view now appears to be that the regime proposed by the European Commission is not appropriate and needs to be amended so that it is fit for purpose. Council is now in the process of discussing what an acceptable regime for non-EU benchmarks would look like.

In addition, the European Parliament began their consideration of the proposal in November. In public statements key Member of the European Parliament working on this proposal have highlighted they are keen to ensure proportionality in the text and identified the regime for non EU benchmarks as an area that needs to be improved as the Commission proposal in this area is not appropriate.

The Italian Presidency has expressed a desire to secure a General Approach by the end of the year. Whilst this is not impossible, there are serious issues remaining where progress is necessary before an agreement can be made.

15 November 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 15 November 2014, on EM 13985/14, the proposal for a regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts. The House of Lords
European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 25 November 2014.

We are grateful for this update and for highlighting the key areas of continued concern. The international element of the proposal is one that was considered most controversial given the widespread use of international benchmarks. It is good that the European Parliament too finds the Commission’s treatment of the international dimension inappropriate. You will be aware that we favour methods to align non-EU benchmarks with the international standards set by IOSCO. You will be aware that a number of Benchmarks are already adhering to these standards since they were announced by IOSCO in 2013. Given the upcoming EU-US Financial Market Regulatory Dialogue in January 2015, can we expect any further outcome of these discussions? We understand from the last meeting that the US is not likely to bring forward any legislative proposal on benchmarks.

We would be grateful for further updates as negotiations progress, and in particular if a General Approach is expected to be reached. In anticipation of such updates we will continue to hold the document under scrutiny.

25 November 2014

IRELAND: EARLY REPAYMENT OF THE INTERNATIONAL MONETARY FUND (IMF) (UNNUMBERED)

Letter from David Gauke MP, Financial Secretary, HM Treasury, to the Chairman

I want to update the Committee on developments regarding the international financial assistance programme for Ireland, and provide further detail on the announcement made by the Chancellor in his Written Ministerial Statement regarding the UK’s bilateral loan to Ireland laid in both Houses on the 13 October.

As you will recall, the UK provided a £3.2 billion bilateral loan to Ireland as part of a €67.5 billion international assistance package with contributions from the IMF (€22.5bn), the European Union (€22.5bn), euro area Member States (€17.7bn) and other bilateral lenders; Sweden (€0.6bn) and Denmark (€0.4bn).

On 27 August 2014 the Irish Finance Minister Michael Noonan wrote to all EU Finance Ministers, setting out his intention to repay early up to €18.3 billion of loans obtained from the IMF. The IMF loans carry a significantly higher interest rate than other elements of the programme.

Where Ireland chooses to make early repayments to one of the lenders under the programme, the loan agreements of all other assistance providers, including the UK and EU, contain a clause requiring that Ireland make proportional early repayments to all the other assistance providers.

On 19 September 2014 Ireland formally requested a waiver of this clause from the UK alongside similar requests to the EU, euro-area Member States, Sweden and Denmark. Ireland have published these documents online at:


The Chancellor has today issued a waiver under clause 19.3 of UK Credit Facility Agreement (Amended 4 October 2012) enabling Ireland to repay up to €18.3 billion of outstanding IMF loans. The waiver that has been agreed is conditional upon all other assistance providers, besides the IMF, issuing similar waivers. This decision does not amend the amount or timing of interest and principle repayments originally foreseen in the Amended Credit Facility Agreement.

The benefits of providing a waiver were set out in a note by the ‘troika’ (European Commission, IMF and European Central Bank) published online on the website outlined above. In their view, early repayments of €18.3 billion to the IMF could generate net fiscal savings of up to €2.1 billion in the period 2015-2020.

The Government believes that the significant benefits to Ireland’s fiscal position and debt sustainability in the coming years are not exclusive to Ireland. Improvements to Irish debt sustainability in the years leading up to repayment of the UK’s bilateral loan enhance the likelihood of repayment of the UK’s loan.

For the loans provided by the EU under the European Financial Stabilisation Mechanism (EFSM), the European Commission is empowered by the loan agreement to provide a waiver by mutual
agreement with Ireland. However, the Commission initiated a written consultation to the European Financial Committee (EFC) on 3 October 2014, concluding on 10 October 2014. A consultation for the loans provided by the euro area occurred simultaneously. The UK’s waiver remains contingent on all other assistance providers issuing similar waivers.

I can confirm that all Member States have agreed to provide a waiver to Ireland on the outstanding loans. Nonetheless, UK’s waiver remains contingent on all other assistance providers issuing similar waivers.

Since there was no Council Decision to be taken and given the expedited timetable of this decision during recess I did not consider it possible nor necessary to consult the European Scrutiny Committees. Furthermore, I supported the provision of a waiver and therefore did not wish to hold up the process which I believe was in the UK’s national interest. Attempting to block the provision of a waiver on these grounds would not have been in line with the Chancellor’s decision to provide a waiver on the UK’s bilateral loan.

13 October 2014

KEY INFORMATION FOR RETAIL INVESTORS AND INSURANCE MEDIATION
(12407/12)

Letter from Andrea Leadsom MP, Economic Secretary to the Chairman

My predecessor last wrote to you regarding the recast Insurance Mediation Directive (to be renamed the Insurance Distribution Directive) in February 2013, and in turn you confirmed that the European Union Committee had cleared this document from scrutiny.

Progress of the directive was put on hold in 2013 and this has largely stayed dormant until negotiations restarted in earnest under the Italian Presidency. Things have since developed quickly to the extent that I think it would be useful to provide an update for the Committee.

A compromise text was tabled at the working group meeting on 21 October which meets most of the UK’s negotiating asks, and similarly has the backing of the Presidency and broad support of other Member States. In the days following this meeting discussions have suggested that the Presidency will look to table a General Approach in the very near future. Although there are some issues still to be finalised, including the alignment of the directive with MiFID/PRIPs, if the General Approach text tabled is in line with our wider negotiating aims, we would look to support it.

In our EM and subsequent correspondence, we highlighted a number of policy issues where there has subsequently been positive progress.

We were concerned that the directive included a provision on Alternative Dispute Resolution as there was a question as to whether this properly related to the internal market. Further, we viewed that this provision would change the nature of the existing UK Financial Ombudsman Service with out-of-court disputes and would reduce consumer protection. These concerns have been alleviated as our successful negotiations have resulted in the deletion of the original provision in the Council text.

The draft of the directive previously prohibited tying insurance products with ancillary services whereas we were of the view that there was no strong evidence suggesting this was needed. This prohibition has now been removed in favour of firms informing customers whether the components of a package are available to be bought separately.

Also, the UK government view has been that sanctions provisions in the directive should be minimum harmonising and we have achieved this in the current Council text.

Finally, the UK was previously concerned that full mandatory disclosure of commission for all insurance sales would not benefit customers as this would serve to overload them with information. The UK supports the position of the current Council text on requirements for disclosure of commission as elements which the UK did not support have been removed from the text.

I trust this information will serve as a suitable update for the Committee. I will of course write to you as a matter of urgency if there is any significant movement ahead of General Approach.

27 October 2014
Letter from the Chairman to Andrea Leadsom MP


We are grateful to you for this update on negotiations. However we would be grateful for clarification of two points. First, which specific issues in terms of alignment with MiFID and PRIPs remain to be finalised? Are you confident that the legislative files will be consistent with one another? Second, you state that you support the current Council text on requirements for disclosure of information as elements which the UK did not support have been removed from the text. Which elements have been removed, and which requirements remain in the current Council text?

We would be grateful for a response to these questions, as well as an update on the Italian Presidency’s attempt to reach a General Approach, by 18 November 2014.

4 November 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter dated 4 November 2014 regarding the recast Insurance Mediation Directive (which has been renamed the Insurance Distribution Directive). You asked for more information on how the text aligns with other directives and on the nature of changes to disclosure requirements. I provide some additional detail below as well as confirmation that the Italian Presidency were able to secure an agreement to a General Approach.

Since I last wrote to the Committee a further text was tabled which the Government found represented an improvement in terms of the UK’s negotiating asks and which was in line with our wider negotiating aims. Therefore on 10 November 2014 Council unanimously agreed a General Approach on IDD.

This text included substantial progress in aligning sanctions provisions with MiFID and PRIIPS so that the text of IDD allows an effective and proportionate sanctions regime which does not conflict with UK law. The sanctions provisions improved include those on the protection of personal data and on the powers available to regulatory bodies.

The significant improvements on sanctions provisions represent an increased alignment of the IDD with other related directives to the extent that we are satisfied that sanction powers can be consistently applied and that IDD overall is more greatly aligned with MiFID and PRIIPS.

I would also like to address your question on disclosures required of insurance distributors and provide additional detail on UK negotiating successes in this area of the text. As background, we had not seen evidence of commission bias in non-investment insurance products and therefore did not see any justification in requiring mandatory disclosure by insurance distributors of granular information on the level and structure of commission received. We believed this would serve to overload customers with information that would not likely be understood.

Following negotiations, elements in the text have been removed which previously mandated that insurance distributors provide a detailed breakdown of how commission is calculated, the proportion of the commission which is based on agreed targets, and additionally details of the targets in place.

These elements have been replaced by less onerous requirements which state that the distributor should disclose the type of remuneration it receives. The Government believes this solution is more flexible for firms distributing insurance and will result in customers receiving more comprehensible information. The directive still includes requirements for a firm distributing insurance to disclose among other things its identity and address, details of its complaints procedures and details of its registration with the financial regulator.

I hope that you find our responses to your questions on specific negotiating issues and also our update on the progress of these negotiations to be of value to your Committee.

17 November 2014
Letter from the Chairman to Andrea Leadsom MP


We are grateful to you for this update on the outcome of negotiations. You state that information disclosure requirements have been amended so that the distributor is required to disclose the type of remuneration it receives. Can you confirm whether there is any requirement to disclose the amount of remuneration received?

We would be grateful for a response to this letter by 9 December 2014.

25 November 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter dated 25 November 2014 regarding the Insurance Distribution Directive. You asked whether there is any requirement for firms to disclose the amount of remuneration received in the draft text of the directive.

The answer depends on the type of insurance being distributed. I previously wrote to you regarding the distribution of non-investment insurance products, whereby in the draft text there is no requirement for firms to disclose the amount of commission, but the amount of fees to be paid by customers must be disclosed. However, with respect to insurance-based investment products, the amount of any remuneration (such as commission) must be disclosed to the customer.

I hope this provides the information you need and you find it to be of use to your Committee.

2 December 2014

MARKET ABUSE DIRECTIVE (16010/11)

Letter from Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury, to the Chairman

I am writing to provide an update on the Criminal Sanctions Market Abuse Directive (CSMAD).

As you may recall, the Government decided to not opt-in to CSMAD at the outset of negotiations because it was not possible to assess the implications of CSMAD while the broader market abuse framework set out in the Market Abuse Regulation (MAR), on which CSMAD is contingent, was at an early stage of negotiations, as was the MiFID Review, which sets out the wider regulatory framework.

Political agreement was reached on CSMAD on 20 December 2013. As a result of the decision not to opt-in, the UK did not have a vote on (and will not be bound by) the Directive. The final text covers market abuse in at least serious and intentional cases for both insider dealing and market manipulation, including the manipulation of benchmarks, and the unlawful disclosure of inside information. The text also sets out minimum-maximum levels of sanctions for these offences.

In previous correspondence, the Government committed to reviewing its decision and after considering the regime set out in the final agreed text on CSMAD, the Government does not believe that the UK would be well served by changing the decision to opt-in to CSMAD.

The UK has led the way in the EU on tackling market abuse. Under the present regime, our custodial terms for insider dealing are higher than 19 other EU Member States, and for market manipulation, higher than 17 other EU Member States. We are able to achieve the objectives of the CSMAD without opting into the Directive. Furthermore, not opting-in provides us with increased flexibility in how we make provision for criminal sanctions in the UK, both now and in the future.

The Government welcomes the fact that the EU has raised the minimum standards for criminal sanctions for market abuse, however it is important to note the unique nature of the UK financial market as a global financial centre. The depth and complexity of our financial market is unmatched in the EU. Rules that work for other Member States will need refinement and amendments to ensure that they are appropriately designed to give regulators the tools required to properly police UK financial markets, whilst also working in an international context.
The Government is committed to updating the UK criminal regime to reflect recent substantial changes in EU the regulatory framework, introduced as part of MiFID2 and MAR, and we will also consider whether any further changes are appropriate to the UK market. The Treasury therefore plans to launch a consultation on new UK legislation for criminal offences in relation to market abuse. This legislation will not only capture the aspects of the EU directive, but more importantly will go further and be better tailored to the more complicated nature of UK markets taking into account the views of a range of stakeholders as well as any lessons to be learnt from recent scandals. The Treasury will work to have the relevant domestic legislation in place by the CSMAD transposition deadline at the latest – this is expected to be at some point in summer 2016. This will guarantee that the UK remains at the forefront of tackling market abuse.

3 July 2014

MONEY MARKET FUNDS (12713/14, 13449/13)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury

Thank you for your letter, dated 13 May 2014, on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking, and for your letter, dated 1 June 2014, on JHA issues pertaining to EM 6020/14. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 10 June 2014.

We are pleased to welcome you to your new post. We are also grateful to you for this comprehensive and thoughtful response to our letter of 1 April 2014. We note in particular your helpful response on defining shadow banking and its benefits and risks. We agree with you that there is an extremely complex web of interconnections between the shadow banking and the regular banking sector. However, given the rapid growth of Shadow Banking, not least in China, we would be grateful for further information on the nature of the global risk arising from its growth in such countries. We concur with your assessment that, while understanding of the sector has increased, more needs to be done. We therefore welcome international regulatory efforts to increase transparency and understanding of the working of the sector.

In that light, we are grateful for your useful explanation of the work of the FSB. We would be grateful for further updates on the FSB’s work as the five workstreams are taken forward. It is particularly important to increase awareness of new risks as they develop, and to ensure that policies are implemented in an internationally consistent manner. On its annual global shadow banking monitoring report, what can be done to ensure that the risks arising from off-shore centres are captured, and that more jurisdictions collect more detailed data so as to allow the FSB’s narrowing down of the data to be effective?

Turning to the Commission’s two legislative proposals, you state that the policy response is at an early stage and it is therefore not possible to provide an assessment of the Commission’s approach at this point. However, we ask you to bear this question in mind in the coming months and to keep us updated as the legislative proposals are taken forward. On the proposal for a regulation on Money Market Funds (EM 13449/13), what is the view of other Member States on the proposal?

On the proposal for a regulation on Securities Financing Transactions (EM 6020/14), you state that other stakeholders, and the European Parliament in particular, “may seek to include additional provisions that detract from those measures agreed at the international level.” Can you be more specific about your concerns? In what particular ways do you anticipate that the European Parliament may seek to amend the proposal? In relation to the delegation of technical provisions to ESMA, you state that the Government will seek “to ensure important matters relevant to the UK interests are properly addressed in the negotiation”. Again, can you be more specific about the UK interests that you are seeking to protect? We also note your assertion that the UK’s JHA opt-in protocol is triggered in relation to this proposal. As you know, the Committee’s consistent position is that the opt-in is engaged only if the proposal cites a Treaty base within Title V TFEU. Given that the deadline to notify the Commission of the UK’s decision was 19 May, we regret that this was not brought to the Committee’s attention until now. Whilst we are grateful for your apology for the delay, we note that this is the second time in a matter of weeks that a JHA opt-in issue has been identified at a late stage. On 31 March 2014, the then Economic Secretary to the Treasury, Nicky Morgan MP, wrote to us in a similar vein in relation to EM 17949/13: Proposal for a Directive on the Union Legal Framework for Customs Infringements and Sanctions. What steps are you taking to improve the...
Government’s internal processes to ensure that JHA issues are identified and brought to the Committee’s attention at an early stage?

While we note that negotiations on the legislative proposals are at an early stage, we would be grateful for an initial response to these questions by 24 June 2014, followed by further updates as negotiations progress. In the meantime we will continue to hold EMs 13449/13 (Money Market Funds regulation) and 6020/14 (Securities Financing Transactions regulation) under scrutiny.

10 June 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 10 June on shadow banking, and your follow up questions.

I am glad that you found my previous letter helpful and comprehensive, and hope this response addresses your outstanding questions.

THE NATURE OF GLOBAL RISK ARISING FROM THE GROWTH OF SHADOW BANKING

In the Financial Stability Board’s (FSB) shadow banking monitoring report of 2013, ten jurisdictions were identified that experienced growth in their shadow banking sectors of over 10% - China, Argentina, India, South Africa, Russia, Brazil, Mexico, Turkey, Korea and Indonesia. Emerging markets, particularly in Asia, have experienced rapid credit growth and a shift in intermediation frameworks towards a more market based model, marked by an increase in the use of corporate bonds (for example, S&P estimates that China overtook the US in the issuance of non-financial corporate debt in 2013).

China’s shadow banking sector growth is noteworthy, although this growth does come from a low base, banks still dominate lending and, as with many emerging markets, there is a need to deepen financial markets to broaden access to finance. The measurement of the sector in China was made possible by the publication of a new statistical measure by the People’s Bank of China, “Total Social Financing (TSF), in 2011. This is not strictly comparable with the sectoral balance sheet data used by the FSB, but gives a much more accurate picture than was possible previously.

Shadow banking growth in China is driven by demand for loans by local governments and property developers which is met indirectly by investors seeking higher yield products, but there is still a good deal of uncertainty around the risks that this growth could give rise to and the inter-connectedness of the shadow banking and traditional banking systems. At worst, failures in the shadow banking system could have spill-over effects, leading to losses in the traditional banking sector.

Recent stresses have strained parts of China’s shadow banking sector but the authorities are aware of concerns and are taking steps to address the issue, although stress could increase in the interim if growth were to slow more than expected.

At the IMF Spring meetings this year, the annual early warning exercise conducted jointly with the FSB noted the potential risks from the growth in shadow banking, recommending that jurisdictions should improve their data collection so as to capture the size of the sector more effectively and the particular risks being taken. By improving monitoring, authorities will be better able to apply macro and micro prudential tools to address excessive leverage, maturity transformation and imperfect credit-risk transfer; and to improve transparency of more complex transactions such as securitised products and Over-the-Counter derivatives.

CAPTURING RISKS FROM OFF-SHORE CENTRES

You raise the quality of information gathered by the FSB’s annual global shadow banking monitoring report and how it might be improved to capture risks from off-shore centres. As mentioned in my previous response, this information is not perfect and it is improved every year. The FSB actively encourages all jurisdictions to improve the data that they collect so as to make the report more accurate; individual actions are essential for creating a common good.

Recently, the FSB’s Regional Consultative Group for the Americas (comprising FSB members and non-members) produced a report on the shadow banking monitoring exercise which sought to design a monitoring exercise specifically for jurisdictions in the region (but compatible with the global study) which mapped the connections of shadow banking to the rest of the financial sector and the potential risks of these connections. A template was developed to capture offshore shadow banking activities in international financial centres (IFCs) and their relationship with the onshore financial system. This will be assessed by the FSB’s Analytical Group on Vulnerabilities and it is hoped that it will provide a
starting point from which the global monitoring exercise can be improved to include IFCs in the future.

**CURRENT NEGOTIATIONS ON THE PROPOSED REGULATIONS REGARDING MONEY MARKET FUNDS AND SECURITIES FINANCING TRANSACTIONS**

You also asked about other Member States views regarding the proposed Regulation on Money Market Funds. No working level meetings have taken place at EU level, and Member States have not yet publicly shared their views on the proposal. It would not be appropriate to discuss the views shared by other Member States in confidence.

In terms of the direction the securities financing transactions (SFTs) may take, the Government is, as always, vigilant to the risk that the Regulation may be diverted away from its core purpose. In this case, to address the financial stability risks arising from shadow banking. Whilst the Government has no specific concerns at the moment, negotiations are inherently fluid.

The Government believes strongly that the Regulation should maintain its current purpose as an element of the international initiative to improve the supervision and transparency of shadow banking. As I stated in my previous letter on this subject, the Government favours a step-by-step approach which carefully implements internationally consistent supervision measures as they are finalised to minimise the potential for gaps in supervision or regulatory arbitrage.

Moving to the matters the UK will seek to clarify on the face of the Regulation, the Government will be seeking to agree a text which will work as planned and will allow for unintended consequences dependant on subsequent decisions from the European Supervisory Authority (ESA) or the Commission. As much of this proposal is highly technical, there are several areas where a European Supervisory Authority or the Commission will be empowered to act, such as in specifying financial instruments of ‘equivalent economic effect’ to those named in the text, and the data templates to be used by firms to report their SFT data to supervisors. Where an ESA or the Commission are empowered to specify the rules further in secondary legislation such as delegated acts, or technical standards, the Government will work to ensure sufficient controls are in place to ensure they do not diverge from the agreed purpose of the legislation.

I will keep your Committee and the House of Commons European Scrutiny Committee informed as negotiations progress on both dossiers.

**IMPROVING THE GOVERNMENT’S INTERNAL PROCESSES FOR HANDLING JHA ISSUES**

The Government takes very seriously the concerns you express in your letters on Shadow Banking, on Bank Structural Reform, and most recently to my colleague, the Commercial Secretary to the Treasury Lord Deighton, on Anti-Money Laundering. This Government is focused on ensuring we meet our scrutiny commitments to Parliament.

To ensure the opt-in is identified at an early stage, the Home Office and Ministry of Justice have recently reissued guidance across Whitehall on the opt-in protocol. In addition, specific training on the application of the opt-in, especially in relation to identifying JHA content and understanding the process for asserting the opt-in is being provided to Departments.

24 June 2014

**Letter from the Chairman to Andrea Leadsom MP**

Thank you for your letter dated 24 June 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 8 July 2014.

You provide helpful and insightful information on the growing risks of shadow banking in emerging markets and in response to our concerns on risks from off-shore centres. It is reassuring that you continue to devote sufficient resources into developing the Money Market Funds and Securities Financing Transaction Regulations by placing due importance on international initiatives designed to improve the supervision and transparency of shadow banking. We are well aware of the difficulties in collecting data on shadow banking activities. We would be grateful if you could keep us informed on the current status of data collection provisions, since this has been a challenging task for many financial centres, and one still being considered by the FSB.

As part of your general approach to negotiations, we recommended that agreement of the text should allow the ESAs to supervise the activities of Shadow Banks with sufficient flexibility, providing
them with the ability to shift targets as the financial system changes. Similarly, while institutions such as the Bank of England have demonstrated a flexible approach to non-financial institutions, providing liquidity backstops to broker dealers and central counterparties in an effort to prevent instability if the financial markets seize up, perhaps comparable efforts could be taken forward by the European Central Bank to ease similar pressure should it build. In this context we note media reports of a leaked draft European Commission report on the European System of Financial Supervision that examines the merit of extending the reach and power of the ESAs to encompass these new areas. Can you shed any light on this matter, and on when the Commission’s report, initially expected to be brought forward at the end of 2013, can be expected to be published?

In answer to our query about the views of other Member States regarding the proposed Money Market Funds regulation, you state that “it would not be appropriate to discuss the views shared by other Member States in confidence.” While we appreciate that the negotiating positions of other Member States remain confidential, our desire is simply to gain a broader understanding of the debate in hand. We would be concerned if you were to rely on the principle of confidentiality to refuse to inform us of the different views within the Council on a proposal. We do not accept that this automatically means that we cannot be informed about the views of other Member States. This can be done in general terms; it does not require disclosure of details which would compromise a Member State’s negotiating position or undermine the decision-making process of the Council. If the Government now refuses to do so, it will severely restrict our ability to scrutinise these policies effectively. So, while bearing in mind that negotiations are at an early stage, we ask you again to provide us with an outline of the different views in the Council on the proposed Money Market Funds Regulation.

We welcome the fact that the belated recognition and enactment of JHA issues has resulted in training course being taken forward.

We would be grateful for a response to these questions by 23 July 2014, and thereafter to be kept updated on EMs 13449/13 and 6020/14 as negotiations progress. In the meantime we will hold both documents under scrutiny.

9 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 9 July on shadow banking, and your follow up questions.

Since I last wrote to you, working level Council discussions on the Securities Financing Transactions Regulation have continued. The Government has continued to press for the regulation to be technically rigorous and consistent with the FSB recommendations in this area. This has been undertaken in co-operation with the UK financial services regulators and in consultation with Industry.

You also asked the Government to shed light on media reports of a leaked draft and when the Commission will publish its proposal for a European System of Financial Supervision. We are aware that a draft of the report was leaked, however it is our understanding that this is unlikely to be the finalised version. A proposal is expected to be published in the coming weeks, more specifically between the end of July and the beginning of September.

As regards whether the European Supvisory Authorities (ESAs) should play a role in the supervision of shadow banks, there are a range of challenging issues that will need to be considered. This ranges from the definition of shadow banks, the expertise required to undertake such supervision to whether national or regional supervisors are better placed to supervise and monitor risks, as well as the need to balance the existing responsibilities of the ESAs with new duties.

In that regard, we are conscious that the ESAs have yet to fulfil their existing mandate.

The ESAs have focused on rule-making in recent years, given the high volume of legislation since the crisis, and we are keen to see the ESAs strengthen their focus on raising standards of supervision across the EU and identifying and mitigating risks through greater analysis of financial markets – two other key aspects of their mandate. These issues will be considered further in light of the forthcoming report from the Commission on the review of the European System of Financial Supervision (ESFS).

You also asked about other views in Council on the proposed Regulation on Money Market Funds. While it would clearly be inappropriate to comment on positions, following an early working group on 3 July, we are in a position to provide more information on the views that have emerged. A number of Member States were supportive of our position, with some raising concerns that it may not be possible to avoid causing serious disruption to short term financing of the real economy if the
Union moves from the existing framework which allows both Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV) funds, to either requiring a capital buffer or prohibiting CNAVs outright.

Some expressed concerns about CNAV funds, with calls for them to be banned. The important role played by money market funds gives rise to prudential concerns that under stressed market conditions they could pose a source of systemic risk. Some concerned about CNAVs suggested they might tolerate them marketing to investors in their country from other jurisdictions, but they were not happy that the Regulation would require them to lift national prohibitions on the establishment of CNAV funds within their territory.

Overall, there does not appear to be any open support for the capital buffer at this early stage, but this working group was only an initial discussion and therefore many of the views expressed are very preliminary.

24 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 24 July 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.

We are grateful to you for the update on the exchange of views at Council working group on 3 July. We note that there was some level of support for the UK’s concerns that the proposals may have damaging consequences for short term money markets and thus the real economy. While there is limited support for a capital buffer, we would benefit from being updated on whether other mechanisms are currently being proposed by way of capital or liquidity management in the future.

The details concerning the marketing of CNAVs in Member States and the requirement for national prohibitions to be lifted is one that we note for future consideration as this Regulation is discussed. We would thus be grateful for further updates as and when progress is being made.

In the meantime we continue to hold EM 13449/13 and 6020/14 under scrutiny.

29 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your EM 12713/14, dated 29 September 2014, on the ECB’s opinion on the European Commission’s proposal for a Regulation on Money Market Funds. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 October 2014.

We support the helpful comments raised by the ECB, in particular those that add weight to concerns on the wider implications on bank intermediation, short term and securitisation markets, as well as MMF concentration.

We take note of the efforts by the ECB to ensure consistency and harmonisation with other connecting regulations, particularly in light of our inquiry into the EU financial sector regulatory framework, which aims to establish the gaps and inconsistencies between regulations. We are alert to the interconnections raised in the ECB opinion. For example, the ECB supports clarity on how the proposal interacts with the national provisions transposing UCITS and AIFM Directives. In addition the ECB also raises the potential implications to bank funding arrangements in conjunction with the Basel III Liquidity Cover Ratio, effectively incentivising banks to raise funding through corporates instead of through asset managers. We also take note of the ECB’s caution with respect to the development of rules on net stable funding, impacting the link between banks and MMFs.

We note the Regulation’s proposed eligibility requirements for short term securitised assets. Given a framework for high quality securitisation that may be developed by European institutions and authorities in the new European Commission, we believe it is important that the incentives for such short term securitised assets are matched for both buyers and sellers, given potential capital requirements. We are following the wider debate on the definition of high quality securitisation and its potential variance with other regulatory approaches. Are there particular divergences or inconsistencies in other EU regulations or Directives that could risk causing fragmentation in the market should these eligibility requirements be agreed?
On the subject of convergence, we note that it may be indeed tougher for the EU to reach convergence with the reform of Money Market Funds in the US. We note that the ECB supports convergence with the US given that a very large share of the world’s MMF industry is established there. We note that the ECB’s support for a capital buffer (albeit one taking into account the risk profile of the MMF) contradicts the SEC’s earlier decision to reject this type of reform measure. Furthermore the SEC’s decision in July 2014 effectively allows the majority of CNAV to remain (mandating conversion to variable NAV for only a minority of CNAV) can be read as another sign that both regimes are moving in different directions. While the US decision is seen to reflect the feature of the US CNAV market, do you have an opinion on this ruling and whether it supports the argument against the controversial 3% capital buffer in the EU? Furthermore the SEC has opted to impose fees and gates for most money market funds. Do you believe this is a solution that is also workable in the EU for all CNAV funds? We note your opposition to a 3% buffer. Can you please expand your view as to the reasons behind this opinion, whether you oppose the buffer as a principle or whether you disagree with its calibration? Would you be able to provide more clarity on the potential harmful effects of introducing such a measure?

We would be grateful for a response to this letter by 28 October 2014. In the meantime we now clear EM 12713/14 from scrutiny, while continuing to hold EM 13449/14 under scrutiny.

15 October 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter concerning EM 12713/14 dated 15 October 2014 regarding the European Central Bank’s (ECB) opinion on the European Commission’s proposal for a Regulation on Money Market Funds.

You enquire as to whether there are any particular divergences or inconsistencies between this proposed Regulation and other EU Regulations or Directives as to the eligibility requirements for short term securitised assets that might give rise to market fragmentation if not reconciled.

As currently proposed the text is likely to be inconsistent with the approach taken elsewhere and it is true that a divergent approach might give rise to market fragmentation although ultimately this will depend on the final nature of any divergences.

As you will be aware,reviving securitisation markets is an important step to improving financing of the economy. Discussions around this issue are already underway within the context of a number of Commission delegated acts. As such the EU’s Economic and Financial Committee has already stressed the importance of ensuring a consistent and coherent framework.

In addition an international working group has been jointly established by the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS) to develop criteria to identify “simple, transparent and consistent” securitisations. This working group is due to provide its final report in 2015 which will help ensure a common framework within which to develop appropriate regulatory and prudential approaches.

You also ask for my view on the ruling by the Securities and Exchange Commission (SEC) on US money market funds (MMFs) and the extent to which I believe it supports arguments against capital buffers in the EU. In so far as it concerns the suitability of capital buffers I agree that the SEC’s conclusions support the argument against the introduction of capital buffers in the EU. Specifically, a buffer sizeable enough to absorb large security defaults as seen during the crisis would almost certainly be unaffordable and reduce yields to investors to such an extent that most Constant Net Asset Value (CNAV) funds as currently exist would cease to be attractive or viable investment vehicles.

You also ask whether the SEC proposals on fee and gates would be a workable solution in the EU for all CNAV funds. Fees and gates are an effective tool for stopping runs once in action although there are questions as to whether the introduction of fees and gates in one fund could trigger redemptions elsewhere.

The US has tried to mitigate this through the use of structured discretion, whereby MMF managers retain some discretion as to whether to introduce either tool. In principal such a solution is workable in the EU although differences between the EU and US markets make a direct transfer of the SEC proposals problematic. In particular the SEC proposals require prime institutional funds to float the

NAV. While this is expected to affect only a small minority of investors in the US, in the EU it would affect virtually all existing CNAV funds.

Connected to this you ask whether the Government’s opposition to capital buffers is one of calibration or principle and ask if I could expand on the reasons for this opposition and what the harmful effects of such a measure may be.

While the proposed application of bank-like regulation to investment funds raises points of principle, in this case my opposition is primarily one of practicality. As noted above, it is hard to see how a capital buffer could be calibrated so as to be affordable while being sufficiently large to absorb losses and provide comfort to investors.

There are further complications around how such a buffer is replenished and whether the need to replenish it simply becomes a channel by which risk is transmitted to banks or other entities who act as sponsors.

To the extent that some CNAV MMFs were to continue operating under a regime which required capital buffers then there is a risk of a significant increase in market concentration. This would exacerbate, not reduce, systemic risks within the financial system.

It is hard to quantify precisely the likely effects of such proposals. This is largely because we cannot be certain of the behavioural response of investors. However, according to one survey 38% of European investors in CNAV MMFs stated that they would reduce their CNAV allocation if the NAV was moved to a floating structure and 36% would disinvest entirely. Given the important role MMFs play in financing the real economy this could have serious repercussions for the European economy, something this Government is rightfully seeking to avoid.

2 November 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 2 November 2014, on EM 12713/14: the ECB’s opinion on the European Commission’s proposal for a Regulation Money Market Funds. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 25 November 2014.

We are grateful for your helpful comments and views on the nature of the impact of the proposed capital buffer. Your reference to JPMorgan’s evidence of the potential decline in use of CNAV funds is noted, however we caution that it should not be read in isolation given there are clearly many factors affecting the reasons why an investor may withdraw funds from an MMF. We also agree that investor behaviour remains uncertain.

With reference to the latest Presidency Compromise text that emerged on 10 November 2014, we note that all mention to the proposed capital buffer has been removed. Can you update us on the Council’s latest compromise text not to support the capital buffer proposed for CNAV funds? What is the justification for the Council’s position on the decision? What do you see as the implications for CNAV of this compromise? Should the capital buffer continue to attract views from each side, would there be benefit in conducting another impact assessment in light of the current Basel capital and funding requirements that have yet to be finalised?

The Presidency compromise also brings retail and small professional CNAV fund requirements into focus. Can you explain the reasoning behind Article 29? Can you explain how alternatives to a capital buffer such as redemption gates and fees would be aligned to what is currently in place for AIFMD and UCITS? Should short term and standard MMFs expect similar treatment instead of a capital buffer? On a broader point, how large is the retail and small professional CNAV fund market?

Article 13a of the Presidency Compromise details some requirements which limit the MMFs from investing more than 10% in another single MMF units or shares. The text says that Member States have the discretion to lift this limit to 20%. We are concerned that the ability for Member States to vary the limit up to 20% runs counter to the principle of creating a single market with a single set of rules. Do you believe this amendment, if adopted, would create divergences in the eligible level of investment of another single MMF between Member States? Is this a concern?

Lastly, can you outline with any specificity the potential legal inconsistencies that apply to the eligibility of short term securitised assets? It would be a failure if the market that is trying to become ‘revitalised’ becomes fragmented due to eligibility requirements. Is there any room for flexibility at the

3 Source: PeerView independent client survey carried out on behalf of JP Morgan.
Level 1 level so as to reduce any future adverse consequences to this market? In light of the latest compromise text, why was the Article on securitisation not revised? How would you intend to improve the text so as to ensure that future international developments can be taken into account?

We would be grateful for a response to this letter, together with an update on negotiations, by 9 December 2014. While we cleared EM 12713/14 from scrutiny on 14 October 2014 we continue to hold EM 13449/14 under scrutiny.

25 November 2014

PROTECTION OF THE EU BUDGET TO END 2013 (13781/14)

Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury, to the Chairman

Thank you for EM 13781/14, dated 15 October 2014, a Report from the Commission on the follow-up to the discharge for the 2012 financial year. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 28 October 2014.

We note the Commission’s assertion that “the figures presented in this Communication demonstrate the positive results of the multi-annual preventive and corrective activities undertaken by both the Commission and Member States. … Moreover, the significance of the amounts reported concerning financial corrections and recoveries should be viewed as an affirmation of the commitment of both parties to ensuring that European taxpayers’ money is being used in accordance with legal requirements.” Do you agree? Is an alternative reading to suggest that the large amounts involve indicate the scale of the problems with illegal and irregular expenditure that exist?

We are disappointed at the lack of detail in the EM about cases pertaining to the UK. You state only that 214 out of 2495 financial corrections related to the UK. Can you be more specific about the reasons for the financial corrections that related to the UK? The Communication states that shared management financial corrections confirmed and implemented in 2013 as compared to payments received from the EU budget was the fourth highest figure in the EU. What is the reason for such a high figure?

We would be grateful for further explanation of a number of assertions in the EM. Can you elaborate on the problems that have been identified in the way in which financial corrections are currently applied? What steps has the Commission taken to address these? In relation to the conformity procedure, can you explain in more detail your argument that the Commission should apply by the same deadlines for issuing responses as apply to Member States? We welcome your support for close collaboration between Commission and Member States’ paying agencies as well as efforts to simplify complex rules and legislation governing the use of EU budget funds. As we have made clear in previous correspondence, it is imperative that the Commission and Member States work together if the EU budgetary process is to work effectively.

We would be grateful for a response to this letter by 11 November 2014. In the meantime we will continue to hold the document under scrutiny.

28 October 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 28 October on the above mentioned EM.

The Committee is correct that the figures in the Commission’s document can be interpreted as indicative of the scale of illegal and irregular expenditure. The Government believes that an important step in robustly tackling fraud against the EU budget has to be improved detection and the fraud figures reflect improvements in this area. The true scale of the problem must be exposed if it is to be dealt with appropriately.

The Committee also sought further detail on the 214 financial corrections for the UK referred to in the report. As set out in table 3.1 of the report, the majority of financial corrections in place across the EU continue to concern agriculture and cohesion funds and this is also true for the UK.

Given the ongoing and universal nature of issues concerning the implementation of agriculture and cohesion funds in accordance with existing regulations, the Government continues to work with
other Member States to encourage close collaboration with the Commission and press for the simplification of the complex rules and legislation governing expenditure in this area.

In your letter, the Committee requests further detail of the problems with the Commission’s application of financial corrections. The Government remains of the view that financial corrections are an important means of addressing and rectifying errors.

However, the application of such corrective measures should take into consideration and reflect the actual risk to EU budget funds. Errors identified do not always present a risk to EU budget funds and yet can lead to a financial correction. This is because the approach taken does not reflect the true impact of the error and can lead to both the imposition of unnecessarily complex control requirements and unduly high costs of control.

Further, the Commission now has new powers to increase the level of flat-rate financial corrections where it identifies multiple issues. It is important that the Commission applies financial corrections in a proportional manner. The Government will continue to engage with the Commission and work with other Member States in Council to improve proportionality in the application of financial corrections.

The Government supports the principle of completing conformity audit enquiries within two years but notes the challenges that this will present. To achieve this aim, the Commission should adhere to the same deadlines as Member States for issuing responses as this will contribute to reducing the length of the overall process.

18 November 2014

Letter from the Chairman to David Gauke MP to the Chairman

Thank you for your letter, dated 18 November 2014, on a Report from the Commission on the follow-up to the discharge for the 2012 financial year. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 28 October 2014.

The scale of the problems with illegal and irregular expenditure remains a matter of great concern. We pursue the issue of the need for corrective measures to take into account the actual risk to EU budget funds in our continued correspondence on EM 13681/I4: follow-up to discharge of the EU Budget for 2013. Following receipt of your letter we are now content to clear EM 13781/I4 from scrutiny.

25 November 2014

RESIDENTIAL PROPERTY DIRECTIVE (8680/11)

Letter from Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury, to the Chairman

I’m writing to you as I wanted to update you on the Government’s approach to the implementation of the EU Mortgage Credit Directive (MCD), also known as CARRP (Credit Agreements Relating to Residential Property) Directive.

I know your committee showed significant interest in this Directive in the past, and my predecessor last wrote to you in June 2013, following political agreement on the Directive, setting out the final position negotiated on a number of key UK priorities. As you may remember, we were satisfied to have achieved an outcome that meant that the Directive was broadly consistent with existing UK mortgage regulation, and to have negotiated a five year transitional provision for the introduction of the standardised customer disclosure document (the European Standardised Information Sheet or ESIS).

On the inclusion of buy-to-let lending we were pleased to have secured an exemption from the detailed requirements of the Directive. This was agreed in the final stages of trilogue negotiations, and represented a significant negotiating win for the UK.

As HM Treasury officials have worked through the details of implementation of this Directive, it has become apparent that the wording, although it provides the UK much more flexibility than it would have had otherwise, does require Member States availing themselves of this exemption to ensure that an appropriate domestic framework is applied to buy-to-let lending. Regulation will only be required for the minority of buy-to-let lending that is to consumers, given that the Directive does not apply to...
borrowing for the purposes of someone’s trade, business or profession and one of the key reasons that we have in the past decided not to bring buy-to-let within the scope of FCA regulation is precisely because of the business characteristics of the vast majority of this borrowing. We therefore expect that the regulations would only apply to a small minority of transactions, where the individual is a buy-to-let borrower due to circumstance more than choice and therefore has the characteristics of a consumer rather than a business. This could, for example, include instances where a borrower has previously lived in a property, but is unable to sell it so must resort to letting the property.

This is still a good outcome for the UK and I am confident that the UK will secure an approach that minimises the Directive’s impact on the domestic market, and we are engaging closely with stakeholders in our efforts to achieve this.

Given your committee’s long-standing interest in this Directive, I wanted to write to you to make you aware of how this issue had progressed in advance of the publication of the HM Treasury consultation. This consultation sets out all the proposed legislative changes, and will be published on the HM Treasury website on 5 September.

1 September 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 1 September 2014, on EM 8680/11, the Residential property Directive. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 October 2014.

We are concerned at your statement that “as HM Treasury officials have worked through the details of implementation of this Directive, it has become apparent that the wording … does require Member States availing themselves of this [buy-to-let] exemption to ensure that an appropriate domestic framework is applied to buy-to-let lending.” Why were the implications of the final agreement not grasped at the time? Could more have been done to do so?

You state that you are confident that the Directive’s impact on the domestic market will be minimised. However we are concerned that the effect will be greater than you are suggesting. How many do you anticipate will be affected by a new domestic framework? What special help will HM Treasury be providing to support those affected? What further information can you give us on the HM Treasury consultation? What further steps will follow the close of the consultation period?

You state that you are engaging closely with stakeholders in your efforts to minimise the Directive’s impact on the domestic market. What further details can you give us on such consultation? What is the view of stakeholders on this requirement and the burden it will place on the domestic market? How would you respond to the reported view of the Council of Mortgage Lenders that the proposal “is based not on any evidence of a need for additional consumer protection, but purely on ensuring that the European legal requirements are met”? How would you respond to their concerns that it may be difficult for lenders to distinguish between consumer landlords and those who went into buy-to-let deliberately, and that this uncertainty might discourage lending?

We would be grateful for a response to this letter by 28 October 2014.

15 October 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter, dated 15 October, responding to my previous update on the implementation of the EU Mortgage Credit Directive (MCD), also known as the CARRP (Credit Agreements Relating to Residential Property) Directive.

In your letter you set out a number of concerns the Committee has around the Government’s proposed approach to implementing the Directive’s requirements around buy-to-let mortgage lending.

Your first question is why the full implications of the final agreement were not appreciated at the time the Directive was finalised. As you will recall, the focus at the time of finalising this agreement was to maintain policy support for the broadest possible exemption for buy-to-let lending. As the UK is almost alone in having a developed buy-to-let market, this was a difficult position to defend. The eventual agreement was that member states wishing to utilise the exemption that the UK fought so hard to win, needed to ensure an appropriate framework for buy-to-let lending for consumers.
As you would expect, we tested and worked through the wording in detail to determine our full obligations, with legal analysis of the final wording concluding that a small proportion of current buy-to-let lending needs to be brought into regulation in order to meet this requirement. However, I remain confident that given the circumstances, the final wording represents a positive outcome for the UK.

The Treasury is continuing to review the processes it has in place to ensure important details such as this are identified during the negotiating stages of future directives, including recent work I highlighted in my letter to you on 20 October 2014 regarding the Bank Recovery and Resolution Directive.

Your additional comments relate primarily to the impact of HM Treasury’s proposed approach to the implementation of the Directive requirements with respect to buy-to-let and our efforts to deal with stakeholder concerns.

As I explained in my previous letter, while the Directive exempts buy-to-let lending from the detailed provisions that will apply to the mainstream mortgage market, it does require us to ensure that an appropriate domestic framework is applied to buy-to-let lending. However, given that the Directive does not apply to borrowing for the purposes of someone’s trade, business, or profession, this framework only needs to apply to buy-to-let mortgage lending to consumers. In most circumstances, buy-to-let borrowers will be using the mortgage to acquire assets for the purposes of running a property letting business. However, we have identified some situations where the borrower does not appear to be acting in a business capacity. Examples of this may be where the property has been inherited or where a borrower has previously lived in the property, but is unable to sell it so resorts to a buy-to-let arrangement. In such cases, the borrower may well be a landlord as a result of circumstance rather than through their own active business decision, and as such looks to be acting as a consumer. However, government’s initial view, informed by discussions with stakeholders, is that such circumstances represent a relatively small proportion of the buy-to-let market.

The proportion of the market that will be subject to these regulations is therefore one factor that Treasury expect will limit the impact of the Directive on buy-to-let mortgage lending. The other factor is the work we are doing to ensure the regime minimises the burdens on lenders while meeting the UK’s legal obligations. This has included working closely with lenders, including through the Council of Mortgage Lenders (CML), to ensure that our rules will make compliance as straightforward as possible.

You ask in your letter for the Government’s response to the CML’s view that the proposed approach is driven by requirement to comply with the MCD rather than analysis about the need for greater protections. As explained in the government consultation document, published on 5 September, the Government agrees that the case has not been made for the conduct regulation of buy-to-let mortgage lending, which is why we are seeking to do the minimum in order to meet the UK’s legal obligations.

The Government is consulting closely with industry and their representatives as the proposals are finalised. Alongside the consultation document itself, this has included a wide range of meetings and a survey of affected firms to find out more about the likely impact.

The consultation closed on October 30 and HM Treasury is now considering what amendments maybe needed to our legislation, taking into account the responses received both formally and informally. A response document will be published in due course, at which I will of course write to update your committee on the implementation process.

6 November 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 6 November 2014, on EM 8680/11, the Residential Property Directive. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 November 2014.

We appreciate that the unique nature of the UK’s buy-to-let market placed the UK in a difficult negotiating position. However we regret that your letter has failed to meet our concerns about the potential impact of the requirement for an appropriate domestic framework to be put in place. This is particularly so given that you fail to provide any figures on the numbers who are likely to be affected, not least in those examples of inheritance of a property or an inability to sell, that you identify. What figures can you give us on the numbers that you and the industry estimate will be affected? What further specific details can you give us on the views of such stakeholders as the Council for Mortgage Lenders?
In light of your statement that “the UK is almost alone in having a developed buy-to-let market”, do you know of any other Member State that wishes to utilise the exemption that the UK secured?

We note that HM Treasury is continuing to review the processes it has in place to ensure important details such as these are identified during the negotiating stages of future directives. You highlight recent work in the context of similar issues with the Bank Recovery and Resolution Directive. Does it concern you that there have been such oversights in quick succession in relation to two legislative files of such core importance to the UK and its domestic interests?

We are grateful to you for offering to update the Committee on the implementation process. We would also be grateful for an update when the response document is published.

We also note EM 13450/14 on Commission Delegated Regulation on the Minimum Monetary Amount of the Professional Indemnity Insurance or Comparable Guarantee to be held by Credit Intermediaries. This will increase the level of PII required to be held from the current minimum levels required in the UK. While we note your assessment, based on discussions with the industry and taking into account cost-benefit analyses by the EBA and FCA, that the effect on UK mortgage intermediaries will be negligible, we would be grateful for further clarification. Can you give more details of the consultation you have held with industry groups? Have any of them raised concerns about the change? You state that the EBA chose the second lowest option following engagement from the UK Government. What is the EBA’s rationale for recommending a higher level in the first place? Is it, as you suggest, in order to provide a small increase in consumer protection? You also state that the FCA has not put a monetary figure on the expected costs. Has there been any estimation of the costs likely to pertain to the UK?

We would be grateful for a response to this letter by 2 December 2014.

18 November 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 18 November, setting out your outstanding concerns about the impact of the Mortgage Credit Directive (MCD) on the buy-to-let mortgage market and on the level of professional indemnity insurance (PII) held by UK mortgage credit intermediaries. I am sorry that my previous letter did not address your concerns.

On the impact of the Government’s proposed approach to meeting the Directive’s requirements for buy-to-let, as explained in my previous letter, you pose a specific question about how many mortgages will be affected. The Treasury has been consulting widely to improve our understanding of the likely impact. This will be reflected in full in the final stage impact assessment, but our current best estimate is that around 10 per cent of buy-to-let transactions could be subject to the new framework.

In terms of the views of stakeholders such as the Council of Mortgage Lenders, their response to the HM Treasury consultation welcomed the Government’s efforts to minimise the impact on industry, including limiting the application to those who are consumers. As a result of this, they thought the impact was likely to be minimal overall, although they recognised that there could be a more significant impact at the margins, for example if only a limited number of lenders chose to participate in lending to buy-to-let consumers, and during the period of transition to the new regime.

You also ask whether the Government is aware of any other Member States that would look to use the exemption secured by the UK. I can confirm that we are not aware that any other Member States are seeking to use this exemption, although it should be added that most Member States seem to be less advanced than the UK in working through the details of implementation.

In terms of the handling of negotiations on this and other dossiers, my previous letter refers to the difficulties associated with the fast-paced nature of EU negotiations and the very large volume of technical detail. HM Treasury will, of course, continue to learn lessons and review and improve processes to ensure that the UK is as effective as possible in meeting our objectives in such negotiations. While both the MCD and the Bank Resolution and Recovery Directive (BRRD) include some elements where HM Treasury could have done more to identify issues with specific elements of the text sooner, I think it is worth noting that the wider aims on both dossiers were achieved with outcomes that were positive for the UK.

You also requested further clarification on a number of issues in relation to EM 13450/14. The first was about consultation with industry. The European Banking Authority (EBA) consulted openly on the
proposed level of PII cover. The Financial Conduct Authority (FCA) highlighted this consultation to UK industry bodies such as the Association of Mortgage Intermediaries. From discussions with the industry at the time of the EBA consultation, the FCA came to understand that the increase in PII requirements for intermediaries, while unwelcome, was unlikely to prove highly significant.

You also ask about the other options considered by the European Banking Authority (EBA). These are set out in more detail in their consultation on this issue. The different options were based on different potential methodologies for calculating the appropriate levels. The EBA concluded that their preferred methodological approach, to arrive at a level through a detailed analysis of the costs and benefits, was not feasible with the data available. This left 3 potential options, the most expensive of which was to align the levels with those set out for insurance intermediaries in the Insurance Mediation Directive. However, the EBA concluded that this approach was not appropriate as the risks, in terms of the number of compensation claims and the compensatable loss of the types of claim to which the activities could give rise, was lower for mortgage intermediaries than insurance intermediaries.

In terms of assessing the cost of this change to the UK, the change is being made through FCA rules, and so is included in their cost benefit analysis of the changes required to implement to MCD. This gives a high level cost benefit analysis which concludes that they ‘do not expect incremental compliance costs to be very large’ but that they also ‘do not expect significant benefits’. However, this analysis does not include a monetary estimate of the incremental cost of this change. The FCA judged that this would be disproportionate because it would have required extensive data to be gathered from industry about their current levels of PII, imposing costs on industry, and the UK would not be in a position to change its approach in response to this estimate.

I hope that this letter addresses your questions. As I previously explained, I will certainly write again to update you when the Government’s response document is published.

2 December 2014

SECURITIES FINANCING TRANSACTIONS (6020/14, 6022/14, 11921/14)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury

Thank you for your letter, dated 13 May 2014, on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking, and for your letter, dated 1 June 2014, on JHA issues pertaining to EM 6020/14. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 10 June 2014.

We are pleased to welcome you to your new post. We are also grateful to you for this comprehensive and thoughtful response to our letter of 1 April 2014. We note in particular your helpful response on defining shadow banking and its benefits and risks. We agree with you that there is an extremely complex web of interconnections between the shadow banking and the regular banking sector. However, given the rapid growth of Shadow Banking, not least in China, we would be grateful for further information on the nature of the global risk arising from its growth in such countries. We concur with your assessment that, while understanding of the sector has increased, more needs to be done. We therefore welcome international regulatory efforts to increase transparency and understanding of the working of the sector.

In that light, we are grateful for your useful explanation of the work of the FSB. We would be grateful for further updates on the FSB’s work as the five workstreams are taken forward. It is particularly important to increase awareness of new risks as they develop, and to ensure that policies are implemented in an internationally consistent manner. On its annual global shadow banking monitoring report, what can be done to ensure that the risks arising from off-shore centres are captured, and that more jurisdictions collect more detailed data so as to allow the FSB’s narrowing down of the data to be effective?

Turning to the Commission's two legislative proposals, you state that the policy response is at an early stage and it is therefore not possible to provide an assessment of the Commission's approach at this point. However, we ask you to bear this question in mind in the coming months and to keep us updated as the legislative proposals are taken forward. On the proposal for a regulation on Money Market Funds (EM 13449/13), what is the view of other Member States on the proposal?

On the proposal for a regulation on Securities Financing Transactions (EM 6020/14), you state that other stakeholders, and the European Parliament in particular, “may seek to include additional provisions that detract from those measures agreed at the international level.” Can you be more specific about your concerns? In what particular ways do you anticipate that the European Parliament may seek to amend the proposal? In relation to the delegation of technical provisions to ESMA, you state that the Government will seek “to ensure important matters relevant to the UK interests are properly addressed in the negotiation”. Again, can you be more specific about the UK interests that you are seeking to protect? We also note your assertion that the UK’s JHA opt-in protocol is triggered in relation to this proposal. As you know, the Committee's consistent position is that the opt-in is engaged only if the proposal cites a Treaty base within Title V TFEU. Given that the deadline to notify the Commission of the UK’s decision was 19 May, we regret that this was not brought to the Committee’s attention until now. Whilst we are grateful for your apology for the delay, we note that this is the second time in a matter of weeks that a JHA opt-in issue has been identified at a late stage. On 31 March 2014, the then Economic Secretary to the Treasury, Nicky Morgan MP, wrote to us in a similar vein in relation to EM 17949/13: Proposal for a Directive on the Union Legal Framework for Customs Infringements and Sanctions. What steps are you taking to improve the Government’s internal processes to ensure that JHA issues are identified and brought to the Committee's attention at an early stage?

While we note that negotiations on the legislative proposals are at an early stage, we would be grateful for an initial response to these questions by 24 June 2014, followed by further updates as negotiations progress. In the meantime we will continue to hold EMs 13449/13 (Money Market Funds regulation) and 6020/14 (Securities Financing Transactions regulation) under scrutiny.

10 June 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 10 June on shadow banking, and your follow up questions.

I am glad that you found my previous letter helpful and comprehensive, and hope this response addresses your outstanding questions.

THE NATURE OF GLOBAL RISK ARISING FROM THE GROWTH OF SHADOW BANKING

In the Financial Stability Board’s (FSB) shadow banking monitoring report of 2013, ten jurisdictions were identified that experienced growth in their shadow banking sectors of over 10% - China, Argentina, India, South Africa, Russia, Brazil, Mexico, Turkey, Korea and Indonesia. Emerging markets, particularly in Asia, have experienced rapid credit growth and a shift in intermediation frameworks towards a more market based model, marked by an increase in the use of corporate bonds (for example, S&P estimates that China overtook the US in the issuance of non-financial corporate debt in 2013).

China’s shadow banking sector growth is noteworthy, although this growth does come from a low base, banks still dominate lending and, as with many emerging markets, there is a need to deepen financial markets to broaden access to finance. The measurement of the sector in China was made possible by the publication of a new statistical measure by the People’s Bank of China, “Total Social Financing (TSF), in 2011. This is not strictly comparable with the sectoral balance sheet data used by the FSB, but gives a much more accurate picture than was possible previously.

Shadow banking growth in China is driven by demand for loans by local governments and property developers which is met indirectly by investors seeking higher yield products, but there is still a good deal of uncertainty around the risks that this growth could give rise to and the inter-connectedness of the shadow banking and traditional banking systems. At worst, failures in the shadow banking system could have spill-over effects, leading to losses in the traditional banking sector.

Recent stresses have strained parts of China’s shadow banking sector but the authorities are aware of concerns and are taking steps to address the issue, although stress could increase in the interim if growth were to slow more than expected.
At the IMF Spring meetings this year, the annual early warning exercise conducted jointly with the FSB noted the potential risks from the growth in shadow banking, recommending that jurisdictions should improve their data collection so as to capture the size of the sector more effectively and the particular risks being taken. By improving monitoring, authorities will be better able to apply macro and micro prudential tools to address excessive leverage, maturity transformation and imperfect credit-risk transfer; and to improve transparency of more complex transactions such as securitised products and Over-the-Counter derivatives.

CAPTURING RISKS FROM OFF-SHORE CENTRES

You raise the quality of information gathered by the FSB’s annual global shadow banking monitoring report and how it might be improved to capture risks from off-shore centres. As mentioned in my previous response, this information is not perfect and it is improved every year. The FSB actively encourages all jurisdictions to improve the data that they collect so as to make the report more accurate; individual actions are essential for creating a common good.

Recently, the FSB’s Regional Consultative Group for the Americas (comprising FSB members and non-members) produced a report on the shadow banking monitoring exercise which sought to design a monitoring exercise specifically for jurisdictions in the region (but compatible with the global study) which mapped the connections of shadow banking to the rest of the financial sector and the potential risks of these connections. A template was developed to capture offshore shadow banking activities in international financial centres (IFCs) and their relationship with the onshore financial system. This will be assessed by the FSB’s Analytical Group on Vulnerabilities and it is hoped that it will provide a starting point from which the global monitoring exercise can be improved to include IFCs in the future.

CURRENT NEGOTIATIONS ON THE PROPOSED REGULATIONS REGARDING MONEY MARKET FUNDS AND SECURITIES FINANCING TRANSACTIONS

You also asked about other Member States views regarding the proposed Regulation on Money Market Funds. No working level meetings have taken place at EU level, and Member States have not yet publicly shared their views on the proposal. It would not be appropriate to discuss the views shared by other Member States in confidence.

In terms of the direction the securities financing transactions (SFTs) may take, the Government is, as always, vigilant to the risk that the Regulation may be diverted away from its core purpose. In this case, to address the financial stability risks arising from shadow banking. Whilst the Government has no specific concerns at the moment, negotiations are inherently fluid.

The Government believes strongly that the Regulation should maintain its current purpose as an element of the international initiative to improve the supervision and transparency of shadow banking. As I stated in my previous letter on this subject, the Government favours a step-by-step approach which carefully implements internationally consistent supervision measures as they are finalised to minimise the potential for gaps in supervision or regulatory arbitrage.

Moving to the matters the UK will seek to clarify on the face of the Regulation, the Government will be seeking to agree a text which will work as planned and will allow for unintended consequences dependent on subsequent decisions from the European Supervisory Authority (ESA) or the Commission. As much of this proposal is highly technical, there are several areas where a European Supervisory Authority or the Commission will be empowered to act, such as in specifying financial instruments of ‘equivalent economic effect’ to those named in the text, and the data templates to be used by firms to report their SFT data to supervisors. Where an ESA or the Commission are empowered to specify the rules further in secondary legislation such as delegated acts, or technical standards, the Government will work to ensure sufficient controls are in place to ensure they do not diverge from the agreed purpose of the legislation.

I will keep your Committee and the House of Commons European Scrutiny Committee informed as negotiations progress on both dossiers.

IMPROVING THE GOVERNMENT’S INTERNAL PROCESSES FOR HANDLING JHA ISSUES

The Government takes very seriously the concerns you express in your letters on Shadow Banking, on Bank Structural Reform, and most recently to my colleague, the Commercial Secretary to the Treasury Lord Deighton, on Anti-Money Laundering. This Government is focused on ensuring we meet our scrutiny commitments to Parliament.
To ensure the opt-in is identified at an early stage, the Home Office and Ministry of Justice have recently reissued guidance across Whitehall on the opt-in protocol. In addition, specific training on the application of the opt-in, especially in relation to identifying JHA content and understanding the process for asserting the opt-in is being provided to Departments.

24 June 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 24 June 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 8 July 2014.

You provide helpful and insightful information on the growing risks of shadow banking in emerging markets and in response to our concerns on risks from off-shore centres. It is reassuring that you continue to devote sufficient resources into developing the Money Market Funds and Securities Financing Transaction Regulations by placing due importance on international initiatives designed to improve the supervision and transparency of shadow banking. We are well aware of the difficulties in collecting data on shadow banking activities. We would be grateful if you could keep us informed on the current status of data collection provisions, since this has been a challenging task for many financial centres, and one still being considered by the FSB.

As part of your general approach to negotiations, we recommended that agreement of the text should allow the ESAs to supervise the activities of Shadow Banks with sufficient flexibility, providing them with the ability to shift targets as the financial system changes. Similarly, while institutions such as the Bank of England have demonstrated a flexible approach to non-financial institutions, providing liquidity backstops to broker dealers and central counterparties in an effort to prevent instability if the financial markets seize up, perhaps comparable efforts could be taken forward by the European Central Bank to ease similar pressure should it build. In this context we note media reports of a leaked draft European Commission report on the European System of Financial Supervision that examines the merit of extending the reach and power of the ESAs to encompass these new areas. Can you shed any light on this matter, and on when the Commission’s report, initially expected to be brought forward at the end of 2013, can be expected to be published?

In answer to our query about the views of other Member States regarding the proposed Money Market Funds regulation, you state that “it would not be appropriate to discuss the views shared by other Member States in confidence.” While we appreciate that the negotiating positions of other Member States remain confidential, our desire is simply to gain a broader understanding of the debate in hand. We would be concerned if you were to rely on the principle of confidentiality to refuse to inform us of the different views within the Council on a proposal. We do not accept that this automatically means that we cannot be informed about the views of other Member States. This can be done in general terms; it does not require disclosure of details which would compromise a Member State’s negotiating position or undermine the decision-making process of the Council. If the Government now refuses to do so, it will severely restrict our ability to scrutinise these policies effectively. So, while bearing in mind that negotiations are at an early stage, we ask you again to provide us with an outline of the different views in the Council on the proposed Money Market Funds Regulation.

We welcome the fact that the belated recognition and enactment of JHA issues has resulted in training course being taken forward.

We would be grateful for a response to these questions by 23 July 2014, and thereafter to be kept updated on EMs 13449/13 and 6020/14 as negotiations progress. In the meantime we will hold both documents under scrutiny.

9 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 9 July on shadow banking, and your follow up questions.

Since I last wrote to you, working level Council discussions on the Securities Financing Transactions Regulation have continued. The Government has continued to press for the regulation to be technically rigorous and consistent with the FSB recommendations in this area. This has been undertaken in co-operation with the UK financial services regulators and in consultation with Industry.
You also asked the Government to shed light on media reports of a leaked draft and when the Commission will publish its proposal for a European System of Financial Supervision. We are aware that a draft of the report was leaked, however it is our understanding that this is unlikely to be the finalised version. A proposal is expected to be published in the coming weeks, more specifically between the end of July and the beginning of September.

As regards whether the European Supervisory Authorities (ESAs) should play a role in the supervision of shadow banks, there are a range of challenging issues that will need to be considered. This ranges from the definition of shadow banks, the expertise required to undertake such supervision to whether national or regional supervisors are better placed to supervise and monitor risks, as well as the need to balance the existing responsibilities of the ESAs with new duties.

In that regard, we are conscious that the ESAs have yet to fulfil their existing mandate. The ESAs have focused on rule-making in recent years, given the high volume of legislation since the crisis, and we are keen to see the ESAs strengthen their focus on raising standards of supervision across the EU and identifying and mitigating risks through greater analysis of financial markets – two other key aspects of their mandate. These issues will be considered further in light of the forthcoming report from the Commission on the review of the European System of Financial Supervision (ESFS).

You also asked about other views in Council on the proposed Regulation on Money Market Funds. While it would clearly be inappropriate to comment on positions, following an early working group on 3 July, we are in a position to provide more information on the views that have emerged. A number of Member States were supportive of our position, with some raising concerns that it may not be possible to avoid causing serious disruption to short term financing of the real economy if the Union moves from the existing framework which allows both Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV) funds, to either requiring a capital buffer or prohibiting CNAVs outright.

Some expressed concerns about CNAV funds, with calls for them to be banned. The important role played by money market funds gives rise to prudential concerns that under stressed market conditions they could pose a source of systemic risk. Some concerned about CNAVs suggested they might tolerate them marketing to investors in their country from other jurisdictions, but they were not happy that the Regulation would require them to lift national prohibitions on the establishment of CNAV funds within their territory.

Overall, there does not appear to be any open support for the capital buffer at this early stage, but this working group was only an initial discussion and therefore many of the views expressed are very preliminary.

24 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 24 July 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.

We are grateful to you for the update on the exchange of views at Council working group on 3 July. We note that there was some level of support for the UK’s concerns that the proposals may have damaging consequences for short term money markets and thus the real economy. While there is limited support for a capital buffer, we would benefit from being updated on whether other mechanisms are currently being proposed by way of capital or liquidity management in the future.

The details concerning the marketing of CNAVs in Member States and the requirement for national prohibitions to be lifted is one that we note for future consideration as this Regulation is discussed. We would thus be grateful for further updates as and when progress is being made.

In the meantime we continue to hold EM 13449/13 and 6020/14 under scrutiny.

29 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your EM 11921/14, dated 29 August 2014, on the ECB’s opinion on the European Commission’s proposal for a Regulation on reporting and transparency of securities financing transactions (SFTs). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 October 2014.

29 July 2014
We agree with the main issues that the ECB see as particularly important in the development of this regulation. We also support the suggestions made by the ECB that the framework of the regulation should be able to adapt to key developments and recommendations from the FSB data experts group as they arise.

You are right to point to the fact that the ECB have expert knowledge and advice, and we agree with you in showing support for the ECB’s expertise in contributing to technical standards by ESMA. We would be interested to know the process and means through which the ECB would formally be able to help in preparing technical standards entrusted to ESMA.

We note that you do not respond to the potential policy implications of the ECB’s suggestion that the Commission propose extending the scope and requirements of the measures within the regulation, such as introducing limits on the re-hypothecation of client assets for the purpose of financing the intermediary’s own-account activities; and the entities allowed to engage in the re-hypothecation of client assets. Would you support including such limits in the regulation to enhance financial stability? Are these measures that the FSB are already looking at introducing, and would they gain support from other Member States? Furthermore, is there a danger that introducing limits could lead to an increase in financing costs?

We support strongly the ECB’s suggestion that terminology in the regulation be aligned with the FSB recommendations, and provide legal certainty to market participants. The ECB also makes a sensible suggestion concerning drafting clarity with reference to ‘title transfer financial collateral arrangement’ and ‘security financial collateral arrangement’. Will you support these drafting suggestions?

Finally, we ask you to reflect on the practical issues surrounding trade repositories taking into account the lessons learnt in the implementation of EMIR. There have been some suggestions that double sided reporting has proved troublesome in practice whereby the Unique Trade Identifier (UTI), which is produced by a counterparty, is not being matched at the Trade Repository with the UTI of the counterparty which was traded with. As a result, barely any over-the-counter (OTC) derivatives and exchange traded derivatives that are being reported to trade repositories have been paired. This has hindered the ability of regulators to assess systemic risks effectively. Is the Government aware of these blockages from conversations with the FCA? Is there likely to be any discussion on lessons learnt from EMIR in the current negotiations on the regulation on SFT reporting and transparency?

We would be grateful for a response to this letter by 28 October 2014. In the meantime we clear EM11921/14 from scrutiny, while we continue to hold EM 6020/14 under scrutiny.

15 October 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 2 November 2014 on the Commission’s proposal for a Regulation on reporting and transparency of securities financing transactions (SFTs). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 4 November 2014.

Given the technical nature of the file, we welcome the Council taking into consideration drafting suggestions by the FSB, National Supervisory Agencies, and the ECB. On sight of the latest Council text, we agree that the Council has tried in various Articles to introduce consistency with existing reporting regulations already in force. We welcome the efforts introduced which allow ESMA to respond flexibly to revised standards at the international level, as well as measures that allow the Commission, assisted by ESMA, to introduce mechanisms to avoid duplicative or conflicting transparency and reporting rules. We welcome for example the re-drafting of ‘re-hypothecation’ to ‘reuse’, which ensures legal certainty of the financial transaction.

Thank you for notifying to us that Renato Soru, an Italian S&D MEP, has been appointed rapporteur for this dossier. We will be following the developments closely in the European Parliament. We would appreciate any update you may be able to provide if there are significant changes to the text, particularly should there be further discussions on additional restrictions on SFTs.

In light of the forthcoming vote in Council, we clear 6020/14 under scrutiny.

We would be grateful for a response to these questions, as well as an update on the Italian Presidency’s attempt to reach a General Approach, by 18 November 2014.

4 November 2014
Thank you for your letter dated 4 November 2014 regarding the Securities Financing Transaction Regulation and your decision to clear the proposal from scrutiny.

I am pleased to report that the Italian Presidency was able to secure a unanimous General Approach on the Securities Financing Transaction Regulation (SFTR). This agreed Council position met the UK’s negotiating objectives as outlined in my previous update.

The agreed text is consistent with the Financial Stability Board (FSB) Recommendations published 29 August 2013, showing a high degree of alignment with FSB principles. As such, the text is both proportionate and workable, and provides clarity as to the types of securities financing transactions within scope of the Regulation. In this regard, the re-drafting of ‘re-hypothecation’ to ‘re-use’ is helpful and has improved legal certainty.

During negotiations, we have ensured that overlaps with existing provisions, such as the European Market Infrastructure Regulation (EMIR), have been taken into account as far as possible. Due to the highly technical and complex nature of some of the provisions, this has in part been achieved by providing scope in certain limited cases for the European Securities and Markets Authority (ESMA) to develop relevant technical standards.

More broadly, the text that has been agreed meets the Government’s objective of increasing transparency within the shadow banking sector, without unduly restricting the use of such transactions. As requested, a further update on the file shall be provided as deliberations within the European Parliament develop, especially in the event that there is discussion of potential further restrictions on security financing transactions.

28 November 2014

Letter from Andrea Leadsom MP to the Chairman

SHADOW BANKING (13426/13)

Thank you for your letter, dated 13 May 2014, on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking, and for your letter, dated 1 June 2014, on JHA issues pertaining to EM 6020/14. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 10 June 2014.

We are pleased to welcome you to your new post. We are also grateful to you for this comprehensive and thoughtful response to our letter of 1 April 2014. We note in particular your helpful response on defining shadow banking and its benefits and risks. We agree with you that there is an extremely complex web of interconnections between the shadow banking and the regular banking sector. However, given the rapid growth of Shadow Banking, not least in China, we would be grateful for further information on the nature of the global risk arising from its growth in such countries. We concur with your assessment that, while understanding of the sector has increased, more needs to be done. We therefore welcome international regulatory efforts to increase transparency and understanding of the working of the sector.

In that light, we are grateful for your useful explanation of the work of the FSB. We would be grateful for further updates on the FSB’s work as the five workstreams are taken forward. It is particularly important to increase awareness of new risks as they develop, and to ensure that policies are implemented in an internationally consistent manner. On its annual global shadow banking monitoring report, what can be done to ensure that the risks arising from off-shore centres are captured, and that more jurisdictions collect more detailed data so as to allow the FSB’s narrowing down of the data to be effective?

Turning to the Commission’s two legislative proposals, you state that the policy response is at an early stage and it is therefore not possible to provide an assessment of the Commission’s approach at this point. However, we ask you to bear this question in mind in the coming months and to keep us updated as the legislative proposals are taken forward. On the proposal for a regulation on Money Market Funds (EM 13449/13), what is the view of other Member States on the proposal?

On the proposal for a regulation on Securities Financing Transactions (EM 6020/14), you state that other stakeholders, and the European Parliament in particular, “may seek to include additional provisions that detract from those measures agreed at the international level.” Can you be more specific about your concerns? In what particular ways do you anticipate that the European Parliament
may seek to amend the proposal? In relation to the delegation of technical provisions to ESMA, you state that the Government will seek “to ensure important matters relevant to the UK interests are properly addressed in the negotiation”. Again, can you be more specific about the UK interests that you are seeking to protect? We also note your assertion that the UK’s JHA opt-in protocol is triggered in relation to this proposal. As you know, the Committee’s consistent position is that the opt-in is engaged only if the proposal cites a Treaty base within Title V TFEU. Given that the deadline to notify the Commission of the UK’s decision was 19 May, we regret that this was not brought to the Committee’s attention until now. Whilst we are grateful for your apology for the delay, we note that this is the second time in a matter of weeks that a JHA opt-in issue has been identified at a late stage. On 31 March 2014, the then Economic Secretary to the Treasury, Nicky Morgan MP, wrote to us in a similar vein in relation to EM 17949/13: Proposal for a Directive on the Union Legal Framework for Customs Infringements and Sanctions. What steps are you taking to improve the Government’s internal processes to ensure that JHA issues are identified and brought to the Committee’s attention at an early stage?

While we note that negotiations on the legislative proposals are at an early stage, we would be grateful for an initial response to these questions by 24 June 2014, followed by further updates as negotiations progress. In the meantime we will continue to hold EMs 13449/13 (Money Market Funds regulation) and 6020/14 (Securities Financing Transactions regulation) under scrutiny.

10 June 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 10 June on shadow banking, and your follow up questions.

I am glad that you found my previous letter helpful and comprehensive, and hope this response addresses your outstanding questions.

THE NATURE OF GLOBAL RISK ARISING FROM THE GROWTH OF SHADOW BANKING

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CURRENT NEGOTIATIONS ON THE PROPOSED REGULATIONS REGARDING MONEY MARKET FUNDS AND SECURITIES FINANCING TRANSACTIONS

You also asked about other Member States views regarding the proposed Regulation on Money Market Funds. No working level meetings have taken place at EU level, and Member States have not yet publicly shared their views on the proposal. It would not be appropriate to discuss the views shared by other Member States in confidence.

In terms of the direction the securities financing transactions (SFTs) may take, the Government is, as always, vigilant to the risk that the Regulation may be diverted away from its core purpose. In this case, to address the financial stability risks arising from shadow banking. Whilst the Government has no specific concerns at the moment, negotiations are inherently fluid.

The Government believes strongly that the Regulation should maintain its current purpose as an element of the international initiative to improve the supervision and transparency of shadow banking. As I stated in my previous letter on this subject, the Government favours a step-by-step approach which carefully implements internationally consistent supervision measures as they are finalised to minimise the potential for gaps in supervision or regulatory arbitrage.

Moving to the matters the UK will seek to clarify on the face of the Regulation, the Government will be seeking to agree a text which will work as planned and will allow for unintended consequences dependant on subsequent decisions from the European Supervisory Authority (ESA) or the Commission. As much of this proposal is highly technical, there are several areas where a European Supervisory Authority or the Commission will be empowered to act, such as in specifying financial instruments of ‘equivalent economic effect’ to those named in the text, and the data templates to be used by firms to report their SFT data to supervisors. Where an ESA or the Commission are empowered to specify the rules further in secondary legislation such as delegated acts, or technical standards, the Government will work to ensure sufficient controls are in place to ensure they do not diverge from the agreed purpose of the legislation.

I will keep your Committee and the House of Commons European Scrutiny Committee informed as negotiations progress on both dossiers.

IMPROVING THE GOVERNMENT’S INTERNAL PROCESSES FOR HANDLING JHA ISSUES

The Government takes very seriously the concerns you express in your letters on Shadow Banking, on Bank Structural Reform, and most recently to my colleague, the Commercial Secretary to the Treasury Lord Deighton, on Anti-Money Laundering. This Government is focused on ensuring we meet our scrutiny commitments to Parliament.

To ensure the opt-in is identified at an early stage, the Home Office and Ministry of Justice have recently reissued guidance across Whitehall on the opt-in protocol. In addition, specific training on the application of the opt-in, especially in relation to identifying JHA content and understanding the process for asserting the opt-in is being provided to Departments.

24 June 2014
Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 24 June 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 8 July 2014.

You provide helpful and insightful information on the growing risks of shadow banking in emerging markets and in response to our concerns on risks from off-shore centres. It is reassuring that you continue to devote sufficient resources into developing the Money Market Funds and Securities Financing Transaction Regulations by placing due importance on international initiatives designed to improve the supervision and transparency of shadow banking. We are well aware of the difficulties in collecting data on shadow banking activities. We would be grateful if you could keep us informed on the current status of data collection provisions, since this has been a challenging task for many financial centres, and one still being considered by the FSB.

As part of your general approach to negotiations, we recommended that agreement of the text should allow the ESAs to supervise the activities of Shadow Banks with sufficient flexibility, providing them with the ability to shift targets as the financial system changes. Similarly, while institutions such as the Bank of England have demonstrated a flexible approach to non-financial institutions, providing liquidity backstops to broker dealers and central counterparties in an effort to prevent instability if the financial markets seize up, perhaps comparable efforts could be taken forward by the European Central Bank to ease similar pressure should it build. In this context we note media reports of a leaked draft European Commission report on the European System of Financial Supervision that examines the merit of extending the reach and power of the ESAs to encompass these new areas. Can you shed any light on this matter, and on when the Commission’s report, initially expected to be brought forward at the end of 2013, can be expected to be published?

In answer to our query about the views of other Member States regarding the proposed Money Market Funds regulation, you state that “it would not be appropriate to discuss the views shared by other Member States in confidence.” While we appreciate that the negotiating positions of other Member States remain confidential, our desire is simply to gain a broader understanding of the debate in hand. We would be concerned if you were to rely on the principle of confidentiality to refuse to inform us of the different views within the Council on a proposal. We do not accept that this automatically means that we cannot be informed about the views of other Member States. This can be done in general terms; it does not require disclosure of details which would compromise a Member State’s negotiating position or undermine the decision-making process of the Council. If the Government now refuses to do so, it will severely restrict our ability to scrutinise these policies effectively. So, while bearing in mind that negotiations are at an early stage, we ask you again to provide us with an outline of the different views in the Council on the proposed Money Market Funds Regulation.

We welcome the fact that the belated recognition and enactment of JHA issues has resulted in training course being taken forward.

We would be grateful for a response to these questions by 23 July 2014, and thereafter to be kept updated on EMs 13449/13 and 6020/14 as negotiations progress. In the meantime we will hold both documents under scrutiny.

9 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 9 July on shadow banking, and your follow up questions.

Since I last wrote to you, working level Council discussions on the Securities Financing Transactions Regulation have continued. The Government has continued to press for the regulation to be technically rigorous and consistent with the FSB recommendations in this area. This has been undertaken in co-operation with the UK financial services regulators and in consultation with Industry.

You also asked the Government to shed light on media reports of a leaked draft and when the Commission will publish its proposal for a European System of Financial Supervision. We are aware that a draft of the report was leaked, however it is our understanding that this is unlikely to be the finalised version. A proposal is expected to be published in the coming weeks, more specifically between the end of July and the beginning of September.

As regards whether the European Supervisory Authorities (ESAs) should play a role in the supervision of shadow banks, there are a range of challenging issues that will need to be considered. This ranges
from the definition of shadow banks, the expertise required to undertake such supervision to whether national or regional supervisors are better placed to supervise and monitor risks, as well as the need to balance the existing responsibilities of the ESAs with new duties.

In that regard, we are conscious that the ESAs have yet to fulfil their existing mandate. The ESAs have focused on rule-making in recent years, given the high volume of legislation since the crisis, and we are keen to see the ESAs strengthen their focus on raising standards of supervision across the EU and identifying and mitigating risks through greater analysis of financial markets – two other key aspects of their mandate. These issues will be considered further in light of the forthcoming report from the Commission on the review of the European System of Financial Supervision (ESFS).

You also asked about other views in Council on the proposed Regulation on Money Market Funds. While it would clearly be inappropriate to comment on positions, following an early working group on 3 July, we are in a position to provide more information on the views that have emerged. A number of Member States were supportive of our position, with some raising concerns that it may not be possible to avoid causing serious disruption to short term financing of the real economy if the Union moves from the existing framework which allows both Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV) funds, to either requiring a capital buffer or prohibiting CNAs outright.

Some expressed concerns about CNAV funds, with calls for them to be banned. The important role played by money market funds gives rise to prudential concerns that under stressed market conditions they could pose a source of systemic risk. Some concerned about CNAVs suggested they might tolerate them marketing to investors in their country from other jurisdictions, but they were not happy that the Regulation would require them to lift national prohibitions on the establishment of CNAV funds within their territory.

Overall, there does not appear to be any open support for the capital buffer at this early stage, but this working group was only an initial discussion and therefore many of the views expressed are very preliminary.

24 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter dated 24 July 2014 on EMs 13426/13, 13449/13 and 6020/14, on Shadow Banking. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.

We are grateful to you for the update on the exchange of views at Council working group on 3 July. We note that there was some level of support for the UK’s concerns that the proposals may have damaging consequences for short term money markets and thus the real economy. While there is limited support for a capital buffer, we would benefit from being updated on whether other mechanisms are currently being proposed by way of capital or liquidity management in the future.

The details concerning the marketing of CNAVs in Member States and the requirement for national prohibitions to be lifted is one that we note for future consideration as this Regulation is discussed. We would thus be grateful for further updates as and when progress is being made.

In the meantime we continue to hold EM 13449/13 and 6020/14 under scrutiny.

29 July 2014

SMALLER CREDIT RATING AGENCIES (9586/14)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury

Thank you for EM 9586/14, dated 3 June 2014, a Report on the Feasibility of a network of smaller Credit Rating Agencies. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 June 2014.

We welcome this Report and agree that it comes to sensible conclusions, namely to encourage regulatory dialogue with stakeholders and conduct an impact assessment once the full effects of CRA3 has been digested by smaller CRAs. We acknowledge the previous and current market obstacles that
have inhibited smaller CRAs from gaining market share and also prevent them from seeing the benefit in forming a network of CRAs.

We are nonetheless concerned that cross-border access for smaller EU CRAs has not been sufficiently addressed. We would welcome your views on whether these barriers are likely to be reduced by ESMA’s engagement with non-EU competent authorities, and whether more measures should be taken.

International efforts have concentrated on measures to reduce references to external ratings in legislation while at the same time ensuring investors carry out their own additional due diligence on a well-informed basis. In light of this, it would be helpful to understand your views on whether a balance can be achieved in stimulating competition with smaller and larger CRAs without relying on the ‘issuer-pays’ model for profitability. Furthermore it is a concern that the size of the three larger and dominant CRAs continues to inhibit the market from becoming truly competitive. It is clear that the incentives of smaller CRAs need to be aligned with the larger CRAs so that they are encouraged to exist and gain more market share without relying on the ‘issuer-pays’ remuneration model. In seeking to shape the conflict of interest debate, we therefore encourage the Government to assess the issues closely connected to smaller CRAs within the European Commission’s reassessment by 2016 of the risks of conflicts of interest due to the ‘issuer pays’ remuneration model.

We would be grateful for a response to this letter by 18 July 2014, as well as updates as and when there are any further developments in this field. In the meantime we are content to clear the document from scrutiny.

18 June 2014

**Letter from Andrea Leadsom MP to the Chairman**

Thank you for your letter of 18 June 2014 on the report on the feasibility of a network of smaller Credit Rating Agencies (CRA), following our Explanatory Memorandum of 3 June 2014.

With regards to barriers for small EU CRAs, the pan-European rules agreed for the credit ratings market have substantively improved their ability to operate and compete in a much larger market. All CRAs that operate within the EU are required to register with the European Securities and Markets Authority (ESMA). The registration process is also duly robust, to ensure that end investors are protected.

Cross-border, I would also refer you to the EU’s equivalence and endorsement processes. Once a third-country’s CRA framework has been deemed equivalent to the EU by the European Commission, EU financial institutions can, subject to various conditions, rely upon credit ratings issued by CRAs in that jurisdiction. The process should also facilitate non-EU financial institutions’ use of credit ratings issued by EU CRAs. To date, the European Commission has completed equivalence assessments for nine jurisdictions.

Increasing competition in the credit ratings market has been a key element of the approach taken by the EU. The most recent CRA Regulations (CRA3) include the requirement that where an issuer, or a related third party, intends to appoint at least two CRAs for the credit rating of the same issuance or entity, the issuer or a related third party, shall consider appointing at least one CRA with a market share of no greater than 10 per cent (depending upon availability and relevance). If at least one small CRA is not appointed, the issuer must document that fact. The CRA3 Regulation has also introduced rules on re-securitisation that require CRAs to rotate. This should facilitate new entrants to the market and offer existing CRAs the opportunity to extend their business into new areas.

In addition, we note that CRA3 requires the public disclosure of information on structured finance instruments. Doing so is likely to reinforce the competition between CRAs in an important market sub-sector, because it could lead to an increase in the number of unsolicited credit ratings, especially from those smaller CRAs not reliant on the ‘issuer pays’ model which previously were not privy to receipt of the information necessary to generate credit ratings. This is welcome in helping to create a level playing field.

15 July 2014

**Letter from the Chairman to Andrea Leadsom MP**

We acknowledge the responses you give in relation to the Committee’s query on stimulating competition more generally for smaller CRAs, while reducing reliance on the ‘issuer pays’ model. We recognise that a number of the requirements laid out in CRA3 will need time to take effect and thus it is too early to advocate specific policy action. The Committee will in future assess the European Commission’s reassessment by 2016 of the risks of conflicts of interest due to the ‘issuer pays’ remuneration model.

Given the report’s recommendation not to establish a network of smaller CRAs but rather to continue with informal stakeholder conversation, we would be interested to receive information on relevant developments that would be a useful indicator to how the current CRA3 regulation is being implemented.

29 July 2014

SOLVENCY II (14263/14)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury


We note that the Solvency II file has undergone a long legislative journey in the EU and has led to some difficult compromises for particular Member States over the years. While we are confident that the Directive will deepen the single market in Insurance and increase the level of policy holder protection across the EU we have some reservations on the fragmentation at the retail end of the market. In a speech on 18 November 2014, Commissioner Hill referred to the different levels of pricing and services levels across Member States, for example when buying car or travel insurance. Will Solvency II, which is intended to deepen the Single Market, address and indeed close the pricing gap seen between Member States? Which pricing anomalies continue to exist in the wholesale market?

We agree and believe that the Government should stick by its commitment to review by December 2018 the capital requirements including methods, assumptions and parameters used by insurers. Furthermore we favour methods to incorporate new developments in standards on securitisation from both BCBS and IOSCO into this Directive, which will be key to ensuring harmonisation and international consistency of measures designed to advance the securitisation market. We will continue to follow industry developments in the insurance market in light of the new Directive which also seeks to develop long-term investment finance in the EU.

We are pleased to note that the Government has taken a very active role in the development of this Directive. This is a good example of what HM Treasury should be doing across all legislative files. We are pleased to note efforts to share the UK’s expertise through participation in expert working groups, and trust that this demonstrates the Government’s commitment to deepening the single market in the insurance sector. Can you furthermore expand on how Solvency II will deepen the Single Market in insurance? It is indeed favourable for the UK market that the Directive adopts the UK model of risk-based, market consistent regulation. Whilst it is encouraging that this file and the technical standards alongside, nears completion, do you believe that the right level of proportionality for small insurers has been adequately incorporated into the Directive? It has been mentioned that costs will fall to insurers in the form of regulatory and reporting. Will small insurers be disproportionately and adversely affected? How will the industry be adapting more generally to the new rules, if the main areas of attention that include capital requirement, will not be expected to increase for insurance firms in the UK? What barriers remain in the single market to insurance, which Solvency II does not attempt to break down? What do you expect by way of any negative or positive short term consequences to the new technical requirements?

We would be grateful for a response to this letter by 9 December 2014. In the meantime we now clear EM 14263/14 from scrutiny.

25 November 2014
Thank you for your letter of 25 November on the Solvency II Directive and its implementing measures. I entirely agree that the Solvency II Directive will deepen the EU’s single market for insurance and strengthen policy holder protection. It is for these reasons that the UK has been a supporter of the Solvency II project and we have worked hard to shape the Solvency II regime so that it will result in a much improved regulatory environment for European insurers. Your letter posed a number of questions and I hope that the answers below will prove helpful.

**How will Solvency II deepen the single market in insurance and address pricing anomalies between Member States?**

The single market already operates freedom of establishment, which allows UK insurers to compete in other EEA insurance markets without the need for separate authorisation. However, the current prudential regimes for insurers differ considerably between Member States, as the current EU regime (Solvency I) is minimum-harmonising. Insurers subject to less stringent prudential rules in their home jurisdiction may be able to offer insurance products at lower prices in other jurisdictions as they will not need to hold as much capital for the protection of policyholders.

Solvency II replaces the different capital standards across the EU with a maximum-harmonising, risk-based solvency calculation. Capital requirements will instead differ between insurers depending on how effectively they manage their risk, but all insurers will be held to the same solvency standard. While some national differences may exist regarding national tax regimes or differences in statutory accounting rules, Solvency II is expected to contribute significantly to a level playing field across the EU, enabling increased competition between UK and non-UK insurers.

Prudential rules, including the level of capital that an insurer must hold and the ways in which an insurer can seek investment returns in order to meet insurance claims, can have a significant impact on the pricing of insurance products. Under Solvency II, all EEA insurers will be held to the same prudential standard, ensuring that prudential factors which influence insurance pricing affect all insurers in the same way.

**What barriers remain in the single market to insurance, which Solvency II does not attempt to break down?**

By creating a single prudential rulebook, Solvency II will ensure that insurers compete on a level playing field. There will of course continue to be different rules across Member States about the design and sale of insurance products offered to consumers, but all insurers will be able to compete on the same basis to offer insurance products within a particular market. To harmonise rules around the design and sale of insurance products would represent a very significant increase in EU competence and I do not see any great demand from Member States for this kind of harmonisation.

**Does Solvency II adopt a proportionate approach for smaller insurers?**

Supervisors are required to apply a proportionality test in their approach to supervision, and this is already captured in the Prudential Regulation Authority’s (PRA’s) current application of supervision rules. Smaller insurers can expect to be less intensively supervised than a larger insurer with a similar risk profile. The burden of reporting requirements on smaller insurers was considered explicitly as part of Solvency II and the legislation now allows supervisors to give reporting exemptions to small insurers, applicable for up to 20% of national markets. The exemptions include reduced quarterly reporting and reduced narrative reporting from annual to three yearly. Transitional provisions that phase in the capital calculations over sixteen years will also assist smaller insurers with limited resources in their preparation for Solvency II.

**How will the industry be adapting more generally to Solvency II?**

While aggregate capital requirements for the UK insurance industry are not expected to increase, capital requirements are likely to be reallocated among UK insurers to some extent, with low risk-profile insurers holding less capital and those with a higher risk-profile holding more. The risk-based capital calculation incentivises insurers to more effectively manage their risks. For example, the Matching Adjustment for annuity products provides a capital benefit to insurers that effectively manage their maturity mismatch risk by matching long-term assets with long-term liabilities. Insurers will also be able to lower their capital requirements through diversification (both in their choice of assets and liabilities).
WHAT DO YOU EXPECT BY WAY OF ANY NEGATIVE OR POSITIVE SHORT TERM CONSEQUENCES TO THE NEW TECHNICAL REQUIREMENTS?

With any major regulatory reform there are likely to be some one-off costs to industry in complying with the new regime. Solvency II is no exception to this and the cost in adapting compliance systems to the new rules will not be insignificant. Unfortunately, these costs have been exacerbated by the significant delay in reaching political agreement over the final Solvency II package. The UK’s contribution to negotiations has prioritised regulatory certainty for the insurance business so that these costs can be kept to a minimum. It is clear that what industry now wants above all else is for the implementation of Solvency II to be completed on time. The UK is, however, better placed than other Member States to meet the implementation challenge. Solvency II is based on an approach to insurance supervision which UK firms and regulators are already familiar with. The UK has also found ways to push ahead with Solvency II preparations even while political negotiations for the Directive were stalled. UK implementation is certainly well advanced compared to that in many other Member States.

REVIEW OF SOLVENCY II AND IMPLEMENTING MEASURES

I entirely agree that we should carefully monitor the operation of Solvency II and review its impact to ensure that the regime is doing what it should to ensure a sound, stable, thriving insurance sector. In particular, it is important to ensure we have a regulatory regime which supports insurers as providers of long-term finance for the wider economy. For this reason, we pushed for both the Directive and its Delegated Acts to contain review requirements. The Commission is due to review the key Solvency II implementing measures that deal with the Solvency Capital Requirement and investment risk-charges by the end of 2018. The Commission must also review the framework provisions around the Solvency Capital Requirement in the Directive itself by the end of 2020. The UK will make a full contribution to these reviews. As the evidence base develops around the appropriate regulatory approach to non-standard investments, such as securitisations, we will urge the Commission to reflect this evidence in Solvency II provisions, including the analysis currently being carried out by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO).

Once again, thank you for the interest you and your Committee colleagues have shown in Solvency II. I hope this letter is helpful, but please let me know if there are any other issues you would like addressed.

2 December 2014

SPECIAL REPORT BY THE EUROPEAN COURT OF AUDITORS ON EUROPEAN BANKING SUPERVISION AND THE EUROPEAN BANKING AUTHORITY (UNNUMBERED)

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary to the Treasury, HM Treasury

Thank you for your EM, dated 13 July 2014, on the unnumbered EM on the Special Report by the European Court of Auditors on European Banking Supervision and the European Banking Authority, together with the Authority’s reply. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.

We have taken a longstanding interest in the work of the ESAs, for instance in our 2011 report on the EU Financial Supervisory Framework. Given this, and in light of the Committee’s new inquiry on the EU financial regulatory framework, the report provides some important insights into the set-up of the EBA and its role in improving the functioning of the internal market, in particular by ensuring high, effective and consistent level of regulation and supervision. Taking the ECA’s recommendations in turn, we would draw your attention to the following issues.

RECOMMENDATION 1: SUFFICIENT TIME SHOULD BE ALLOWED FOR DRAFTING AND FOR CONSULTATION AND A CROSS-SECTORAL IMPACT ANALYSIS SHOULD BE CONSIDERED

While the EBA has met its procedural deadlines with respect to public consultations, there have been instances where consultation periods were unnecessarily squeezed in order for the EBA to meet deadlines set externally by the legislators. The ECA recommend that the EBA be given observer status in the legislative process. The EBA outline in their reply how this could be achieved in practice.
Do you agree with what they have proposed? What do you believe is the best way forwards to include the EBA in the legislative process so that it can better deliver on its mandates and ensure stakeholders are consulted with the time period allocated to them? Would these be changes that could be included in relation to the Commission’s review of the European System of Financial Supervision?

RECOMMENDATION 2: THE EBA SHOULD CONTINUE TO PROMOTE THE EFFECTIVENESS OF THE COLLEGES OF SUPERVISORS

The ECA report highlights that the supervisory colleges that exist for cross-border banking groups have tended to be used for more procedural conversations rather than those dedicated to enhancing information sharing and discussing risk. While we note that significant progress has been made to improve the functioning of the colleges despite these limitations, the EBA maintain that for significant improvements in the supervisory convergence in the EU to take place, a change in mandate in primary legislation is required. Do you believe that this is ultimately the best way to respond to the limitations that the EBA currently embodies? Furthermore, what steps is the UK taking to enhance information exchange before November 2014 when the ECB’s supervisory responsibilities come into force?

RECOMMENDATION 3: A CLEAR AND WIDE-RANGING MANDATE AND SUFFICIENT EXPERIENCED STAFF ARE NEEDED FOR THE RELIABILITY OF BANK STRESS TESTS. EU-WIDE RESOLUTION MECHANISMS SHOULD BE DESIGNED TO WORK EFFICIENTLY.

We note the ECA statement that the EBA had been under-resourced and operated with a limited mandate, which led the EBA’s role in facilitating and coordinating the stress tests in 2011 to be unreliable. While the mandate for the EBA remains to facilitate and coordinate future stress testing, the EBA however raises the important point that the legal responsibility for the conduct of the stress testing remains with the competent supervisors. The EBA thus has no control on the results. Do you agree that the EBA’s mandate should be strengthened enabling the EBA to deal directly with banks, in order to conduct peer analyses, challenge the banks’ results on the stress testing and publishing data accordingly? Where do you think the responsibility for the results of the stress testing should lie?

RECOMMENDATION 4: STRENGTHENED MEASURES ARE NEEDED FOR CONSUMER PROTECTION IN THE EU FINANCIAL SECTOR

A number of the shortcomings set out in the ECA’s report on legislation dealing with consumer protection have been addressed in additional directives in 2011, 2012 and 2013. However the EBA still has limited scope to take legally binding decisions. The EBA has managed to respond to urgent situations through identifying and addressing issues through non-binding legal instruments, but there is no mandate for it to act with binding decisions in emergency situations. Do you believe there is scope to extend the mandate for the EBA to make binding decisions by way of consumer protection? How effective has the Joint Committee structure been in addressing problems of overlap between the three supervisory agencies?

RECOMMENDATION 5: ESTABLISHMENT OF A PERFORMANCE MEASUREMENT SYSTEM

We also agree with the measures to track the EBA’s core activities in order to assess their achievements and objectives as an organisation.

RECOMMENDATION 6: CLARIFICATION OF ROLES AND RESPONSIBILITIES IS NECESSARY FOR A SUCCESSFUL BANKING UNION AND EFFECTIVE BANKING SUPERVISION.

One of the most serious shortcomings set out in the report is the further clarification of the role and responsibilities between the ECB, NSAs and EBA in terms of EU-wide supervisory tasks. The EBA notes in its reply to the ECA report that it does not consider the MoU as an appropriate instrument for clarification of roles and responsibilities between the EBA, the ECB and NSAs, and considers any such changes can only be taken at the level of primary legislation. Do you believe the MoU is indeed appropriate as a means for clarification of supervisory responsibilities between all parties?

Given that the ECA visited the EBA in 2012 and early 2013, why were these issues not raised at the same time as the ongoing proposals for Banking Union were being discussed in early 2013? What is the UK Government currently doing to ensure that an effective system of supervisory cooperation will be up and running in November, when the ECB takes up its supervisory responsibilities?
Thank you for your letter dated 29 July 2014 on the unnumbered Explanatory Memorandum on the Special Report by the European Court of Auditors (ECA) on European Banking Supervision and the European Banking Authority (EBA), together with the EBA’s replies. We welcome your interest on the reports and the implications aspects of these will have on the Commission’s review of the European System of Financial Supervision (ESFS).

RECOMMENDATION 1: SUFFICIENT TIME SHOULD BE ALLOWED FOR DRAFTING AND FOR CONSULTATION AND A CROSS-SECTORAL IMPACT ANALYSIS SHOULD BE CONSIDERED

In your letter, you raised a number of questions regarding the ability of the EBA to contribute to the legislative process. We share the broad thrust of the EBA’s response to the ECA and favour clarifying the roles of the ESAs in the legislative process, in the interests of transparency and accountability. For instance, we believe the ESAs should be consulted by the Commission at the start of the Level 1 process, including on their ability to deliver, the timing of review clauses, and the mandates and priority order of Level 2. We also believe that each of the ESAs should be required to publish an assessment of any new proposal, covering: the strengths of the evidence and analysis presented by the Commission in its impact assessment; the implementation timetable; the effect on SMEs and how the approach will be proportionate; and any issues with level 2 delegating provisions. Your response referred to the possibility of the EBA having observer status during the legislative process, which could be one approach to achieve the above. In addition, we strongly support the ECA’s overarching recommendation that the ESAs should have adequate time to produce and consult on Level 2 rules, which could be addressed by having deadlines relative to the entry into force of the basic legal act. Each element of this should be considered as part of the Commission’s review of the ESFS.

RECOMMENDATION 2: THE EBA SHOULD CONTINUE TO PROMOTE THE EFFECTIVENESS OF THE COLLEGES OF SUPERVISORS

In your letter, you asked whether legislative change was required to support the EBA’s ability to promote the effectiveness of the colleges. Our objective is for the EU to achieve consistently high standards of supervision; however, it is not to achieve supervisory harmonisation whereby the same tool is used with the same intensity to address the same risk in all Member States, as this would lead to a mechanistic approach to supervision and run counter to judgement based supervision – the need for which is one of the lessons of the crisis. Therefore, while we agree with the ECA that the EBA should continue to support the effectiveness of the colleges, we do not see any need for the EBA’s mandate to require legislative change.

You also asked what steps the UK is taking to enhance information exchange before November 2014 when the ECB’s supervisory responsibilities come into force. The Bank of England has been engaging with the ECB at all levels to establish and foster a strong supervisory relationship.

RECOMMENDATION 3: A CLEAR AND WIDE-RANGING MANDATE AND SUFFICIENT EXPERIENCED STAFF ARE NEEDED FOR THE RELIABILITY OF BANK STRESS TESTS. EU-WIDE RESOLUTION MECHANISMS SHOULD BE DESIGNED TO WORK EFFICIENTLY

You raised the question as to whether the EBA should deal directly with banks with regard to stress tests. It is important to recognise that the EBA is a system manager – it is not a day-to-day supervisor. For the EBA to have a direct supervisory relationship with a firm would present a conflict of interest with its role as a system manager. On this basis, the EBA’s role in stress tests is to organise and oversee, provide quality control and comparability, and not to deal directly with banks.

RECOMMENDATION 4: STRENGTHENED MEASURES ARE NEEDED FOR CONSUMER PROTECTION IN THE EU FINANCIAL SECTOR

There are two situations in which the EBA is potentially able to exercise binding powers on supervisory authorities in emergency situations. The first is when the Council has declared an emergency in accordance with Article 18 of the EBA Regulation where there is a need to address serious risks to the orderly functioning and integrity of financial markets, or the stability of the financial system. The second is where binding powers are vested with the EBA in accordance with Article 9(5) of the EBA Regulation, which in addition to being to ensure the order and integrity of the
markets or financial system stability, may be for the purpose of consumer protection. In such cases, where there is an emergency the EBA may be empowered to take decisions binding on supervisory authorities and market participants to impose restrictions on financial activities. However, this role has to be switched on in a specific provision in a Directive or Regulation (such as has happened in relation to ESMA and the EBA in the recently made Markets in Financial Instruments Regulation (see Articles 40 and 41 of that Regulation)).

You asked how effective the Joint Committee (JC) structure has been in addressing problems of overlap between the three ESAs. First, it is worth noting that the JC only really became operational in 2012, sometime after the ESAs were introduced, and so it remains relatively early to fully assess how it is functioning. However, it has an important role to play in ensuring coordination at across the ESAs and examining issues that are relevant across the markets that the ESAs monitor, considering the ESFS system as a whole. In this regard, the function and remit of the JC as set out in the Regulations is appropriate and should be maintained. The ESAs should focus on continuing to develop the efficiency and capacity of the JC and ensuring that the ESAs are encouraged to work collaboratively on issues of shared interest.

**RECOMMENDATION 5: ESTABLISHMENT OF A PERFORMANCE MEASUREMENT SYSTEM**

We share the views of the ECA, EBA and Committee that the EBA should establish a performance measurement system to assess their achievement and objectives as an organisation.

**RECOMMENDATION 6: CLARIFICATION OF ROLES AND RESPONSIBILITIES IS NECESSARY FOR A SUCCESSFUL BANKING UNION AND EFFECTIVE BANKING SUPERVISION.**

You raised the issue of the Memorandum of Understanding (MoU) between the EBA, ECB and NSAs. The SSM Regulation specifies the conditions for cooperation with other authorities, including the requirements for an MoU between the ECB and other competent authorities from non-participating member states, alongside cooperation with the EBA. An MoU between the ECB and Bank of England will therefore need to be implemented prior to the SSM taking up its supervisory responsibilities. The UK Government has argued throughout banking union discussions that it is important to clarify the roles and responsibilities of various bodies and that it considers an MoU to be appropriate for the Bank of England, ECB and other regulators. This view was shared by the co-legislators. It is, however, a matter for the EBA as to why it did not raise its concerns during 2012 and 2013 when this issue was under discussion.

A number of the issues you raise are being taken forward by the Bank of England, including the UK’s ongoing engagement with the ECB on supervision of banking union and the formulation of the MoU, and they may be best placed to provide you further information on these technical areas.

31 August 2014

**Letter from the Chairman to Andrea Leadsom MP**

Thank you for your letter, dated 31 August 2014, on the unnumbered EM on the Special Report by the European Court of Auditors on European Banking Supervision and the European Banking Authority, together with the Authority’s reply. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 9 September 2014.

We are grateful to you for this helpful response. Your reply suggests that the UK Government is broadly satisfied with the level of powers of the EBA enshrined to it under its founding regulations. Is this correct? Although you have acknowledged that the UK Government supports clarification of roles and responsibilities between the European Supervisory Agencies, National Supervisory Authorities and the operations of the Single Supervisory Mechanism, we would be grateful for any further information or concerns that you have on this issue, while we consider these uncertainties.

We welcome your suggestion for ways in which the ESAs can be more involved in the Level 1 process. It is hoped that the changes introduced through the review of the ESAs by the Commission will lead to improvements in the Level 2 process. Can you clarify what is currently impeding the opportunity for each of the ESAs to be able to publish an assessment of any proposal, covering for example the strengths of the evidence and analysis presented by the Commission in its impact assessment?

You state that any enhanced level of information exchange would cause a conflict of interest between the Authority and the financial institutions that it does not directly supervise. We note that issues concerning increasing data exchange were picked up as a proposed medium term legislative change in
the context of the Commission’s recently-published review of the ESAs. How much support is there from other Member States for this proposed legislative change? In terms of strengthened measures for binding powers for the ESAs, you note that this has to be ‘switched on’ in a specific provision in a Directive or Regulation. Do you support this method going forwards in other important dossiers?

We would be grateful for a response to this letter by 6 October 2014. In the meantime we now clear the document from scrutiny.

10 September 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter dated 10 September 2014 on the unnumbered Explanatory Memorandum on the Special Report by the European Court of Auditors (ECA) on European Banking Supervision and the European Banking Authority (EBA), together with the EBA’s replies.

With regard to your further questions, the UK Government is broadly satisfied with the level and nature of the powers that the EBA Regulation provides to the EBA. Indeed, one concern we have with the existing review of the European System of Financial Supervision is that there are proposals for all three ESAs, and not just the EBA, to have more powers before they are delivering in full on their existing mandate or utilising their full powers as strategic level regulators. For instance, we would welcome a stronger focus by the ESAs on their mandate to conduct economic analysis of markets in order to prevent financial instability.

At present, it is possible for the ESAs to issue own initiative opinions on Commission legislative proposals, to the extent that they relate to issues within their respective areas of competence, although the potential use of this ability is not as clear or as proactive as it could be. To date, they have not done so. Given the expertise of the ESAs, we believe that having them provide published technical assessments of legislative proposals, either soon after Commission publication or at some other stage in their development, would contribute to better legislative proposals and that their broader engagement, in an appropriate fashion, in the legislative process would help ensure a higher standard of final legislation. There may be merit in making any ESA role in this regard clearer and with defined parameters to ensure that the role of the co-legislature is not inadvertently infringed in any way.

You asked about the degree of support from other Member States for the Commission’s proposal for increasing data exchange. There has only been a preliminary exchange of views between Member States on the Commission’s review of the ESAs, and so the various positions of other Member States on this issue are not yet clear.

Finally, you referred to the use of specific provisions for “switching on” binding powers in Directives and Regulations. The UK Government supports this mechanism for ESA powers being used in specific legislation as it means that the co-legislature have to give specific consideration and explicit direction as to how these powers ought to be used in any one policy area, how such powers sit within the wider legislation and how the overall policy is best delivered.

6 October 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 6 October 2014, on the unnumbered EM on the Special Report by the European Court of Auditors on European Banking Supervision and the European Banking Authority, together with the Authority’s reply. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 21 October 2014.

We are grateful to you for this helpful response. You state clearly that the UK Government is satisfied with the level of powers of the EBA enshrined to it under its founding regulations. We note that you encourage the ESAs to fulfil their responsibility in economic analyses within their area of competence. We are supportive of your willingness to find ways to include the EBA, and its technical skills, early on in the legislative process. While you mention that there has only been an initial exchange of views at this stage, we would like to be kept up to date on any progress, which would allow the EBA and ESAs generally to be more involved in the level 1 process.

However, we remain concerned that the UK Government is opposed to considering extending the mandate of the ESAs to include more powers on supervisory convergence and mediation. We understand that the objective of the EBA is to promote convergence of supervisory practice at a high supervisory standards across the EU. However it is difficult to see how the EBA, and ESAs overall, can
otherwise evolve in ways that best suit the goals and objectives set out for them in the European financial system given their limited powers to make or enforce decisions on supervisory convergence and to resolve disputes with National Supervisory Authorities.

In response to our query concerning the ‘switching on’ of binding powers for the ESAs, you state that you are content to pursue this method on a case-by-case basis. We are concerned that over time some ESAs may end up with binding powers in some areas and not others, making their powers piecemeal and disjointed. Do you recognise this as a concern?

Given your clear intentions not to promote the ESAs with greater powers, we remain concerned that the effectiveness of the EBA may become compromised. We would be grateful for updates as to the progress of the short term and medium term legislative changes. In the meantime we now clear the document from scrutiny.

21 October 2014

STANDARD VAT RETURN (15337/13)

Letter from David Gauke MP, Financial Secretary, HM Treasury, to the Chairman

I am writing to provide you with an update on progress under the Greek and Italian Presidencies on the Commission proposal for an EU wide standard VAT return. In the Explanatory Memorandum dated 7 November 2013, I explained that while it could offer real benefits for businesses involved in cross border trade, it would be challenging to achieve a balance between simplification for EU business and the needs of the tax authorities of all 28 Member States, for whom the VAT return is an important tool. The Commission therefore introduced a compromise solution to provide a certain amount of flexibility.

In your letter of 14 February 2014 you asked to be updated on progress, and in the meantime your Committee decided to continue to hold the document under Scrutiny. The Greek Presidency concentrated on provisions in relation to VAT return processes. Essentially this covered error correction, submission of returns (including by electronic means) and payment of VAT. The consequence is that the current text would enable the UK to retain its existing procedures, which are much favoured by UK businesses.

An orientation discussion at ECOFIN in June 2014 set the tone for the Italian Presidency. In particular that:

— The objective should be to reduce administrative burdens for businesses and national tax authorities, whilst at the same time ensuring no increase in the overall burden for businesses in any individual Member State.
— The Commission should explore a cost effective solution for setting up an EU VAT web portal to provide readily available information to businesses on the VAT rules across the Member States.

The Italian Presidency has begun discussions on the information requirements of the standard VAT return. Some Member States are keen to include more and more information. Others, in particular the UK, want to keep things as simple as possible.

The UK’s current 9 box return is supported by UK businesses and they want to retain that. As the Office for Tax Simplification said in its recent report - Review of the Competitiveness of the UK Tax Administration - “The UK’s VAT return always wins praise for simplicity - as one person put it ‘I support the idea of a common EU VAT return, but only if the return is based on the UK model.’”

However, the Presidency has to date given ground and increased the information requirements, and also suggested that a common template should be mandatory. We and others do not agree and are therefore resisting that due to the potential for increased burdens, costs and errors for businesses.

The Italian Presidency gave a progress report to ECOFIN on 7 November and undertook to reflect on the best way forward to obtain agreement. From bilateral discussions with Latvia, we know the forthcoming Latvian Presidency plans to continue negotiations.

I will continue to keep you informed of the progress of negotiations.

27 November 2014
Thank you for the letter from the former Financial Secretary to the Treasury, dated 4 April 2014, on EM 6022/14, the Commission’s proposal for a Regulation on structural measures improving the resilience of EU credit institutions, and for your letter, dated 1 June 2014, on JHA issues pertaining to the proposal. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 10 June 2014. In doing so we took account of evidence heard on the proposal on 8 April 2014 from Martin Spolc, Deputy Head of Unit, Banks and Financial Conglomerates II, DG Internal Market, European Commission, and on 6 May 2014 from Sir Win Bischoff, former Chairman, Lloyds Banking Group, Dominic Morris, Director, Group Public Affairs, Lloyds Banking Group, and Anthony Browne, Chief Executive, British Bankers Association (BBA). We set out the evidence heard, and our own views and questions, under a number of headings below.

THE RATIONALE BEHIND THE PROPOSAL

Martin Spolc described the proposal as the “final cog in the wheel to complete the regulatory overhaul of the EU banking system”. He said that the proposal was justified on the grounds that the size and complexity of a small number of the largest and most complex institutions remained a concern: “these banks remain too big to fail, too costly to save and too complex to resolve”, which meant that they “enjoyed special privilege” in the form of an implicit public subsidy: “they believe, and there is a perception, that if these banks get into difficulties the Governments will step in to bail them out rather than let them fail.” This in turn leads to “moral hazard, excessive risk-taking and weaker market discipline.” Martin Spolc stressed the Commission’s view that risky trading activity had shifted some banks’ focus from customer-oriented service, and that such activity should not benefit from implicit government support.

Do you agree with this analysis of the problem? Is the Commission’s proposal the right way to seek to address it, or is there a case for a simpler model of separation between commercial and investment banking? Overall, is the Commission’s proposal an improvement, or a step back, from the Liikanen proposals? Do you agree with Martin Spolc that this is the final cog in the wheel to complete the regulatory overhaul of the EU banking system? Or does more need to be done?

WHICH INSTITUTIONS?

Martin Spolc told us that a “too big to fail” bank is defined as one whose failure would have systemic implications, but that such a judgment should not only be based on an institution’s size, but should also take account of the riskiness of its trading activity. Nevertheless, the proposal was likely to capture “only a very small number of the largest and most complex banks”, perhaps 30 to 35 in total. Individual Member States would be able to impose structural measures on small banks not captured by the proposal. Is this the right approach to ensure that all systemically-important banks are included within the proposal’s scope? Given that only a limited number of institutions will be affected, is there a case for a uniform approach to smaller institutions?

A REGULATION OR A DIRECTIVE?

Martin Spolc told us that the Commission had opted to propose a regulation rather than a directive because of the importance of a single rulebook for systemically important banks with significant cross-border activity. In terms of the regulatory burden, he noted that it would be easier for a bank if the rules were applied consistently across the EU. A regulation was also proposed to make it easier for the rules to be applied in the context of Banking Union, since the ECB would only be required to implement one set of rules rather than numerous national laws.

Anthony Browne thought it an unusual piece of legislation as a regulation with derogation and discretion for national authorities. However, he said that the Commission had to adopt a more flexible approach because of the work that had already been undertaken by different Member States.

Would there have been any advantages for the proposal to have been brought forward in the form of a directive? Does it set any kind of (unhelpful) precedent, in particular given the suggestion that a regulation was adopted to suit the demands of the ECB in its role as single supervisor within Banking Union? What are the likely future implications of such a preference for regulations for non-participants in Banking Union/ non-members of the Eurozone, such as the UK?
THE BAN ON PROPRIETARY TRADING

Martin Spolc said that the Commission recognised the difficulty of disentangling proprietary trading from market-making, which is why it proposed a narrow definition of “trading that is carried out with the exclusive purpose of making a profit for the bank itself without any actual close relationship with the customer”. In the Commission’s view, “proprietary trading activities not linked to clients’ activity should simply not be permissible.” Martin Spolc acknowledged that the Commission’s analysis suggested that proprietary trading represented only a limited part of banks’ activities and revenues, meaning that any ban would be unlikely to lead to significant costs. Nevertheless there were social benefits of banning proprietary trading, including “reducing systemic risks, complexity, interconnectivity and conflicts of interest.”

Dominic Morris referred to the practical difficulty that banks had found of separating market-making activities from proprietary trading, “because there is a point in the day when you are actually holding it on your books”. He said that 1300 pages of the Dodd-Frank regulations sought to deal with this practical interface, “and it would be a nightmare for the regulators to police”. Anthony Browne noted that the US ban on proprietary trading under the Volcker rule had proved more complicated than Paul Volcker initially anticipated: “the trouble is that the more you try to define it, the more complex it is. A lot of activities — such as market making and other forms of client facilitation and so on, which are entirely normal and laudable activities of banks — tend to look very similar to proprietary trading.”

Anthony Browne acknowledged that the Commission’s proposals seemed simpler than the Volcker regulation: “Ultimately, it boils down to intent: if the sole intent of a transaction is to make money on behalf of a bank rather than to facilitate a client, then you could define that as proprietary trading, but it is quite difficult to judge transactions not by what the transaction is but by the intent of the transaction. You could have two transactions that are basically identical except one has a different intention from the other; one would be banned because the intent is different from the other”.

Sir Win Bischoff was concerned about the proposed ban on proprietary trading, and suggested that the impact of a ban would be greater than many, including the UK Government, had suggested. On the likelihood of the proprietary trading provisions being amended, Sir Win Bischoff expected that “common sense will prevail”, and that a narrow definition would be adopted to allow market making to continue in some form, so as to provide both liquidity and financing.

On the other hand, Anthony Browne asserted that proprietary trading was not a huge part of the business model of UK banks, and was not a high level concern for the BBA’s members, who either did not get involved with proprietary trading or found it to be a totally marginal activity. What would concern them would be an attempt to “Volckerise” the narrow definition, resulting in “all the banks’ activities, such as market making, suddenly [having] to be processed through this lens … There would be a huge cost to that. There would obviously be burdens on the way they operate. They might have to stop doing something that basically no one has a problem with”. In his view, proprietary trading was not so dangerous that it needed to be banned in any case. He argued that 4% of total losses in relation to the global financial crisis were down to proprietary trading. In his view it was preferable to separate proprietary trading activity rather than ban it completely.

Is the Commission’s proposed definition likely to prove effective at banning the trading activity it seeks to target, or could it have any unintended consequences? Or is it so narrowly drawn as to be unlikely to have any practical effect? How will it be enforced, and how can it be ensured that the distinction between such activity and legitimate market-making activity is retained? Do you perceive any dangers in seeking to ban proprietary trading, even on the basis of such a narrow definition? How would you respond to the Commission’s argument that a ban would bring “social benefits”, even if the financial implications are limited? Do you anticipate attempts to broaden the definition of proprietary trading during the negotiating process? If so, what steps are you taking to ensure that any negative effect on the day-to-day activity of UK institutions, for instance in legitimate market-making activity, is minimised? How can the effect of a ban be effectively monitored in the years ahead? What lessons can be learned from the US experience? In light of such experience, are you concerned at the lack of international consistency in the approach to proprietary trading?

STRUCTURAL SEPARATION

On the proposals for structural separation, Martin Spolc noted that the Commission came to the conclusion that, rather than basing a separation decision on size as the Liikanen Group had proposed, “it would be better and more nuanced to base the separation decision on criteria … such as leverage, complexity, profitability, associated market and counterparty credit risk and interconnectedness.” He also stressed the importance of providing a “limited and carefully framed degree of supervisory discretion … to judge the riskiness of certain trading activities on a case-by-case basis”, so that a
supervisor could choose to separate certain activities that it judged to pose systemic risk even if the
criteria were not exceeded. Alternatively a supervisor could decide not to impose structural
separation “if the supervisor was convinced by the arguments put forward by the banks that the
trading activities do not cause systemic or financial stability risks”. The supervisor would have to
consult the EBA in such cases, and, if it was decided not to enforce separation, the supervisor would
have to disclose its decision.

We agree with you that, given the proposal’s application across a diverse set of national banking
sectors in the EU, some degree of supervisory discretion is appropriate. Are you content that
sufficient safeguards are in place in the proposal as drafted to ensure that this power is not used in an
inappropriate fashion?

THE IMPACT ON THE UK AND THE DEROGATION PROVISIONS

Martin Spolc stressed that the Commission proposals were compatible with the UK Banking Reform
Act, and shared the same objective of protecting core deposit-taking and lending from trading
activities. As a result, he thought the costs of applying both sets of rules to one banking group would
be limited. Nevertheless he acknowledged the difference between the two, including the
Commission’s proposal to ban proprietary trading, the “conceptual difference” between the UK
approach in separating retail activity from trading activity and the Commission’s proposal to separate
trading activity from deposit-taking activity (although they led to the same outcome of separating
retail and trading activity), and the territorial scope. On the latter issue, Martin Spolc observed that
the Commission proposed a broader scope because it wanted to avoid regulatory arbitrage and the
possibility of banks circumventing the rules by shifting some of their trading activity outside the EU to
third countries.

Martin Spolc justified the proposed derogation provisions on the grounds that it was logical for the
Commission to scrutinise existing laws and to judge whether they achieve equal or greater results
than the Commission’s proposals. He added that banks subject to UK law obtaining the derogation
would not be affected by the EU regulation. However, subsidiaries of the UK banking groups that
carried out important activities in the EU or outside the UK that would not be captured by the UK
law would be captured by the EU law.

Anthony Browne stressed that “it is very important that these European proposals do not make it
impossible for the UK and for the UK banks to implement” the Banking Reform Act, and “that meant
they had to have national derogation, because I cannot see any other way around it.” Yet other
countries viewed the derogation provisions as being designed specifically for the UK “because we
were first out of the traps” with domestic legislation.

Anthony Browne agreed that the EU legislation’s extraterritoriality was a major difference from the
UK approach: “it affects the global operations of EU banks and, indeed, to some extent, the
operations of global banks operating within the EU, both of which are untouched by the Financial
Services (Banking Reform) Act.” He also noted that “if you are a UK-headquartered bank, your global
operations are potentially affected by the Commission proposals in a way that they are not by the
Financial Services (Banking Reform) Act proposals. A lot of non-EU banks’ or non-EEA banks’
operations in the UK could potentially be affected by this legislation as well.” He noted that the
Commission proposal was deliberately designed to capture the entire global operations of EU-
headquartered banks, so long as they fit certain criteria. By contrast, the UK legislation was
deliberately designed not to have such an extraterritorial effect in order to make sure that London’s
competitiveness as a global financial centre, nor the competitiveness of UK-headquartered banks,
were not impaired.

You state that the derogation provisions remove the risk of a duplicated compliance burden.
However, we would be grateful for your view of the likely impact of the proposal on a UK-
headquartered group, as well as a UK-headquartered institution, and how the derogation would apply
in each case. For instance, what will be the impact on the global activity of a UK-headquartered
group? What will be the impact on the activity of subsidiaries of a UK-based group operating outside
the UK? What will be the impact on the UK activity of EU banks headquartered in other Member
States? Given the limited extraterritorial effect of the UK Banking Reform Act, is it fair to state that
UK-based banks will be at a competitive advantage compared to those based in other Member States?
Given the interconnection between the financial sector in the UK, the EU and globally, and given the
cross-border nature of banking activity, what assessment have you made of the overall economic
impact of the Commission’s proposals on the UK? What is the view of the PRA on the proposals as
the UK’s competent authority? Can you provide any more detail about the concerns set out in your
EM that the draft regulation "maintains an appropriate balance between the role of the member state and the role of the Commission"?

FRANCE AND GERMANY

Martin Spolc noted that the Commission proposal went further than the French and German model in proposing to ban, rather than separate, proprietary trading, and in seeking to capture a broader scope of trading activities, such as complex securitisations, “that might be risky and might not be related only to activities such as lending to hedge funds”. While it was too early to state precisely what the impact of the reforms would be, he said that the Commission’s proposal, as it stood, would have a significant impact on the French and German banking sectors.

Sir Win Bischoff noted a push against the proposal by France and Germany, who would either wish, through derogation, not to be a part of the regulation “or would wish to persuade the Commission to do something that is closer, perhaps, to Liikanen, which allows some sort of trading to take place inside either the ring-fenced entity or the non-ring-fenced entity.” In his view, the French and German approach to proprietary trading was workable, whereas the Commission’s proposals were more problematic for financial institutions. Yet “if they do not find a way in Europe to have a united view of how banking structure should be carried forward, that is not a good thing for Europe.”

Anthony Browne said that in France and Germany, banks, government and regulators alike were “incredibly hostile” to the proposals: “There is an awful lot of anger about it. I have certainly been party to some really quite hostile exchanges between French and German banks and Commission officials on it.” He found it difficult to see how the proposal could survive in its current form without the support of the French and German Governments.

What assessment would you make of the reaction in France and Germany to the Commission’s proposal? Do you recognise the description of their reaction as “incredibly hostile”? Do you agree with our witnesses that the chances of the Commission’s proposal being agreed as it stands are therefore slim? What amendments do you anticipate France and Germany seeking to make? For instance, do you anticipate any amendments to the derogation provisions?

INTERNATIONAL CONSISTENCY AND THIRD COUNTRY EQUIVALENCE

Martin Spolc stressed the Commission’s commitment to international consistency and convergence, noting that it was in contact with all major jurisdictions to ensure that any possible overlaps in application or inconsistencies were minimised. He said that the third country equivalence regime would make it possible for third-country banks operating via branches in the EU, or subsidiaries of the EU banks operating overseas, to be exempted from the regulation. This was designed to reduce compliance costs for banks that undertook cross-border activity.

Sir Win Bischoff noted that some European banks, including Deutsche Bank, BNP, Santander, Barclays and HSBC, were sizeable global operators: “For the regulated, who have to deal with regulation or this kind of structural separation in a number of countries, it is going to be quite difficult. … The extraterritoriality of it is a real difficulty.” Across the financial sector more generally, he stressed how difficult it was to apply global standards: “there may be convergence, but it is going to be increasingly difficult. … There is not going to be that much commonality all that soon”. In his view, it would have been preferable to have a single set of rules across the EU, if not globally.

Anthony Browne agreed: “If you started at the beginning of this process and said, ‘Do we need national legislation in the UK, France, Germany and Belgium and also European legislation on top of that? Is that an ideal framework?’ you would be hard-pushed to find anyone, including many of the authors, to say that would be the case.” He added that part of the reasons why different countries had come up with slightly different answers was because of the complexity of banks. The idea of a level playing field in Europe was a good idea in principle, but the Commission needed to reflect the fact that a lot of activity had already been undertaken in individual countries, notably the UK. Nevertheless, BBA members wanted as much international consistency in legislation as possible: “The more differences there are, the more compliance costs there are and the more difficult it is to do business – and, also, the more scope it creates for regulatory arbitrage”.

Notwithstanding the reforms being implemented as a result of the UK Banking Reform Act, do you agree with our witnesses that it would have been preferable, in principle, to reach agreement on a common set of rules across the EU, if not globally? Given where we find ourselves, what can be done at this stage to ensure that there is as much international legislative consistency as possible, thereby minimising compliance costs and the risk of regulatory arbitrage? What has been the reaction in other major global financial centres to the proposal?
In terms of the division of home and host responsibilities, Martin Spolc acknowledged that the proposal gave responsibility to the lead (i.e. home) supervisor. He expected the issue to be prominent in the negotiation process, but at this stage the Commission’s judgment was that “a decision on the structural measures is so important that the lead supervisor should have the final say”.

We would be grateful for a full explanation of the Government’s concerns about the division of home and host responsibilities. What would be the practical impact of the Commission’s proposal, as drafted? Are you concerned at the shift in responsibility to the home authority? Does this set an unhelpful precedent?

In his evidence before us, Martin Spolc highlighted a number of issues that he anticipated would be dealt with through delegated powers. This included the definition of thresholds for certain criteria on which a decision about structural separation would be based, decisions on whether certain trading activities would be separated, the EBA’s role in developing regulatory and implementing technical standards, decisions on third country equivalence and defining good and bad securitisation. On the latter issue, Martin Spolc said that the proposal was the first time that EU legislation had attempted to separate and distinguish between good and bad securitisation. The Commission recognised that good securitisation might be good for long-term financing and providing support to the real economy, whereas some securitisation would be complex and could prove to be toxic.

In light of the concerns expressed in your EM about the scope of such delegated powers, how would you respond to Martin Spolc’s evidence? Are these appropriate measures to be set out in delegated acts? Is it possible to distinguish between good and bad securitisation and, if so, what should be the basis of such a judgment?

Notwithstanding the complexity of these issues, Martin Spolc told us that there was no reason why political agreement should not be reached before the end of 2015. He said that while Member States had expressed some concerns, discussions at the informal ECOFIN in April had been “very positive. There was broad endorsement of the objectives of the proposal and the Ministers also decided to start technical discussions on this proposal after Easter.”

Do you share Martin Spolc’s optimism about the prospects for agreement? Is his description of negotiations thus far a fair one? What update can you give us on subsequent discussions, and the timetable for progress over the coming months?

We also note the Government’s assertion in your letter of 1 June 2014 that the UK’s JHA opt-in protocol is triggered in relation to this proposal. As you know, the Committee’s consistent position is that the opt-in is engaged only if the proposal cites a Treaty base within Title V TFEU. Given that the deadline to notify the Commission of the UK’s decision was 19 May, we regret that this was not brought to the Committee’s attention until now. Whilst we are grateful for your apology for the delay, we note that this is the second time in a matter of weeks that a JHA opt-in issue has been identified at a late stage. On 31 March 2014, the then Economic Secretary to the Treasury, Nicky Morgan MP, wrote to us in a similar vein in relation to EM 17949/13: Proposal for a Directive on the Union Legal Framework for Customs Infringements and Sanctions. What steps are you taking to improve the Government’s internal processes to ensure that JHA issues are identified and brought to the Committee’s attention at an early stage?

We appreciate that some of these questions are difficult to answer at this early stage in negotiations. However, we would be grateful for a full response to as many of these questions as is possible at this stage, by 10 July 2014. We will continue our examination of these important proposals as negotiations progress in the coming months. In the meantime we will continue to hold the document under scrutiny.

10 June 2014
Thank you for your letter of 10 June relating to the Commission proposal on structural reforms of EU credit institutions and to the evidence given to the Sub-Committee at its meeting of 10 June 2014. Whilst I have endeavoured to answer as many of your questions as possible, we are still in the early stages of negotiations on this complex dossier and as such some issues still remain unclear and will need to be returned to in the future.

The first issue you raise in your letter concerns the justification for the proposal. The Government agrees that some globally systemic banks benefit financially from perceived implicit taxpayer guarantees that they will receive financial aid from governments if they are at risk of failing. The Government therefore believes that structural reforms rolled out across the EU could help to level the playing field across the Single Market in this regard. Structural reform measures specifically aim to address the issue of banks which are “too big to fail” by making them more resolvable and protecting depositors. These are complementary to other EU regulations such as the Capital Requirements Directive IV and the Bank Resolution and Recovery Directive which also aim to tackle the issue of implicit taxpayer guarantees. The proposal is therefore welcome. Overall, the Government believes this proposal is generally in line with its own structural reforms. Relative to the Liikanen proposal, the degree of supervisory discretion is positive. However, there remain areas where we believe the proposals could be improved, such as third country provisions and the powers of home and host authorities.

The Government believes that the application of the proposal is in line with addressing “too big to fail” as it aims to capture banks that are large and complex. Nevertheless, smaller institutions can also prove to be systemic and this often depends on the banking sector in which such institutions operate. Given the diversity of banking sectors across Europe, we consider the proposal adequately addresses this issue by allowing Member States to ring-fence such institutions where necessary to support financial stability. The Liikanen proposal did not provide such supervisory discretion and the Government believes that the Commission proposal in this respect is helpful. Rather than being unlimited, this supervisory discretion will be applied within a common framework set out in the regulation. The Government will however scrutinise this closely to make sure that this is properly calibrated.

You also raise the question of whether or not there would have been any advantages for the proposal to have been brought forward in the form of a directive. The Government’s priority is to ensure that the proposal provides sufficient flexibility to be compatible with implementation of the Banking Reform Act. The Commission proposal does provide for some supervisory discretion as well as a derogation provision and the Government will be seeking to maintain these elements during the course of negotiations.

Moving on to your questions regarding proprietary trading, the Commission’s definition is intentionally narrow so as to minimise unintended consequences and also to ensure that the prohibition is enforceable. As you are aware, the Volcker Rule in the USA also proposed a ban on proprietary trading but with a much broader definition. Private sector analysis of this found that, among other negative consequences, the ban impaired market liquidity trading, reduced access to credit and increased bank fees for consumers and businesses. These are important factors to consider when assessing the Commission proposal. As currently drafted, the Government does not believe that the ban will entail widespread unintended consequences as the Parliamentary Commission on Banking Standards found in its report of 5 March 2013 that there is little to suggest that proprietary trading is commonplace among the UK’s main banks. It is not yet clear at this stage whether or not there will be concrete attempts to broaden the definition of proprietary trading. The Government will however be scrutinising this area of the dossier to ensure that the ban is effective and that useful market-making is not hindered.

The question of whether or not the ban would bring about ‘social benefits’ is an interesting one. The Financial Services (Banking Reform) Act 2013 (“the Banking Reform Act”) provides for an independent review of the case for a proprietary trading ban in the UK to be undertaken in 2021 which may be able to shed more light on this issue. With regard to international consistency in this area, the proposal does include a provision for third country equivalence which would reduce the potential for duplication and excessive compliance costs.

You also raise questions surrounding the impact on the UK and the derogation provisions. The current drafting leaves some room for uncertainty on how the regulation would apply in this respect. Our initial reading is that, given that the UK Banking Reform Act only applies to banks established in the UK and EU branches of UK banks, EU subsidiaries of UK banks would be subject to the Commission’s proposals and the derogation would not apply. The impact on UK subsidiaries of banks
Regarding the extra-territorial impact on third countries, the proposal gives power to the consolidating supervisor to apply structural measures to all group entities – regardless of where they are located. The current drafting of these provisions is unclear and the Government will clarify this as the negotiations progress. However, our understanding is that the Commission intend for this to apply only to subsidiaries which hold deposits that are covered by the UK’s Financial Services Compensation Scheme. Furthermore, the Government would like to make it clear that the purpose of a derogation is not to secure a competitive advantage for UK banks vis-à-vis other Member States but rather to maintain the robust structural reform measures that we have put in place for reasons of financial stability. Regarding the position of the PRA, I understand that they have provided evidence to the Committee on a previous occasion and we are working closely with their officials to ensure that UK priorities for this dossier are aligned.

You also asked for more detail on the question of the appropriate balance between the member state and the Commission. As set out in the EM, the Government is committed to ensuring the draft regulation maintains an appropriate balance between the role of the member state and the role of the Commission. This means that we will be looking carefully at the regulation as it is negotiated to ensure that the Commission is not given a greater role than is justified and that the Council and/or the Member States have an appropriate role provided for in the legislation. In particular, we will seek to ensure that any Commission role in the granting of a derogation is proportionate and that the process is timely and designed to minimise market uncertainty. We will have to judge this on a case by case basis as negotiations continue. We will keep the Committee updated in the event that any issues arise.

The Government considers that the economic impact of the proposal on the UK will be minimal given that the major UK banks will be exempted from the measures as they are covered by the Banking Reform Act. Furthermore, bank structural reform will help to stabilise the European Economic Area, to which UK firms have a large exposure, and it is likely that UK firms will benefit from this added stability. However, there is a possibility that some firms which are not currently covered by the Banking Reform Act may be covered by these new requirements. We estimate the one-off transitional costs for these firms to be between £50m and £500m. The Government will also want to ensure that the third country provisions do not place undue costs on non-EEA firms, or on third-country subsidiaries and branches of EU banks and we will scrutinise these elements of the proposal closely.

You also raise questions concerning international consistency and third country equivalence. The UK financial sector is a very global and interconnected one and it makes sense to ensure that financial regulation in different jurisdictions is compatible. Setting minimum standards at international fora such as the FSB and the G20 is key to ensuring international legislative consistency and this practice should continue. Nevertheless, the UK economy has a large exposure to its financial sector and so the need for consistency should not prevent the UK from introducing a strict regulatory regime where this is deemed necessary for financial stability. With respect to delegated powers, the proposal includes a large number of delegated acts which create uncertainty and enhance the role of the EBA. The Government will be scrutinising these elements of the proposal closely in order to ensure a sufficient amount of certainty as well as supervisory discretion for competent authorities. The Government agrees that certain characteristics can be used to indicate ‘good’ securitisations, and we welcome efforts from the Bank of England, and others, to develop a ‘qualifying’ designation for securitisations. Furthermore, the draft Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 permits ring-fenced banks to engage in securitisation subject to safeguards. This is however an instance where the Financial Stability Board (FSB) and the G20 is key to ensuring international legislative consistency and this practice should continue. Nevertheless, the UK economy has a large exposure to its financial sector and so the need for consistency should not prevent the UK from introducing a strict regulatory regime where this is deemed necessary for financial stability.

You also ask about the implications of the division between home and host responsibilities. The approach for dealing with the division of supervisory tasks between home and host supervisors is established in both the CRD4 package and the Bank Recovery and Resolution Directive. More specifically, the role of the home authority under the CRD4 package is principally to apply capital requirements at the level of the group undertaking; it does not have any direct supervisory powers vis-à-vis subsidiaries located in other Member States. The proposal on structural reform however...
diverges from this approach by giving decisions regarding structural separation to the consolidated supervisor of the group. There is little scope for the host authority, or for the home authority of a subsidiary of a group which is not the consolidated supervisor, to influence the decision on separation. The Government believes that it is for the Financial Conduct Authority and the Bank of England to regulate banks established in the UK. However, the limited role envisaged for authorities other than the consolidated supervisor could undermine UK authorities’ supervisory powers with regard to subsidiaries and branches of parent undertakings established in other Member States. The Government will look to improve the text so as to ensure that UK authorities retain supervisory powers over UK banks.

Regarding the progress of negotiations, the third working group took place on 2 July and the Italian Presidency has scheduled a further working group on 17 July. Whilst there is general agreement in the Council surrounding the objectives of the proposal, there are divergent views among Member States as to how these can be achieved and this may take some time to resolve. Furthermore, the European Parliament elections have delayed the appointment of a rapporteur and no internal negotiations or debates have yet taken place. We therefore expect negotiations on this dossier to be lengthy and to conclude around the end of 2015, which is not out of the ordinary for a file of this size and complexity.

Finally, the Government takes very seriously the concerns you express on matters of JHA process and is focused on ensuring we meet our scrutiny commitments to Parliament. As I also noted in my recent letter on the Shadow Banking and the Securities Financing Transactions proposal, this Department and the Government as a whole are taking steps to address this. To ensure the opt-in is identified at an early stage, the Home Office and Ministry of Justice have recently reissued guidance across Whitehall on the opt-in protocol. In addition, specific training on the application of the opt-in, especially in relation to identifying JHA content and understanding the process for asserting the opt-in is being provided to Departments.

As referenced earlier, this is an extensive proposal that will be negotiated over the course of at least the next year and as the dossier progresses I look forward to a continued dialogue with the Committee.

16 July 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 16 July 2014, on EM 6022/14: Structural Reforms of EU Credit Institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 22 July 2014.

We are grateful to you for this thoughtful response to our 10 June 2014 letter. We are particularly grateful for your helpful clarification in terms of the application of the derogation provision and the issue of home/host responsibilities. The outcome on both these aspects of the regulation evidently remains highly uncertain, and we would therefore be grateful for updates as these issues are discussed further.

We accept that negotiations are still at an early stage and that many issues, these included, therefore remain unclear. Having said that, there are a number of questions in our letter which you have not addressed which are points of principle and information rather than being dependent on the progress of negotiations. These include:

— Whether this is the final cog in the wheel of the regulatory overhaul of the EU banking system, or whether further reform will be necessary;
— Whether the use of a regulation rather than a directive sets any kind of unhelpful precedent;
— What are the implications of a preference for regulations for non-members of the eurozone such as the UK;
— The reaction in other major global financial centres to the proposal.

Such questions are highly relevant to our new inquiry, launched on 16 July 2014, reviewing the EU financial regulatory framework. As such we would be grateful for a more detailed response to these specific points.

We welcome your promise to keep the Committee updated in the event that any issues arise in relation to discussion of the derogation provision. However you do not mention an extremely significant recent development, namely media reports of a leaked Council Legal Service Opinion.

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questioning the legality of the derogation provision. What are the implications of the Council Legal Service Opinion? What steps are being taken to address the concerns that it has raised? Is it inevitable that the derogation provision will need to be amended? Do you remain confident that the derogation provision can be retained, and if so, in what form?

We would be grateful for a response to these questions, as well as an update on negotiations including the 17 July Working Group, by 2 September 2014. In the meantime we will continue to hold the document under scrutiny.

22 July 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your follow-up letter of 22 July regarding the Commission proposal on structural reforms of EU credit institutions.

The first question you raise in your letter concerns the regulatory overhaul of the EU banking sector. As you are aware, much has been done in recent years to address the systemic risks posed by the financial sector, which were exposed during the financial crisis. The crisis also revealed that many banks rely on and benefit financially from perceived implicit taxpayer guarantees that they will receive public aid in the event of failure. The EU regulatory agenda has tried to tackle these issues firstly through the Capital Requirements Directive and Regulation in order to increase banks’ capacity to absorb losses in times of stress through the introduction of binding capital and liquidity requirements. This legislation is complemented by the Bank Recovery and Resolution Directive which aims to address the issue of “too big to fail” by introducing a regime for the orderly resolution of failing systemic banks. The Directive also helps to tackle implicit public guarantees by ensuring that losses are borne by creditors and that depositors are protected, therefore significantly reducing the likelihood of a taxpayer bailout.

Structural reform of the banking sector is complementary to these measures and is an integral part of reducing implicit taxpayer guarantees. By separating trading activities from core activities which are essential to the real economy and which governments were inclined to protect during the crisis, structural reform measures help to prevent widespread public bailouts. The Government therefore supports structural measures for banks as part of the fuller regulatory reform of the banking system.

Nevertheless, there remains more to be done, including reaching international agreement on binding minimum leverage ratios and loss absorbing capacity for banks. Ensuring international consistency in areas such as cross-border derivatives and shadow banking is also key to reforming the financial sector. Nevertheless, the banking sector is a dynamic one and it is important to adequately assess the impact of regulation across the financial sector. For example, as the Commission notes in its impact assessment, the separation or prohibition of certain trading activities could result in these activities shifting to unregulated sectors such as shadow banking. The Government believes that effects such as these should be closely monitored following extensive regulatory overhaul to ensure that the objectives of reforms are met and excessive unintended consequences are minimised.

You also asked whether the use of a regulation rather than a directive sets an unhelpful precedent and the implications for the UK of a potential preference for regulations. Since the financial crisis, the EU has introduced a stream of reforms to the banking sector comprising both directives and regulations. Indeed, there are some instances where a regulation is more appropriate for a particular policy area than a directive. However, it is the Government’s opinion that such a decision must be based on the content and merits of the proposal. This is an issue that the Government scrutinises closely and will continue to do so across the EU policy spectrum. In the case of Bank Structural Reform, the Government’s priority is to secure a sufficient amount of flexibility for Member States, regardless of the legal form of the measure.

This commitment to flexibility also pertains to the leaked Council Legal Service opinion. This is a piece of evidence the Government will consider alongside a variety of other non-binding sources as discussions progress with all Member States.

Regarding the reaction of other global financial centres to the proposal, there has been a limited reaction to the EU proposal so far. Nevertheless, a Financial Stability Board work stream has been established to assess the effects of structural reforms in different jurisdictions. Discussions have so far been high level and focused around the benefits of structural reform measures, namely reducing the interconnectedness of banks and facilitating their resolution. Comments specifically relating to the EU proposal on bank structural reform have been limited. Nevertheless, some general concerns were raised such as potential impediments to cross-border financial flows and the trapping of liquidity or capital in domestic silos. Concerns were also raised surrounding the prohibition of proprietary trading.
which some believe may have a negative impact on the liquidity of foreign financial markets. It was however acknowledged that the concrete impact of measures in different countries was not yet known given that many rules had yet to be finalised.

More specifically on the negotiations on the Bank Structural Reform proposal, the fourth Council working group took place on 17 July. Whilst negotiations are still at an early stage, meetings have established the main issues as being the division of power between home and host authorities, the application of the regulation, the ban on proprietary trading and the derogation. There has been extensive discussion surrounding the ban on proprietary trading, with some Member States raising concerns that an outright ban could potentially shift such activities to the shadow banking sector. The level of supervisory discretion has also been a focus for discussion, with some countries calling for more flexibility for supervisors in deciding whether or not to impose structural measures upon a firm, although a relative few would like to see more automaticity in this respect. Council working groups are set to recommence from the end of September and continue through the autumn. Nevertheless, given the complexity and size of the dossier, we expect negotiations to be lengthy and to conclude by the end of 2015.

I hope this response provides some clarity on the issues you raise in your letter and I look forward to a continued dialogue with the Committee as the negotiations on this dossier progress.

1 September 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 1 September 2014, on EM 6022/14: Structural Reforms of EU Credit Institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 9 September 2014.

We note that negotiations remain at an early stage. Nevertheless the issues at stake which you cite, including the division of power between home and host authorities, the ban on proprietary trading and the derogation provisions are all vital issues. Noting that Council working groups are set to recommence at the end of September, we would be grateful for a further update on negotiations by 3 November 2014. In the meantime we will continue to hold the document under scrutiny.

10 September 2014

Letter from Andrea Leadsom MP to the Chairman

Thank you for your letter of 10 September requesting an update on the negotiations on Bank Structural Reform.

In the Council, there have been six working groups to date, with the most recent occurring on 28 October. These are expected to continue on a monthly basis throughout the Italian Presidency until the end of the year. Discussions have been relatively high-level and no conclusions have been made; and we do not expect there to be an agreement in the Council by the end of the year. During the course of Council negotiations general concerns have been raised by Member States regarding the timing of the proposal, its aims and the overlap with other pieces of financial regulation. The main issues Member States have raised concerns on are: the treatment of proprietary trading, the separation process, home and host responsibilities and the derogation.

The proprietary trading ban has been the subject of numerous discussions in the Council, which have focused firstly on the definition of proprietary trading and secondly on how such activities should be treated. Whilst there are some Member States that believe the Commission’s proposal is appropriate, a number of other Member States are concerned that the narrow definition of proprietary trading would lead to regulatory arbitrage, considering a broader definition to be more appropriate. However, some of these Member States also believe that banning such activities could have a negative impact on other services such as market-making whilst also increasing the risk that these activities move to the shadow banking sector. Member States that take this view generally tend to prefer a separation of these activities rather than an outright ban. The Government will seek to ensure that any treatment of proprietary trading is both effective and does not hinder activities that are essential for market liquidity, such as market-making.

There have also been Council discussions on the process by which banks separate, the focus being placed on how much discretion supervisors should have when deciding whether or not to separate a bank. Some Member States appreciate the level of supervisory discretion that the Commission has proposed but would like to extend this further. On the other hand, some other Member States would prefer more automaticity when deciding if a bank should separate. This would generally involve
banks having to meet certain criteria that are detailed in the regulation and, once these are met, they will automatically be obliged to separate. However, such discussions have so far been exploratory, no textual amendments have been proposed and no conclusions have yet been reached.

A number of Member States have also raised concerns regarding the role of supervisors. As I have mentioned in previous correspondence, the Commission proposal gives all decisions regarding the structural separation of banks to the consolidating supervisor of the group. This clearly diverges from the established practice in other EU legislation, such as the Capital Requirements package and the Bank Recovery and Resolution Directive. Some Member States refute this approach, on the grounds that such decisions will have a material impact across Member States and that host authorities should therefore have a more prominent role than is currently envisaged in the Commission’s proposal. The Government shares this concern as it believes that it is primarily the responsibility of the Financial Conduct Authority and the Bank of England to regulate banks established in the UK. The Government will continue to pursue an outcome that does not undermine this point in relation to structural reform.

The derogation has also been discussed by the Council, however this has not been a focal point of the negotiation so far. Some Member States have raised concerns regarding the derogation as they believe this could fragment the Single Market and some are concerned about the legal approach taken. However, many Member States recognise that the reforms this Government has pursued are more robust than the proposal and they are willing to allow some flexibility in this regard. The Government is focused on ensuring the proposal recognises the ‘super-equivalence’ of the Banking Reform Act and that the UK reforms remain accommodated in the approach.

The European Parliament, on the other hand, has only just started its legislative procedure, and the first exchange of views took place on 4 November. Gunnar Hökmark, a Swedish conservative MEP has been appointed as rapporteur of this dossier. In the past, Mr Hökmark has publicly spoken out against the proposal on the grounds that ring-fencing is unnecessary in light of other regulatory reforms (such as the Capital Requirements package and the Recovery and Resolution Directive) and the potential negative impact on the real economy.

Other shadow rapporteurs include Jakob von Weizsacker (German, Socialist), Syed Kamall (British, Conservative), Sylvie Goulard (French, Liberal), Philippe Lamberts (Belgian, Green) and Fabio de Masi (German, Communist). It is not yet clear whether or not these MEPs share Mr Hökmark’s view and it is therefore uncertain which direction the parliament will take. Nevertheless, Mr Hökmark’s rapporteur’s report is due to be published on 18 December, following a hearing with members of the industry, academics and interested stakeholders on the 2 December. The final report of the European Parliament is due to be voted at the end of March.

I hope you find this update on the negotiations so far helpful, and as the dossier progresses I look forward to a continued dialogue with the Committee.

7 November 2014

Letter from the Chairman to Andrea Leadsom MP

Thank you for your letter, dated 7 November 2014, on EM 6022/14: Structural Reforms of EU Credit Institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 18 November 2014.

We note that negotiations have thus far been at a relatively high level, and indeed that there remain fundamental divisions in relation to key issues including the ban on proprietary trading, supervisory discretion and home/host responsibilities. What do such divergent views, together with the uncertainty about the European Parliament’s approach, indicate about the prospects of agreement being reached on this legislative file? How real is the danger of fragmentation of the Single Market that some Member States have raised concerns about?

We understand that the issues concerning proprietary trading are complicated due to the definitions involved and whether it is favourable to have a narrow or broad definition. It is however evident that a number of European Banks have already started to reduce their proprietary trading desks in their efforts to deleverage. In light of this trend, can you provide details of the current level of proprietary trading in Europe? Given the rules on proprietary trading in the US, have there been adverse consequences on market making as a result? If market making and proprietary trading activities do start to move out of the regulated sector, is this socially harmful to the financial sector and the development of risks? To what extent are hedge funds regulated in providing such services? Taking all this into account, do you agree that there is a strong case for separation as opposed to an outright ban?
We note your update on the derogation provisions. Given your statement that "many Member States recognise that the reforms this Government has pursued are more robust than the proposal and they are willing to allow some flexibility in this regard", how confident are you that a compromise can be reached to accommodate the UK’s position? Which Member States are sympathetic to the UK’s position?

You state that concerns have been raised by Member States regarding the overlap with other pieces of financial regulation. Given that the question of inconsistencies between legislative files is a key component of our current inquiry into the EU financial sector regulatory framework, we would be grateful for more details of such concerns. Does the Government share such concerns? You cite the divergence in terms of provision of decision making power to the consolidating supervisor of the group from established practice in other EU legislation such as the Capital Requirements package and the Bank Recovery and Resolution Directive. What would be the consequences of such inconsistency? Has the UK or other Member States drawn attention to any other inconsistencies?

We would be grateful for a response to these questions, together with an update on negotiations, by 8 December 2014. In the meantime we will continue to hold the document under scrutiny.

19 November 2014

SYNTHESIS OF THE COMMISSION’S MANAGEMENT ACHIEVEMENTS IN 2013
(10944/14)

Letter from the Chairman to David Gauke MP, Financial Secretary to the Treasury, HM Treasury

Thank you for the Explanatory Memorandum from the former Financial Secretary to the Treasury, Rt Hon Nicky Morgan MP, dated 7 July 2014, on EM 10944/14 on the Commission Communication: Synthesis of the Commission’s Management Achievements in 2013. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 22 July 2014.

I would first like to take the opportunity of welcoming you to your new position.

While the number of reservations has declined, the Committee notes the importance of the increase in scope and financial exposure of the new reservations, as well as the translated amount of risk therein. Are you encouraged by the fact that financial recoveries and corrections in 2013 exceeded the average amount for 2009-2013? Does this suggest that the Commission’s supervisory and control systems have demonstrated a positive trend in terms of their corrective capacity?

We note that the UK is subject to three reservations; miscellaneous aid schemes on market measures funded by the European Agricultural Guarantee Fund (EAGF); management and control systems for operational programmes under the European Regional Development Fund/Cohesion Fund/Instrument for Pre-accession Assistance (IPA); and management and control systems for operational programmes in the European Structural Fund. The Commission states that action has been taken in each of these area. Can you provide more detail on the nature of the issues at hand and the steps that have been taken to address that problems that have arisen?

We strongly advocate the need for the EU budget to be managed with effective internal control systems in place, strengthening accountability and transparency of DGs and Heads of Services in the process. As raised in relation to the Committee’s scrutiny of management achievements in 2012, we favour effective forms of deterrence. We therefore welcome the new mechanism for suspending agricultural payments as an ex-ante instrument to protect the EU budget from weaknesses in Member States’ control systems. Do you believe more ex-ante instruments should be in force in other expenditures of the EU budget?

You note that a number of problems have been identified with the way the net financial corrections are currently applied. While statistics on net financial corrections per Member State are welcomed, do you agree with the Commission’s assessment that a quicker procedure for net corrections would incentivise Member States to address weaknesses in their management and control systems? The Commission also emphasise the challenges of shared management. We note the Commission’s concerns on shared management, in particular the observation by the European Court of Auditors that two-thirds of errors could have been identified by national authorities. What practical changes
can the Government undertake to implement the Commission’s recommendations to support first level checks?

We would be grateful for a response to this letter by 2 September 2014. In the meantime we will continue to hold the document under scrutiny.

22 July 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 22 July on the above named report. Your letter contains a series of questions on the detail of the report, specifically in relation to reservations.

FINANCIAL RESERVATIONS

Your letter asked whether the Government is encouraged by the Commission’s figures for financial recoveries and corrections in 2013. The Government notes the Commission’s continued efforts to take effective action where errors are identified, including through the use of financial corrections. However, as set out in HM Treasury’s explanatory memorandum summarising the Commission’s communication on the application of financial corrections for agricultural and cohesion policy (EM 18030/13 of 16 January 2014), a number of problems have been identified in the way the Commission currently applies financial corrections.

As such, while the Commission’s clear engagement in this area is encouraging, we will continue to urge the Commission to ensure that financial corrections are consistently applied in appropriate circumstances and reflect the genuine misuse of EU budget funds.

UK RESERVATIONS

Your letter also asked for further information regarding three UK financial reservations referenced in the report. It is worth noting that there has been no suggestion of misuse of funds in any of the programmes concerned. The financial corrections made were the result of technical deficiencies rather than the misappropriation of funds or the failure of management and control systems.

— The reservation under the European Agricultural Guarantee Fund (EAGF) concerned the Fruit and Vegetable Producer Organisation regime. The UK has already conducted a thorough review of associated Producer Organisations and no longer approves those that do not meet the scheme’s requirements. DEFRA will continue to actively engage with the Commission to better understand the nature of residual concerns.

— The Commission identified technical deficiencies in the management and control systems for operational programmes within the UK, including the Cohesion Fund and the European Regional Development Fund (ERDF).

— Following a review of the Managing Authority’s (MA) sampling methodology, ERDF payments to Wales were temporarily interrupted on technical grounds. The Welsh Government is optimistic that the situation will be resolved shortly. As a result of active engagement with the Commission, the interruption to ERDF payments to England was lifted in March 2014.

— The Commission identified technical deficiencies in the management and control mechanisms of some UK MAs in relation to EU Structural Funds (ESF). Working with Commission services, the MAs concerned have implemented agreed actions to remedy identified deficiencies. Following the satisfactory implementation of these changes, the Commission lifted the partial interruptions to the Northern Ireland ESF programme in December 2013 and to the England programmes in March 2014. Welsh and Scottish MAs continue to actively engage with the Commission to address identified shortcomings.

EX-Ante INSTRUMENTS

You asked about the wider use of ex-ante instruments to protect the EU budget. While ex-ante measures, such as suspensions, are a useful means of ensuring that EU budget funds are only received
and deployed in accordance with existing rules, the Government highlights the importance of ensuring that these measures are deployed carefully to maximise their impact.

In the HM Treasury EM mentioned above (EM 18030/13), the then Economic Secretary confirmed that the Government supports the reduction in the length of the conformity procedure. This would both improve the impact of financial corrections and the Commission’s ability to accurately calculate the appropriate level of correction.

**HMG ACTION TO IMPLEMENT COMMISSION’S RECOMMENDATIONS**

The Government will continue to push for clarity and consistency in the interpretation of the complex legislation and rules governing EU budget expenditure. While we remain of the view that the mismanagement of EU funds by national authorities is unacceptable, the Commission has a role to play in ensuring that all those involved in the use and monitoring of EU funds are considering and applying the rules in the same way.

The Government continues to actively engage with both the Commission and the European Court of Auditors to improve the quality of first level checks and, where appropriate, make changes to existing processes. For example, the Rural Payments Agency has introduced pro-active land change detection to improve the quality and currency of data in its land registry.

12 September 2014

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**Letter from the Chairman to David Gauke MP**

Thank you for your letter, dated 12 September 2014, on EM 10944/14 on the Commission Communication: Synthesis of the Commission’s Management Achievements in 2013. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 October 2014.

We are grateful for the explanation and detail of the financial reservations brought upon the UK in each of the three areas identified by the Commission. We welcome the fact that necessary reviews have already taken place and that technical deficiencies are being prioritised. We note your response on the use of ex-ante instruments, and the relatively successful efforts by the Commission’s supervisory and control systems that have demonstrated a positive trend in terms of their corrective capacity.

We would be grateful for clarification of your statement that ERDF payments to Wales were temporarily interrupted on technical grounds, but that the Welsh Government is optimistic that the situation will be resolved shortly. Can you confirm that in the meantime Wales continues not to receive ERDF funding? We would be grateful for clarity as to the details involved.

It is hoped that the Government’s continued commitment to keep a watchful eye over the EU budget, coupled with the Commission’s improved supervisory and control systems will help to mitigate the inefficiencies and errors at the national level. Nevertheless, significant challenges remain at the national level surrounding weak management and control systems. The Committee would welcome practical recommendations and innovative ways to support and improve first level checks.

We now clear EM 10944/14 from scrutiny.

14 October 2014

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**Letter from David Gauke MP to the Chairman**

Thank you for your letter of 14 October 2014 on the above mentioned EM. Your letter sought further information regarding the temporary interruption of European Regional Development Fund (“ERDF”) payments to Wales referred to in my letter of 12 September.

The Welsh European Funding Office has confirmed that on 14 October 2014, the Commission Services communicated that the conditions for lifting the procedure to interrupt ERDF interim payments concerning the West Wales and the Valleys (2007UK161P0002) and East Wales (2007UK162P0012) programmes had been fulfilled and that interim payments for these programmes can now be processed again. This is indicative of the UK’s responsive and collaborative approach to financial management.

I thank the Committee for clearing this report from scrutiny.

21 November 2014

We note that ERDF interim payments relating to the West Wales and the Valleys and East Wales programmes can now be processed again. Can you clarify why the interruptions occurred, and which conditions were fulfilled to enable the interruption to be lifted?

We would be grateful for a response to this letter by 16 December 2014.

2 December 2014