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 1 December 2013- 4 June 2014

**ECONOMIC AND FINANCIAL AFFAIRS**

**(SUB-COMMITTEE A)**

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2014 ALERT MECHANISM REPORT- 2014 EUROPEAN SEMESTER (15803/13)

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


These documents cover familiar territory. As you acknowledge, the Annual Growth Survey sets out the same reform priorities as for the past two years. Is this a sign of the Commission’s persistence in tackling these issues or a sign of its failure adequately to do so? What assessment would you make of the progress being made across the EU to meeting each of these priorities? To what extent do you think that such progress as has been achieved is down to the coordination framework enshrined in the European Semester?

We also note that the UK has exceeded the same three macroeconomic indicators as last year: general government debt, private sector debt and the change in export market shares. In light of this, are you content with the rate of progress in addressing each of these issues? How long do you anticipate it taking for the UK to fall below the threshold in each of these cases?

The EMs come across as somewhat defensive in terms of EU monitoring of the UK economy. You assert, for example, that the Macroeconomic Imbalances procedure is a useful means of strengthening understanding of macroeconomic risks, but particularly in the euro area. You dispute the Commission’s factual analysis of the UK’s progress in implementing the CSRs. You make clear that the UK is not subject to sanctions under the MIP. In both EMs, you raise concern about the automatic inclusion of non-euro area Member States in the Social and Employment Scoreboard, and the inclusion of social auxiliary indicators in the Alert Mechanism Report. We agree with you that the UK,
as a non-euro area Member State, is not subject to sanctions, that the commitment that certain measures remain voluntary for non-euro area Member States should be respected, and any assessment should naturally be based on accurate statistics. Given that the effects of macroeconomic imbalances impinge upon the entire EU, do you not agree that the Commission's monitoring of the economic situation of all EU Member States is on balance valuable, even if the application of such oversight (for instance in terms of whether sanctions apply) varies between eurozone and non-eurozone Members? In what practical ways can the growth friendly fiscal consolidation that both the Commission and the Government support be achieved?

German parliamentarians suggested to us on our recent visit to Berlin that both the UK and the EU would benefit if the UK were more intensively engaged in the Semester process. Witnesses to our current Genuine Economic and Monetary Union inquiry have also argued that the economic policy coordination process as encapsulated in the Semester tends to display a bias towards fiscal discipline at the expense of employment and growth. Similarly, it has been argued that the Semester process has become too complex and needs to be streamlined. Do you agree? If so, what changes do you wish to see? If such changes were made, would the Government's support for the process strengthen?

We would be grateful for a response to these questions by 13 January 2014. In the meantime we will hold the documents under scrutiny.

17 December 2013

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter of 17 December on the Annual Growth Survey (AGS) and Alert Mechanism Report (AMR), following our Explanatory Memoranda of 3 December.

In your letter you recognised that these documents cover similar territory to the European Semester publications from previous years; for example, the AGS sets out the same priorities for reform as last year. This is because the issues raised take time to be fully implemented and shows the Commission is continuing to tackle these important issues.

You also asked for our assessment of the progress being made to meet these priorities. A number of Member States have taken unprecedented action to stabilise their economies, consolidate their public finances and undertake structural reforms. Our view is that the European Semester is a valuable tool for Member States to share good practice and generate consensus around what action is needed. This is particularly important in areas where reforms fall under Member State competence, for example on labour market reforms.

As you point out, the 2014 AMR has identified the same three indicators as the 2013 AMR. This reflects the fact that these economic imbalances take time to address. It is also a reminder of the importance of the Government's economic strategy to deal with these imbalances. However, looking beyond the headline figures shows an improvement in the export market share and private sector debt indicators for the UK. According to the AMR, the former has improved from -24.3% to -19.0% whilst the latter has been reduced by 1 percentage point from 80% to 79%. Going forward, we expect further progress to be shown on all three indicators as the Government continues to address these imbalances as set out in the Autumn Statement. However, it is not possible to comment on the timing of when these three indicators will return to levels below the thresholds as the OBR do not publish directly comparable indicators in their Autumn Statement forecasts. In terms of government debt, this government inherited the highest deficit in peacetime history. While there has been significant progress in reducing the deficit it remains the case that debt levels will continue to rise until borrowing costs are reduced further. The OBR forecast that debt will peak in 2015-16 – a year earlier than forecast at Budget 2013. The government is committed to ensuring the public finances are restored to a sustainable path, with debt continuing to fall as a percentage of GDP in the long term.

You also asked about whether the UK Government considers the Commission's monitoring of the economic situation of all 28 EU Member States to be – on balance – valuable, even if the application of such oversight necessarily varies between eurozone and non-eurozone Member States. The UK Government does see this as – on balance – valuable, but recognises that it is right that the level of oversight is greater for euro area countries, due to the specific challenges resulting from the sharing of a common currency.

The UK Government has shown that growth friendly fiscal consolidation can be achieved through converting current expenditure to capital expenditure and investing appropriately. The UK has consolidated expenditure and at the same time achieved the second fastest economic growth in the G7 in Q3 of 2013.
In your letter you noted that it has been argued that the Semester process has become too complex and needs to be streamlined. The UK Government agrees that the Semester needs to continue to focus on growth and employment and that it shouldn’t be distracted by additional proposals, such as a justice scoreboard, ‘greening’ the Semester, or the inclusion of social indicators and a social dimension, as these risk diluting the important focus of the Semester on the economic imperatives of growth and employment.

In preparation for the March European Council, the ECOFIN Council is due to adopt conclusions on the AGS and the AMR in early 2014.

13 January 2014

Letter from the Chairman to Nicky Morgan MP


Given you have provided a comprehensive response to our queries we are now content to clear these documents from scrutiny.

28 January 2014

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

Letter from Sajid Javid MP, Financial Secretary, HM Treasury, to the Chairman

The European Parliament, the Council and the Commission reached political agreements on BRRD and DGSD on 17 December. The Government successfully achieved its objectives in both files and supported the agreements.

BANK RECOVERY AND RESOLUTION DIRECTIVE

As you know, this legislation is intended to protect our taxpayers and economies by weakening the link between sovereigns and banks. It is an important addition to the action the UK has already taken through our own reforms, including a resolution regime, a domestic bail-in tool and structural reform of the banking sector. Many of the UK’s reforms have informed the final agreement of this legislation.

BAIL-IN

The UK introduced a domestic bail-in power through the Banking Reform Act and we fully support the introduction of an EU-wide bail-in regime. This is a vital tool for the orderly resolution of the globally systemic banks the UK is home to. The bail-in tool in the BRRD strikes a reasonable balance between constraint and discretion. This protects the level playing field whilst giving resolution authorities the flexibility they need to take into account particular liabilities that could pose a grave threat to financial stability. In practice, this means that the BRRD puts an obligation on Member States to bail-in 8% of a bank’s total liabilities, if losses at the bank reach this level, but with flexibility to exclude certain liabilities from the tool. Creditors will have the safeguard that they will not be left in a worse position than they would have been had the bank entered insolvency.

While we supported the agreement on BRRD, we reserved our position in a minute statement at ECOFIN on the lawfulness of the exemption, from the scope of the bail-in tool, of variable remuneration regulated by a collective bargaining agreement.

TREATMENT OF DEPOSITORS

The BRRD enhances the protection granted to depositors across the single market. For example, covered deposits are exempt from bail-in and the introduction of depositor preference means that deposits from natural persons and SMEs, including any such deposits in branches of EU banks in non-EU countries, are protected in the event of bank failure. Furthermore, deposits covered by deposit guarantee schemes are granted a higher level of preference in the insolvency creditor hierarchy as established in Banking Reform Act.
GOVERNMENT FINANCIAL STABILISATION TOOLS

The directive includes government financial stabilisation tools broadly aligned with those in the UK Banking Act. As in the Banking Act, the conditions on their use are stricter than the other resolution tools. Governments will only be able to use taxpayer money to help failing banks in systemic crises and once 8% of the failing bank’s liabilities have been bailed-in. The European Commission will determine the existence of a systemic crisis under existing State Aid rules.

Member States will be able to recapitalise genuinely viable institutions in order to address capital shortfalls established in stress tests or asset quality reviews (whether at national or Union level or under the Single Supervisory Mechanism) subject to State Aid. The Commission will review the need for such support by 1st January 2016.

RESOLUTION FINANCING

The final agreement maintains the flexibility we secured in the Council General Approach and European Parliament texts to count our bank levy as a resolution financing arrangement.

In the final agreement, the resolution financing arrangement can be used to absorb losses equivalent to 5% of a failing bank’s liabilities but only once 8% of the bank’s liabilities have been bailed in and subject to approval by the Commission.

THE ROLE OF THE EUROPEAN BANKING AUTHORITY (EBA)

The final agreement does not provide a binding mediation role for the EBA when resolution actions are taken. Instead, when taking resolution actions, national authorities shall follow the resolution plan unless they assess that the circumstances of the case mean resolution objectives would be better achieved by departing from the resolution plan.

Member States can request binding mediation on resolution plans if they cannot reach agreement on plans for banking groups that have institutions established in another or more Member States.

The EBA’s role in third country relationships is limited to that provided for in the existing EBA regulations.

The UK minute statement also noted that it is essential that the text of the proposed Regulation establishing the Single Resolution Mechanism is fully aligned with the BRRD Directive in order to protect the functioning of the internal market.

DEPOSIT GUARANTEE SCHEMES DIRECTIVE (DGSD)

The DGSD aims to harmonise the laws of the Member States regarding the rules on deposit guarantee schemes to offer robust protection for consumers, as well as contributing towards ensuring financial stability. Negotiations on this directive had been stalled since 2011, but were re-opened by the Lithuanian Presidency. The final agreement was reached on 17 December.

DGS FUNDING

The UK’s key issue in the DGSD was the Council’s and Parliament’s requirements to establish an ex-ante Deposit Guarantee Scheme (DGS) fund to the pay-out to holders of covered deposits in the event of a bank going insolvent. The Council General Approach set the minimum size of the pre-fund at 0.5% of covered deposits, while the Parliament text set it at 1.5% of covered deposits. This would not have been appropriate for the UK’s banking sector dominated by large institutions which, if needed, would be resolved using the tools in BRRD rather than left to go insolvent. The introduction of depositor preference means that the DGS is highly unlikely to be called upon in resolutions of large banks.

In the final agreement, the Government succeeded in preventing the requirement that the UK establish an ex-ante funded DGS. Instead, if a small bank enters insolvency and a payout to covered depositors is required, the UK DGS (the Financial Services Compensation Scheme (FSCS)) will collect the necessary funds from the industry on an ex-post basis – as it does now. If in the view of the supervisory authority, it is not possible to collect ex-post funds immediately, we will be able to lend proceeds of the bank levy to the DGS. The DGS will then recoup the money from the industry to repay the loan.
COVERAGE LEVEL

The coverage level remains at €100,000 and the UK can maintain our current level of protection at £85,000 as long as there isn’t an extreme currency fluctuation on the day the DGSD becomes law. To ensure this is not an issue, we succeeded in increasing the flexibility in the conversion rate to €5,000 from the €2,500 previously agreed in the General Approach.

PAY-OUT PERIOD

The final agreement ensures that in cases of bank insolvency, covered depositors will get their money back within 7 working days (although there will be a phase in period of 10 years). This is an improvement on the General Approach which allowed pay-out to take up to 20 days. The UK has already introduced a 7 day pay-out. The DGSD will now provide a level playing field for both consumers and banks across Europe.

BRAND ISSUE

The coverage level applies per depositor, per authorised institution. Consumers are covered up to £85,000 for every account they hold with a separate authorised institution. If the consumer has a number of accounts with the same institution, or within the same banking group, their deposits will be aggregated and compensation will be paid up to the £85,000 limit. This means that if a consumer has an account with NatWest and with RBS (which are part of the same group), and has £50,000 in each account, only £85,000 across both accounts will be protected.

However, there is an obligation on credit institutions to clearly inform depositors that this is the case. Depositors with funds above the limit are still able to obtain protection by spreading their deposits between institutions which are not part of the same banking group.

NEXT STEPS

The Jurist Linguist process will now take place for both files before a final vote in the European Parliament plenary takes place.

The UK will implement the provisions necessary to comply with the BRRD by 1 January 2015 and the DGSD within 12 months of it coming into force.

HM Treasury, the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority, along with the Financial Services Compensation Scheme on the DGSD, will consult on the transposition of the Directives into UK law in due course.

28 January 2014

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

I am writing to update you on the Bank Recovery and Resolution Directive (BRRD) and the provision of emergency liquidity assistance (ELA) by the Bank of England. I am replying as the Treasury Minister now responsible for financial services issues.

During the Jurist Linguist process of the BRRD negotiations, we sought drafting changes to clarify the articles relating to the write down of capital instruments at the point of non-viability. Specifically, the Government sought to clarify that it would not be necessary to write down or convert into equity the capital instruments of a firm receiving liquidity support from a central bank and the central bank provides this liquidity on the firm basis of an indemnity from its government as long as the firm is fully solvent. This change brought the trigger conditions for the write-down of capital instruments in line with those for bail-in and with the Basel 3 agreement which requires that capital instruments are written down or converted when a non-viable firm accesses public finances.

The conditions for bail-in in the BRRD, and the EU state aid rules, are explicit that it is not necessary to write down or convert into equity the creditors of a firm when that firm accesses liquidity support from a central bank and the central bank provides liquidity on the basis of an indemnity from its government, as long as the firm has no capital shortfall.

The UK amendment was in no way designed to soften the “no bail-out” stance of the Directive. The Government is firmly committed to the BRRD, having been firm proponents of this legislation since the outset; indeed as you are aware much of it is based on existing powers which the UK already has. The Directive offers a strong and effective solution to preventing taxpayer funded bail-outs of the
It is standard practice for central banks around the world to provide liquidity to solvent banks on a fully collateralised basis in times of market stress. From time to time the UK government provides the Bank of England with an indemnity against that lending. This indemnity protects the balance sheet of the Bank of England, not the firm receiving the liquidity support. The Bank of England was given such indemnities in the recent financial crisis because the amount it lent was large relative to its balance sheet. In practice, no losses were incurred on that lending so the indemnity was not called on. This was as expected given the Bank of England only lent to solvent firms and against collateral that would protect against a possible failure to repay the loans.

It is also important to recognise that the use of such indemnities is explicitly permitted in the EU, including in the Eurozone, and several other EU states provide for such indemnities in their legal framework. In addition, the State aid process means that in contrast to other liquidity facilities not backed the state, the European Commission has a role in ensuring that the support is priced adequately and is strictly temporary greatly reducing the possibility of excessive use of liquidity support tools.

Our proposal therefore addressed a purely technical but important issue. It would not have weakened the directive and indeed gained support in technical discussions. However at the political level 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, which would have provided the reassurance some MEPs needed, against the backdrop of an overriding concern that the directive should not be weakened.

While the Government is disappointed that our proposed amendment has not been accepted, we remain fully confident that the Bank’s capacity to respond appropriately where a solvent institution is facing severe liquidity shortages will not be impacted.

11 May 2014

COHESION FUND (15250/11)

Letter from Michael Fallon MP, Minister of State for Business and Enterprise, Department for Business, Innovation and Skills, to the Chairman

I am writing to let you know the final position on the above Regulation, which your Committee had cleared from scrutiny. The final Regulation was voted on at the European Parliament’s plenary session in November 2013 and taken as an A point at the Agriculture Council on 17 December. It was published in the Official Journal on 20 December 2013 as EU1300/2013 and came into force the next day.

The investment priorities proposed by the Commission were amended in the final regulation so that the wording of them was consistent with that in the Regulation 1304/2013 on the use of the European Regional Development Fund for the investment and jobs goal. The final regulation also made clear that support for undertakings in difficulty or investment in airport infrastructure unless linked to environmental protection was outside the scope of the Cohesion Fund. It precluded support for housing unless linked to the promotion of energy efficiency or renewable energy use and avoided double support for schemes that already benefitted from greenhouse gas emission trading allowances. The changes were acceptable to the UK Government.

The final budget agreed for the Cohesion Fund was €66.36bn in 2011 prices. This is consistent with the European Council Conclusions of February 2013 on the multiannual financial framework. As you are aware, the United Kingdom does not receive an allocation from the Cohesion Fund, as its GNI per capita is greater than 90% of the EU-27 average.

The Commission had proposed that €10bn from the Cohesion Fund should be transferred to the Connecting Europe Facility to support transport infrastructure projects. This was endorsed by the European Council Conclusions of February 2013. The rules governing how this 10bn should be spent and managed are set down in the Common Provisions Regulation (EU 1303/2013).

12 May 2014
Letter from Sajid Javid MP Financial Secretary, HM Treasury, to the Chairman

I am writing regarding the above Explanatory Memorandum which was cleared by the Committee in February 2011.

The Regulation entered into force on 1 April 2012 and was transposed into UK law on 15 January 2013 as 'The Payments in Euro (Credit Transfers and Direct Debits) Regulations 2012'. Member States were required to comply with the Regulations by February 2014, however, the rules will apply from 1 February 2016 in the UK as the UK are exercising the maximum permitted derogations from the timetable in line with the Government's policy on European legislation to avoid gold plating.

On 13 January 2014, the European Commission proposed postponing the SEPA end dates by an additional 6 months, from 1 February 2014 until 1 August 2014. This is because a number of euro area Member States were unlikely to meet the February 2014 deadline. The European Commission has done this via an urgent quick fix legislative proposal, published on 13 January, with a one day silence procedure. This means that member states are required to respond to the proposal by noon on 14 January. Member States are required to confirm whether they have no objections to the proposal or whether they have very serious concern or object to dealing with the matter at the earliest possible Coreper as an "I" Item (without discussion).

From a policy perspective, the Government does not see any reason to object to this. As we have taken advantage of the derogation offered and implemented a longer end date of 2016, the postponement does not give rise to any problems for the UK.

However, I have a number of concerns around the timing of introducing this proposal and of the chosen procedure for reaching agreement. On top of this, Member States have only been given one day to respond to the proposal meaning I am unable to give the UK Parliament sufficient time to scrutinise the proposal. I will therefore be abstaining in the silent procedure, both on grounds of scrutiny and on the approach to timetabling, and will be making my dissatisfaction at the handling of this process known.

13 January 2014

CUSTOMS INFRINGEMENTS AND SANCTIONS (17949/13)

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

Thank you for your Explanatory Memorandum 17949/13 dated 13 January 2014, on the Union Legal Framework for Customs Infringements and Sanctions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 28 January 2014.

We note your concerns over the proportionality of the proposal and your intention to tackle this issue during the course of negotiations. We also note your criticism of the existing proposal but would like to understand exactly how you believe the scope of the proposal should be reduced. How could it best be designed to allow for the flexibility desired by a number of Member States whilst also providing the level playing field benefits? We understand that there was a high-level compliance seminar in 2012 where this proposal was discussed amongst Member States. We would be grateful for more details regarding the views of other Member States on this proposal.

We would welcome a response to this letter by 12 February 2014. In the meantime we will continue to hold this document under scrutiny.

28 January 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter dated 28 January.

Your committee sought the following from the Government:

— Our view about how the scope of the proposal should be reduced;
— Our view on how the proposal could be redesigned to allow Member States flexibility while also providing the level-playing-field benefits; and
— More information about the views of other member states.

In answering your first two questions, it is important to consider whether this proposal is necessary. We are sceptical whether there is a compelling case that such a measure is needed to strengthen the functioning of the internal market and, even if there were, that the current proposal would deliver the Commission’s objectives.

At a strategic level we have two reservations.

Firstly, the Commission in its Explanatory Memorandum sets out the differences in the treatment of customs infringements across the EU, but, in our opinion, it has not demonstrated that these differences distort, in practice, the internal market’s operation. Therefore there is a question whether this proposal is required at all.

Secondly, while we understand the reasoning behind harmonising penalties, we believe the proposal as drafted would not deliver a harmonised solution, given the differing legal systems within the 28 Member States.

The UK uses both criminal and civil sanctions for customs infringements. We use the latter to penalise non-compliance with customs law where there is no dishonest conduct and where prosecuting would be disproportionate. We use criminal sanctions for particular offences, for example, where a person breaches our prohibitions and restrictions rules, where a person deliberately provides false documents, and where there is intent. The Commission’s proposal while designed to be silent on the use of criminal sanctions is not. By including rules on the treatment of prohibitions and restrictions it raises questions about the balance between criminal and civil sanctions.

There is a risk that the Commission’s proposal would limit the UK’s ability to apply criminal sanctions at the level we believe is appropriate and proportionate for certain customs offences, by capping the upper level for all customs sanctions. Therefore we would advocate limiting the scope of the proposal by clarifying that it only applies where the Member State chooses to apply civil sanctions.

At a technical level, we would seek two additional key changes.

Firstly, we do not support the Commission’s idea as is set out in Articles 3 to 5 that a particular customs infringement only results from a clear-cut intention and consequent action. We believe that an infringement listed in Article 3 could be more than a strict liability offence, while there is little reason to believe that all offences in Article 4 would arise because the offender was negligent. The Commission’s approach blurs the distinction between the act and the reason behind the act, which we consider key principles in English and Scots law.

Secondly, we would want to amend the proposal so that the sanction is based upon the amount of tax not declared and not, as the Commission proposes, the value of the goods. We believe this would provide a better indication of the offence’s seriousness and thereby ensure that any sanction was proportionate.

These issues were discussed at the 2012 high-level compliance seminar held in Copenhagen. At that seminar and in subsequent discussions the majority of Member States have expressed their opposition to an EU-wide framework. This includes all our like-minded allies and all large Member States.

11 February 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your letter, dated 11 February 2014, on EM 17949/13, on the Union Legal Framework for Customs Infringements and Sanctions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 25 February 2014.

We are grateful to you for this informative response, and for the detail you provide on the specific amendments you are seeking to make. Noting these, and the contentious nature of the proposal amongst a number of Member States, we will continue to hold the document under scrutiny. We would be grateful for further updates as negotiations progress.

25 February 2014
Letter from Nicky Morgan MP to the Chairman

I am writing to alert your Committee to a JHA opt-in issue that the Government has identified within the above directive.

The Government has concluded that even though here is no JHA legal base cited in the proposed Directive, Article 15(2) triggers the Opt-in Protocol. The Article sets out the rules for deciding which Member States can exercise its jurisdiction where two more Member States have an interest. One of the proposed tests would give priority to Member States bringing criminal proceedings where another was proposing to bring civil proceedings.

In our view such a provision engages Article 82 of the TFEU and the Opt-in applies. While we not support the bulk of the proposed Directive, we have decided to opt in to Article 15(2) because in our opinion it is helpful to set out clear rules about which Member State will take action where a customs infringement concerns two or more Member States. This should result in more effective and speedier action against non-compliance and fewer disputes between customs authorities, which, in principle we would support.

Owing to the deadline, we informed the Council Presidency of our decision to opt in on 17 March, I regret that I was not able to update you regarding this development at an earlier date, as unfortunately on this occasion the JHA provision was not identified at a suitably early stage. I have asked officials to ensure that internal processes are put in place to minimise the likelihood of this occurring again.

31 March 2014

Letter from the Chairman to Nicky Morgan MP


We note your assertion that the UK opt-in applies to this proposal even though it does not have a legal basis falling within Title V of Part Three of the TFEU. As with other matters where this question has arisen, we reiterate that we do not consider that the UK opt-in is engaged in the absence of such an express legal basis, and we therefore consider the UK automatically takes part in the adoption and application of the entirety of this proposal. We accept however in this case that the difference does not have any practical effect given that the UK opt-in has been, or will be, exercised.

We would be grateful for updates as negotiations progress. In the meantime we will continue to hold the document under scrutiny.

8 April 2014

Letter from Nicky Morgan MP to the Chairman

Following my letter dated 31 March, I am writing to set out the Government’s assessment of progress on the proposed Customs Infringements and Sanctions Directive.

Negotiations have progressed very slowly in the face of the UK and other Member States raising a significant number of policy concerns. These cover all aspects of the proposal, but the key ones are the linking of infringements to certain behaviours (i.e. “strict liability”, “negligence” and “intentional”) and the imposition of both minima and maxima sanctions, given the predicted impact on Member States’ legal systems and the restriction of their ability to impose custodial sentences.

To aid this debate, in conjunction with my counterparts from both the German and Dutch administrations, on 10 April the UK submitted a letter to the Greek Presidency setting out in detail our concerns with the Commission proposal. A copy of this letter is enclosed [not printed] for your information.

I am pleased to be able to note that the strength of opposition has persuaded the Greek Presidency to suspend the article-by-article discussion of this proposal temporarily while it considers its next steps. The Government, along with our Dutch and German colleagues, have argued that the proposal should be withdrawn, though we understand that the Commission will seek further discussion on the proposal, the basis and timing of which is currently unclear.

When we hear more I will of course update your committee.
EUROPEAN COURT OF AUDITORS ANNUAL REPORT ON THE IMPLEMENTATION OF THE BUDGET IN 2012 (UNNUMBERED)

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


We regret that the ECA has been unable to provide a favourable Statement of Assurance for the nineteenth consecutive year. We agree with you that this undermines the credibility of EU spending. Of particular concern is the increase in the error rate from 3.9% to 4.8%. How would you account for such a sharp increase? Can you explain to us the basis on which the ECA is unable to provide a favourable Statement of Assurance, but nevertheless is able to give an unqualified Statement of Assurance on the reliability of the accounts? Do you agree that a large amount of responsibility for addressing these issues lies with Member States, including the UK? What powers does the Commission have at its disposal to address problems in Member States? Are they sufficient, and are they being used? Would you support the Commission being provided with strengthened powers, for instance powers of sanction or a means to recommend the withdrawal of funding?

The ECA has called for a rethink of EU spending rules and recommends simplifying the legislative framework. In particular, it notes that the 2014–2020 programming period looks likely to remain expenditure oriented – designed for getting the EU budget allocated and spent - rather than focusing on the value it is intended to bring. We agree with this conclusion. What practical steps can be taken to meet these concerns?

Whilst your EM states that the report contains the Commission’s responses to the ECA’s observations, we regret that it fails to provide any further information. We would therefore be grateful for a summary of the Commission’s response to the ECA’s key conclusions and recommendations, and the Government’s analysis of the Commission’s position.

The report identified a large number of problems and issues pertaining to the UK, including:

— Reservations on European Fisheries Fund management and control systems;
— Weaknesses in management and control systems for the European Social Fund;
— A Commission error in calculating the UK abatement;
— A GNP reservation for 1995-2001 still in place in relation to the UK (the only other country so affected is Greece). Overall, the UK has 11 GNI reservations outstanding, the most of any Member State;
— Eight VAT reservations outstanding;
— In Chapter 3 (in relation to which we acknowledge the UK was subject to an additional audit), weaknesses were detected concerning the correct assessment of the eligibility of permanent pasture, and the ECA cited specific examples of examples of incorrect data in the Land Parcel Identification System and the Geographical Information System. The Court also observed several cases where the aid amount was calculated on the basis of areas larger than those actually determined by on-the-spot checks carried out by national inspectors. Control systems in on-the-spot measurements revealed that the Court’s measurements differed by more than applicable tolerance margins from the results reported by paying agency inspectors in the United Kingdom (Northern Ireland) for 6 out of 42 and in the United Kingdom (England) for 8 out of 21 measurements. In the United Kingdom (England and Northern Ireland) Single Payment Scheme aid is granted for grazeable woodlands. However, when the Court re-performed on-the-spot inspections in the United Kingdom (England) several such parcels were found to contain no grass and therefore did not meet the definition of grazeable...
woodlands. National inspectors had reported the areas to be fully eligible for EU aid. In the United Kingdom (Northern Ireland) the Court observed that reconciliation of the amounts recorded in the debtor’s ledger to the underlying individual records was not always possible and accrued interests were not recorded in the table of undue payments. Overall, of the three IACS supervisory and control systems examined the two that were assessed as not effective were the United Kingdom (England and Northern Ireland):

- Cases of non-compliance with agri-environment requirements were detected in the UK;
- Non-respect of eligibility requirements for investment projects was found in the UK;
- In relation to the European Agricultural Guarantee Fund, for 12 out of 47 measurements re-performed by the Court in the United Kingdom (Northern Ireland), the measurement results differed by more than the applicable tolerance margin from the results reported by the certification body;
- In a European Regional Development Fund (ERDF) project in the United Kingdom for the expansion of a university and for the supply of a bio demonstrator facility, the contract was divided into two lots. During the evaluation stage, however, both lots were jointly evaluated, altering the outcome of the tender. As a result, the contract was awarded in an irregular manner;
- In an ERDF project in the United Kingdom for a fund providing grants and loans to social enterprises with limited financial capability, salaries and other expenses were wrongly included in the cost claim as staff costs, instead of a management fee being claimed (calculated as a percentage of the direct costs) as provided for in the EU regulations. This resulted in an overcharging of expenditure in the cost claim;
- The English Audit Authority in the UK is rated as partially effective in complying with key regulatory requirements and in ensuring the regularity of transactions.

Your EM also states that “the UK has already taken steps to address many of the issues raised in the report”, and that “the Government remains committed to improving national systems”. As the above list illustrates, a large number of issues pertaining to the UK have been identified by the ECA. We would be grateful for further details on the steps already taken in relation to each of these problems, and your future efforts to tackle these problems. What evidence can you give us that the UK’s national systems and processes are improving? What specific examples can you give of improvements over the past 12 months? Given the financial expertise available, should the UK not be setting a good example in the standard of its national systems? Why is this not the case?

We will hold the document under scrutiny pending a response to these questions. We would be grateful for a response by 27 January 2014.

17 December 2013

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter of 17 December 2013 regarding the European Court of Auditors’ (“ECA”) report on the implementation of the EU budget in 2012. Your letter covers a number of questions which I have responded to below.

INCREASED ERROR RATE

As you know, the Government shares your concern that the ECA’s error rate has once again increased, and by such a significant margin. You asked how we account for such a sharp increase in the error rate. While the Government notes that the ECA’s change in methodology accounts for a portion of the increase (0.3 percentage points), we believe that the key reason for the increase is insufficient improvements in the financial management of EU funds.
ECA’S STATEMENT OF ASSURANCE

Your letter asks for an explanation of the difference between the ECA’s overall qualified Statement of Assurance and their unqualified Statement of Assurance on the reliability of the accounts. As part of their annual audit process, the ECA assessed the reliability of the EU accounts and, for the sixth consecutive year, concluded that they fairly represent the financial position of the EU for that year. This means that the EU accounts had been reliably prepared and clearly set out the amounts of funding reimbursed to Member States. For this reason, the ECA gave an unqualified Statement of Assurance on the reliability of the accounts. However, the ECA separately assessed the payments made in 2012 against the legislative requirements governing the use of budget funds. The errors identified in this area resulted in an overall error rate that falls above the ECA’s 2% threshold which resulted in an unfavourable statement regarding the overall implementation of EU budget funds.

RESPONSIBILITY OF MEMBER STATES

You asked whether responsibility for addressing these issues lies chiefly with Member States. The Government has been clear that Member States have a role to play in effectively managing the EU funds they receive. The UK takes this role very seriously and, where appropriate, we have taken steps to develop and improve our related processes. However, overall responsibility for the management of EU budget funds lies with the Commission which needs to both review its own systems and processes, and work with the ECA and Member States to better understand and address the reasons for the year on year rise in the error rate.

COMMISSION POWERS TO ADDRESS MEMBER STATE ERROR

Your letter also asked whether the Commission has sufficient powers to address problems in Member States and whether those powers are being used. The Commission has a number of powers to address issues of poor financial management in Member States, most notably the power to require a Member State to return any funds the Commission finds they have incorrectly received or used (financial corrections). The Commission recently published a Communication (COM(2013) 934 final) setting out improvements to the process for financial corrections in the 2014-2020 programme period. One improvement includes the removal of the Commission’s discretion to decide whether Member States should be required to return incorrectly received Cohesion Policy Funds as this will now be the standard process for all cases of serious deficiencies. This example shows that increasing the Commission’s powers is not always the most suitable solution to addressing Member State error.

The Government therefore supports adopting a more strategic and systematic approach to addressing Member State error, including structured engagement with Member States to better understand and resolve the origins of their difficulties, particularly where these difficulties have been shown to be systemic. This approach should also involve the simplification of complex processes and improved guidance to ensure that Member States have a consistent understanding and approach to the management of EU funds in their country.

FOCUS ON SIMPLIFICATION AND PERFORMANCE WITHIN THE 2014-2020 PROGRAMME PERIOD

You asked what steps can be taken to ensure that the 2014-2020 programme reflects the ECA’s recommendation for a focus on value. The Government notes the Commission’s responsibility in this area and the Commission’s indication in the ECA report that it will take steps to ensure that performance (i.e. the effect of EU funds, or value for money) is considered and assessed as part of financial management audits within the next MFF. The Government looks forward to the Commission’s efforts to implement this refocus throughout the 2014-2020 programme period and will work with like-minded Member States to ensure that the Commission meets this commitment.

COMMISSION’S RESPONSE TO THE ECA’S KEY CONCLUSIONS AND RECOMMENDATIONS

Your letter asked for a summary of the Commission’s response to the report’s main recommendations and conclusions which focus on four broad themes: an increased focus on performance, i.e. whether EU funds are being deployed effectively; the simplification of complex EU and national legislation governing the use of EU funds; strengthening Member States’ systems and controls; and improvements to the Commission’s processes concerning the management of EU funds.
INCREASED FOCUS ON PERFORMANCE

The Commission broadly supports the ECA’s call for a focus on performance and value for money stating that “evaluations should produce information on results and impacts”. In the ECA’s report, the Commission confirms that it will take greater account of performance in Annual Activity Reports and is developing a framework for stronger and more coherent monitoring, evaluation and reporting on the performance of EU financial programmes for the next MFF. As set out above, the Government will work with like-minded Member States to ensure that the Commission makes useful changes to achieve this commitment.

SIMPLIFICATION OF LEGISLATION AND RULES GOVERNING THE USE OF EU FUNDS

In addition to the broader call for the simplification of complex EU legislation and the reduction in ‘gold-plating’ (national bodies exceeding the terms of EU legislation when implementing them into national law), the ECA indicates that the regulatory framework for the 2014-2020 programme period should include the simplification of eligibility rules. The Commission broadly supports this aim and sets out that it is already taking steps to address this as far as it is able. Further, the Commission considers that it is not possible to review the eligibility rules for all Member States and has therefore adopted a case-by-case approach to assessing/reviewing national eligibility rules as specific concerns are revealed in individual Member States.

The Government fully supports the ECA’s recommendation. While we recognise that some steps have been taken in this area, they are not sufficient and the Commission needs to work with Member States to identify areas requiring clearer legislation. For example, the recent CAP reform has not delivered genuine simplification and Member States will need to work with the Commission to ensure that any further reforms fully take into account the difficulties faced by Member States in complying with the existing, complex legislation.

IMPROVEMENTS IN MEMBER STATES’ SYSTEMS AND CONTROLS

The ECA has recommended improvements to the way in which Member States operate their systems and controls. For example, through improving their assessment of land eligibility and the quality of first level checks more broadly. The Commission concurs with the ECA’s findings and is of the view that responsibility for these improvements lies with Member States who have access to guidance and training in relation to the management and use of EU funds. The Commission also notes that where Member State errors are identified, it seeks to follow up through clearance procedures, issuing further guidance where appropriate and requiring Member States to take remedial action to address the issue.

The Government remains of the view that both Member States and the Commission have a role to play in this area, and that the Commission should do more to resolve many of the systemic issues relating to systems and controls. For example, although guidance is available in relation to expenditure under Chapter 3 (Agriculture: market and direct support), as evidenced by previous ECA reports, this area of expenditure is consistently affected by error. The Government therefore considers that more work needs to be done to understand these systemic difficulties or errors and resolve them, including through ensuring that guidance better reflects and considers the challenges faced by Member States.

IMPROVEMENTS TO THE COMMISSION’S PROCESSES

Throughout the report, the ECA recommends areas for the Commission to improve its management of EU funds. Examples of these recommendations include improvements to the Commission’s verification of GNI data and the timely clearance of expenditure. In most cases, the Commission notes the ECA’s findings and indicates that it will take them into account as part of reviews of or changes to these processes.

The Government welcomes the ECA’s findings and notes that, although the Commission’s initial response is broadly encouraging, it will be important for the ECA to examine whether these recommendations have been acted upon in next year’s report.

UK REFERENCES IN THE ECA REPORT

Your letter asked for further information on a number of UK specific issues mentioned in the report which I have set out below. Where appropriate, further detail has been included in the attached annex [not printed].
RESERVATIONS ON EUROPEAN FISHERIES FUNDS ("EFF") MANAGEMENT AND CONTROL SYSTEMS

The reservation on the UK European Fisheries Fund related to the confidence levels in relation to the effectiveness of the EFF Management and Control System. In light of these findings, substantial additional audit testing was undertaken, concluding in June 2013. In July 2013, the Commission’s Directorate-General for Maritime Affairs acknowledged the satisfactory resolution of all the issues associated with the reservation and removed the 2012 reservation on the UK EFF programme.

WEAKNESS IN MANAGEMENT AND CONTROL SYSTEMS FOR THE EUROPEAN SOCIAL FUND ("ESF")

The weaknesses identified were due to minor issues relating to audit processes and specifically related to the UK’s ability to retrieve data rather than a failure in procedure. In this case, the England ESF managing authority ("MA") concerned was able to provide sufficient evidence confirming that the required award notification had been given, but was unable to provide evidence that his had been done within the necessary deadline.

The MA continues to work closely with the Commission where shortcomings in first level checks have led to high error rates and has developed detailed Action Plans to improve management and control procedures. This has resulted in a significant fall in the levels of error during 2013.

COMMISSION ERROR IN CALCULATING THE UK ABATEMENT

The UK was granted a correction resulting in a reduction in our GNI-based own resources contribution. The Government welcomes this correction by the Commission and will continue to support their efforts to accurately calculate this contribution from Member States. The ECA raises the possible risk that the Commission may miscalculate the correction due to the complexity of the calculation. However, I am encouraged by the report concluding that the examined supervisory and control systems are effective in relation to the calculation of the UK correction.

GNP RESERVATION FOR 1995-2001 AND ELEVEN OUTSTANDING GNI RESERVATIONS

The GNP reservation is the subject of ongoing engagement between the UK and the Commission. The UK is also actively engaging with Eurostat and the Commission to address the outstanding GNI reservations. As a result of this work, two reservations were lifted in July 2013 and the Commission is considering whether the UK has satisfactorily addressed further reservations.

EIGHT OUTSTANDING VAT RESERVATIONS

The Commission visited HMRC in October 2012 and examined the UK’s VAT bases for the three years 2009-2011. Following this control visit, the number of outstanding reservations fell to six. By January 2014 this figure had further reduced to four. For the two new reservations covering the years 2009-2011, projects have been scheduled to review the associated methodologies and the results will be submitted to Commission controllers. It is anticipated that the reservations will be lifted during 2014 and 2015.

The first of the two ongoing reservations also covers the years 2009-2011 and relates to the calculation of deductions in respect of cars purchased by a taxable person for use in the course of their business. Due to the complex nature of the underlying calculation, the methodology has been extensively queried leading to experts convening in November 2013 to review the calculation. The results will be submitted to Commission Controllers for consideration and, assuming they are satisfactory, the reservation is expected to be lifted during 2014/2015. The second ongoing reservation covers the years 2005-2011 and concerns VAT exemptions in relation to specific aircraft. A project to review the eligibility requirements under UK and EU legislation has been scheduled.

VARIOUS WEAKNESSES IN RELATION TO THE UK’S (ENGLAND AND NORTHERN IRELAND) MANAGEMENT OF FUNDS WITHIN CHAPTER 3

Assessment of the eligibility of permanent pasture, grazable woodland, and weaknesses in Land Parcel Identification System ("LPIS") and Geographical Information System ("GIS") data

The ECA identified weaknesses in the assessment of the eligibility of permanent pasture by four Member States, including the UK. The report notes that these issues are systemic and have been considered by the ECA in previous reports in relation to other Member States. The UK has nevertheless recognised the importance of reacting to the ECA’s findings and sought to improve our associated processes. Further detail is set out in the annex attached [not printed] to this letter.
Issues with on the spot checks

The NI authorities have accepted that there were some inconsistencies in their identification of maximum eligible areas ("MEA"). Since this was brought to their attention, they have reassessed all relevant cases highlighted by the ECA and are satisfied that in all cases the farm businesses concerned were correctly paid against the correct MEA. Further, the recent LPIS refresh detailed in the annex [not printed] to this letter has resolved this potential issue.

Inconsistent/irreconcilable records

The ECA’s assessment of this control as “partially effective” appears inconsistent with the report’s confirmation that the assessed procedures for accounting for recoveries are satisfactory. Nevertheless, England’s Rural Payments Agency (“RPA”) has introduced improvements to its debt management and these are the subject of ongoing discussions with the Commission. As set out above, for any real errors the risk to EU funds was low and the relevant UK agencies have taken corrective action to improve controls. However, in some cases the UK does not accept the ECA’s interpretation of the regulations or their conclusions regarding the quality of the work of the paying agencies and the UK continues to engage with the Commission on these issues.

Examples of non-compliance with agri-environmental requirements

A select number of Member States, including the UK, were subject to additional audits under Chapter 3 of the ECA’s report. These audits identified examples of non-compliance with agri-environmental requirements. The Commission has acknowledged that, while weaknesses remain in the implementation of agri-environmental measures in all Member States, the overall quality of the implementation has improved during the 2007-2013 assessment period. This shows that Member States, including the UK, continue to improve compliance with the often complex implementation requirements. The UK will continue to work with like-minded Member States to press for simplified administrative systems and processes to tackle such systemic errors.

Non-respect of eligibility requirements for investment projects

The UK (England) is cited as one of ten Member States where examples of non-compliance with investment projects were identified. The UK authorities concerned accept that the necessary procurement requirements were not wholly adhered to in these identified cases and conducted a retrospective exercise to assess whether the cost of the equipment funded was reasonable and to ensure that lessons could be learned from this oversight.

Differing European Agriculture Guarantee Fund ("EAGF") measurements

The UK (NI) is referred to in relation to the measurement of land parcels under the EAGF. The report states that 12 out of the 47 parcels assessed by the ECA were outside tolerance but, following submissions from NI, this number has been reduced to six.

In relation to the six remaining parcels, the NI authorities maintain that the variation in the measurements re-performed by the Court are a result of ‘real world’ or natural changes introduced after the control check had taken place. As set out in point (b), the NI authorities question the fact that the inspections took place some time after the control check and did not take into account these real world changes.

Issues with the implementation of the European Regional Development Fund ("ERDF")

As part of the Government’s drive to share professional services across Whitehall, the Department for Business, Innovation and Skills is working with the Department for Work and Pensions to explore the possibility of a single audit authority function for the 2014-2020 ERDF and ESF programmes. Among other things, this proposal aims to facilitate the sharing of good practice and the improvement of audit processes, as well as ensure consistency in audit procedures and practice, including the application of EC and national rules. A final decision on the proposed single ERDF-ESF Audit Authority for the 2014-2020 programmes is expected to be made in early 2014. This is one example of work within the UK to improve efficiency and increase consistency with the aim of improving our management of EU funds.
The UK’s ESF England Audit Authority rated as “partially effective”

The UK (England) was one of two Member States to have their Audit Authorities (“AA”) responsible for the management of Structural Fund expenditure assessed for the 2007-2013 programme period. The ECA concluded that the UK England ESF AA was “partially effective”. As a result of the ECA’s observations regarding the UK’s processes for auditing procurement and State Aid, the UK has revised its checklists and included these in an update to our audit manual. Further, the UK ESF AA responded to the ECA’s findings by making the required changes to the audit process and completed an agreed review of one of the audits included in the ECA’s re-performance audit. The results of this review have been included in the AA’s 2013 Annual Control Report sent to the Commission on 23 December 2013.

It is notable that the ECA did not identify any deficiencies regarding compliance with Commission guidelines on the production of Annual Control Reports and the annual opinion and, crucially, the error did not result in funds being misused. In their response, the Commission stated that they were satisfied with the AA. This is supported by the Commission’s last audit of the AA where they awarded the AA their highest “category 1” assessment.

The UK setting an example of compliance

I should like to again reiterate how seriously the UK takes financial management of EU funds. I hope that the information provided in this letter serves to reassure the Committee that the UK continues to react swiftly, taking relevant action to resolve identified weaknesses in our national systems and processes.

I agree that the UK should continue to seek to set a good example of financial management both for our citizens and other Member States. The Government takes fraud against the EU budget extremely seriously and tackles this issue through robust management controls and payment systems that seek to prevent incidences of fraud occurring, and taking genuine steps to address identified weaknesses in our systems and processes. However, at an EU level, it’s important that the UK continues to work with likeminded Member States to push the Commission towards greater simplification of complex EU level rules and processes that hinder Member States in the effective handling of EU funds.

30 January 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your two letters, both dated 30 January 2014, on the unnumbered EM on the European Court of Auditors Annual Report on the Implementation of the EU Budget in 2012. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 11 February 2014.

We are grateful to you for your detailed response to our queries. While you acknowledge that Member States have a role to play, we are concerned by the implication of your statement that overall responsibility for the management of EU budget funds lies with the Commission. We agree with you that the Commission needs to review its systems and processes. We also agree that there needs to be a system of structured engagement with Member States to tackle systemic issues. Nevertheless, we reiterate that a large amount of responsibility for addressing such problems lies with Member States. In particular, Member States must take a proactive stance to tackling these issues rather than waiting to respond to problems once identified by the Commission. How would you respond? What specific steps can Member States take to bring about the necessary improvements in the financial management of EU funds? While we agree with you that the UK and like-minded Member States must push the Commission towards greater simplification of EU rules and processes, such arguments will carry more authority if the UK and other Member States have first taken the necessary steps to put their own houses in order.

We note your thorough response to our request for more information on issues identified in the report pertaining to the UK. We welcome the steps already taken to address the problems identified, and call on you to continue to increase efficiency and consistency in the management of UK funds. We note in particular the work being undertaken by the Department for Business, Innovation and Skills and the Department for Work and Pensions to explore the possibility of a single authority function for the 2014-2020 European Regional Development Fund and European Social Fund programmes. You state that a final decision is expected in early 2014. We would be grateful for an update on these discussions once a decision is made.
Having said this, we were struck by the unrevealing nature of your response regarding the GNP reservation for 1995-2001 still in place, and the 11 GNI reservations outstanding overall (the most of any Member State). You state that the GNP reservation is the subject of ongoing engagement between the UK and the Commission, and that you are actively engaging with Eurostat and the Commission to address the outstanding GNI reservations. What is the nature of the problem? What has caused such a high number of reservations, including one from so long ago? How confident are you that the Commission will judge that the UK has sufficiently addressed these issues?

We would be grateful for a response to this letter by 11 March 2014. In the meantime we are content to clear the document from scrutiny.

11 February 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter of 11 February 2014 regarding the European Court of Auditors’ (ECA) Annual Report on the Implementation of the EU Budget in 2012. I thank the committee for clearing this document from scrutiny and note your additional questions.

RESPONSIBILITY FOR EU BUDGET IMPLEMENTATION

Your letter asked for clarification of the Government’s view that implementation of the EU Budget is largely the responsibility of the Commission. As I set out in my letter of 30 January 2014, the Government believes that Member States have a clear responsibility to effectively manage the EU funds that they receive. I agree with the committee that this responsibility should involve a degree of proactive monitoring, by Member States, on the use of funds in order to ensure compliance with existing obligations.

However, as recognised by the ECA in its recommendations, the Commission needs to better identify and resolve the reasons behind the steadily rising error rate. While the Commission’s responsibilities in this area do not absolve Member States of their obligations, it is important to recognise the Commission’s overarching role in facilitating Member States’ compliance. This has become increasingly clear within the context of simplification as many of the existing rules governing the management of EU funds are complex and have resulted in differing interpretations of the requirements. While these differing interpretations do not always lead to funds being spent inappropriately, they do contribute to the error rate.

The Government therefore considers it essential that the Commission ensures that the rules governing financial management of EU funds are understandable and that associated guidance facilitates a universal interpretation and application of Member States’ obligations in this area. It is for this reason that the UK continues to work with like-minded Member States to proactively urge the Commission to act on the ECA’s call for further simplification.

POSSIBLE SINGLE AUDIT AUTHORITY FUNCTION FOR 2014-2020

Your letter referred to the steps taken to address the UK specific concerns in the ECA’s report and requested an update on a possible single audit authority function for 2014-2020 European Regional Development Fund and European Social Fund programmes. May I first apologise for the typo in my earlier letter incorrectly attributing this work to BIS and DWP rather than DCLG and DWP. This initiative is an encouraging example of a Member State proactively seeking to simplify and better coordinate a national process to improve financial management. As there have been no developments since my letter of 30 January 2014, I am unable to provide an update at this time but can confirm that a decision is expected this year.

GNP AND GNI RESERVATIONS

With regards to the GNP reservation, following extensive cooperation and engagement between the UK and Eurostat, I am pleased to confirm that this reservation relating to insurance was lifted in November 2013. The time taken to lift it was primarily due to the complexity of the subject and the extent to which the Office for National Statistics (ONS) had to develop new methodologies and make system changes across a number of areas in the National Accounts.

With regards to the outstanding GNI reservations, these have been introduced over several years. However, 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.

Significant progress has been made over the last few years on lifting such reservations. In Blue Book 2012, three country-specific reservations were addressed and lifted, including the GNP reservation for insurance. In Blue Book 2013, the UK aimed to address a further three country-specific reservations and one transversal reservation. Note that transversal reservations are those applied to all EU Member States, highlighting inconsistencies in treatment between Member States or detailing areas in which all Member States need to make improvements. In Blue Book 2014, ONS plans to address a further four country specific reservations and two transversal reservations.

Most recently, Eurostat undertook a direct verification visit in February. Going forward, ONS have agreed to send methods papers and published articles to Eurostat in advance of the Questionnaire and Quality Report, submitted annually in September. This will facilitate dialogue in advance of Eurostat assessments to ensure high level proposals are meeting the broad scope of the reservation.

1 March 2014

EUROPEAN GLOBALISATION ADJUSTMENT FUND (14562/13)

Letter from the Chairman to Esther McVey MP, Minister for Employment, Department for Work and Pensions

Thank you for your Explanatory Memorandum 14562/13, dated 13 December 2013, on a report on the activities of the European Globalisation Adjustment Fund in 2012. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 January 2014.

We are also grateful for your update on negotiations in relation to extension of the EGF in the 2014-2020 Multiannual Financial Framework Period (EM 15440/11). As we have stated on a number of occasions, we oppose this extension since we are not convinced that the EGF is the most effective means by which to provide support for large-scale redundancies. We note that your predecessor’s most recent update indicated that during negotiations he highlighted the lack of any evaluation of spending as an unjustifiable gap in responsible spending. We agree that the yearly reporting process is inadequate in evaluating the value for money of this spending. For example, whilst details are provided of the number of assisted workers who find work, there is no attempt to assess what would have happened under the counterfactual. This could be done by evaluating the outcomes for a comparator group who are not provided assistance. This report could also provide concrete examples of what this money is spent on and what outcomes are achieved. We would be grateful if you could elaborate on what work is being done to improve this reporting process so that the value for money of this spending is more fully assessed.

We would be grateful for a response to this query by 14 February 2014. In the meantime we are content to clear EM 14562/13 from scrutiny.

14 January 2014

Letter from Esther McVey MP to the Chairman

Thank you for your letter dated 14 January 2014 asking what work is being done to improve the reporting process so that the value of this spending is more fully assessed.

Officials have checked with the the EMPL Committee, the European Parliament’s committee responsible for employment policies and all aspects of social policy, working conditions, vocational training and the free movement of workers and pensioners, and also the Commission as to their plans, and there are currently no further plans for improving the analysis process.

We will continue not to support the EGF and will continue to push against it to ensure effectiveness and efficiency. We will ensure that the agreed transparency measures in compiling the activity reports are adhered to and followed, and we will challenge any discrepancies.

10 February 2014
EUROPEAN LONG TERM INVESTMENT FUNDS (12044/13)

Letter from the Chairman to Sajid Javid MP, Financial Secretary, HM Treasury
Thank you for your letter, dated 30 November 2013, on EM 12044/13 on European long term investment funds. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 10 December 2013.

We would like to reiterate our concerns relating to the inclusion of fund of funds structures in this framework. We are convinced that if they are to be included, this would require additional measures to protect retail investors, such as a limit on management fees. We would welcome regular updates in relation to this proposal, particularly as your engagement with industry representatives progresses and once you are clearer on the details of the tax treatment of ELTIFs. In the meantime we will continue to hold this document under scrutiny.

10 December 2013

EUROPEAN SEMESTER: PREVENTION AND CORRECTION OF MACROECONOMIC IMBALANCES (7413/14)

Letter from the Chairman to Nicky Morgan MP, Financial Secretary, HM Treasury
Thank you for EM 7413/14 on the Communication from the Commission on the results of in-depth reviews on the prevention and correction of macroeconomic imbalances, and the unnumbered EM on Macroeconomic imbalances: United Kingdom 2014. These were both received on 31 March 2014. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 13 May 2014.

The Commission notes that macroeconomic imbalances which have been built up over many years are gradually receding, and that the economic recovery is gaining ground. Nevertheless, the Commission is right to acknowledge that the recovery is still fragile and uneven, and that some new concerns have arisen. We welcome the Commission’s acknowledgement of the significant challenges that remain, including very low inflation, slow growth, the need to improve access to credit and the “major policy and social challenge” that the very high level of unemployment represents. The Commission is also right to acknowledge the spillover effect of macroeconomic imbalances throughout the euro area.

These findings chime with our own conclusions, as set out in our Euro area crisis: an update report, published on 4 April 2014. That report concluded that there were welcome signs that the euro area crisis had eased, but that it would be unwise to conclude that the storm had entirely passed. We cited fundamental weaknesses which made the euro area vulnerable to future shocks, including: immense economic imbalances between core and periphery countries; destructively high levels of unemployment and youth unemployment; incomplete structural reforms in a number of Member States; anaemic growth; growing fears of a deflationary spiral; and continued political tensions at the effect of ‘austerity’ on the lives of EU citizens. In light of this, we concluded that EU leaders needed to promote growth-friendly policies, and press on with structural reform and the completion of the Single Market. We also stressed that creditor Member States, notably Germany, had their own obligations to stimulate growth and demand.

Do you believe that the Commission and other EU institutions have done enough to acknowledge and respond to these weaknesses? What specific steps would you wish to see taken to put the eurozone (and the EU as a whole) on a path to sustainable growth? In particular, how concerned are you at the growing deflationary threat? What steps should be taken, in particular by the ECB, to counteract the worrying fall in inflation rates?

Turning to the UK assessment, we acknowledge that the Commission continues to cite three macroeconomic imbalances: household debt; the housing market; and external competitiveness. Do you agree with the Commission’s assessment that macroeconomic imbalances continue to exist in each of these areas? How would you respond to the Commission’s recommendations for action in each of these?

You again stress that the UK is not subject to sanctions under the Macroeconomic Imbalances Procedure or at any point in the European Semester. In light of this, what is the practical effect of the UK’s participation in the Semester process? To what extent does it impact upon the Government’s policy-making decisions? What benefits, if any, of the process for the UK would you cite? Are there
any drawbacks? How would you summarise the differences in the way that the Semester is regarded and responded to amongst euro area and non-euro area Member States (including the distinction between Member States with or without an obligation to join the single currency in the future)? Do you agree that the Semester is more effective at identifying symptoms of macroeconomic imbalances rather than underlying structural weaknesses? How would you wish the Semester process to evolve in the future? How do other Member States wish to see the Semester process reformed? Could other parameters be used to judge the economic health of individual Member States?

We would be grateful for a response to these questions by 2 June 2014. In the meantime we are content to clear the documents from scrutiny.

13 May 2014

EUROPEAN SOCIAL FUND AND EUROPEAN REGIONAL DEVELOPMENT FUND
(15253/11, 15249/11)

Letter from Michael Fallon MP, Minister of State for Business and Enterprise, Department for Business, Innovation and Skills, to the Chairman

I am writing to let you know the final position on the above Regulation, which your Committee had cleared from scrutiny. The final Regulation was voted on at the European Parliament’s plenary session in November 2013 and taken as an A point at the Agriculture Council on 17 December. It was published in the Official Journal on 20 December 2013 as EU1301/2013 and came into force the next day. The final agreement was set out in my letter of 13 August 2013.

12 May 2014

EUROPEAN SOLIDARITY FUND (12883/13)

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

Thank you for your letter of 10 September 2013 on the EU Solidarity Fund (EUSF) Regulation, following the Explanatory Memorandum of 26 August 2013. Council Working Group discussions were launched in January and I am now in a position to respond to the questions in your letter.

You asked for an update on the timetable for negotiation of the regulation governing the EU SF. The Presidency has conducted negotiations to a very compressed timetable with a number of Council Working Group meetings since 10 January. A Presidency text was discussed at COREPER on 12 February and is now in trilogue. Given the pace at which discussions are progressing, the timetable for negotiations going forward is not clear but I understand that the Presidency is aiming to secure an agreed text in time for the March or April plenary.

BUDGETARY RESTRAINT

In HM Treasury’s explanatory memorandum of 26 August 2013, the previous Financial Secretary set out that the Government had two key objectives in the negotiations. The first objective was to ensure that budgetary restraint was considered. Your letter acknowledged the Government’s aim to ensure that Budget size is respected and queried whether we thought budgetary control would not be exercised, particularly in relation to the proposal for the use of recoveries to fund advance payments.

In discussions thus far we have worked with like-minded Member States to eliminate language that could result in budget size not being respected. This has included discussions of the proposed mechanism for advance payments funded by recoveries. We will continue to carefully assess all proposals and intervene as appropriate to ensure that budgetary control is exercised.

INDIRECT EXPANSION OF THE FUND’S SCOPE

The Government’s second objective has been to protect the existing scope of the Fund. We have achieved this by resisting proposed expansions and, pressing for the insertion of clear eligibility requirements and the removal of ambiguous language that exposes the Fund to interpretation and confusion. This has included consideration of the proposed definition of “slowly unfolding disasters”.

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Finally, your letter asked whether the Government had cause to believe that the principle of subsidiarity would not be respected. The Government maintains that the EU SF is an emergency Fund designed to supplement rather than replace national efforts following a major natural disaster. As set out above, we have strongly opposed proposals to expand the scope of the Fund and continue to work with like-minded Member States to ensure that eligibility thresholds remain sufficiently robust and that the original purpose of the EU Solidarity Fund is maintained.

In light of the compressed EU timetable, I hope that by writing to you now I am able to give the committee as much time as possible to consider my response.

GOVERNMENT RESPONSE TO FLOODING

Finally, your Committee Clerk separately enquired about options for EU SF assistance for the recent UK flooding.

The Government is doing everything it can to support those affected by flooding and has announced a package of measures to support affected homes and businesses. Further detail of the package of measures can be found on the Treasury website:


The Government notes that there are a number of eligibility requirements for a Member State applying for EU SF assistance, as set out in Council Regulation (EC) No 2012/2002. This includes an eligibility threshold of total direct damage greater than €3 billion in 2002 prices or 0.6% of our GNI, apart from in exceptional circumstances relating to intense regional damage. As part of the wider response, these eligibility requirements are being considered.

As such, the Government continues to consider all funding options, including EU SF, to ensure that we pursue the best course of action for UK taxpayers.

27 February 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your letter, dated 27 February 2014, on EM 12883/13, the proposal for a regulation amending the regulation establishing the European Solidarity Fund. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 March 2014.

You state that a Presidency text was discussed at COREPER on 12 February. Given that we continue to hold the document under scrutiny, what clarification can you give of the nature of these discussions in terms of the implications for the scrutiny reserve? Does the fact that trilogues have begun indicate that broad consensus on the Council position was reached at that stage? Although we appreciate that negotiations have been fast-moving and that consequently you may have been restricted in what you could tell us, given that Council Working Groups have been going on since 10 January we are disappointed not to have received an update at an earlier date. We would therefore be grateful for further information on the nature and outcome of the 12 February COREPER discussion, and whether the UK was party to any broad agreement on the Council position at that stage.

We would also be grateful for more detail on whether the Government’s aims have been met. What, for instance, was the outcome of consideration of the proposed definition of “slowly unfolding disasters”?

Although the letter makes clear that the Government are considering applying to the Solidarity Fund, you do not indicate when you expect to reach a decision. UK citizens affected by recent flooding would presumably wish such decisions to be made as a matter of priority. When do you expect to reach a decision? We would be grateful if you would inform us, as a matter of urgency, whether, if it was believed that the eligibility conditions were met or likely to be met, the Government would apply for use of the Fund?

We understand that the Presidency is seeking to secure an agreed text at COREPER on 12 March. We would be grateful for a response to these points, as well as a full update on the outcome of negotiations, the amendments made to the original proposal, and the extent to which the final text meets UK concerns, by 25 March 2014. In the meantime we now clear this document from scrutiny.

11 March 2014
Letter from Nicky Morgan MP to the Chairman

Thank you for your letter dated 11 March 2014 on the negotiations to amend the regulation establishing the EU Solidarity Fund. I appreciate the committee’s swift consideration of my letter of 27 February and thank you for clearing the draft text from scrutiny.

UPDATE ON THE OUTCOME OF NEGOTIATIONS, INCLUDING FEBRUARY’S COREPER

Your letter asked for an update on negotiations and clarification of the nature of the discussions at February’s COREPER. The compromise text presented at COREPER on 13 February was close to finalisation but did not represent a formal and agreed Council approach. Due to a number of outstanding issues, including a lack of consensus on the approach to advance payments, the text could not be agreed at COREPER and was therefore referred to trilogue.

Following further Council working group discussions on the outstanding issues, the Council’s position on the draft text was confirmed at COREPER on 12 March. I would like to reassure the Committee that, bearing in mind the scrutiny reserve, the UK abstained from voting on the text. We expect the draft text to be approved by Parliament at the second plenary during the week of 14 April with Council agreement sought shortly afterwards.

In parallel, the Presidency had begun informal trilogue discussions with the European Parliament to speed up the negotiation process and ensure a conclusion ahead of election purdah. Following Council agreement at March’s COREPER, the text was then approved by the European Parliament’s Regional Committee on 19 March and will now go forward to the second Plenary session in April.

GOVERNMENT OBJECTIVES

Your letter also asked whether the final text met the Government’s objectives. I am pleased to report that we have successfully worked with our like-minded Member States to secure both of our key objectives: budgetary restraint and seeking to protect the scope of the Fund. By working with like-minded Member States, we successfully secured a budget disciplinarian approach to the more challenging amendments, including advance payments and the threshold for regional disasters, to ensure that there is no change to the overall size of funds allocated to the EU SF or the budget size in the Multi-Annual Financial Framework Regulation for 2014-2020. We also resisted calls to expand the Fund, including the proposed inclusion of man-made disasters.

You asked about the definition of slowly unfolding disasters, such as droughts, which will be expanded upon in further Commission guidance. However, the UK successfully worked with other Member States to block the de facto creation of a special application and payments category for slowly unfolding disasters thereby controlling this potential expansion of scope.

AMENDMENTS TO THE COMMISSION’S PROPOSAL

Your letter also asked for further information on the amendments made to the Commission’s original proposal which I have summarised below:

REGIONAL DISASTERS

The threshold for regional disasters remains unchanged at 1.5% of the region’s GDP but the agreed text now accommodates a reduced threshold of 1% for the listed outermost regions.

CLARIFICATIONS

The agreed text contains a number of further clarifications, including regarding the scope of technical assistance. The text also contains a UK-driven insertion limiting the use of the fund for infrastructure repairs as such costs can be catered for through other sources of budgeted EU funding and do not reflect the immediate and urgent nature of EU SF funding.

APPLICATION PROCESS

The agreed text sets out the application process in greater detail, including a requirement for the Commission to provide clear guidance on the application process. The text also includes explicit timelines for decisions to reduce the delay associated with the consideration of an application and the deployment of EUSF funds.
Further, the application deadline has been extended by two weeks (a compromise to a proposed fifteen week deadline) and the text now allows eligible countries to submit additional, relevant information after the application deadline in justified cases. This amendment takes account of the reported challenges faced by eligible States in collating the necessary information while in a state of emergency.

Finally, the deadline for using EUSF funds has now been extended from one year to eighteen months, a compromise to a proposed extension to two years.

ADVANCE PAYMENTS

Following lengthy discussions on the proposed use of assigned revenue, funding for the advance payments mechanism will now be sought from within the agreed Multi-Annual Financial Framework for 2014-2020. Additionally, the advance payments mechanism now contains a UK-driven insertion establishing a clear two month deadline for the Commission to recover any unduly paid advances.

UK APPLICATION TO THE EUSF

Finally, your letter asked for further clarification of the Government’s intention to apply to the EUSF for funding following the recent adverse weather in the UK. As you are aware, EU Solidarity Fund money is available to Member States suffering from large-scale natural disasters. It is subject to a number of eligibility requirements, including on the level of direct damages. Comparing the damage today to the 2007 floods, and following contact with the Commission, our assessment is we have not met these conditions.

However, I would like to assure the Committee that the Government continues to do everything it can to assist those affected by flooding and has announced a package of measures to support affected homes and businesses, which includes £130 million for flood recovery in the South West. Further details of this package can be found on the HM Treasury website: www.gov.uk/government/news/uk-floods-2014-government-response. In addition, the Government is in discussion with other EU institutions, such as the European Investment Board, to support this package.

25 March 2014

EUROPEAN TERRITORIAL, COOPERATION GROUPINGS (15251/11)

Letter from Michael Fallon MP, Minister of State for Business and Enterprise, Department for Business, Innovation and Skills, to the Chairman

I am writing to inform you of the final outcome of negotiations on the above regulation, which your Committee had cleared from scrutiny on 19 June 2012. The final Regulation was voted on at the European Parliament’s plenary session in November 2013 and taken as an A point at the Agriculture Council on 17 December. It was published in the Official Journal on 20 December 2013 as EU1300/2013 and came into force the next day.

In my letter of 27 February 2013, I set out the Council’s partial general approach. This was to large extent reflected in the final regulation. The use of EGTC’s remains optional but the rules on their operation are clearer, particularly in respect to issues of liability.

12 May 2014

EU STRUCTURAL AND COHESION FUNDS (15243/11, 13730/12, 7537/13, 8946/13)

Letter from Michael Fallon MP, Minister of State for Business and Enterprise, Department for Business, Innovation and Skills, to the Chairman

I am writing to let you know the final agreed position on the above Regulation and subsequent amended proposals, which your Committee had cleared from scrutiny. The final Regulation was voted on at the European Parliament’s plenary session in November 2013 and taken as an A point at the Agriculture Council on 17 December. It was published in the Official Journal on 20 December 2013 as EU1303/2013 and came into force the next day.
My letter of 13 August 2013 had set out the emerging agreement on many issues, such as strategic programming, the common strategic framework, ex ante conditionalities, management and control, information and communication and financial instruments. I noted that some important issues had still to be discussed in depth. The European Parliament had not at that time given its formal consent to the Multiannual Financial Framework and this had an impact on consideration of the Common Provisions Regulation.

The European Parliament in particular had concerns about “macroeconomic conditionality” (renamed “measures linking effectiveness of ESI Funds to sound economic governance” in the final regulation – see Article 23 of Regulation 1303/2013). It argued that macroeconomic policies were outside the control of regions who often had the responsibility for managing ESI programmes and who therefore should not be penalised for breaches of for example the stability and growth pact. The final agreement between the two institutions keeps the principle of macroeconomic conditionality, but introduces further safeguards, particularly for the strand linked to non-respect of the EU’s economic governance. This included greater scrutiny of the process of applying suspensions and a new annex that made clearer the scope and level of suspension of commitments or payments. The final agreement kept the derogation for the United Kingdom, secured at the February European Council.

The European Parliament had been strongly opposed to the idea of a performance reserve, wanting it abolished (effectively 0%). The final agreement was for 6%, above the Commission’s original proposal of 5% but lower than the 7% proposed at the February European Council in 2013. The UK would have preferred to have maintained the 7% figure and abstained in the vote, issuing a joint declaration with Denmark, Germany, Austria, Finland, Sweden and Netherlands (who all still voted in favour).

Finally, the European Parliament was concerned about cash flows, particular for those Member States who were experiencing financial difficulties. The level of advances were therefore increased on a gradual basis.

In your letter of 17 October 2012, you mentioned specifically the use of delegated acts. The Commission’s original proposal had proposed the use of delegated acts to amend the annexes on ex ante conditionalities (the preconditions that need to be met before spending on a particular priority can begin) and information and communication. These provisions were deleted in the final agreement. The Commission had proposed that the Common Strategic Framework should be set down in a delegated act. In the final agreement, this is now annex I. However, as a compromise, the European Parliament and Council agreed to the Commission being able to amend two aspects of the common strategic framework by delegated act (article 12 of Regulation 1303/2013). These were in respect of changes to EU policies or instruments that were mentioned in the Common Strategic Framework and changes in cooperation activities. The Common Strategic Framework as agreed did not set down indicative actions.

Since the regulation came into force, the Commission has published three delegated acts linked to the Common Provisions Regulation, including the European Code of Conduct for Partnership which came into force on the 7 March. In the Government’s opinion, these were within the scope of the delegation and informal consultations with the devolved administrations and managing authorities in England revealed no concerns over the content.

As you may be aware, the Common Provisions Regulation required each Member State to prepare a Partnership Agreement setting out its strategy for using the Funds to develop its own growth potential and take forward the EU2020 agenda. The UK submitted its draft Partnership Agreement on 17 April, ahead of the deadline set in the Regulations, and is now waiting for formal observations from the European Commission.

12 May 2014
Letter from Nicky Morgan MP, Economic Secretary to the Treasury, HM Treasury, to the Chairman

I would like to update the Committee on progress regarding EM 12201/12: Financial Assistance for non-euro area Member States.

In early December 2013, negotiations moved quickly and as I previously mentioned, the Lithuanian Presidency attempted to reach a Council General Approach by the end of the year. The Chancellor of the Exchequer attended the ECOFIN meeting of 10 December 2013 where this proposal was discussed.

Given our substantive concerns, the Chancellor outlined that the UK could not support the proposal at ECOFIN. Other Member States also expressed reservations. Since there was a lack of consensus at that Council and in view of the fact that the Greek Presidency has recently made clear that this regulation is not a priority for them, this proposal will not progress further at this stage. Therefore we will not be seeking Parliamentary time for this regulation.

17 March 2014

Letter from the Chairman to Nicky Morgan MP

I am writing in response to your letter, dated EM 12201/12: Financial Assistance for non-euro area Member States. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 25 March 2014.

We are disappointed to note that this letter is a carbon copy of the letter sent to the House of Commons European Scrutiny Committee, and fails to acknowledge our letter of 12 November 2013 or respond to the questions that we then raised. We are also disappointed that it took over three months for you to write with an update on the 10 December 2013 ECOFIN discussions.

In light of this we would be grateful for a more detailed account on the outcome of discussions at the December ECOFIN. On which precise grounds did the Chancellor state that the UK could not support the proposal? You state that other Member States also expressed reservations. Can you be more specific about which Member States raised reservations, and the nature of their concerns? How much progress (if any) was made towards agreement on the two issues cited in our November letter, namely limiting the role of the ECB in relation to Member States not intending to adopt the euro; and the European Parliament’s proposal to use the Balance of Payments facility for the recapitalisation of financial institutions? On the latter issue, what are the negative consequences that you believe would arise from the introduction of such a facility?

Are there any amendments to the proposal as a whole that would lead the Government to reconsider their position and support the proposal? You state that the proposal “will not progress further at this stage”. Is there any realistic prospect of negotiations recommencing in the future?

We would be grateful for a response to these questions by 9 April 2014. In the meantime we will continue to hold the document under scrutiny.

25 March 2014

Letter from Nicky Morgan MP to the Chairman

Thank you for your letter of 25 March on Financial Assistance for non-euro area Member States, following my letter of 17 March.

The ECOFIN meeting of 10 December was the final ECOFIN of the Lithuanian Presidency. I’m afraid it was unclear for some time whether the incoming Greek Presidency were planning to proceed further with negotiations on this proposal. I was therefore unable to update the Committee with any certainty on how the proposal would progress.

At the ECOFIN meeting on 10 December, the Chancellor stated that the UK saw no need to amend the proposal and that the facility “as it already exists is sufficient and works perfectly well.” This is illustrated by the recent completed programmes to Hungary in 2008, Latvia in 2009, and the ongoing programme to Romania (2013) which remains undrawn.

The Presidency’s press release sets out in more detail the position of other Member
On the first of the two issues cited in your November letter, I believe that the UK secured appropriate wording in relation to the role of the ECB. This included limiting the ECB to only monitoring those Member States whose currency is participating in the ERM II agreement.

With regard to the European Parliament’s proposal to use the Balance of Payments facility for the recapitalisation of financial institutions, the UK made clear that we could not support such a proposal. In my view, this would have gone beyond the intention of the Balance of Payments facility and could have been an EU financial backstop to Banking Union members.

The Government will consider further amendments as and when negotiations recommence. Whether this will occur in the near future is a matter for upcoming Presidencies, there is currently no indication that this is the case.

7 April 2014

**Letter from the Chairman to Nicky Morgan MP**

Thank you for your letter, dated 7 April 2014, on EM 12201/12: Financial Assistance for non-euro area Member States. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 13 May 2014.

We note that there is no indication that negotiations are likely to recommence in the near future. We would be grateful for updates as and when there are any developments. In the meantime we will continue to hold the document under scrutiny.

13 May 2014

**FINANCIAL REPORTING AND AUDITING FOR THE PERIOD 2014-2020 (5213/13)**

**Letter from Jo Swinson MP, Parliamentary Under- Secretary for Employment Relations, Consumer Affairs, Department for Business, Innovation and Skills, to the Chairman**

I am writing to update you on progress with the Commission’s proposal to provide funding support to the International Financial Reporting Standards Foundation (IFRS Foundation), the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB) for the period 2014 – 2020.

When I wrote in May, I undertook to provide a further update when the impact on this proposal of any recommendations from Philippe Maystadt’s review and the views of the European Parliament became clearer.

**THE MAYSTADT REVIEW:**

The decision by the Commission to review the arrangements underpinning the process for the adoption of IFRS for use in the EU called into question the future of EFRAG and, therefore, the scope of the funding proposal. Mr Maystadt has now completed his review and his report “Should IFRS standards be more European” was published on 12 November.

As part of his review, Mr Maystadt considered a number of options to reinforce the EU’s ability to influence the development of international accounting standards. Having consulted widely, and recognising the need to deliver improvements promptly, he recommends that EFRAG continues to have a role but that its governance arrangements are transformed. This option received the greatest support from stakeholders and is the least burdensome of the options he considered. He makes a number of detailed recommendations to improve stakeholder representation and influence, in particular at board level. This conclusion means it is appropriate to continue to consider providing funding to EFRAG over the 2014-2020 budget period. However, the availability of funding will be dependent upon EFRAG’s response to the report. This has been reflected in the negotiations as described below.

Whilst not directly relevant to this proposal, the report considers other issues related to the EU’s influence in the development of IFRS and the EU’s approach to adoption of these. Mr Maystadt makes a number of recommendations on these too. I enclose a copy of the report for your information.
VIEWS OF THE EUROPEAN PARLIAMENT:

The Parliament brought forward a number of amendments, some of which we support e.g. the deletion of provisions for the Commission to make use of delegated acts in relation to future beneficiaries of the funding programme, and others, such as the imposition of detailed conditions of funding to the IFRS Foundation, which we strongly oppose. Other Member States share our views on these issues which have been the subject of intense discussions between the Presidency and the Parliament. The Parliament has requested more regular feedback on the activities of the bodies being funded and this is reflected in the compromise text currently being discussed.

CURRENT POSITION:

The funding proposal has been the subject of discussions by Council Members over the summer. Following those discussions, and trilogues, the draft proposal has been amended to:

i. Remove the ability of the Commission to use delegated acts to determine future recipients of funding within the budget period. Should the Commission consider it appropriate to fund a new body, even the direct successor of a current funding recipient, it will need to publish a proposal to do so.

ii. Require the Commission to provide the Council and the Parliament with annual reports on the activities of the IFRS Foundation and the PIOB.

iii. Require the Commission to provide the Council and the Parliament with reports on the activities of EFRAG and, in particular, its progress with its reform programme.

iv. Limit the period for which funding will be made available to EFRAG pending evidence of it implementing governance reforms in line with recommendations made by Mr Maystadt in his report. The Commission will bring forward a proposal for continued funding for the remainder of the budget period, subject to satisfactory progress with its reform programme. (The precise length of this initial funding period is still subject to negotiation but is unlikely to exceed three years.)

v. Reduce the budget envelope. This reflects (iv) above.

vi. Restrict the Commission’s funding to the PIOB to EUR 300,000 pa in the event funding received by it from the International Federation of Accountants exceeds two-thirds of its total annual funding. (This reflects the expectation that the PIOB will be effective in achieving its objective of diversifying its funding base for the future.)

vii. A retrospective effect clause has been inserted to enable the Commission to fund the recipient bodies from 1 January 2014, regardless of the date of adoption. This acknowledges the delay in securing agreement of this proposal and is necessary to avoid a reduction in the amount available to each body in 2014.

The amendments noted at (i), (iv) and (v) address the points raised by the UK in relation to the original text.

The UK and other Member States continue to strongly resist any proposals from the Parliament that might be construed as imposing conditions on funding to the IFRS Foundation. Any such conditions would be inappropriate and contrary to the objective of ensuring that the beneficiaries of the programme are able to accomplish their public interest mission in an independent and efficient manner.

I hope this additional information is sufficient to enable you to release this proposal from scrutiny. The negotiations on this proposal are drawing to a close. The Commission is keen to secure agreement as soon as possible to remove uncertainty about the future of the funding programme and avoid disruption to the funding streams of the recipient bodies. If agreement is reached, it is possible the proposal will be considered by Council later this month.

4 December 2013
Letter from the Chairman to Jo Swinson MP


We are grateful to you for this useful update. We note the conclusions of the Maystadt review that EFRAG continues to have a role but that its governance arrangements are transformed. We would be grateful for your summary and assessment of what is envisaged. Are you satisfied that the proposed reforms will provide sufficient safeguards to overcome your concerns about a potential conflict of interest in EFRAG’s role? What indication have you had of EFRAG’s likely response to the recommendations?

Pending further detail on these matters, it appears to us that the revised draft proposal strikes a sensible compromise. We would however be grateful for further details as to the length of the initial funding period, once this is agreed. We note your determination to resist the European Parliament’s wish to include detailed conditions of funding to the IFRS Foundation, and would be grateful for an update on whether your efforts to oppose this proposal prove successful.

In light of this, and in light of the fact that negotiations on the proposal are now drawing to a close, we are now content to clear the document from scrutiny. However we would be grateful for a response to these questions, together with an update on the outcome of negotiations, by 20 January 2014.

17 December 2013

Letter from Jenny Willott MP, Parliamentary Under-Secretary for Employment Relations and Consumer Affairs, Department for Business, Innovation and Skills, to the Chairman

Thank you for your letter of 17 December 2013 to Jo Swinson providing scrutiny clearance for the Commission’s proposal to provide funding support to the International Financial Reporting Standards Foundation (IFRS Foundation), the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB) for the period 2014 – 2020. In your letter you requested further information about the proposed reform of EFRAG and sought confirmation on aspects of the final negotiated position.

In his report, Should IFRS standards be more “European”? Philip Maystadt considers three options to address concerns raised with him about the current arrangements for the adoption of IFRS for use in the EU. Taking account of views expressed and the proximity of European elections, he concludes that the preferred option is to reform EFRAG. He notes that this option received “maximum support from stakeholders and it is the least burdensome”. The detail of the option is provided at section 2.3.3 of the report and is accompanied by eight recommendations. In summary he recommends that:

— EFRAG should focus on its remit regarding the IFRS standards in accordance with the IAS Regulation. (Currently EFRAG’s activities go wider than this and extend to non-listed companies which fall outside of EU regulation in this regard);

— Consideration should be given to the possibility of funding EFRAG through a system of compulsory contributions/levies paid by listed companies that use and benefit from IFRS;

— Pending the implementation of such a system, Member States organise a national funding mechanism, if they have not yet done so, to support EFRAG and that funding from the European Commission is increased if funding from this mechanism is insufficient to ensure an appropriate budget;

— EFRAG’s General Assembly membership is extended to include those bodies (private and public) who are contributing financially or in kind. The General Assembly should then exercise oversight over the decision-making Board and act as a sounding board for the Commission for its participation in the IFRS Monitoring Board;

— The Supervisory Board is replaced with a high-level Board which, relying on the work of the technical group, would approve comment letters to the IASB and endorsement advice letters to the Commission. He proposes that the new board has members from European public institutions, stakeholders
and national standard setters, with a Commission nominee having speaking rights;

— EFRAG, national standard setters and other European bodies are more coordinated when conducting field tests and that they produce impact assessments which correspond to the needs of users and the European legislator; and there

— There continue to be quarterly meetings between EFRAG and representatives of all national standard setters, including Norway and Switzerland, noting that these are particularly important for smaller Member States and to inform preparation for the IASB’s Accounting Standards Advisory Forum.

The Government is broadly content with the proposals to reform EFRAG. The recommended changes should go some way to ensure that EFRAG’s advice to the Commission is more rounded and representative of views from a wider range of EU stakeholders. However, at November’s meeting of ECOFIN, the Government indicated it does not support a move from national funding mechanisms to funding EFRAG through the imposition of a compulsory levy. We understand that EFRAG has already begun to respond to Mr Maystadt’s recommendations and we will monitor progress.

The final text of the Financial Reporting and Auditing proposal provides an initial period of three years funding for EFRAG. Further, Member States successfully opposed proposals to impose detailed conditions on funding to the IFRS Foundation. The proposal is expected to be debated by the European Parliament in plenary in February with the Council expected to vote shortly after.

20 January 2014

Letter from the Chairman to Jenny Willott MP


You state that EFRAG has already begun to respond to the Maystadt Review recommendations. What indication can you give us of the nature of its response?

You state that the proposal is expected to be debated by the European Parliament in plenary in February with the Council expected to vote shortly afterwards. We would be grateful for a response to our question, together with an update on the outcome of negotiations, by 17 March 2014.

4 February 2014

Letter from Jenny Willott MP to the Chairman

Thank you for your letter of 4 February 2014 concerning the Commission’s proposal to provide funding support to the International Financial Reporting Standards Foundation (IFRS Foundation), the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB) for the period 2014 – 2020. In your letter you requested further information about the nature of EFRAG’s response to recommendations in the Maystadt Review concerning its governance arrangements. You also requested an update on the outcome of negotiations by 17 March.

EFRAG GOVERNANCE ARRANGEMENTS

EFRAG has moved quickly to take on board the recommendations set out in Mr Maystadt’s report, Should IFRS standards be more “European”? A first step was to seek assurance that the organisation’s legal form – an international not-for profit body formed under Belgian law – would facilitate the changes proposed, which it does. At the 28 January meeting of the Accounting Regulatory Committee (ARC), the European Commission reported that EFRAG is now working closely with it and other proposed stakeholders to move to the proposed structure. A further update is expected at the next meeting of ARC on 8 April. As the EU’s co-financing of EFRAG beyond 2016 is dependent upon satisfactory revision of its governance arrangements, it will be important that EFRAG can demonstrate effective implementation of the recommendations quickly.
PROGRESS WITH NEGOTIATIONS

Despite the completion of negotiations on the text of this proposal, some MEPs have continued to express concerns about the EU’s contribution to funding of the IFRS Foundation. In part, these concerns relate to historic failings by the IFRS Foundation to provide timely statutory notifications to Companies House of changes in its directors. The MEPs concerned have questioned if it is appropriate to fund a body which has defective governance arrangements. As a consequence of this consideration of the proposal was deferred.

The IFRS Foundation has acknowledged these failings publicly and has put in place arrangements to ensure there is no recurrence of such errors. Having investigated the situation, BIS and Companies House consider that the IFRS Foundation is presently compliant with its legal obligations; that the registrar’s objective of ensuring that the record is up to date has now been achieved; and that no further action is required in this case. A letter to this effect was sent to the Commission.

The proposal was subsequently discussed and agreed by the European Parliament in plenary on 12 March. The proposal will now be referred to Council for consideration. I will write again to inform you of Council’s decision at the earliest opportunity once this is known.

15 March 2014

FINANCIAL SERVICES: CENTRAL SECURITIES DEPOSITARIES AND SECURITIES SETTLEMENT (7619/12)

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

I am writing to update you on the progress of the CSD Regulation. Following provisional discussions between the Council and the European Parliament, the compromise text was approved by the Council on 26 February and adopted by the European Parliament in plenary session on 15 April. The Government supported the agreement of the compromise text in Council as it is consistent with our position.

I have summarised below the resolution of the three principal issues, which Sajid Javid MP highlighted in his letter to you dated 3 October 2013 and were then outstanding.

— On the process for authorisation of banking services, the final agreement follows the General Approach, which the Government strongly supported. It provides for a process of close cooperation between relevant national authorities in which ESMA has only a non-binding mediation role and the home authority makes the final decision.

— On the securities settlement regime, the Government achieved its objective of securing additional flexibilities beyond those in the General Approach in relation to less-liquid securities and markets. In particular, the text provides for a longer time period in the buy-in remedy for securities on SME growth markets.

— On the third country regime, the final agreement reflects the General Approach. This provides appropriate transitional arrangements for non-EU CSDs currently providing services into the EU.

The agreement is still subject to the Jurist Linguist process and formal approval by the Council before publication of the Regulation in the Official Journal of the European Union.

15 May 2014

FINANCIAL TRANSACTION TAX (6442/13)

Letter from Sajid Javid MP, Financial Secretary, HM Treasury, to the Chairman

I am writing in relation to the Committee’s 10 December 2013 report Financial Transaction Tax: Alive and deadly, which was debated in the House of Lords on 17 December with Lord Newby representing the Government.

I welcome the report which makes a number of points with which the Government strongly agrees.
As you are aware from discussions with my predecessor as Financial Secretary, Greg Clark, the Government strongly shares the Committee’s concerns surrounding the legality of the FTT proposal currently on the table, in particular with respect to the extraterritorial aspects of the tax. In April 2013 the Government challenged the decision authorising enhanced cooperation in the area of FTT at the Court of Justice of the European Union (CJEU). In our view, the tax would infringe on the rights and competences of non-participating Member States, and would depart from accepted international tax norms. This is not just the view of the UK – the widely leaked legal opinion from the Council Legal Service, mentioned in the report, endorses some of the main aspects of the UK legal challenge, as well as making further arguments.

The Government also shares the view of the Committee that the European Commission’s approach to the enhanced cooperation procedure, under which the proposal is being taken forward, has failed adequately to take into account the views of non-participating Member States. Furthermore, as you know, we believe there has been a failure to support this proposal with a sufficiently detailed impact assessment.

The enhanced cooperation procedure is a relatively untested tool, but has the potential to be useful in the future. Indeed it has previously been used positively, with the support of the UK, in negotiations over the Common European Patent which had been held up for some years. This was a development that was clearly in the UK’s interests, and illustrates that when used in the right way, enhanced cooperation can be an effective tool. Furthermore, as the Chancellor commented in his speech to Open Europe on 15 January, if others are able to use enhanced cooperation to create expensive job destroying ideas like a FTT, we could think about using it in future for job creating measures that others oppose.

Therefore, as Lord Newby emphasised in the debate on 17 December, and as we have emphasised to other Member States, it is crucial that the right precedents are set at the early stages of its use in order to provide all Member States with confidence if the procedure is to be used effectively in future. This is in the interests of both the Member States and the Commission.

A third point which the Committee rightly highlights in its report is that it is highly unclear how the tax will be collected, and what obligations will fall on non-participating Member States as a result of EU mutual assistance and cooperation rules. As the Committee notes, one of our grounds at the CJEU is that the FTT would inevitably impose collection costs on non-participating Member States that should, under the terms of the Treaty, be fully borne by the participating Member States.

Lord Newby explained at the debate that we disagree with the Committee’s view that the Government has been diffident in its approach to the FTT proposal. As your own original FTT report noted, at Davos in early 2012 the Prime Minister called the potential tax “quite simply madness”, something that can hardly be called an act of ‘diffidence’.

The Government has been fully engaged with the proposal, and has done so since well in advance of its publication. Even before the use of enhanced cooperation was requested by the participating Member States, the Government was looking ahead to the potential risks of such a project and taking appropriate advice. We have closely engaged with other Member States at all levels, as well as with businesses, pension funds, trade bodies, exchanges and all types of financial market user to identify the key issues and risks that the European FTT poses, and to inform the Government’s position.

Since negotiations on the FTT began in February last year, UK officials have been closely involved in the discussions at Council working group meetings – of which there have been six so far – including submitting written technical questions to the Commission. Officials have frequent bilateral discussions with other Member States about the FTT. The Government continues to be active in Council negotiations and will ensure that the UK’s views are raised and discussed as part of this process.

The report is also critical of the Government’s decision to abstain from the vote on the Council decision authorising the use of enhanced cooperation for the FTT, arguing that the Government should have voted against the authorising decision, and encouraged other non-participating Member States to do the same. We note the Committee’s views. However, we maintain that the decision to abstain from the vote had the same practical effect as voting against the decision. As my predecessor has said in previous correspondence, not all other Member States shared our level of concern on all aspects of the tax. Additionally, many other non-participants did not want to block others from introducing a FTT per se. Ahead of the January ECOFIN, where the authorising decision was passed, it was clear that those wanting to proceed with enhanced cooperation would have enough support to approve the decision under qualified majority voting, despite the concerns that we and some other Member States raised at the time. Moreover, in our view our abstention did not prejudice our subsequent legal challenge.
Lord Harrison at the 17 December debate rightly highlighted London’s importance as a global trading
centre. Indeed financial services across the UK contribute significantly to EU growth and prosperity,
and as the leading global financial centre, the UK intends to remain the gateway to Europe.

The UK continues to remain an influential player in Europe on financial services. In the banking union
negotiations, for example, we ensured that the interests of the British taxpayer are protected, and
that under no circumstances will British taxpayers be financially liable for the costs relating to
resolution decisions taken as part of banking union. We have not shrunk from using the Courts
where necessary to defend the single market and UK interests – in respect of the FTT and other
legislation.

As for the progress of the legal challenge, there have been no significant developments since the
debate on 17 December. The process of exchanging written arguments has now closed. The next
steps are in the hands of the Court and the Parties may in due course be invited to attend an oral
hearing if the Court decides that it is necessary to hear further evidence before it can make a ruling.

9 February 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 9 February 2014, providing the Government’s response to the
House of Lords European Union Committee report, Financial Transaction Tax: Alive and deadly. This
response relates to EM 6442/13, the proposal for a Council Directive implementing enhanced
cooperation in the area of Financial Transaction Tax. This response was considered by the House of
Lords Sub-Committee on Economic and Financial Affairs at its meeting on 25 February 2014, and by
the European Union Select Committee at its meeting on 4 March 2014.

We are pleased to note that the Government strongly agree with many of the points made in the
report. We note in particular your comments regarding the use of the enhanced cooperation
procedure, and the importance of setting the right precedents for its use in the future. We will
continue to monitor the use and evolution of the enhanced cooperation tool in the months to come.

You object to the Committee’s criticisms of the Government’s approach to negotiations, noting that
the Prime Minister’s description of the potential tax as “quite simply madness” cannot be described as
an act of diffidence. We have never called into doubt the Government’s clear objection to the
proposal for an EU Financial Transaction Tax. Indeed, our first report on the subject, Towards a
Financial Transaction Tax?, cited the Prime Minister’s remark, and made clear that the Government had
“remained consistently opposed to the introduction of a tax at EU level.” Our criticism is a more
nuanced point, namely that for too long the Government relied on the facile assumption that an FTT
pursued by some Member States but not including the UK would inevitably be of benefit to the UK in
terms of the relocation of financial activity, and was unlikely to be agreed in any case. It was this
assumption that we maintain led the Government to adopt a diffident approach to negotiations in the
run-up to Council approval being given to the use of the enhanced cooperation procedure. In our
view, the Government were too slow to wake up to the potential threat that such a tax would pose.

In the House of Lords debate on our report on 17 December 2013, Lord Newby, replying on behalf
of the Government, said that it might then have been difficult to secure a qualified majority against the
proposal. But of course blocking it would have needed only a qualified minority. And given that the
enhanced cooperation involves only a minority of Member States, building a blocking minority against
it, on the precautionary basis that the substantive proposal should have been presented before
procedural approval was sought, might well have been possible. We remain puzzled that the
Government apparently made no such attempt.

You set out the ways in which the Government have been involved in Council negotiations, which we
welcome. We urge you to maintain such efforts in the months to come. However we would be
grateful for more information on the latest state of negotiations. Which Member States are now
leading the push for agreement of an FTT? Given that the end of the European Parliament term is fast
approaching, how likely is it that an FTT proposal will emerge from negotiations? What form will it
take, and on what timescale will agreement be sought?

We note that there have been no significant developments in relation to the legal challenge since the
debate on the Committee’s report on 17 December. However, we would note that Court of Justice
of the European Union has since chosen not to uphold the UK’s legal challenge regarding the legality
of Article 28 of the Short Selling Regulation (EU No 236/2012). What are the implications of this
ruling for the UK’s legal challenge against the decision authorising enhanced cooperation?

We would be grateful for a response to this letter by 19 March 2014.
Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 5 March.

You requested an update on FTT negotiations. As Lord Newby mentioned in the debate on your Committee’s report, negotiations resumed in December after a pause. There was a further Council working group on 29 January, focusing largely on technical matters, and more are planned.

You may be aware that, following the Franco-German Economic Council in January, France and Germany committed to making joint proposals to reach a compromise on FTT “within the next months”, although I am reluctant to predict whether there will be agreement before the European Parliament elections in May. Any potential compromise will need to be discussed at Council level and, at the time of writing, no new proposal has been put to the Council working group for discussion. We will update the Committee in the event of any significant developments.

On the CJEU’s judgment regarding the legality of Article 28 of the Short Selling Regulation, the Government does not believe that this will have any implication for the UK’s legal challenge against the decision authorising enhanced cooperation in the area of FTT. The bases of these two legal challenges differ, as do the issues which are under consideration, and we therefore expect the decision on FTT to be made on its own merits. I should also note that, since our last correspondence, the Court has decided that it will not require an oral hearing.

It is worth bearing in mind the possibility (discussed in previous correspondence) that the Court concludes that the present UK challenge against the authorising decision is too early. If that happens, our ability to challenge any eventual implementing directive, if necessary, should be confirmed.

18 March 2014

Letter from the Chairman to Sajid Javid MP


We welcome your commitment to update the Committee in the event of any significant developments in relation to negotiations on the Financial Transaction Tax proposal. You state that any potential compromise will need to be discussed at Council level. We trust that you are lobbying those Member States that are not participating in the proposal being taken forward under enhanced cooperation. We would also ask you to keep us similarly updated on any developments in relation to the UK’s legal challenge. In the meantime, we will continue to hold the document under scrutiny.

25 March 2014

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

Further to the letter from the previous Financial Secretary to the Treasury of 18 March I am writing to update you on two recent developments concerning the EU Financial Transaction Tax proposals.

ECJ RULING ON UK LEGAL CHALLENGE

First, on 30 April the Court of Justice of the European Union ruled, as widely anticipated, that the UK challenge against the Council decision authorising the FTT was premature. The Court found that:

“The contested decision does no more than authorise the establishment of enhanced cooperation, but does not contain any substantive element on the FTT itself. The elements of a future FTT challenged by the United Kingdom are in no way constituent elements of the contested decision”

In other words, the Court concluded that the FTT directive itself, once adopted, and not the authorising decision, is the proper target for any legal challenge. The ruling therefore has the effect of confirming that, should it become necessary for the UK to challenge the FTT directive, there is no risk that the Court could rule our challenge out of time.
The possibility of a prematurity ruling was discussed in previous correspondence with the Committee, and was directly addressed in the application to the Court, where we said:

“The United Kingdom recognises that it may be argued that this application for annulment is premature and that, rather than challenging the Authorising Decision, the United Kingdom should challenge the measure ultimately adopted by the Participating States (the “Implementing Measure”). However, given the fundamental importance of the issues raised in this application, the United Kingdom cannot take the risk, however small, that, if it does not challenge the Authorising Decision, it might be said to be out of time subsequently to challenge the Implementing Measure...

“...Should the Court take the view that the present application is manifestly inadmissible on the grounds of prematurity, the United Kingdom would be content for the adoption of such an order disposing of this application. This would give the United Kingdom the legal certainty that it needs, clearing the way for it to challenge the Implementing Measure”

The Government is satisfied with the ruling, and the Chancellor signalled to other finance ministers at this week’s ECOFIN that we will not hesitate to challenge the final FTT directive if it does not address our concerns.

ECOFIN STATEMENT BY PARTICIPATING MEMBER STATES

Secondly, the Member States involved in the enhanced cooperation process – minus Slovenia – circulated the enclosed [not printed] short statement at the 6 May ECOFIN meeting expressing their renewed commitment to a FTT.

The main points of note are that the participants wish to implement the tax in stages, with the first stage applying to “shares and certain derivatives”; and that they wish to implement the tax by January 1 2016.

However, as the Chancellor said on Tuesday, the document says nothing about the crucial issues. In particular, it does not specify which types of derivatives are envisaged to be included in the first stage of the tax. Nor does it address the key UK concerns about the territorial reach of the tax (i.e. whether the tax will be confined to instruments “issued” in an FTT country, or be wider in scope, along the lines of the current proposal).

It is obvious, as recognised by participating Member States’ finance ministers at the meeting, that there remains significant work to do before any compromise can be agreed. The UK will be active participants in these discussions, and we will rigorously assess any emerging proposal against its impacts on non-participating Member States and the single market – from both a legal and economic perspective.

The Chancellor also expressed strong concerns at the meeting that negotiations over the FTT were proving insufficiently transparent, noting the importance of taking care over this use of enhanced cooperation and reminding colleagues that Article 330 of the TFEU says that all Member States may participate in discussions of an enhanced cooperation proposal. This, he said, was part of the deal in return for other Member States proceeding with an enhanced cooperation proposal.

In this on-camera session, the Chancellor was openly supported by the finance ministers of Sweden, Denmark, Hungary, Malta, the Netherlands and Luxembourg. As a result the Presidency undertook to promote full transparency in future discussions.

The Chancellor also drew attention to the growing concerns expressed about the tax by European public bodies, including central banks, sovereign debt managers, and the European Investment Bank – who had written to finance ministers in advance of the meeting.

At the time of writing there were no further Council working groups scheduled to discuss the FTT. I will write again to update you in the event of any significant developments.

11 May 2014

Letter from the Chairman to Andrea Leadsom MP


This letter is written in light of significant developments in relation to the FTT in recent days, in particular the Court of Justice of the European Union’s 30 April 2014 rejection of the UK’s legal
challenge against the decision authorising the use of the enhanced cooperation procedure, and the 6 May ECOFIN “state of play” discussions.

We note your response to the CJEU’s judgment. We particularly note that it states that the Court’s review “must not be confused with the review which may be undertaken, in the context of a subsequent action for annulment, of a measure adopted for the purposes of the implementation of the contest decision.” What more can you tell us about the implications for negotiations on the FTT proposal, and for any future challenge against a substantive proposal for an FTT?

Given that the decision the Government was contesting was the authorisation for enhanced cooperation, we question why you did not challenge the lawfulness of the procedures leading up to the adoption of that decision as an additional ground. As you know, we are of the view that there was a fundamental flaw in the process, namely that the Council did not have sight of the proposal on which enhanced cooperation was being recommended until after the authorisation decision. As a consequence there was neither a proposal nor an impact assessment available to assess what the impact of the proposal would be on non-participating Member States, and more widely whether the proposal complied with the Treaty requirements on enhanced cooperation. We have never understood why the Government did not seek to insist on seeing the planned Proposal before authorisation, and seek to build a precautionary blocking minority against its authorisation unseen.

We have also received a response from the Commission to our December 2013 report, Financial Transaction Tax: Alive and deadly, which I have attached [not printed]. In its response, the Commission seeks to refute the arguments of the Council Legal Service, to defend its use of the enhanced cooperation procedure, and to stress that obligations to collect the tax under joint and several liability will only apply in exceptional circumstances. How would you respond to the Commission’s arguments? Is the Commission correct in stating that “the Commission services had presented the basic lines of [the] forthcoming proposal (based on the original proposal while in essence strengthening anti-avoidance) in the relevant Working Party of the Council before the adoption of the Authorising Decision”? If so, how much detail was provided when the “basic lines” of the proposal were discussed? Does this not add weight to our argument that the UK should have sought to oppose the Authorising Decision?

We are grateful for your update on the discussion at the 6 May ECOFIN. We note that the joint statement by ministers of Member States participating in enhanced cooperation states that they have agreed on a progressive implementation of the tax, focussing at first on “the taxation of shares and some derivatives”, to reach agreement by the end of 2014, with the first step implemented by 1 January 2016 at the latest. What are the implications of this agreement? Noting that no further Council working groups have been scheduled, what is the next step in terms of the progress of negotiations? We are concerned by the lack of precision in relation to the assertion that “some derivatives” will fall within the FTT’s scope. Have participants given any indication as to what “some derivatives” means?

In our March 2012 report, Towards a Financial Transaction Tax?, we predicted that, “given the manifest weakness of the Commission’s FTT proposal … it appears that a tax on the Stamp Duty model is more likely to be introduced”. Do the most recent discussions, and the evident lack of consensus on a broader tax, indicate that a Stamp Duty-type model will indeed be adopted? In light of the existence of the UK Stamp Duty, what analysis have you undertaken as to the likely impact of the implementation of such a proposal on the UK, if implemented? What position will the UK take if such a tax is proposed?

We agree with the Chancellor’s criticism of the participants for the secrecy in which they have worked on their proposals, and for failing to take account of the potential extraterritorial effect and the likely impact on non-participants. The Joint Statement indicates that participants will seek to “take into account the concerns voiced by non-participating Member States”. You also state that the Presidency has undertaken to promote full transparency in future discussions. How will you ensure that this commitment is fulfilled? What concrete steps do the participants need to take to ensure that such concerns are taken into account? If they do not do so, can you confirm that the UK stands ready to submit a further legal challenge against any proposal that is adopted? Which other Member States have indicated support for the UK’s position? We note that Slovenia did not agree to the Joint Statement. Why was this? Is there any indication that the resolve of participating Member States in support of the FTT is weakening? What are the Government doing to persuade Member State colleagues of the validity of the UK’s concerns?

We repeat our view that the FTT proposal as drafted could have serious repercussions for non-participants, including the UK, and on the City of London as the EU’s global financial market. We also reassert our view that such a tax can only be effective if implemented at a global level. We urge the
Government to remain closely engaged in negotiations as they progress, and to keep us informed of developments.

We would be grateful for a response to this letter by 2 June 2014. In the meantime we will continue to hold the document under scrutiny.

13 May 2014

HIGH LEVEL GROUP ON OWN RESOURCES

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

I am writing to you in relation to the work of the High-Level Group on Own Resources, under the Chairmanship of former Italian Prime Minister Mario Monti, established in February 2014. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this issue at its meeting on 13 May 2014.

We understand that the Working Group held its first meeting on 3 April 2014. Given the importance of the issues under consideration, we are anxious to begin our engagement with its work at an early stage. We note the Working Group’s announcement that it will issue a first assessment at the end of 2014, taking into account input from national parliaments. This Committee will seek to accept this invitation to provide input to the process, taking account of the conclusions set out in our 2011 report on the EU Financial Framework from 2014 and our 2012 follow-up report on The Multiannual Financial Framework 2014-2020.

As we prepare our contribution to the High-Level Group’s consultation, we would be grateful for an indication of HM Treasury’s current thinking on the future of Own Resources. In particular, while we support the Government’s commitment to ensuring that the UK abatement remains in place, we would stress that this should not rule out planning on the Government’s part about how the system of Own Resources might be reformed. We would therefore be grateful for an indication of any proactive planning that the Government have undertaken in relation to the work of the Group, how you plan to provide input into the process, as well as an indication of the issues that you would suggest that this Committee takes into account in preparing its own submission.

We note that the Working Group’s planning is at an early stage. We would therefore be grateful to receive further details of its work, including future meetings, its timetable of work during 2014, your own engagement with its activity, and in particular its plans to engage with national parliaments before the first assessment is published, as soon as it is known.

We would be grateful for a response to this letter by 5 June 2014.

13 May 2014

Letter from Nicky Morgan MP 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

INDICES USED AS BENCHMARKS IN FINANCIAL INSTRUMENTS AND FINANCIAL CONTRACTS (13985/13)

Letter from Sajid Javid MP, Financial Secretary, HM Treasury, to the Chairman

Thank you for your letter of 19 November in response to my previous letter setting out my concerns regarding subsidiarity in the Commission proposal.

In your letter you stated that the Government’s view that there is scope for action at an EU-wide level in relation to some benchmarks contradicts the Government’s belief that the proposal breaches the principle of subsidiarity. The Government considers that there are scenarios where it would be appropriate to take action at EU level, for example in the case of EURIBOR. Any failure of EURIBOR would have significant negative effects on the market as well as possible stability implications for the entire EU. Furthermore, the contributors to EURIBOR are distributed across a wide range of Member States. There, therefore, does seem to be some scope for action at the EU level for this benchmark.

Whilst the Government considers that EU level action may be appropriate for a small subset of benchmarks, for many benchmarks in the EU, action would be more appropriately taken at national level where action can be tailored as necessary to deal with particular problems associated with specific benchmarks and the benchmark-setting process in each jurisdiction. One obvious example of this, which I mentioned in my previous correspondence, would be in relation to national statistics authorities and the benchmarks they produce. However, the same principle applies where a benchmark administrator, EU contributors and market activity are all (or nearly all) located in one Member State. That Member State is likely to be best placed to assess how best to apply the International Organization of Securities Commissions (IOSCO) benchmark principles in a robust and proportionate way.

You also requested the Government response to the Commission’s assessment that action at EU level is justified in order to enhance the single market. We are not convinced that the Commission has provided sufficient evidence of the benefits of EU action. Further the Commission has provided insufficient assessment of the impact of the proposal. The Government is concerned that any potential benefit of EU action could be outweighed by the potential harm caused by the current proposal with its broad and uncertain scope. The harmonised, ‘one-size-fits-all’ solution, which does not cater for the diverse range of EU benchmarks, could cause some administrators or contributors to cease producing, or contributing to, benchmarks altogether.

You also question whether the proposal would be more appropriate as a Directive than a Regulation. An approach to benchmark reform allowing Member States to take action reflecting the specifics of different benchmarks in each jurisdiction would be more appropriate than the prescriptive rules applying to all benchmarks, regardless of their nature, as set out in the Commission proposal. However, in its impact assessment the Commission sets out its justification for a Regulation and it seems unlikely that they will withdraw their proposal.

In your letter, you note possible options for reducing the scope. The Treasury is working with the Financial Conduct Authority to develop options for a more appropriate and targeted scope.
Finally you declared an interest in the views of the financial services industry. The Government is actively working with industry to understand the potential implications of the proposal as well as specific areas of concern. It is clear the main concerns of industry relate to the broad scope of the proposal and the third country regime.

1 December 2013

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 1 December 2013, on EM 13985/13 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 17 December 2013.

We note your view that, since the Commission has set out its justification for a Regulation it seems unlikely that the proposal will be withdrawn, but wonder if you have approached other Member States with the idea of addressing this issue through a Directive rather than a Regulation? What have been their responses? We also reiterate the claims made by the Commission that action in relation to benchmarks is justified at EU level to enhance the single market in financial services. How would you respond?

We understand that the European Parliament is keen to progress with this dossier and that the lead rapporteur, Sharon Bowles MEP, published a draft text on 13 November 2013, containing some amendments aimed at tailoring the regime. What is your reaction to these amendments? Is it a step in the right direction? What progress, if any, is being made in Council on this proposal?

We would welcome a response to our queries by 20 January 2014. In the meantime we will continue to retain this document under scrutiny.

17 December 2013

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 17 December on EM 13985/13 indices used as benchmarks in financial instruments and financial contracts in response to my previous letter setting out my concerns regarding the Commission proposal and its compliance with subsidiarity.

In your letter you ask whether the Government has approached other Member States with the idea of addressing this issue with a Directive rather than a Regulation. As with negotiations of all financial services dossiers, the Treasury is in contact with finance ministries across the EU with the aim of building consensus to help secure UK objectives. During discussions with those finance ministries, concerns have been raised about aspects of the Commission’s proposal.

As set out in my letter dated 1 December, the Government believes that limited action may be justified at EU level for a limited number of benchmarks. However we strongly disagree with the Commission’s claims that the action it has taken, on the scale it has proposed, is justified.

You note the draft text published by Sharon Bowles MEP on 13 November. The Government considers that the proposed amendments included in the draft are an improvement on the Commission proposal, and represent a step in the right direction. They remain subject to discussion and debate within the European Parliament and we are engaging with MEPs to explain our preferred approach.

There is not yet a clear indication as to when Council discussions will commence.

13 January 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 13 January 2014, on EM 13985/13: 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 28 January 2014.

In our previous letter of 19 November 2013, we asked whether it would be sensible to distinguish between indices that are traded, like the FTSE 100, and those that cannot be traded, like LIBOR, which are more susceptible to manipulation. How would you respond?
We would be grateful a response to this question by 28 February 2014, as well as regular and detailed updates as the negotiations on this dossier progress. In the meantime we will continue to retain this document under scrutiny.

28 January 2014

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 28 January on the EU proposal on indices used as benchmarks in financial instruments and financial contracts.

In your letter you asked for the Government’s view as to whether it would be sensible to distinguish between indices that are traded, like the FTSE 100, and those that cannot be traded, like LIBOR, which are more susceptible to manipulation.

While instruments that reference the FTSE 100 and LIBOR can both be traded, I agree that it is reasonable to draw some distinction between indices that are based purely on transaction data such as the FTSE and those like LIBOR that contain an element of judgement. It is however important to note that purely transaction based benchmarks could also be manipulated, particularly if the relevant market is thinly traded.

The Government has been clear that the scope of the Commission proposal is too broad, and if the proposal is to be effective and appropriate, the scope must be narrowed. Factors such as the means by which a benchmark is compiled and the nature of the underlying data are clearly relevant to this objective, although it is not clear that either of these factors would always be suitable as sole determinants of which benchmarks are within scope of the proposed legislation.

Council negotiations are yet to commence on this proposal.

11 February 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 11 February 2014, on EM 13985/13: 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 February 2014.

Can you confirm that a vote in the European Parliament ECON committee has been delayed? What are the implications of this in terms of the timescale for agreement of the proposal? Does this mean that Council negotiations are unlikely to start before the end of the European Parliament?

In light of the fact that Council negotiations have yet to commence, we will continue to hold the document under scrutiny. In the meantime we would be grateful for a response to our questions by 25 March 2014.

25 February 2014

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 25 February on the EU proposal on indices used as benchmarks in financial instruments and financial contracts.

In your letter you asked for further information on the European Parliament ECON committee’s progress on the proposal and the possible implications on the timescale for final agreement.

A vote in the European Parliament (EP) ECON Committee on an agreed version of an EP text was recently delayed. We understand that this was due to differing views amongst the political groups as to the nature the text. At present it is unclear if the European Parliament will be able to agree their version of the text under the current mandate.

The delay in EP deliberations does not have an impact on Council negotiations, which we expect to commence before the end of this EP term, before continuing alongside the next EP session and into the next Council Presidency.

5 March 2014
Letter from Sajid Javid MP, Financial Secretary, HM Treasury, to the Chairman

I am writing to update you on the progress of the European Commission’s proposal for a review of the Markets in Financial Instruments Directive (MiFID II). A provisional political agreement between the Council and European Parliament was reached at a trilogue meeting on 14 January.

All aspects of this provisional agreement are consistent with the Government’s position. I note that my predecessor wrote to you in July 2013 with details of the compromise package agreed at General Approach. This note focuses in particular on aspects of the final agreement that have changed from General Approach.

OPEN ACCESS

As you know, the Government has always strongly supported this policy. The political agreement retains all of the core principles of the Commission’s approach. This will mean that Europe’s most significant vertically-integrated trading venues and clearing houses will be required to open themselves up to competitors. Although the final compromise contains the option for firms with the agreement of their regulator to delay implementation by two and a half years, the Government secured enhancements to the European Market Infrastructure Regulation which should ensure there is competitive challenge from the cleared OTC derivatives market during this interim period.

TRANSPARENCY

The European Parliament accepted the key elements of the Council’s previously agreed approach to transparency in both the equity and non-equity markets.

COMMODITY DERIVATIVES

The Government achieved its objective of ensuring that the power to set position limits rests with national competent authorities. This should mean that position limits can be calibrated to fit the different structures of various markets. The Government is satisfied that the agreed package of measures will ensure that commodity derivative markets are properly regulated throughout the EU.

The Government also ensured that certain physically-settled electricity and gas contracts are out of scope of the entire legislation. Oil and coal contracts will also remain out of scope of the costly clearing obligations under the European Market Infrastructure Regulation (EMIR), and may be subject to a review that will take them out of financial services regulation altogether. This allays our concern that including physically-settled commodity derivative contracts in the scope of MiFID could unnecessarily increase the costs of energy firms, leading to higher energy prices.

THIRD COUNTRIES

We have ensured that the UK retains control over granting access to non-EU firms who wish to provide investment services exclusively in the UK.

You may recall that we had significant concerns that the Commission’s proposed equivalence process could result in the erection of unnecessary barriers to cross-border trade in financial services. The Government has dealt with this issue, by successfully negotiating for a passport that applies in addition to, rather than in place of, bilateral trading relationships. Subject to a Commission decision that the third country regulatory regime is equivalent to the EU’s, this passport will allow third country firms to provide investment services to professional clients and investment firms throughout the entire EU.

ORGANISED TRADING FACILITY (OTF)

The provisional agreement retains the Commission proposal for an OTF category for non-equity instruments. In order to secure important derogations from the prohibition on dealing against own capital, which should ensure the proper functioning of these markets, the Council agreed in trilogue negotiations to remove the OTF for equity instruments. Although the Government supported both categories, the retention of the equity OTF was a lower priority objective.
HIGH FREQUENCY TRADING (HFT)

The provisional agreement remains broadly the same as the General Approach. The European Parliament successfully negotiated for the inclusion of measures to charge higher fees for cancelled orders, and to ensure high frequency traders keep records of all orders they place. However, the more damaging proposals for a ban on sponsored access and for minimum resting times for orders were not included.

INVESTOR PROTECTION

The Government is somewhat disappointed at the lack of ambition in the investor protection framework. Whilst this framework was not a substantial change from the General Approach, it was disappointing that the Council – due to opposition from France, Germany and a group of other Member States – could not agree to the European Parliament's proposals to strengthen protections for the consumers of certain insurance products.

Nonetheless, the final provisions will allow the Government to continue to pursue our existing rigorous approach via domestic legislation. We will also continue to make the case for higher standards of investor protection at the EU level in future negotiations.

NON-DISCRIMINATION CLAUSE

A recital to support the principle of non-discrimination for the provision of investment services within the Single Market remains in the provisional political agreement.

The provision of investment services is ever-more reliant on investment firms and market infrastructures being able to provide services across borders. It is vitally important that there are no artificial barriers to the ways in which these services are provided. In particular, it is important that there are no location requirements related to the currency of financial instruments over which investment services are provided. This recital builds on the Treaty base, and will ensure that the principle of non-discrimination is rigorously applied for the specific challenges faced by the Single Market in investment services.

The provisional agreement is still subject to formal approval by both the Council and the European Parliament. We anticipate that the legislation will enter into force in the second quarter of this year.

29 January 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 29 January 2014, on EMs 15938/11 & 15939/11: MiFID II. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 February 2014.

We are grateful to you for this informative update. We note that the agreement is, by necessity, a compromise, as your letter makes clear. In light of the contentious nature of the proposals, we would be grateful for a final update from you once the Council and the European Parliament have given formal approval.

11 February 2014

MUTUAL ASSISTANCE (17110/13)

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

Thank you for your Explanatory Memorandum 17110/13, dated 17 December 2013, on the proposal for a revision to Regulation (EC) No 515/97 on mutual assistance between administrative authorities and the Commission to ensure the correct application of the law on customs and agricultural matters. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 January 2014.

We note your concern relating to the proposed role of the Commission. We do, however, acknowledge the Commission’s argument that, given trade is global, Member States alone cannot efficiently observe, detect and mitigate risks entailing breach of customs legislation and other customs-
related risks. Can you provide further details in relation to your concerns? Exactly how could this new role for the Commission impinge on HMRC and the Border Force?

You highlighted the potential impact on economic operators and we understand you intend to consult with UK economic operators to test the accuracy of the Commission’s claims that it has proposed the most cost-effective way to transmit the required information. We would welcome an update from you once you have the results of your UK-based consultation into this matter.

You expressed concerns about the proposed centralised database and, in particular, you emphasised that there could be duplication with another piece of legislation. Which piece of legislation are you referring to? We would welcome more information on this particular concern.

We understand that information on container movements is important but would be interested to know what proportion of trade in goods is undertaken via containers. How would this proposed extension capture the movement of goods via other means? We are also interested to understand whether this proposed revision would contribute to tackling the problems exposed by the horsemeat scandal.

We would also be grateful for further details on the use of delegated acts and the impact on agricultural matters when you have further clarification on these elements.

We would welcome a response to these queries by 29 January 2014. In the meantime we will continue to hold this document under scrutiny.

15 January 2014

Letter from Nicky Morgan MP to the Chairman

Further to your letter of 15 January, I am writing in response to your questions.

PROPOSED ROLE OF THE COMMISSION

The Government is concerned that the proposal for a revision to Regulation (EC) 515/97 could expand the Commission’s current role from the investigation of fraud associated with own resources to playing a leading role on EU-wide customs risk management and targeting.

The Government would welcome the use of EU-wide risk data and analysis to support its own risk management systems; however we are concerned that the proposal could lead to EU-driven targets that impinge on HMRC and the Border Force’s risk management, prioritisation and resource deployment decisions - areas of Member State competence.

ECONOMIC OPERATORS

The Government is exploring how best to engage UK economic operators that may be affected by the proposal to verify the Commission’s conclusions on the cost effectiveness of the proposal.

CENTRALISED DATABASE

The Government is concerned that the Commission’s plans for a new centralised database cuts across other initiatives such as an e-manifest proposal currently being developed by the Commission and the establishment of a single-window reporting mechanisms for ships arriving and/or departing from Member State ports that will include manifest data (Directive 2010/65/EU). We want to ensure the proposal does not lead to unnecessary duplication or burdens on business and Member States.

CONTAINERS

It is widely held that approximately 90% of the EU external freight trade is containerised, (Source: Lloyds Marine Intelligence Unit). No data is currently available on the proportion of trade in goods undertaken via containers within the internal market of the European Union. The Government assesses this to be significantly less as the majority European Union internal borders are land based and much of the trade in goods is by means of road and rail.

The proposed revision of Regulation (EC) No 515/97 would capture the movement of goods via other means as they enter or leave the European Union (but not the movement of goods between Member States).
THE HORSEMEAT SCANDAL

While the proposal is unlikely to help independently identify horsemeat contaminated consignments it could potentially help with tracing the source of any contamination once a contaminated consignment has been identified separately.

DELEGATED ACTS

Negotiations are at an early stage and although no further information on delegated acts is currently available, the Government is vigilant in this area.

AGRICULTURE

My officials have been in contact with the Department for Environment, Food, Regions and Agriculture (DEFRA). The initial assessment is that other than the potential for enhanced detection and tackling of Common Agricultural Policy-related fraud there is no direct impact on agricultural matters.

I hope that this further information is useful to the Committee in considering this proposal.

28 January 2014

Letter from the Chairman to Nicky Morgan MP

Thank you for your letter, dated 28 January 2014, on EM 17110/13: the proposal for a revision to the regulation on mutual assistance between the administrative authorities of the member states and cooperation between the latter and the Commission to ensure the correct application of the law on customs and agricultural matters. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 4 February 2014.

We would be grateful for updates as negotiations progress, in particular regarding the outcome of your engagement with UK economic operators to test the accuracy of the Commission’s claims that it has proposed the most cost-effective way to transmit the required information, and the use of delegated acts. We would also be grateful for further information on the position of other Member States regarding this proposal.

Noting that discussions are at an early stage, we will continue to hold the document under scrutiny.

4 February 2014

PARENT SUBSIDIARY DIRECTIVE (16918/13)

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

Thank you for your Explanatory Memorandum 16918/13, dated 7 January 2014, on amendments to the Parent Subsidiary Directive. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 22 January 2014.

We welcome your detailed consideration of this proposal. However, we would be grateful for elaboration of your point regarding consistency of the proposal with developments in the OECD Base Erosion and Profit Shifting project. Is there anything in particular that has prompted this concern?

We would be grateful for a response to this letter by 6 February 2014. In the meantime we will continue to hold this document under scrutiny.

28 January 2014

Letter from David Gauke MP to the Chairman

Thank you for your letter of 28 January on the proposal to amend the Parent Subsidiary Directive (PSD), following our Explanatory Memorandum of 7 January. In response to your query, I would like to provide more detail on the extent to which this relates to wider work underway at the OECD in addressing Base Erosion and Profit Shifting (BEPS).

There is a degree of overlap between the proposed amendment to Article 4 of the PSD, and item 2 of the OECD BEPS Action Plan.
The proposed amendment to Article 4 is intended to allow for the remedy of a specific tax loophole concerning the use of “hybrid loan” arrangements in cross-border situations resulting in double non-taxation.

Item 2 of the BEPS Action Plan has a broader objective. It calls for the development of:

“…model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.”

Hybrid loan arrangements would fall within the scope of this model guidance. The UK has therefore reiterated, in Council Working Group, that EU work to address hybrid mismatches should acknowledge the parallel discussions in the OECD. There has been acceptance of this point, with a number of Member States intervening to support the UK. The Greek Presidency committed to ensure that any relevant developments in the OECD would be notified within the Council working group.

11 February 2014

Letter from the Chairman to David Gauke MP


We are grateful to you for your response to our questions, and are now content to clear the document from scrutiny. We would however be grateful to receive further updates as negotiations progress.

25 February 2014

SHADOW BANKING (13426/13), MONET MARKET FUNDS (13449/13) AND SECURITIES FINANCING TRANSACTIONS (6020/14)

Letter from the Chairman to Sajid Javid MP, Financial Secretary, HM Treasury

Thank you for EM 13426/13, dated 10 October 2013: Commission Communication: Shadow Banking—Addressing New Sources of Risk in the Financial Sector; EM 13449/13, dated 30 September 2013: Proposal for a Regulation on Money Market Funds; and EM 6020/14, dated 26 February 2014: Proposal for a Regulation of the European Parliament and of the Council on Reporting and Transparency of Securities Financing Transactions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 1 April 2014. We were assisted in our scrutiny of these documents by evidence heard on 10 December 2013 from Patrick Pearson, Acting Director of Financial Markets, European Commission; and on 11 March 2014 from Matthew Fell, Director, Competitive Markets, CBI. We set out their evidence under a number of headings below, followed by a series of questions to which we would be grateful for a response.

DEFINING SHADOW BANKING

Shadow banking is a complex area that is difficult both to define and quantify. Patrick Pearson described it as “financial intermediaries that conduct maturity, credit or liquidity transformation without explicit access to central bank liquidity or public sector guarantees. In concrete terms, you are talking about security dealers, hedge funds, other financial companies that buy long-term assets, such as bonds backed by mortgages or corporate debt. ... The transactions involved ... are securities, funding transactions, repo transactions, tripartite repo transactions, securitisation”.

Matthew Fell told us that there was no single definition of what should be included within shadow banking. The broadest definition of shadow banking was that it was not banking. More specifically, new innovations such as crowd funding, peer-to-peer lending and the private placement market for corporate commercial papers could all fall under the definition, as could a greater use of equity finance, including private equity. A more formal definition would comprise a combination of entities (including money market funds, investment funds, insurance companies) and activities (securitisation of lending, repurchase transactions). A key difference between mainstream banking and shadow banking was that banks tend to hold loans on their balance sheet through to maturity, whereas in shadow banking they are often sold off and converted into securities.

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The term ‘shadow banking’ is itself contentious. Patrick Pearson told us that it was a misnomer, because regulators knew what the risks were. Although alternative terms such as market finance and alternative market finance had been used, ‘shadow banking’ had stuck, and was no longer viewed as a pejorative term nor intended as such. Matthew Fell thought that term was unhelpful because of its negative connotations and because it covered such a broad range of activities, but said that it had stuck.

How would you characterise shadow banking? Is there a single definition that you believe is most appropriate? Which activities and transactions fall within such a definition? Are there any that you would specifically exclude? Do you regard shadow banking as a pejorative term? Do you agree with our witnesses that, whatever its accuracies, the term has now stuck?

THE SIZE OF THE SHADOW BANKING SECTOR

Both our witnesses noted the significant size of the shadow banking sector. Patrick Pearson cited a figure of $71 trillion in shadow banking activities worldwide, about half the size of banking sector activity, and a “big number [that] almost defies imagination.” Of this, $26 trillion was in the USA, $22 trillion in the eurozone and $9 trillion (£5.5 trillion) in the UK (twice the size of UK GDP). Mr Pearson noted that the sector had grown by 7% in 2012, but that figure contained wide variations, from a fall of 11% in Spain to growth of 42% in China. In the UK, shadow banking activity increased by 10% because of a growth in derivatives holdings, of which London was the world centre. Matthew Fell agreed that the UK was a significant player within the sector.

Do you concur with these estimates of the size of the shadow banking, both worldwide and in the UK? What would you identify as the primary reasons for the sector’s growth? What predictions would you make for its future growth and development?

THE BENEFITS OF SHADOW BANKING

We asked our witnesses if shadow banking was a good or bad thing. Patrick Pearson said that it was a complex question, because shadow banking involved “a complicated web of interactions and interrelations in the financial market from money market funds to hedge funds, to alternative investment funds, to banks, to broker-dealers who lend to and from each other.” He stressed that it was an important source of liquidity in the sector, which was proving increasingly important as banks de-risked and de-leveraged in the light of new regulatory requirements. It was particularly important for SMEs.

Matthew Fell said that the CBI was broadly positive about shadow banking because the financial crisis had revealed an overreliance on banking, “and when that went wrong there was not much else to turn to. People were asking things of it that it was probably never designed to do”. Banks were now more focussed “on the things that they ought to be doing, which has created these opportunities and the space for the shadow banking system to grow into”. Having a diverse range of financing options available to businesses and individuals was a good thing. This was particularly true for SMEs, who had less access to a broad range of financing activities. It was also beneficial more broadly by way of diversification of risk and increased choice and competition, thereby keeping banks on their toes.

Do you agree that shadow banking serves an important function in counteracting an overreliance on the banking sector? Do you share our witnesses’ view of its benefits in terms of increased liquidity, increased funding for SMEs, diversification of risk and increased choice and competition? What other benefits would you highlight? What tangible benefits can you cite that have arisen from the growth of the shadow banking sector?

THE RISKS OF SHADOW BANKING

In spite of these benefits, Mr Pearson noted the risks deriving from the interconnection between shadow banking and the banking sector. He observed that the financial crisis reminded investors that claims on shadow banks posed many more risks than deposits insured by banks. As a result, investors engaged in wide and sometimes disorderly flights from the shadow banking system. Firms wanted to recover the money they had lent against collateral quickly. The false assumption that lending to shadow banks was risk-free was undermined, leading to dramatically corrected evaluations of the balance sheets of regulated firms and of the liquidity of unregulated firms, followed by a crisis that engulfed the entire financial system.

Mr Pearson noted that the financial crisis revealed failures in both the shadow banking system and the regulated banking system. The regulatory system failed to monitor the activities of the normal banks
in engaging with the shadow banking system. The shadow banks provided “dodgy investments” to the regulated banks, which then marketed the investments themselves. For example, sub-prime mortgages were sold by regular banks to investors through special purpose vehicles to move the risks off balance sheet. But when investors found that they had been sold “dud” investments, they went straight to the bank and demanded they honour the investments sold into the market. He noted how sub-prime mortgages were repackaged—“sliced and diced” into an investment product that mixed them with truly risk-free mortgages—into packages that investors bought. The complexity of the product sold became so opaque that those in the financial sector did not trust each other’s exposure to investment in these products.

Matthew Fell said that there was no clear-cut answer as to the link between the financial crisis and shadow banking. However, he acknowledged that regular banks could be part of the funding chain for shadow banking activity, for instance by extending a line of credit to a provider of finance in the shadow banking sector. Regular banks could also invest in shadow banking products and be funded by money market funds. He estimated that UK banks’ credit exposure to the shadow banking sector was about 10% of its total exposure—a large figure compared to other mainstream international economies. Where such interconnectedness existed, there was a risk of contagion. The challenge was to manage such risk. His sense was that shadow banking was now less exposed than it had been before the crisis.

To what extent were failures in the shadow banking sector and the interconnections between it and the banking sector responsible for the financial crisis? Do you believe that the nature of the interconnection between the shadow banking sector and the regular banking sector is now understood? How would you characterise the nature of the risk that shadow banking poses? Is there any truth in the assertion that the sector is less exposed than it was before the crisis? Are such risks outweighed by the potential benefits of shadow banking?

THE GLOBAL REGULATORY RESPONSE AND THE ROLE OF THE FINANCIAL STABILITY BOARD

The global regulatory response to shadow banking has been led by the Financial Stability Board (FSB), whose recommendations were endorsed by the G20 in St Petersburg in September 2013. Patrick Pearson stressed that “the financial sector and financial services have developed into something that is so complex, so interconnected and global that we need to ask ourselves where the boundaries of regulation are”. He thought that there had been a measured regulatory response, with no “huge regulatory initiatives” or prohibition of shadow banking. He was confident that regulators understood that unwanted regulatory initiatives could have a detrimental impact on an important source of liquidity. Nevertheless, they were concerned that the threat of future problems could have increased. Because the banking sector, insurance sector and hedge funds were now regulated, there was a perception that liquidity needs would be financed by “the unregulated market, the shadow financing market”, rather than the traditional banking sector. Mr Pearson stressed that “patience, coherence and a joined-up approach” were critical “because financial markets are global markets. If we regulate here, the activity will move elsewhere.”

Matthew Fell said that there had been much recent regulatory focus on shadow banking. The crisis made people think that shadow banking needed to be much more transparent, in order to understand the nature of the risk and the level of exposure. He stressed the importance of global consistency, given “very mobile flows of capital that do not easily respect geographical boundaries.” He praised the FSB’s work in seeking to understand and mitigate the interaction between banks and shadow banking, and to reduce the susceptibility of money market funds to runs. He also thought that its efforts to boost transparency were “really helpful in understanding where risk ultimately lies in the system”. He felt that transparency was “the single most effective policy tool to properly understand where risk lies and whether you have emerging problems.” The CBI was cautious about further steps. In Mr Fell’s view, the fact that the sector had fared better in the crisis than the mainstream banking sector suggested that risks were better understood and managed therein, or at least better diversified.

What is your assessment of the global regulatory response thus far to the growth of the shadow banking sector, led by the Financial Stability Board? Has the FSB done an effective job? Has its work been proportionate? Has it done enough? How can it be ensured that there is an effective balance between global, EU and national responsibilities? Is such a framework being put in place?

THE ROLE OF THE EU

Patrick Pearson sought to summarise the EU’s approach to reform of the sector. He noted that a number of small, measured reforms had been introduced in recent years, which were in line with international standards and the work of the Financial Stability Board. These reforms had been
focused on the regulated sector: banks, hedge funds, insurance companies and pension funds. This was important in an EU context: given the links between the two, the regulated sector was a powerful tool for addressing risks in the unregulated shadow banking sector.

Mr Pearson stressed that the priority at this point was “transparency, transparency, transparency.” The EU was following the road map set out by the FSB and agreed by the G20, including requirements to gather data, require reporting and conduct impact assessments to understand the impact of certain measures on shadow banking. A freestanding EU shadow banking legislative proposal would not make sense and was not necessary. Besides the proposals already being planned, the Commission would wait for agreement and consensus at the G20 Financial Stability Board level before proceeding.

Matthew Fell observed that the European Commission’s priorities echoed those of the Financial Stability Board in headline terms. However, he argued that their paths began to diverge when one examined the detail. Using the case study of money market funds (see below), Mr Fell also argued that the Commission could be better at coordinating its proposals on shadow banking with other financial services reforms.

Overall, how would you assess the EU’s approach to shadow banking? Has it adopted a proportionate approach? Has it been focussed on the right priorities? Are its efforts to encourage greater transparency to be welcomed, and are they likely to bear fruit? Are the Commission’s proposals in line with international guidelines? Do you share the concerns raised with us that the Commission diverges from the FSB in terms of the detail, or that the Commission should have more effectively coordinated its proposals with other financial services reforms? If so, what specific examples can you give us where the Commission’s approach has caused problems?

NATIONAL RESPONSIBILITIES AND THE ROLE OF THE UK

Patrick Pearson told us that there was “no intention of Europeanising” the national systems of oversight and supervision. There was already collaboration between central banks in the European System of Central Banks. He said that there were positive relationships with the UK, and that there was an enormous amount of expertise given London’s role as the global capital of finance. It was therefore “logical for regulators, not only in Europe but also outside Europe, to turn to the expertise and the knowledge to understand much better what is going on and what the risks are. The industry is regulated here. The industry is domiciled here in most cases.”

Matthew Fell argued that greater thought needed to be given to what activity could be supervised at European level, and what could be left to individual Member States. While an EU (or global) approach was merited in terms of supervising genuinely cross-border activity, setting the overall framework, ensuring effective coordination and in information-sharing to spot emerging risks or bubbles, monitoring of relatively low-risk high-volume activity might be better suited to national supervisors. Given the “incredibly broad” nature of shadow banking, it would be logistically impossible for the EU to monitor all such activity in any case. In his view, “the default is that it is always best to set supervision at a local level”. He advocated “a common regulatory framework that would apply to the UK in the same way in which it would apply to other member states and further afield, coordinated and driven through the Financial Stability Board and the European Commission proposals and then implemented at a UK level.”

Mr Fell also thought that there was scope for greater cooperation between HM Treasury and the UK business sector on shadow banking. Though there were conversations about such things, “it is not yet a proper, joined-up debate on a set of overlaying regulations”.

What is the most effective balance between EU and national responsibilities in regulation and supervision of the shadow banking sector? Is such a balance being struck at the present time? Is the Commission sufficiently aware of which responsibilities are best undertaken at national level? While we recognise the merits of a model of setting a regulatory framework at EU level and implementing it in detail at the national level, are there any risks in such an approach? Given the scale of shadow banking activity in the City of London, how would you characterise the UK’s approach to oversight of the sector? Are you content that the UK’s expertise in shadow banking activity is taken account of both in EU and global discussions? Could more be done to enhance cooperation between the Government and the UK business sector?

EM 13449/13: MONEY MARKET FUNDS

We asked our witnesses about the Proposal for a Regulation on Money Market Funds (EM 13449/13). Patrick Pearson explained that money market funds (MMFs) absorbed around 22% of all short-term debt securities issued by governments or corporates. They were used to invest excess cash for a
short period. Because money market funds invested in a broader range of assets than a bank deposit “you are not putting your eggs in one basket”. 95% of EU money market funds were domiciled in France, Luxembourg and Ireland. However, the largest money market fund investment management centre was in the UK.

Mr Pearson said that there were areas of risk in money market funds which should be regulated to provide investor security and to address the negative feedback loops which had arisen. The financial crisis had shown that money market funds were prone to investor runs. They struggled to honour all redemption requests at the same time, creating a liquidity bottleneck. This in turn created market uncertainty. If corporate treasurers could not get their money out quickly, there would be a direct impact on salaries and the real economy. Stability could be a problem: in the case of Constant Net Asset Value (CNAV) Money Market Funds, if investments were not able to meet the promise that every £1 invested will be repaid on a £1 by £1 basis, then there could be massive outflows from the sector. In addition, many money market funds were sponsored by banks and other financial institutions, which could result in them having to provide extra liquidity to the Fund. In the UK, household names in the banking sector such as HSBC, Royal Bank of Scotland and Lloyds “support these money market funds, and this support is not reflected on the balance sheets as a contingent liquidity liability. So these are serious financial stability issues.”

Mr Pearson explained that, while the Commission had proposed that CNAVs build up a 3% liquidity buffer over three years to meet these obligations, it had decided against calls from a majority of Member States and central banks in the EU, and from the European Systemic Risk Board (ESRB), to prohibit CNAVs altogether: “We felt that it would be brutal, intrusive, incursive and unnecessary and reduce immediately an important liquidity buffer from the market.” The 3% buffer was a compromise that would remove the exposure of banks to their money market funds. The Commission had calculated that the buffer would create costs but would not wipe out CNAVs altogether. He also pointed out that, while there were 300 Variable NAVs (VNAVs), there were only 23 CNAVs in Europe, the largest of which, JPMorgan, Goldman Sachs and BlackRock, accounted for 50% of all funds under management: “we are not talking about a proposal here that will drive small money market funds out of the market; they left a long time ago.” He stressed that the Commission had considered alternatives to a buffer. Regulation as per banks would be “the end of money market funds”. Regulating CNAVs only, as in the US, would not work because of the different characteristics of the money market fund sectors in the US and the EU. He also argued that a mark to market rule was not a panacea and would introduce significant volatility rather than solving the stability issues that needed to be addressed.

Matthew Fell noted that money market funds were already regulated under the separate UCITS and AIFM Directives. He said that the new proposal should have been better coordinated with such reforms. He also noted how the proposal was inconsistent with the US approach, where they had chosen not to apply capital buffers. This created an uneven playing field, meaning that US companies had better and more affordable access to money market funds than would be the case for the UK and EU if the reforms were pursued. He said that CBI members found it helpful to have a money market fund facility open to them. The key was to focus on how to provide transparency.

We also note media reports that the European Parliament ECON Committee’s recent scheduled vote on the Money Markey Funds Regulation was postponed because the Committee was “split down the middle”. Further progress is not expected until after the European Parliament elections.

How would you respond to the Commission’s defence of the Money Market Funds regulation as a proportionate proposal that will remove the exposure of banks to their money market funds? Do you share its analysis that money market funds are prone to investor runs, thus creating financial instability? In light of the Commission’s assertion that the material effect of the proposal will be limited, how would you justify your concerns set out in EM 13449/13, that the mandatory conversion of CNAVs to VNAVs is unduly burdensome; the imposition of a capital buffer is not suited to investment funds; and that the Commission underestimates the wider economic impact of preventing MMFs from making certain investments. Which alternative approaches would you suggest? To what extent do other Member States share your concerns? Given the contentious nature of the proposals, what update can you give us on the progress of negotiations?

EM 6020/14: SECURITIES FINANCING TRANSACTIONS

We also asked our witnesses about the proposal for a Regulation on Reporting and Transparency of Securities Financing Transactions (EM 6020/14). Prior to the proposal’s adoption by the Commission, Patrick Pearson noted that shadow banking and securities financing transactions were not areas that regulators had engaged in before. Nevertheless, the fact that securities could be used and reused in
the financial system over and over again created risks. He said that requiring all securities financing transactions and the underlying collateral to be reported to public trade repositories was necessary so that central banks had a good overview of how many securities were used as collateral in the system, who was using them and the exposure of the financial industry to those activities. Mr Pearson added that the idea for a central repository for all data on securities financing transactions had emanated from Paul Tucker, former Deputy Governor of the Bank of England, on the grounds that “before we even try to regulate something, we need to know what it is we are trying to regulate, and we can’t regulate something if we do not have the information.” He thought that the central bank community across the EU and beyond were supportive. On potential further steps, such as haircuts to the value of securities financing transactions, the Commission had insisted that a full impact assessment of the impact on EU economies be conducted first before jumping to regulatory conclusions. There was a clear road map for such actions in 2014-15.

Matthew Fell said that industry was still analysing the proposals, but the initial sense was that the Commission had rushed it out. Given that it may follow up with more substantive rules on securities legislation, he found it to be an example of where the Commission was only tackling one bit of the jigsaw relative to what the FSB was considering: “Doing that in a piecemeal way, with more to follow, is perhaps not the most helpful approach, and we would encourage it to look at it in the round, do it properly and come back with a proposal that has had more time for input from stakeholders.”

Do you share the view that the Commission has taken an unhelpful “piecemeal” approach to securities financing transactions, or do you agree with the Commission that a step-by-step approach is the most sensible option? Can you elaborate on the general concerns set out in EM 6020/14, ideally relating them to the specific terms of the Commission proposals? You state that the proposal needs to be consistent with FSB recommendations. Is there any aspect of the proposal that leads you to believe that this is not the case? Is there anything in the proposal as drafted to suggest that reporting requirements will not be proportionate and workable? Are there any overlaps with existing provisions that you are particularly concerned about? What analysis have you given to the proposed use of delegated and implementing acts and the role of the European Supervisory Bodies? You state that there is no timetable for discussion as yet. Has the Commission set out any ‘ballpark’ timescale for negotiation and agreement?

We would be grateful for a response to these questions by 6 May 2014. In the meantime we will hold EM 13449/13 and 6020/14 under scrutiny. However we are content to clear EM 13426/13 from scrutiny.

1 April 2014

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

Thank you for your letter of 1 April on shadow banking, following our Explanatory Memoranda on this subject. The discussions you have had on the subject pose several questions that relate to the Government’s position on this important and complex issue. I will seek to address the issues you raise in the order that they appear in your letter.

Defining Shadow Banking

The term “Shadow Banking”, coined during the crisis, has, for better or worse, stuck and is in common usage in the financial sector and amongst regulators. As such, it is not a pejorative term, but a shorthand for an important part of the financial system. A number of organisations and commentators have attempted to define shadow banking, with the Financial Stability Board (FSB) calling it “credit intermediation involving entities and activities (fully or partially) outside the regular banking system”. This is a very broad definition and captures a great deal of financial activity, some of which does not raise great risks. For example, pension funds and insurance companies traditionally match long-term assets with long-term liabilities. As they tend to hold these without borrowing against them, they do not generate the sort of risks that primarily concern us in this context.

Essentially, the financial system intermediates flows of finance between non-financial providers of funds and users of funds. The traditional banking sector takes deposits from households and businesses in order to lend money to other households and businesses. These banks are leveraged and they engage in maturity transformation. But they are not the only means of channelling financial flows. Capital can also flow directly from households to businesses or via intermediating institutions such as insurance companies or investment funds. While these flows are forms of non-bank financial
intermediation, they do not exhibit leverage and maturity transformation. It is this that creates some of the distinctive risks of shadow banking.

For instance, a Money Market Fund (MMF) might lend money raised from investors to an asset backed commercial paper Structured Investment Vehicle (SIV), which buys the tranched debt issued by a special purpose vehicle — a chain of intermediation which introduces both leverage and maturity transformation, but in multiple steps, rather than within one bank balance sheet.

The shadow banking system is, therefore, a set of activities, markets and contracts as well as institutions which are linked by a highly complex web of transactions.

For the purposes of identifying the activities worthy of closer scrutiny and a regulatory response, the FSB has further narrowed down this definition, adding “and involving some combination of leverage and maturity/liquidity transformation.”

This definition is useful in that it allows us to concentrate on the aspects of shadow banking that generate the sort of risks that we are concerned with. The shadow banking system does not take deposits as regulated banks do and so engages in maturity and liquidity transformation without having access to central bank funding or safety nets such as deposit insurance.

THE SIZE OF THE SHADOW BANKING SECTOR

The figures for the size of the shadow banking sector quoted by your witnesses, Patrick Pearson and Matthew Fell, come from the FSB’s annual global shadow banking monitoring report 2013 (using end-2012 data) and, as such, represent the best estimate of the size of the global shadow banking sector. However, it should be noted that this report shows a decline in non-bank financial activity during 2012 with the size of the sector falling to 354% of GDP, against 384% in 2011.

The scope of the FSB’s annual report grows every year, with the 2013 version covering about 80% of global GDP and 90% of global financial system assets. It includes data from 25 jurisdictions and the Euro-area as a whole. However, the risks arising from most off-shore centres are currently not captured, creating a potentially large gap.

The report adopts a ‘macro-mapping’ approach based on national Flow of Funds and Sector Balance Sheet data which captures all non-bank financial intermediation to provide a conservative estimate. The 2013 report saw the first attempt to ‘narrow down’ this data by filtering out non-bank financial activities that have no direct relation to credit intermediation; that are already prudentially consolidated into banking groups; and assets related to self-securitisation. This is a work in progress and the headline figures in the report quoted by your witnesses come from the conservative estimate before narrowing down, but this approach will become more important in the future — although it should be noted that many jurisdictions still do not collect the more granular data required to narrow down.

Shadow banking is likely to continue to grow where there is appetite for lending that cannot be met by the traditional banking sector, such as in developing economies where the financial sector is still developing.

THE BENEFITS OF SHADOW BANKING

Shadow banking entities can interact directly with the real economy, as when a money market fund (MMF) takes investors cash and invests it into a wholesale market, purchasing commercial paper from a finance company that finances a loan to buy a house, a car or some other good. Other parts of the system might not touch the real economy at all. For example, repo markets allow short-term cash investors to generate returns from dealers who wish to finance long positions in securities. A securities dealer trading on its own account helps provide liquidity to markets through its own activity and by encouraging borrower and investor activity.

When appropriately conducted, non-bank financial intermediation provides a valuable alternative to bank funding, which is particularly important in developing economies where broadening and deepening of financial markets is essential for growth; but also in Europe, which has historically been heavily reliant on credit from the traditional banking sector. It provides credit and liquidity to the real economy, including SMEs and can improve efficiency and drive innovation in the financial system, for example by allowing an entity to specialise in a niche area, generating expert knowledge and economies of scale.
The crisis showed that shadow banking could create procyclical build-ups of leverage, did not fully transfer credit risk, was susceptible to runs, and was extremely complex, leading to uncertainty over who was exposed to whom.

In the build up to the crisis, the shadow banking system under-priced risk and when investors worried about the true value of those longer-term assets, many decided to withdraw or not rollover their funds. This, in turn, led to fire sales of assets and to other entities having to reduce the value of those assets on their books. The inter-connectedness of banks and the shadow banking sector and a lack of transparency over who owed what to whom caused serious difficulties for the traditional banking sector and the global economy as a whole.

Parts of the shadow banking system involves complex interconnections with the traditional banking system: MMFs funded banks as well as asset backed commercial paper (ABCP) conduits; ABCP conduits and SIVs were sponsored by banks; loans that went into securities were often originated by banks or their subsidiaries; and there is an extremely complex web of short-term secured funding markets linking money market mutual funds, banks, investment bank broker dealers, hedge funds and asset managers seeking to earn additional return via securities lending.

Recognising that a lack of information played a role in the development and spread of crisis, the international regulatory response has sought to improve transparency and fill the identified data gaps with the aim of better understanding the shadow banking system and spotting future risks early. Understanding of the sector has certainly increased, but this is an ongoing process with much work still to be done.

The Global Regulatory Response and the Role of the FSB

At the G20 summit in Seoul, the FSB was asked to “work in collaboration with other international standard setting bodies to develop recommendations to strengthen the regulation and oversight of the shadow banking system”.

The FSB has adopted an activities based approach to taking forward this remit; that is, it focuses on the activities, markets and contracts involved in the shadow banking system, rather than looking to target specific institutions. This led it to set up five work-streams. Of course, looking at activities inevitably pulls out institutions and entities that engage in these activities, Work-Stream 2, for example, looks specifically at money market funds (MMFs).

Work-Stream 1

Work-Stream 1 focuses on the links that can exist between banks and shadow banks and on ensuring that all banks’ activities, including interactions with the shadow banking system, are appropriately captured in prudential regimes.

The Basel Committee on Banking Supervision (BCBS) published final standards on capital requirements for banks’ equity investments in funds in December 2013 that will take effect from 1 January 2017 and will apply to banks’ investments in the equity of all types of funds that are not held for trading purposes.

The final BCBS standard for measuring and controlling large exposures was published in April 2014, taking effect 1 January 2019. The purpose of large exposure limits is to constrain the maximum loss a bank could face in the event of a sudden failure of a counterparty and help ensure the bank remains a going concern.

BCBS also aims to present proposals for consultation later this year around the question of what should be the scope of consolidation used to define the entities within groups to which the Basel framework is applied. This includes consideration of how shadow banks to which a bank is connected are included within the regulatory scope.

Work-Stream 2

Work-Stream 2 addresses MMFs since these can create money equivalent assets held by businesses, households or institutions, but were outside the regulatory constraints normally applied to private money creation. Final policy recommendations were developed by the International Organization of Securities Commissions (IOSCO) in October 2012 with a peer review of implementation being carried out this year. These aim to reduce the susceptibility of MMFs to runs by improving valuation and liquidity management; conversion of stable net asset value (NAV) MMFs to floating NAVs where workable, or
additional safeguards functionally equivalent to prudential requirements on banks; and strengthened standards on the use of credit ratings and on disclosures to investors.

**WORK-STREAM 3**

In August 2013 the FSB published a high-level policy framework for strengthening oversight and regulation of shadow banking entities. This includes a menu of policy tools to mitigate financial stability risks from the shadow banking system that authorities can apply within a nationally defined regulatory perimeter.

Authorities will share information through the FSB to maintain consistency across jurisdictions and to minimise ‘gaps’ in regulation and, therefore, regulatory arbitrage opportunities.

Key to this is the new information-sharing process which was launched in March by the FSB. This focuses on 5 “economic functions” or “activities” that will be used by national authorities to classify their non-bank financial entities and activities according to the shadow banking activities/risks such entities pose. Each economic function has an associated policy toolkit. This process is extremely important as it will allow authorities to identify new and residual shadow banking risks in a more forward-looking manner by focusing on “activities” rather than “legal forms or names (i.e. entities)”. Authorities will also be able to learn from each other’s experiences by sharing quantitative data and information on policy measures in a structured manner.

Important as this process is, it should be noted that the information to be shared is extremely technical and might not be gathered by all jurisdictions yet. The differences in shadow banking across jurisdictions also means that the data gathered is unlikely to be immediately comparable. This initiative will provide real benefits, but will take time to bed in.

Work-Stream 3’s expertise is also being leveraged for the FSB’s work towards identifying non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs). This looks at finance companies, broker dealers and asset managers (including hedge funds) with a view to examining their activities and identifying any systemic risks that they might pose. A consultation on this work closed in April and the FSB will update the G20 on its work in November.

**WORK-STREAM 4**

WS4 deals with incentive alignment in securitisation. IOSCO reviewed the market and published final recommendations in 2012 and will conduct a peer review in 2014 to assess implementation. The recommendations focus on addressing misaligned incentives and inadequate risk management that was a feature of the pre-crisis landscape via risk-retention standards (“skin in the game”), transparency and standardisation.

**WORK-STREAM 5**

WS5 addresses secured financing markets – repo, prime brokerage finance, securities lending and cash collateral reinvestment - which interconnects commercial banks, broker dealers, asset managers, MMFs and hedge funds.

A policy framework for non-centrally cleared securities financing transactions was published in August 2013. It includes improvements to market transparency and reporting to authorities; minimum standards on cash collateral reinvestment, collateral valuation and re-hypothecation; and proposals for collateral haircuts.

These include numerical “haircut floors” to be applied to securities financing transactions (when non-government collateral is posted by non-banks to receive cash from banks) and minimum methodological standards for calculating collateral haircuts. The aim is to limit the most aggressive terms of leverage available to non-banks from banks and to promote sound collateral management while pushing back against any procyclicality in market haircuts set by investors.

The second round of the second stage of the FSB’s Quantitative Impact Study (QIS) on these haircut proposals was completed in early 2014 and proposals are being refined, with a final publication aimed for by end 2014.

The UK is fully supportive of the FSB’s work on shadow banking. As proposals are finalised, it is important to maintain awareness of new risks as they develop and to implement policies in an internationally consistent manner. A robust system of monitoring and peer review is essential to make sure that we achieve consistency in the implementation of reforms with the aim of building a more integrated financial system.
THE ROLE OF THE EU

You asked about the overall effectiveness of the EU approach to shadow banking, specifically with regard to transparency requirements. The Government has been clear that the potential risks of shadow banking are best addressed through a proportionate programme of transparency and supervision that:

— Takes account of current legislation;
— Is consistent with international measures; and
— That does not inadvertently reduce choice and competition.

These principles inform the framework the Government uses for assessing the Commission’s proposed measures on shadow banking.

The Commission’s stated strategy for dealing with shadow banking, as expressed in its Green Paper on Shadow Banking in 2012, and developed later in its Communication to the Council and the European Parliament in 2013, involves closely modelling its new transparency and financial stability reforms on measures agreed at the international level. The Government supported this objective in its response to the 2012 Green Paper, where it underlined the importance of preventing regulatory arbitrage, recognising the potential for current legislation to address the issues, and of the need for an improved understanding of the entities and activities involved.

However the practical measures taken by the Commission are currently at an early stage. The proposal on MMFs and on the Transparency and Reporting on Securities Financing Transactions (SFTs) are the first legislative measures the Commission has adopted on shadow banking and both are at an early stage of negotiations. It is not possible to provide an assessment of the Commission’s overall approach at this early stage.

NATIONAL RESPONSIBILITIES AND THE ROLE OF THE UK

The balance of responsibilities between the EU and the UK, the aims of the Commission and the risks of the current approach are very important issues that the Government continues to consider as discussions on financial services regulation continue to develop at the FSB and in the EU. The current policy framework consists of three main stages;

— the Financial Stability Board (FSB), which considers the high level policy responses to shadow banking and works towards international co-ordination
— the European Union, (including the co-legislative process and European Supervisory Authorities) which implements a common European framework of rules and co-operation arrangements, and
— National authorities, which implement legislation and policy measures, and contribute expertise back to the FSB.

The Government believes that the current framework is effective and does not believe that considerable change is necessary as it utilises the respective levels of expertise and capacity at each level in an effective and efficient manner.

You also asked about how the UK is regulating shadow banking, and feeding in to EU discussion. The UK framework for addressing all systemic risks is contained in the Financial Services Act 2012 which established a new system for the management of systemic risks. Under the new framework, the Financial Policy Committee (FPC) has the power to make recommendations to HM Treasury, including on the ‘regulatory perimeter’ — that is, both the boundary between regulated and non-regulated activities within the UK financial system, and the boundaries of different regulators within the regulated sector. In particular, the FPC may provide recommendations on: which activities should be regulated, and which should not; whether institutions carrying out regulated activities should be designated for prudential regulation by the PRA, rather than the FCA, and vice versa; where the FCA might be able to set product intervention rules; and the types of unregulated institutions from which the PRA may collect information.

It is appropriate at this stage to note that most firms which fit within the definition of shadow banking are in some way regulated. Therefore, considerations of how to regulate shadow banking in future must include an assessment of how current regulation is doing so already. Thus in considering the regulatory perimeter, the FPC must closely monitor developments in the shadow-banking sector. The FPC has committed to assess and mitigate systemic risks beyond the existing regulatory perimeter on an annual basis, with its first assessment to be set out in the second quarter of 2014.
On this basis, the FPC reviews how well the current regulatory framework deals with potential risks to financial stability posed by firms engaging in shadow banking alongside those engaging in ‘traditional’ activities.

The position of London as a leading international financial sector and the rigorous approach taken by UK supervisors has enabled the Government and national authorities to make a significant contribution to international discussions at the FSB and the EU. The presence and expertise of the FCA and BoE in the area of Financial Services is recognised and valued in international forums.

Regarding the policy proposals issued by the Commission, you note that some have criticised their approach to shadow banking as unhelpfully ‘piecemeal’. There is a rationale for the Commission to propose policy responses to FSB recommendations as they are issued, instead of waiting until the appropriate scope and content of an all-encompassing shadow banking law become clear. The Government recognises that there are benefits to this approach because in some areas there are clear policy measures that can be taken, while in others authorities are still gathering information and building their understanding of potential threats.

MONEY MARKET FUNDS

Moving specifically to the issue of MMFs and the EU proposal to impose prudential requirements on them, you ask about their stability and the desirability of the Commission’s chosen policy response.

Regarding the vulnerability of MMFs to investor runs, European MMFs experienced significant outflows during the financial crisis, as much as 40% in the case of certain French Variable Net Asset Value (VNAV) MMFs. It is not clear that these outflows necessarily constitute “investor runs” and European MMFs were able to manage their liquidity issues. However, there were more definite runs in the case of many US MMFs so, while there are a number of differences between the US and EU markets, it is clear that MMFs can suffer from investor runs under certain circumstances.

While such a run could force a “fire sale” of a fund’s assets which might disrupt any market into which it has invested, it is not clear the extent to which this would lead to greater financial instability.

Turning to the questions you raise about the proportionality of the Commission proposal itself, the Government has concerns that the requirement to hold a 3% capital buffer and others proposals are disproportionately burdensome as they may render some funds uneconomic, and underestimate the likely wider economic impact.

According to the latest data we estimate Constant Net Asset Value (CNAV) MMFs make up 47% of MMF assets under management in Europe or just under half a trillion Euros. From discussions with both industry and many investors who use CNAV products we understand a large proportion of investors would not, or would not quickly, use MMFs if a CNAV product were unavailable. The most common view is that investors, such as Corporate Treasury Departments, would elect to put their money on deposit with ‘national champion’ banks. However, as a result of Basel III many Banks would not welcome these deposits.

For those investors who do switch to VNAV funds, there are also likely to be significant costs and complexities. In particular they will have to reconsider their credit policy, their tax and accounting exposure and redevelop internal systems to cope with the fluctuate net asset value.

The Government further believes that there is a significant risk that the introduction of capital buffers will render CNAV funds uneconomic. In particular given the extremely small margins of these products the cost of holding the capital is likely to render all but the largest CNAV funds unviable. The Government is concerned that a proposal which is tantamount to de facto prohibition is not proportionate.

Moreover, the proposal underestimates the wider economic impact of the proposal on the provisions of MMF services. MMFs are important providers of short term finance to financial institutions and corporations. As such they have an important part to play in promoting economic recovery. For investors MMFs are a basic, low risk investment product, to assist in day-to-day cash management. To the extent that investment moves out of MMFs and into short term cash deposits investors receive will suffer from less diversification and greater exposure to a single entity.

You also ask about whether the Commission proposals will reduce the exposure of banks to their MMFs. As proposed the capital buffer appears to be open ended, meaning that it would need to be topped up as the buffer is drawn upon. This would greatly increase the exposure of banks to their MMFs, potentially up to the full size of the MMF in question.
The Government is considering alternative approaches. There are a number of aspects of the Commission’s proposal, including enhanced liquidity requirements, enhanced transparency, enhanced oversight and new ‘Know your customer’ requirements which are broadly in line with the UK approach. In addition we are considering a system of redemption gates, which in extremis could be used to forcibly stop a run for a temporary period to allow liquidity in the fund to recover during a credit event.

This could be combined with Liquidity fees, these are fees charged when an investor redeems during a time when liquidity has become constrained. This ensures investors cannot benefit from early redemption where the shadow NAV has fallen below the published NAV. When in force, this removes any first mover advantage and ensures fairness of treatment across all investors.

SECURITIES FINANCING TRANSACTIONS

Regarding the Commission proposal on Securities Financing Transactions (SFTs), the Government considers that the regulation is drafted with the intention of closely implementing the FSB recommendations on securities financing transactions, ‘Repo’ markets and the re-hypothecation of client assets which form part of its Work-Stream 5. The Government will seek to ensure that the legislation remains as close as possible to the relevant FSB recommendations including where other stakeholders in the negotiation may seek to include additional provisions that detract from those measures agreed at the international level. We believe this may occur as the dossier is considered by the European Parliament.

However, as noted in the EM 6020/14, in an area of specific detail, the Commission has gone further than the FSB recommendation. The rules on the re-hypothecation of client assets include a requirement for a counterparty to gain consent before engaging on re-hypothecation. The stated purpose of this addition to the requirements is to increase investor protection and further address potential information issues between market participants to ensure they approve of the risks of their transactions. While noting that this is a justifiable aim, the Government will work during the negotiation to ensure the provisions are not unduly rigid and do not disproportionately reduce choice and competition.

Another area of ongoing scrutiny for the Government is in the area of what technical provisions will be delegated to the European Securities and Markets Authority (ESMA) to develop in consultation with national supervisory authorities and regulators. Such an approach is judged to be necessary where the subject matter is of a technically complex, but un-contentious nature, and where it is important for experts to finely tune the requirements with regard to the latest developments in supervisory and regulatory practice. The Government will closely scrutinise which matters are delegated to supervisory authorities to ensure important matters relevant to the UK interests are properly addressed in the negotiation.

Finally, the timetable of negotiation of this proposal is no clearer than when the Government last submitted information for scrutiny. Since the last EM 6020/14, there has been no commitment to a timetable of discussion of the SFT proposal.

13 May 2014

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

I am writing to inform you that the Government identified that certain measures included in these proposals engaged the UK’s JHA protocol and subsequently decided to opt-in to them. As you know, the Government believes that the UK’s JHA opt-in protocol is triggered when a proposal contains JHA content, irrespective of the legal base the Commission has chosen for its proposal.

The measures considered were Article 28(3) in the bank structural reform proposal and Article 20(3) in the securities financing transactions proposal. Both proposals were issued under an Article 114 legal base. They include similar provisions requiring Member States who have laid down criminal sanctions for breaches of some elements of the proposals to share specific information about criminal investigations with authorities in other Member States and with the European Supervisory Authorities. The Government found that these measures engaged the UK’s protocol. The deadline to notify the Commission of our opt-in decision was 19 May.

After the Government reached a coordinated position on this matter we informed the Commission of our decision to opt-in to the highlighted measures in both proposals. This decision was taken
because exchanging information about specific criminal investigations could be very helpful for regulators in enforcing the Regulations.

I regret that the late identification of JHA issues and work required to develop a firm position did not allow for the Government's enhanced JHA scrutiny obligations to be carried out in this instance.

1 June 2014

SHORT SELLING REGULATION (13840/10)

Letter from Sajid Javid MP, Financial Secretary, HM Treasury, to the Chairman

I am writing to update you on the Government’s legal challenge brought in the European Court of Justice, regarding the legality of Article 28 of the Short Selling Regulation (EU No 236/2012). This letter is for information, and follows my predecessor’s letter of 31 May 2012.

Article 28 of the Short Selling Regulation grants powers to the European Securities & Markets Authority (ESMA) to place restrictions on short selling of various instruments, in emergency situations. The Government sought clarity from Court on the lawfulness of the margin of discretion given to ESMA under this article. The Regulation went to ECOFIN in February 2012, and the UK had to abstain due to our concerns over the Article 28 powers. The UK launched a challenge in the European Court of Justice in May 2012, and the Court’s judgement has now been published.

The Court has chosen not to uphold the UK’s challenge. In particular, the Court has found, contrary to the UK’s arguments, that the restrictions on ESMA’s powers to intervene in short selling in Article 28 are sufficiently precisely defined and are therefore compliant with the requirements in Case 9/56 of Meroni v High Authority. Additionally, regarding the UK’s argument that Article 28 does not amount to a harmonising measure under Article 114 of the Treaty for the Establishment of the EU, the Court has clarified that the use by ESMA of its intervention powers to address financial market or systemic stability risks would amount to a harmonising measure across the European Union.

This judgement is final, and the European Court of Justice has no appeals process. This is separate from broader negotiations and the judgement itself will not be discussed at ECOFIN.

The Government had brought the challenge to gain legal certainty on the powers which can be conferred to EU agencies. This judgement offers more clarity and up to date case law on ensuring consistency of powers delegated to agencies under the Treaties.

5 February 2014

SINGLE RESOLUTION MECHANISM (12315/13)

Letter from the Chairman to Sajid Javid MP, Financial Secretary, HM Treasury

I am writing to you with regard to EM 12315/13 on the proposal for a Regulation establishing a Single Resolution Mechanism and a Single Resolution Fund. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on Tuesday 3 December 2013.

We decided to write to you in advance of the 10 December ECOFIN meeting, at which we understand that the Lithuanian Presidency will seek to agree a General Approach on the proposals. We are disappointed not to have had the opportunity to consider in advance of the ECOFIN meeting your reply (yet to be received) to our 10 September letter to your predecessor on the proposal, nor EM 15683/13 on the ECB’s Opinion on the proposals (which, although due on 26 November and dated 30 November, was not received until 3 December). The Sub-Committee is considering the proposals in the context of its current inquiry into EU ‘Genuine Economic and Monetary Union’ and the implications for the UK. The Committee will set out its full analysis of the proposals in its final report, which we hope to publish early in the new year. In the meantime, we thought that it would be helpful to set out our emerging views in advance of the 10 December ECOFIN meeting.

In May this year, German Finance Minister Wolfgang Schäuble wrote in the Financial Times that it might be necessary to agree a timber-framed rather than a steel-framed resolution mechanism in the short term, in particular because the more radical changes needed to create a comprehensive and fully effective single resolution mechanism (SRM) would require treaty change. We are concerned that, given that it may not be possible to construct an optimum resolution mechanism without treaty
change, any agreement reached in the absence of treaty change risks being, by definition, a sub-optimal solution. We fully understand the urgency with which the Lithuanian Presidency is seeking to make progress on the proposals, so as to ensure that a deal is agreed before the end of the European Parliament term. However, we urge you and Council colleagues to consider the implications of any deal. We fear that the viability of any agreement will only be tested in the event of a resolution crisis, by which time it will be too late to make any amendments. It is imperative that any mechanism that does emerge from negotiations strengthens rather than undermines the EU banking sector. A rushed and flawed agreement may be the worst solution of all.

We would particularly invite you to bear in mind our observations and questions in relation to five areas of outstanding agreement:

— The legal base of the proposal. What are the implications of the use of a Single Market legal base for a measure not designed to apply to all Member States? If sufficient safeguards were secured, might it not be consistent with the interests of the UK financial community? What update can you give us on negotiations?

— The scope of the SRM: In order to be effective, we agree that the SRM needs to cover all banks authorised in the participating member states. Any discussions of ways to enhance the role of national resolution authorities must not undermine this principle. Do you agree?

— The role of the Commission as the decision-making authority. What in your view are the advantages and disadvantages of the Commission taking on the proposed role as the resolution authority? Will it conflict with its other responsibilities? Does it have the necessary resources and expertise to take on the role? What role should the Council play in the resolution process? Is there a case for another institution, for instance the ECB, taking on this role? The Council has agreed that “any mechanism should be swift, robust and effective” in its decision-making. Given the complexity of the proposed decision-making process, how realistic is this in practice? In an ideal world, would a preferable solution be to set up a new resolution authority? If so, what are the risks of settling for a sub-optimal solution in order to obviate the need for treaty change?

— Structure of the single resolution fund. We are deeply concerned that the Council’s statement that it “is still in the process of looking for the best solution”, and that the Presidency is still considering how the fund can be constructed in a transitional period, indicate that negotiations on the resolution fund have not progressed beyond first principles. In our view, a resolution mechanism without an effective resolution fund would be flawed from the outset. The Lithuanian Presidency has stated that work should continue on the premise that there will be a single fund. Do you agree that some form of mutualisation is necessary if this aim is to be met? In light of the political sensitivities involved, how likely is it that agreement on an effective fund can be reached? Is there a danger that a sub-optimal agreement will undermine the resolution mechanism and consequently confidence in the EU banking sector?

— Equality of treatment of participating and non-participating Member States. The Council has stated that “options will be considered to resolve these issues in a reasonable and fair manner”. What safeguards are you looking to secure in order to ensure that the interests of non-participating Member States, and the EU as a whole, are protected?

In light of the significance of these outstanding issues, we would urge you to remain engaged in all aspects of the negotiations. In EM 15521/13 on the Commission’s Work Programme for 2014, the Government stated in relation to the SRM that they are “continuing to consider the strength of the rationale presented by the Commission for its choice of Treaty base and the suitability of the Treaty base for the necessary content of the proposal and will continue to engage actively in negotiations to mitigate risks to the integrity of the Single Market.” Important though these aspects of the negotiations are, we would urge you to ensure that the UK’s involvement is not so narrowly restricted. Even although the UK will not participate directly in Banking Union, an effective Single Resolution Mechanism is essential not only for the viability of the eurozone but also for the health of the City of London as Europe’s banking capital and the economic wellbeing of the EU as a whole as
well as its Member States. The UK has much to contribute to negotiations in helping to ensure that
the mechanism that emerges from negotiations is as effective and durable as possible.

In order to allow us to take account of a reply before the end of the year, we would be grateful for a
response to this letter, together with an update on the outcome of the 10 December ECOFIN, by 12
December 2013.

3 December 2013

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 10 September 2013 regarding the proposal for a Single Resolution
Mechanism. Given that the core elements of the Commission’s proposal have remained wide open, I
wanted to wait until substantive discussions had taken place at ministerial level before updating you on
the direction of negotiations. In addition, each of the points that you raised has been the subject of
considerable analysis within Government, some of which is still ongoing, requiring a delayed response.

Ministers discussed the Single Resolution Mechanism in detail at ECOFIN on Friday 15 November. In
that meeting the Presidency reconfirmed the European Council’s agreement to reach a general
approach in Council before the end of the year. To enable an agreement to be reached by that
deadline, the Presidency mandated working groups to continue examining the proposal and consider,
in particular:

— The scope of the Single Resolution Mechanism, including whether there
could be a greater role for national resolution authorities in participating
Member States.

— The governance structure of the proposal, including the voting modalities in
the Single Resolution Board and possibilities for exploring a greater role for
the Council.

— The structure of the Single Resolution Fund, how it will be built up and
options for handling the transitional period.

— Options for resolving the issue of non-contractual liability and equality of
treatment of participating and non-participating Member States.

Following further consideration of these issues, the Presidency currently aims to reach a general
approach at ECOFIN on 10 December.

Regarding the first three strands of follow-up work, we are broadly content for SRM participants to
take judgements on the detailed design of the SRM provided it is consistent with the principles set out

The fourth area of further work listed above reflects concerns from a number of Member States
outside the euro, including the UK. The Government will continue to work for an outcome to the
negotiation that provides appropriate safeguards for the UK and other non-participants from any fiscal
liability accruing to the EU Budget in relation to SRM actions. We will also look to negotiate
arrangements that ensure equality of treatment as between the Commission (in respect of SRM
participants) and national resolution authorities in the context of European Banking Authority
decisions.

Progress has been made during the autumn in Council working group negotiations on a number of
issues, including ensuring that there are clear provisions on the face of the Regulation ensuring an
equivalent application of State aid rules to the Single Resolution Fund (SRF) and to national resolution
financing arrangements Important improvements have also been made to the text in relation to an
explicit requirement that the Commission and Single Resolution Board (SRB) cannot discriminate
against non-participating Member States; the relationships between the SRB and Commission with
resolution authorities in non-participating Member States; and symmetry of powers as between the
Board/Commission on the one hand and resolution authorities in non-participating Member States on
the other.

Nevertheless, significant further work is still required in a number of areas, including securing
safeguards for the UK and other non-participants from any fiscal liability accruing to the EU Budget in
relation to SRM actions and ensuring full alignment between the Regulation and the draft Bank
Recovery and Resolution Directive, which remains in trilogue discussions with the European
Parliament.
The Government has, of course, registered with the Presidency that the Regulation remains under parliamentary scrutiny in the UK.

Moving to the questions raised in your letter. Firstly, you asked about alternatives to an Article 114 TFEU legal base. The Government is continuing to consider the strength of the rationale presented by the Commission for its choice of Treaty base and the suitability of the Treaty base for the necessary content of the proposal. The Commission has not indicated any intention to bring forward a proposal on an alternative Treaty base.

Secondly, you asked for further clarification of which elements of the proposal are potentially incompatible with EU law and the Meroni judgement. At a fairly early stage in Council negotiations, the Council Legal Service provided advice setting out which provisions in the proposal were, in its view, incompatible with Meroni. The Opinion of the Council Legal Services is already in the public domain. Therefore I can inform you that the CLS indicated a number of areas of concern on the proposed roles for the Single Resolution Board, including in relation to resolvability assessments (and matters to remedy impediments to resolvability) (Articles 8), the resolution scheme (Article 16), and matters relating to the financing and management of the SRF (Articles 54 to 71).

The Government broadly agrees with this analysis. As a result of this legal advice and subsequent discussion in Council working groups, considerable progress has now been made to reduce the discretion of the SRB in the exercise of a number of its functions, including those listed above.

Finally, you asked about the role of the Commission. While it is accepted that the Commission’s role is defined in broad terms in the Treaty of the European Union, it must also be noted that the proposed conferral of executive power using secondary legislation is unprecedented. Under the proposal the Commission would take on the role of recovery and resolution decision-maker for banks in participating Member States, in addition to its existing, EU-wide roles, as competition authority, trade negotiator and single market enforcement authority. Apart from these executive roles, the Commission would also continue to enjoy the sole right of legislative initiative, including for single market issues in respect of recovery and resolution.

If the Commission takes on a new role as decision-maker on recovery and resolution issues, the Government will seek to work with other Member States and the Commission to mitigate the potential for conflicts of interest. This could be done through reform of the Commission’s internal decision-making procedures and increasing the transparency of its decision-making. The case for specific audit and review arrangements, perhaps involving a role for the European Court of Auditors, should also be considered. A greater involvement of other EU institutions such as the Council could also help address conflicts of interest by reducing the concentration of tasks in a single institution, but would need careful consideration to ensure that any approach is legally and operationally workable.

Regarding your specific question on State aid procedures, the Government is not convinced that the simple inclusion of references to the “by analogy” application of the State aid provisions in the Regulation are a sufficient condition to ensure that State aid rules and procedures apply equally to uses of the SRF in the way that they would in relation to national resolution financing arrangements. During Council negotiations the Government is pushing hard for proper consideration of this issue to ensure a rigorous and non-discriminatory application of State aid controls.

The kind of provisions which are currently being considered in negotiations include requirements that the Commission could not adopt a resolution framework or approve the use of assistance from the Fund without first having taken a positive decision that the use of the Fund is consistent with the internal market. It would also require greater detail on the face of the Regulation concerning relevant existing procedural and substantive State aid rules, which should be applied in a resolution context. Negotiations in the Council have made significant progress on the inclusion of such safeguards.

Hopefully the information provided to the Committee will mean the Government is able to freely support the proposal at ECOFIN should a positive outcome be reached in the final stages of negotiations.

3 December 2013

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 3 December on the Single Resolution Mechanism, which crossed with my own letter to you of the same date.

I wanted to update you on progress during the discussions at ECOFIN on 10 December and address the questions raised in your letter. I have also noted carefully the views set out in your letter.
As a result of discussions at the ECOFIN meeting, it is clear that the basic elements of any proposal are likely to be as follows:

— There remains a consensus among participating Member States for the new Single Resolution Board to take most decisions on bank resolution, with the involvement of EU institutions limited only to those decisions that demonstrably cannot be taken by an EU agency under existing case law. The Board’s detailed decision-making arrangements remains to be agreed.

— The scope of the Single Resolution Mechanism will continue to be that all banks are covered within the overall mechanism, with national resolution authorities playing a larger role with respect to smaller banks and in resolutions where no external funding is required.

— Some Member States have proposed moving some elements of the proposal to an intergovernmental agreement between the participating Member States, in particular the mutualisation of resolution funding. Ministers will meet next week to finalise the scope of this agreement and how it will interact with the SRM’s provisions. There was broad agreement that an intergovernmental agreement would include provision for participating Member States to compensate non-participating Member States for any liabilities they incurred (including via the Union budget) as a result of Union institutions performing tasks under this Regulation.

The Government will continue to approach negotiations constructively and will be prepared to support an agreement on the SRM Regulation provided it is consistent with the overall framework for dealing with banking failure in the Bank Recovery and Resolution Directive (which remains subject to discussion in trilogies) and provides for fair and equal treatment of non-participating Member States.

You also asked a number of specific questions concerning the SRM, some of which were addressed in my letter of 3 December and developments have allowed for the following additional observations.

Firstly, the legal base. As noted above, following the ECOFIN discussion, issues relating to the Single Resolution Fund (SRF) may be split from the other legislative elements of the proposal and agreed separately in the form of an inter-governmental agreement. Nevertheless, the Government continues to be concerned about the use of a single market legal base for a measure essentially aimed at strengthening economic governance in the euro-zone, noting the potential precedent this may set for legislating for measures which essentially concern the single currency area whilst acting on a single market base. However, with other Member States content with a combination of a 114 legal base and the use of an inter-governmental agreement to cover financial issues, and given the important progress made at ECOFIN on issues of concern to the UK, as noted elsewhere in this letter, I am minded at this stage not to actively oppose the use of an Article 114 legal base for this measure. Of course this will need to be kept under review, in particular, as regards the outcome of further discussions on our other concerns and the Government will of course reserve its position on this point pending final agreement on the file after negotiations with the European Parliament are completed and the final shape of the proposal is clear.

Secondly, you asked about the role of the Commission. I have little to add to what I said in my previous letter regarding this. Whilst it might, in some respects, be preferable for the Single Resolution Board (SRB) to be solely responsible for taking decisions on resolution issues to deliver a swift, robust and effective mechanism, the constraints of the Meroni case law make it impossible for an agency to take unambiguously final decisions on issues such as resolution that involve policy discretion. That said, the latest drafting of the proposal envisages a more constrained role for the Commission, essentially deciding whether to endorse or not decisions made by the SRB. Where the Commission decides against endorsement, it seems likely that provisions will be agreed whereby the Council will review the decision and may take a different view by simple majority. I envisage non-participating Member States indicating that they would not vote in such a way so as to disturb the prevailing majority amongst participating Member States. Against that backdrop, I intend to prioritise securing the operational safeguards around the Commission’s role set out in my earlier letter to you. The latest text of the SRM proposal represents progress in this regard, with a requirement for functional separation between Commission officials working on resolution issues and those working on State aid matters. However, we await further details of the Commission’s approach here where we are expecting them to release a draft statement shortly.

You also asked about equal treatment of participating and non-participating Member States. As noted previously, significant progress has been made in this area, including ensuring that there are clear provisions on the face of the Regulation ensuring an equivalent application of State aid rules to the
Single Resolution Fund (SRF) and to national resolution financing arrangements. Important improvements have also been made to the text in relation to an explicit requirement that the Commission and Single Resolution Board (SRB) cannot discriminate against non-participating Member States; the relationships between the SRB and Commission with resolution authorities in non-participating Member States; and symmetry of powers as between the Board/Commission on the one hand and resolution authorities in non-participating Member States on the other.

You also asked questions relating to the scope of the mechanism and the structure of the Single Resolution Fund in the wider context of building a successful banking union.

The Government continues to believe that breaking the link between banks and sovereigns is the best way to restore long-term stability and confidence to both public finances and the financial sector. This is why we are in the process of agreeing a strong bank resolution regime for all Member States in the Bank Recovery and Resolution Directive, which will set out the minimum powers that public authorities will need to have to address failing and failed banks. This will build on the updated banking State aid framework to shield taxpayers across the Single Market from future losses.

But it is for those Member States that have resolved to centralise banking supervision and resolution to determine how the detailed design of the governance and financing arrangements. We recognise that a number of important issues remain under discussion. But it is important to remember that we are not legislating in a vacuum. The crisis in Cyprus demonstrated to all that there is no room for complacency and the full weight of the European Council is encouraging reforms that will support both the euro and the whole European economy.

Finally, I wanted to thank you for your willingness to waive scrutiny at ECOFIN on 10 December. Although, in the end, it was not possible to reach agreement on a general approach there the Chancellor and I were very grateful for your flexible approach in view of the fast-moving nature of discussions taking place that day.

The Presidency now plans to seek agreement on a general approach on the SRM Regulation and to finalise the scope of the intergovernmental arrangement referred to above at an extraordinary ECOFIN next week, likely to be held on Wednesday 18 December. Discussions to finalise texts, including with the European Parliament, would then continue in the New Year.

I appreciate that these are significant issues. But it would greatly help the Chancellor and I at next week’s negotiations if we had your support for an agreement which secures UK interests and, in particular, ensures no budget liability for the UK and provides for equal treatment for participating and non-participating Member States.

12 December 2013

**Letter from the Chairman to Sajid Javid MP**

Thank you for your letters, dated 3 and 12 December, on EM 12315/13: the Regulation establishing a Single Resolution Mechanism and a Single Resolution Mechanism, and EM 15863/13 on the Opinion of the European Central Bank on the same proposals. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 17 December 2013.

We are grateful to you for your most recent letter, and for the clarity you provide on the current state of negotiations on this complex set of proposals. We note that considerable progress has been made towards reaching an agreement on elements of the package including the proposed role for the Single Resolution Board, Commission and Council, the legal base and the treatment of participating and non-participating Member States. In particular, we welcome the safeguards you have secured in relation to the latter point. We also welcome the evolution of the Government’s views on the question of the appropriate legal base; we endorse your current position on this issue.

We note that issues relating to the Single Resolution Fund may be split from the other legislative elements of the proposal and agreed separately in the form of an intergovernmental agreement. What will be the impact of this move on the SRM proposals as a whole? How long is it envisaged that it will take to reach agreement on the Resolution Fund? Given the contentious issues at stake, how big is the risk that it will not be possible to reach agreement on the Resolution Fund and the remaining elements of the Resolution Mechanism at the same time? What are the implications of this? What will be the impact of this move on the UK and other non-participants? What will be the impact of this decision on the resolution mechanism and on confidence in the EU banking sector as a whole?

We note with concern recent *Financial Times* reports that both ECB President Mario Draghi and Commissioner Michel Barnier have expressed concern that the emerging deal will prove inadequate.
Mr Draghi has warned that “decision-making may become overly complex and financing arrangements may not be adequate”, and stressed that “one can’t have hundreds of people consulting on whether a bank is viable or not.” Mr Barnier warned that the emerging deal was “too complex”. Resolution needs to take place extremely quickly if market confidence is not to be undermined. Do you share these fears that the emerging agreement risks making the resolution process too complex to work effectively?

Taking these developments as a whole, we stress that a flawed and rushed agreement which would undermine confidence must be avoided at all costs. What assurance can you give us that the agreement that is emerging will strengthen and not undermine confidence in the EU banking sector?

Our forthcoming report on Genuine Economic and Monetary Union will consider these issues in some depth, and we will continue to hold EM 12315/13 under scrutiny until that report is published. However, in recognition of the importance of the issues at stake, we are willing to grant a scrutiny waiver to allow you to vote in Council should this prove necessary. We also now formally clear EM 15863/13 on the ECB’s Opinion on the proposal from scrutiny.

We would be grateful for your analysis of the impact of these developments, your response to our questions, and an update on the outcome of the extraordinary ECOFIN scheduled for 18 December, by 7 January 2014.

17 December 2013

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 17 December on the Single Resolution Mechanism (SRM).

After lengthy and, at times, difficult negotiations which ran through into the late evening of 18 December, ECOFIN agreed the following:

— A General Approach on the SRM (on which the UK maintained a reservation – see below);

— A draft Decision of the representatives of the euro area Member States meeting within the Council to draw up an Inter-Governmental Agreement (IGA) covering the establishment of the Single Resolution Fund (SRF) and draft Terms of Reference for that IGA, which it is intended should be agreed by 1 March 2014. Membership of the IGA will be open to all Member States that wish to be a Contracting Party. However, its provisions will only be binding on Member States that are part of the SRM. All non-participating Member States may participate as observers in the negotiations.

— A statement by Eurogroup Ministers on backstops to the SRM - in specific conclusions agreed by the Council to be recorded in the minutes of the ECOFIN meeting it was confirmed that the backstop will not be funded by the Union or by non-participating Member States (see further below);

— A declaration of the representatives of the 28 Member States meeting within the Council on voting modalities in relation to decisions on resolution actions under the SRM and;

— Specific conclusions agreed by the Council to be recorded in the minutes of the meeting covering voting modalities, a reimbursement mechanism for non-participants and backstops. The December European Council conclusions in turn welcomed “the general approach and the specific conclusions reached by the Council on the Single Resolution Mechanism”.

I will elaborate on a few specific points of particular interest to the UK. Firstly, we have achieved our key objective of securing an agreement to an effective reimbursement mechanism to ensure that non-participating Member States shall be reimbursed for amounts paid in own resources corresponding to the use of the Union budget in connection with non-contractual liability and costs related thereto arising from implementation of the SRM. This is clearly set out both in the draft Decision and the Terms of Reference on the IGA. The Commission will be invited by the 28 Member States to coordinate any reimbursement action.

Secondly, the Government secured text in the SRM Regulation on a range of issues that, taken together, deliver equal treatment for non-participating Member States. In particular, there are clear provisions on the face of the Regulation ensuring an equivalent application of State aid rules to the SRF and to national resolution financing arrangements. The Regulation also now contains an explicit
requirement that the Commission and Single Resolution Board (SRB) cannot discriminate against entities in non-participating Member States, while relationships between the SRB and Commission with resolution authorities and national competent authorities in non-participating Member States will be enshrined in Memorandum of Understanding with a separate MoU in relation to each jurisdiction (such as the UK) which is home to at least one global systemically important institution. There will also be symmetry of powers as between the Board on the one hand and resolution authorities in non-participating Member States on the other.

Thirdly, we also secured text in the SRM Regulation to address potential conflicts of interest in the European Commission between its role under the SRM and its other executive and legislative functions. It is worth noting that the Commission role in SRM decision-making is now significantly amended compared to the original Commission proposals.

Fourthly, we have secured strong text providing a role for the European Court of Auditors in evaluating the use of the Fund and the work of the Board, which will strengthen transparency and accountability in relation to resolution decisions under the SRM.

Finally, I will comment on the voting modalities. This issue arose because of the desire by some participating Member States to ensure a role for the Council in SRM decision-making, albeit in certain, fairly limited circumstances. So, whilst the Single Resolution Board (SRB) will be the main decision-taker on resolution issues for participating Member States, the Council, acting by simple majority on a proposal of the Commission, has the right to object, or propose amendments to, decisions taken by the SRB.

Given that the decisions to be taken by the Council in these circumstances will concern the resolution of entities in the participating Member States the Member States made a declaration on Council voting on resolution issues. This provides that non-participating Member States may undertake to exercise their right to vote in a manner which does not prevent the adoption of a decision by the Council under the SRM which reflects the majority view amongst participating Member States. I wish to stress that this does not mean that the UK has given up its vote in Council on these issues. Indeed, that would not be possible under the Treaties. Moreover, the declaration is explicit that the declaration reflects the exceptional circumstances of this legislation and “does not constitute a precedent for use in any other context”.

I was grateful for your committee’s willingness to grant a waiver from scrutiny. However, ultimately the Chancellor decided to maintain a reservation on the agreement to the General Approach. He tabled a Minute Statement at Council which reads:

“Noting the general approach reached at the ECOFIN Council on 18th December, the UK supports the establishment of the Banking Union for the eurozone and the broad agreement that was reached. The UK reserves its position on certain legal issues relating to the Single Resolution Mechanism, pending the judgment of the Court of Justice of the European Union in Case 270/12.”

Turning now to your questions, ECOFIN agreed that negotiations on the Inter-Governmental Agreement (IGA) should be concluded by 1 March 2014. The core elements for the IGA have already been agreed in the terms of reference document adopted at ECOFIN. If this timetable is met then there should be no question of the SRM Regulation being finally agreed, after trilogues with the European Parliament, before the IGA has been concluded. As for the decision to split out elements of the Regulation relating to the SRF into an IGA, whilst this had added to the complexity of the final stage of negotiations in the Council I do not envisage that, in and of itself, this shift to two legal instruments should reduce the effectiveness of the resolution mechanism.

You also set out some general concerns that the decision-making process envisaged for the SRM is too complex and would not be able to take decisions in a timely manner.

I have some sympathy with these concerns. However, the final decision-making arrangements specified in Article 16 of the Council’s general Approach on the SRM Regulation are perhaps not as complex or time-consuming as some of those quoted in your letter feared at the time they were speaking.

The SRB is the key decision-making body in resolution actions for participating Member States. However, the Meroni case law and associated restrictions on the sub-delegation of powers make it inevitable that one or more EU Institutions will need to be somehow involved in the process. The compromise agreed at ECOFIN envisages that, after the SRB has taken a decision in a resolution action, the Commission then reviews the decision. If it has no objection the Board’s decision can take effect. If it objects or wishes to amend the SRB’s decision it must make a proposal to the Council to that effect who will decide on the matter by simple majority. So, there is a “double-lock” mechanism before the Board’s decisions can be overruled which, in practice, should mean that the involvement of
the Commission or Council should only be in the most exceptional cases. In our view, this provides for a more independent SRB than that proposed by the Commission or currently envisaged by the European Parliament which would give the Commission very broad rights to intervene in the decisions of the SRB.

A resolution scheme enters into force after its adoption by the Board in the event of no objections from the Council within 24 hours. Otherwise, the Council may, on a proposal from the Commission, address directives to the Board to re-formulate its scheme within a set deadline. In the event that the Board does not agree with one or more of the directives formulated by the Council it may, within the deadline set by the Council, address a notice to the Commission and Council requesting their amendment. The Council, on a proposal from the Commission, may then amend its directives within 24 hours of receiving the notice from the Board. If it fails to act within 24 hours or expressly rejects the request for amendment, the Board shall incorporate the Council’s directives into the resolution scheme.

These arrangements should prove workable in practice although, as ever, much will depend on the manner in which they are implemented and close co-operation between the Board, Commission and Council will clearly be vital.

In conclusion, the Government believes that the agreement on the SRM reached at ECOFIN on 18/19 December is an important step in setting up a workable euro-zone banking union, which the UK supports. It also ensures that the interests of British taxpayers are protected and the integrity of the single market is guaranteed. The next step will be to ensure that the gains we have secured during the Council negotiation are protected during trilogues with the European Parliament and that the IGA delivers a practical reimbursement mechanism.

7 January 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 7 January 2014, on EM 12315/13, the Regulation establishing a Single Resolution Mechanism and a Single Bank Resolution Fund. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 14 January 2014.

We are grateful to you for this account of the outcome of negotiations at the 18 December 2013 ECOFIN. We will analyse this agreement in our report on Genuine Economic and Monetary Union and the implications for the UK, to be published shortly.

In the meantime, we would be grateful for one point of clarification. You state in your letter that the UK reserved its position on certain legal issues relating to the Single Resolution Mechanism, pending the judgment of the Court of Justice of the European Union in Case 270/12. You state in your letter to William Cash MP, Chairman of the House of Commons European Scrutiny Committee, also dated 7 January 2014, that “concerns regarding the Article 114 single market base ... in part, informed the decision to maintain a reservation. It is something we will come back to in light of the considerations set out in the Minute Statement.” This is in spite of the fact that your letter to us of 12 December 2013 stated that, “with other Member States content with a combination of a 114 legal base and the use of an inter-governmental agreement to cover financial issues, and given the important progress made at ECOFIN on issues of concern to the UK, as noted elsewhere in this letter, I am minded at this stage not to actively oppose the use of an Article 114 legal base for this measure.” We would be grateful for clarification of the reason for the UK’s reserving its position, and specifically what “certain legal issues relating to the Single Resolution Mechanism” the Government had in mind in maintaining a reservation.

We would be grateful for a response to these questions, together with any update on further negotiations, by 21 January 2014. In the meantime we will continue to hold the document under scrutiny.

14 January 2014

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 14 January 2014 on the Single Resolution Mechanism (SRM). I hope you found our update on negotiations helpful, and I will consider your forthcoming report on Genuine Monetary Union and the implications for the UK.
You have asked for further clarification on the legal issues which influenced our legal reservation on the SRM general approach agreed at ECOFIN on 18 December 2013. Our reservation refers to the pending judgment of the Court of Justice of the European Union (CJEU) on the UK’s challenge to certain aspects of the Short Selling Regulation (SSR) [Case C-270/12].

By way of background, the SSR was adopted on the basis of Article 114 TFEU, in response to short selling in light of the financial crisis; and an EU agency (ESMA) was delegated discretionary powers of intervention in the financial markets of EU Member States by way of legally binding acts, should a threat arise to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the EU. The UK has challenged these powers on several grounds: in particular that Article 114 TFEU was an incorrect legal base for the conferral of these powers, because they are not harmonising measures and secondly, that the conferral of powers was unlawful as it confers on an EU agency (ESMA) the powers to undertake decisions which involve a wide degree of policy discretion (contrary to the Meroni principle).

The Advocate General’s Opinion (AGO) was issued on 12 September 2012. As regards the suitability of the legal base, the AGO did not object in principle to the establishment of ESMA and the regulation of its tasks generally on the basis of Article 114 since it can properly be described as concerning the approximation of Member State rules. However, the specific powers delegated to ESMA under the SSR were a different matter, since decisions made under the relevant provision could not properly be described as having as their object the improvement of conditions for the establishment and functioning of the internal market. The AGO did not consider those powers as seeking to achieve greater harmonisation of national laws, but saw them as supplanting specific national decisions with EU-level decisions. As such, Article 114 TFEU was not the proper legal base. The AGO considered that the provision could have been made under Article 352 TFEU, which would have required unanimity in Council.

As you will appreciate, the outcome of this case has the potential to significantly impact aspects of the SRM negotiations. If the legal base aspect of the Opinion were followed by the CJEU, the use of Article 114 TFEU as the legal base for the SRM proposal may need to be reconsidered. Moreover, we are continuing to consider the suitability of the decision-making structure under the SRM, including the extensive role for the SRB as set out in the General Approach text, pending the judgment of the CJEU in the short selling case.

I hope this helps to address your specific concerns.

18 January 2014

Letter from the Chairman to Sajid Javid MP


Since receiving this letter we have learnt that the Court of Justice of the European Union has issued its judgement in relation to the Short Selling Regulation and that the UK challenge has not been upheld. We would be grateful for your analysis of the implications of this judgment. In the current context, what are the implications with regard to your concerns regarding the Single Resolution Mechanism?

We would be grateful for a response to these questions. In the meantime we will continue to hold EM 12315/13 under scrutiny.

28 January 2014

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 28 January on the implications of the judgement of the Court of Justice of the European Union (CJEU) on Article 28 of the Short Selling Regulation the Government’s approach to negotiations on the Single Resolution Mechanism (SRM).

The preliminary analysis of this judgement by legal advisers suggests two areas where the judgement could impact on the SRM.

The first is the legal base for the SRM proposal. As you know, the SRM Regulation has an Article 114 legal base under the Treaty on the Functioning of the EU. The judgement tends to support the view that the CJEU will afford the legislator a wide margin of discretion in the choice of legal base in this area. It seems probable that the CJEU would regard the SRM proposal as part of an overall scheme of
harmonisation, having particular regard to the legal framework to be established for all EU Member States under the Bank Resolution and Recovery Directive (BRRD)). The Court is also likely to view it as something that both (further) harmonises national laws, by removing certain discretions that would otherwise be available to the participating Member States under the BRRD, and provides a scheme under which the process of harmonisation will be implemented through the new framework of decision-making by supra-national authorities.

The second relates to the proposed conferral of various powers on the new EU agency to be established under the SRM: the Single Resolution Board (SRB). In its judgment the Court reaffirmed the existence of the Meroni principles (as set out in EM 12315/13). However, it appears to have adopted a relatively relaxed approach to the application of these principles in practice. Nevertheless, as a matter of law, the Court made clear that it remains the case that tasks conferred on agencies need to be well-framed to ensure that their executive powers are sufficiently limited by the appropriate conditions and criteria. I intend therefore to continue to scrutinise carefully the precise framing of powers for the SRB in the SRM proposal with a view to ensuring that the powers are sufficiently well-framed so as to ensure compliance with the Meroni principles.

In practice it currently appears unlikely that the judgement, in and of itself, will necessitate major changes to the General Approach text agreed by ECOFIN at the end of last year.

28 February 2014

Letter from the Chairman to Sajid Javid MP

Thank you for your letter, dated 28 February 2014, on EM 12315/13 on the Single Resolution Mechanism (SRM). The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 March 2014.

We note your preliminary analysis of the implications for the SRM negotiations of the judgement of the Court of Justice for the European Union (CJEU) on Article 28 of the Short Selling Regulation. Does the CJEU’s (in your words) “relatively relaxed approach to the application of these principles in practice” indicate that the Meroni doctrine cannot, in and of itself, be relied on as the basis for an objection to EU agencies taking on such powers?

What update can you give us on negotiations on the SRM? How confident are you that agreement can be reached by the end of the current European Parliament term?

We would be grateful for such an update by 25 March 2014. We also hereby confirm that the EM 12315/13 was cleared from scrutiny upon publication of our ‘Genuine Economic and Monetary Union’ and the implications for the UK report on 14 February 2014.

11 March 2014

Letter from Sajid Javid MP to the Chairman

Thank you for your letter of 11 March on the Single Resolution Mechanism. I am grateful for your committee’s decision to clear this EM from scrutiny. You asked for an update on the state of play with the negotiations.

Negotiations on the SRM have been taking place on two separate but closely linked tracks: trilogue negotiations between the Presidency, the Commission and the European Parliament on the SRM Regulation; and an Inter-Governmental Conference between Member States on the Inter-Governmental Agreement (IGA) side.

In the SRM Regulation negotiations, after a prolonged period earlier in the year where there was little progress on the main issues, Ministers discussed the appropriate stance for the Council to take in subsequent trilogues with the Parliament at the ECOFIN Council on 11 March, including on the respective roles of the Single Resolution Board’s executive and plenary formations and the threshold for majorities in plenary session.

Separately, Ministers met in Inter-Governmental Conference format on the eve of the March ECOFIN. This meeting resolved almost all the outstanding issues with the text of the IGA, although the text could not be finalised in isolation from the negotiations with the Parliament on the SRM Regulation given the closely related subject matter of the two instruments. In addition, participating Member States indicated their flexibility to speed up the pace of mutualisation of contributions to the Single Resolution Fund.
These developments allowed highly productive trilogue negotiations to take place on 12 March and on 19/20 March. The latter session, which ran through the night, agreed the outlines of a possible deal. A further trilogue is scheduled for 24 March which will aim to pin down outstanding details.

As the shape of a final deal becomes clearer I would like to highlight the following points of particular interest to the UK which we have corresponded about extensively over the last six months.

Firstly, we have successfully defended the principle equal treatment between participating Member States and non-participating Member States set out in the Council General Approach (the detail was set out in my letter of 7 January to you). It now looks highly likely that all four of the provisions I set out there will be included in the final version of the text without significant changes to what was originally agreed in Council at the end of last year. We will of course continue to review carefully the detailed technical drafting that emerges in the next few days to ensure it meets our concerns.

Secondly, the IGA text includes detailed provisions for a budget reimbursement mechanism that ensures non-participating Member States are compensated for their share of any costs falling on the EU Budget as a result of non-contractual damages payments awarded against the Commission (or the Council) under the SRM. In particular, the current text ensures a role for the Commission in administering the mechanism and a right of recourse to the CJEU to allow non-participating Member States to enforce their rights if necessary. This ensures the UK will be fully protected from cost arising from the SRM.

To allow the Court to play this dispute settlement role under the Agreement, the IGA will be designated as a “special agreement” within the meaning of Article 273 TFEU. Although the UK will not itself be a Contracting Party to the IGA, my intention is for the UK to join the Contracting Parties in designating the IGA as a “special agreement”. This will allow the UK access to the CJEU to enforce its rights under the budget mechanism in the event that that should prove necessary.

A “Bangladesh decision” will need to be taken by the Council by unanimity to confer a role on the Board and the Commission under the IGA. Given it is very much in the UK’s interests for the Commission to administer the reimbursement mechanism I intend to support this approach.

Thirdly, we have protected the provisions agreed in Council General Approach conferring a strong role on the European Court of Auditors in evaluating the use of the Single Resolution Fund and the work of the Board, which will strengthen transparency and accountability in relation to resolution decisions under the SRM.

Fourthly, regarding potential conflicts of interest in the Commission, the Regulation will require the Commission to set out how it will ensure organisational separation (‘Chinese Walls’) between its resolution tasks under the SRM and its other executive and legislative functions thereby helping to protect equal treatment between participating and non-participating MS.

Fifthly, a compromise was reached on the role of the Commission and Council in the decision-making process. For Meroni reasons, the Commission will have discretion to object to the Board’s proposed resolution scheme on discretionary aspects of the resolution scheme. The scope of the Commission’s discretion to object will be further discussed in the technical trilogue. The Council will be able to object to the Single Resolution Board’s proposed resolution scheme, when acting on a proposal of the Commission, on public interest grounds and/or to approve or object to a modification by the Commission of the amount of the Fund provided for in the resolution scheme of the Board.

Finally, as noted in previous correspondence, there is no appetite in the Council and very strong opposition in the Parliament to changing the legal base of the SRM Regulation from Article 114 TFEU. It is clear that this will be the legal base for the Regulation.

In the context of these negotiations, we agreed the text of a political Declaration of the 28 Member States in connection with the IGA. This stresses the political commitment of the Member States to the bail-in rules set out in the Bank Recovery and Resolution Directive and the SRM Regulation and commits not to support any changes to these rules which do not lead to, at least, “the same and not less stringent result” unless all 28 Member States agree. I regard this as useful means of adding to the credibility of the bail-in rules.

Following the trilogue on 19/20 March, the Presidency now intends to take forward further technical work with the Parliament urgently with a view to putting the emerging deal to COREPER for consideration at its scheduled meeting on 26 March. If that indicates support for the deal it is then likely to be voted on in the Parliament’s ECON committee by 8 April before being put to a vote in the Parliament’s final plenary session on 13-17 April. Following the completion of work by jurists-linguists, the final text of the Regulation would then be formally adopted by Council later in the year.
probably at some stage during the late spring. The IGA would be opened for ratification by Contracting Parties on a similar timescale.

I believe a deal along the lines described above represents a very good outcome for the UK, with legally enforceable protection for UK taxpayers from costs associated with use of the SRM and strong protections to ensure a level playing field between participating and non-participating Member States, protecting the integrity of the single market.

On the legal base, given the CJEU’s judgement in the Short Selling Regulation case (C-270/12) and the Government’s legal analysis of the effect of this judgement (set out in my letter to you of 28 February) I have concluded that we should accept this given the success we have had in defending the UK’s primary interests in this dossier.

**IMPLICATIONS OF SHORT SELLING REGULATION CASE**

You also asked whether the outcome of the Short Selling Regulation case indicates that the CJEU takes the view that the Meroni doctrine cannot, in and of itself, be relied on as a basis for objection to EU agencies taking on delegated powers.

I am advised that this is not the case. Meroni objections can still be made where the envisaged powers are insufficiently well-framed, though the bar as to what is insufficient is higher than was previously understood to be the case.

22 March 2014

**Letter from the Chairman to Sajid Javid MP**

Thank you for your letter, dated 22 March 2014, on EM 12315/13, the Single Resolution Mechanism. The House of Lords European Union Economic and Financial Affairs Sub-Committee considered this document at its meeting on 1 April 2014.

We are grateful to you for your account of the issues of particular interest to the UK, and welcome the safeguards that you have secured. You state the agreement “represents a very good outcome for the UK”. However, such assurances count for little if the central question is ignored, namely: will the Single Resolution Mechanism actually work? In our report on ‘Genuine Economic and Monetary Union’ and the implications for the UK, we stressed that the UK’s interest would be best defended if the Government’s arguments were couched in terms of ensuring the overall stability and efficiency of EU markets. Given the collateral damage for the UK economy of a failure in the EU banking system, what assurances can you give us that the UK has been active in seeking to ensure not only that its own interests are defended, but also that the SRM will prove effective in practice?

We understand that COREPER reached agreement on 27 March. Can you therefore confirm media reports that:

— The transitional mutualisation period during which national ‘compartments’ will be pooled into the single resolution fund was set at eight years, and that 40% of funds will be mutualised in the first year and 60% of funds in the second, during which time the fund will be able to borrow on the financial markets;

— The ECB will have primary responsibility for declaring a bank likely to fail;

— The decision-making procedure for resolution has been revised to make it somewhat more streamlined than that proposed by the Council, and that time limits are included to enable resolution decisions to be taken swiftly over a weekend?

Such changes would go some way to addressing the anxieties about the effectiveness of the Single Resolution Mechanism set out in our ‘Genuine Economic and Monetary Union’ and the implications for the UK report, published in February 2014. Nevertheless, substantial concerns remain.

In terms of the resolution process, you state that a compromise was reached on the role of the Commission and the Council in the decision-making process. However the complexity of your account of the changes illustrates the complicated nature of the resolution process and the large number of actors involved. What specific role will the ECB play? What further clarity can you give on the respective roles of the Council and Commission, and the manner in which the Council’s involvement will be triggered? What update can you give us on discussions in the 24 March technical trilogue on the scope of the Commission’s discretion to object?
To aid our understanding, it would be helpful if you could give us a theoretical example of how the process will work in practice, for instance in i) an uncontroversial case and ii) a contentious case where the Council was actively engaged? What is the nature of the time limits that are designed to ensure a resolution can take place quickly? Given reports that the process could still involve numerous bodies and more than 100 individuals, are you confident that the mechanism can ensure that a timely and effective resolution process is carried out? Does the involvement of Member States via the Council in the resolution process create a risk that resolution decisions will be politicised? Do you share our concern that, even at its full strength of €55 billion, the resolution fund will be ill-equipped to deal with the scale of bank failures witnessed in recent years? What will happen if such funds prove insufficient? Does the commitment in the Council agreement to make bridge financing available “from the European Stability Mechanism in accordance with existing procedures” go far enough?

We would be grateful for a response to these questions, as well as an update on negotiations (including the 24 March trilogue, the 26 March COREPER, the 8 April ECON Committee meeting and the 13-17 April European Parliament plenary) by 28 April 2014. We also look forward to receiving HM Treasury’s response to our ‘Genuine Economic and Monetary Union’ report at the same time, which we expect will also explore these issues and respond in full to the recommendations in our report.

1 April 2014

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

Thank you for your letter of 1 April to Sajid Javid on the Single Resolution Mechanism (SRM). I am replying as the Treasury Minister now responsible for financial services issues.

State of negotiations

I considered it useful to briefly update you on the state of negotiations, following the letter from the former Financial Secretary to the Treasury on 22 March.

After further intense negotiations between the Presidency and the European Parliament, and discussions at COREPER on 27 March, the Presidency wrote to the Parliament indicating its support for the terms of a provisional deal on the SRM. This text was then agreed by the Parliament’s ECON committee on 8 April and was subsequently endorsed in its plenary session on 15 April. Following the completion of work by jurists-linguists, the final text of the Regulation will then be formally adopted by the new European Parliament and the Council later in the year, probably at some stage during the early summer.

UK approach to negotiations

Turning to the points of substance, your letter suggests that “the UK’s interests would be best defended if the Government’s arguments were couched in terms of ensuring the overall stability and efficiency of EU markets and of the Single Market in Financial Services”.

The Government did indeed raise throughout negotiations the need to ensure that the SRM is designed in such a way that it protects the integrity of the Single Market. As part of this, a key point of success was the inclusion of text to safeguard the interests of non-participating Member States, and ensure the equal treatment of Member States across the Single Market, as set out in more detail in the aforementioned letter of 22 March.

The Government also took a strong view on the form of the resolution decision-making process under the SRM, balancing the need for efficiency, legality, accountability and legitimacy. I would like to highlight three points in particular where the UK played a major role in the final stages of the negotiation.

Firstly, the UK was instrumental in securing a requirement on the face of the Regulation for the Commission to set out how it will ensure organisational separation (‘Chinese Walls’) between its resolution tasks under the SRM and its other executive and legislative functions. Aside from helping to protect equal treatment between participating and non-participating Member States, this requirement also improves the quality of the resolution decision-making process by reducing the likelihood that extraneous factors will influence the Commission’s decisions.

Secondly, the UK also strongly supported an appropriate role for the Council in the decision-making process. This reflected our view that the Council, rather than the Commission, should be the final arbiter on issues relating to modifications to the amount of funding from the Single Resolution Fund
(SRF) to be drawn down in individual cases, and in judging whether the public interest test for resolution is satisfied in circumstances where the Commission disagrees with a draft resolution scheme proposed by the Single Resolution Board (SRB).

Thirdly, the UK succeeded in securing provisions conferring a strong role on the European Court of Auditors in evaluating the use of the SRF and decisions relating to resolution, which strengthens transparency and accountability in relation to resolution decisions under the SRM.

These were all important issues in the final stages of negotiations and I believe that the UK’s strong position on these points contributed to agreement on an effective SRM, which works for participants and non-participants alike.

DETAIL OF RESOLUTION PROCESS

You asked a number of factual questions about the detail of the final deal and the resolution process under the SRM.

There are two possible scenarios under the SRM resolution process – (i) where there is no objection from the institutions regarding the SRB’s proposed resolution scheme; and (ii) where institutions object to the SRM’s proposed resolution scheme.

The initial steps are the same under both scenarios. Three conditions must be satisfied in order for any resolution action to be taken:

— Firstly, a bank must be declared as “failing or likely to fail”. The primary responsibility for making this assessment falls to the European Central Bank (ECB). The SRB will also have the right to make such a determination in its executive session, but only if it has first notified the ECB of its intention to do so, and the ECB has made no determination on whether this condition is met within three days of receiving the SRB notification.

— The second condition relates to the viability of alternative solutions. The SRB in its executive session will assess whether there is a reasonable likelihood that private sector intervention or supervisory action could avoid failure. National resolution authorities, in close cooperation with ECB, can also assess whether this condition is met.

— The third condition relates to the public interest. The SRB in its executive session will be responsible for assessing whether a resolution is justified against the public interest criteria set out in the Regulation.

If these three conditions are satisfied, the SRB in its executive session will adopt a resolution scheme in order to place the entity under resolution; determine the application of resolution tools to the institution; and determine the use of the SRF to support resolution action. The SRB plenary session will have a role in deciding on the use of the Fund, if the total proposed is above €5bn, with a liquidity weighting of 0.5; or once the net accumulated use of the Fund in the last consecutive 12 months reaches €5bn per year. This has no implication on the timelines, or the respective roles of the Commission and Council.

The resolution scheme must then be transmitted to the Commission immediately.

Under scenario (i), the resolution scheme will enter into force if no objection has been expressed by the Commission or Council within 24 hours of transmission of the resolution scheme by the SRB. In most cases it is likely that no objection will be expressed, so the resolution scheme will then come into force immediately after the 24 hour period has elapsed.

Under scenario (ii), an objection or amendment could be raised by the Commission in relation to the SRB’s proposed resolution scheme. If the Commission objects to the SRB’s proposed resolution scheme on discretionary grounds, it must inform the SRB within 24 hours of transmission of the resolution scheme by the SRB.

If the Commission objects to the SRB’s proposed resolution scheme on the grounds that the public interest criterion is not met, or proposes a material modification to the amount of the SRF used in the resolution scheme, it must make a proposal to Council within the first 12 hours of transmission. The Council will then have a further 12 hours to decide whether to agree to the Commission’s proposal by simple majority.

Where, within 24 hours of transmission, the Commission or Council has approved amendments to the scheme, the SRB will have 8 hours to modify its scheme accordingly.
If the Council rejects a draft resolution scheme on the grounds that the public interest criterion is not met, then the entity concerned will be placed into an insolvency procedure in accordance with the applicable national insolvency rules.

Therefore, the maximum time envisaged for the resolution process under scenario (ii) is a total of 32 hours from transmission of the resolution scheme by the SRB to the Commission.

The resolution scheme must then be implemented by the relevant national resolution authorities. Where this is not the case, the SRB can directly order institutions to carry out the necessary action. It is important to note that national resolution authorities in the participating Member States will remain responsible for resolution decision-making for the majority of credit institutions, but only where no recourse to the SRF is proposed.

**INSTITUTIONAL ROLES IN DECISION-MAKING**

The Government recognises that the decision-making mechanism involves a degree of complexity in terms of the various possible routes by which a decision is ultimately reached. However, this is a necessary outcome, given the potentially substantial financial, economic and political impacts of resolution decisions.

However, in practice, the respective roles of the SRB, Commission and Council are very clearly defined in the final text of the Regulation, and the deadlines for action mean there should be no reason why, under all possible scenarios, final decisions cannot be reached in the course of a weekend.

You also asked whether the conferral of a role on the Council in the decision-making process risks politicising any decision-making. It is important to note that the Council can only become involved in the decision-making process if the Commission proposes to reject a resolution scheme on public interest grounds, or if it proposes to make a material amendment to the use of the SRF. However, where there is a disagreement between the SRB and the Commission on the use of the SRF or in judging the public interest, the Government believes that democratic legitimacy requires that the Council has the final say on the matter given the direct impact of these decisions on taxpayers across Member States of the EU.

**FUNDING AND BACKSTOPS**

Turning to your question on the SRF, the Fund will be built up over a period of eight years, with 40% of contributions mutualised in the first year, 60% in the second year and then linear increments until the fund is fully mutualised at the end of year eight. It is important to note that whilst the expected value of the Fund will be around €55 billion, the SRF will also be able to raise additional ex-post levies in the event of a shortfall. It will also have the ability to borrow on the markets and from other resolution financing arrangements (on a purely voluntary basis).

Moreover, it is worth re-calling that the whole purpose of the SRM and other banking legislation (the Bank Recovery and Resolution Directive) is to avoid recourse to public funding by providing for tough bail-in rules, which will be the main source of funding in the case of a bank failing.

Ultimately the issue of backstops for the SRF is one for the Member States participating in the Banking Union. However, we have been clear that the system should operate quickly and efficiently, and be fit for purpose. A common backstop would certainly be desirable. In this context it should be noted that Euro-group and ECOFIN Ministers committed, in their statement of 18 December, to develop a backstop during the transitional period and for this backstop to be fully operational at the latest after ten years. The European Council has welcomed this statement on the SRM backstop while noting that the backstop arrangements for the SRM will not be funded from the Union budget or by non-participating Member States. Progress shall be reviewed soon after entry into force of the SRF. In addition this statement makes clear that, during the transitional period, bridge financing for the SRF will be available from national sources (backed by bank levies) or from the European Stability Mechanism (ESM) in line with agreed procedures.

*8 May 2014*
Thank you for your letter of 26 November 2013 on the EU Commission’s proposal for a standard VAT return, following the Explanatory Memorandum of November 2013.

I am grateful for the Committee’s confirmation that you will not recommend that the House issues a subsidiarity Reasoned Opinion.

Based on the Commission’s Impact Assessment, I agree that it would appear that the benefits of this proposal across all EU businesses may outweigh the costs to those businesses and to the Member States:

— An estimated cost saving of €15 billion (£12.7 billion);
— Set up and switch over costs for business no more than €4.25 billion (£3.6 billion); and
— Implementation costs to each Member State around €30.5 million (£25.9 million).

Looking at this from the perspective of UK businesses, there are a number of issues to keep in mind. The first is that the benefits to businesses within individual Member States will vary, given that the starting points are very different. This is partly reflected in the Commission’s Impact Assessment. For example, the estimated gross annual cost saving of €15 billion (£12.7 billion) is on the basis of nineteen Member States reducing the current number of boxes downwards (confusingly to a maximum of 36 boxes, not the 26 as set out in the proposal). However, the impact assessment does not identify cost savings within individual Member States.

We also need to be mindful of the impacts on the UK VAT return and procedures. UK businesses have been very clear that they wish to continue to benefit from the very simple nine box UK VAT return and with flexibility in the rules and procedures associated with it. Given that the proposal aims to standardise the information to be provided within individual boxes, it will require, as a minimum, a degree of change in any Member State that currently falls outside that standardisation. Even such relatively minor changes to the UK VAT return will impact on all 1.9 million UK businesses that are registered for VAT, a high proportion of which are SMEs.

The proposal also includes a degree of standardisation to the rules and procedures associated with VAT returns. This will impact on any UK business that takes advantage of the current flexibility but will no longer be able to continue with that approach in the future.

For example, UK businesses are concerned about the potential impact of proposed changes to the timing of payments and to the frequency of filing returns. The proposal would potentially remove the flexibility currently provided by the UK in allowing large businesses to submit quarterly returns, while making payments on account. Such flexibility is valued by such businesses who would not welcome a move to monthly returns.

Similarly, small businesses using the Annual Accounting Scheme also make interim payments. This optional simplification scheme allows smaller businesses to submit just one return per year, but also to make part payments throughout the year to ensure they can manage their affairs sensibly. Any change to this would run counter to the aim of assisting small businesses and reducing administrative burdens.

The costs and benefits to UK businesses involved in cross-border trade within the EU will also be dependent on the degree of change to be made in other Member States to implement a standard VAT return and the decisions still to be made in due course in those Member States in terms of the number of boxes going forward.

Finally, much of the technical detail, definitions and procedures are to be decided under comitology. This means we don’t yet know what the end product will be both in terms of the standardised VAT return and some of the rules and procedures associated with it.

You asked for an example of a significant decision on which the UK could be outvoted through the use of comitology. On the standard VAT return itself, the definitions of the compulsory boxes in Article 250 are to be determined by comitology under Article 255a(b). This will therefore determine what is and what is not to be included within each box. For example, the current UK Box 4 covers the concept of “the tax for which deduction is made”, and includes:
We cannot be certain whether the comitology procedure would enable the UK to continue to include all those elements within the relevant compulsory box or whether some elements would fall outside it and instead potentially fall within an additional optional box.

The proposed error correction procedure provides an example on the impact of comitology on rules and procedures associated with the standard VAT return. The legislative proposal establishes the high level principle and the right for Member States to set the time period in Article 250(2). But the procedures for correction of errors are to be determined by comitology under Article 255a(c). The UK currently allows businesses to make smaller corrections automatically on a following VAT return. Larger corrections need to be notified, and there are penalties and interest implications which are built into the procedure. It is not clear what will or will not be possible in the future.

These examples have potentially significant cost and IT implications for businesses and for HMRC. But at this stage they cannot know what IT changes might be required and what the costs or benefits are likely to be.

Businesses views about the legislative approach are mixed. Not surprisingly, there is widespread support for the Commission’s objectives. However, on the detail of Commission’s proposal, UK businesses have flagged up concerns, including those highlighted above. Many also make the point that such an approach doesn’t deal with the key issue they face when trading within the EU, which is a lack of readily available information. They tell us that the real challenge lies in knowing the underlying rules in a Member State and how to apply them. And the problems are particularly acute for SMEs.

Businesses would like to see progress on the EU Web Portal concept highlighted in the Commission’s Communication on the Future of VAT (EM 18288/11). That would be an EU IT information platform, with access available to all EU businesses. It could provide information about returns, but also about the underlying VAT rules across the EU. The concept was discussed at a recent EU VAT Forum meeting (another initiative highlighted in the Commission’s Communication on the Future of VAT), which aims to bring together tax administrations and businesses to discuss EU operational issues and ‘best practice’. Although some Member States resist these initiatives, the UK is actively supporting both and is working closely with UK and EU businesses to raise the profile and the priority.

The Commission legislative proposal was presented to ECOFIN in mid-November, where there was no discussion, and then to Council Working Group on 3 December. Following the Commission’s presentation, Member States expressed initial high level reactions. The majority of Member States (including the UK) supported the overall objectives. Many, however, indicated technical concerns, and no doubt these will emerge in more detail once technical discussions on the legal text begin in earnest. The next Council Working Group will be under the Greek Presidency and is scheduled for mid-January.

10 December 2013

Letter from the Chairman to David Gauke MP


We are grateful for your reply, and in particular for the useful information that you provide on the views and concerns of UK business. We welcome the fact that the Government and UK business both support the Commission’s objectives, albeit that there are concerns about some of the technical detail. In the event that such details can be resolved, will the Government be minded to support the
proposal? For instance, can sufficient safeguards be put in place to ensure that the risks that you identify in terms of use of the comitology procedure can be minimised?

We also join with you and UK business in supporting the EU Web Portal concept. This strikes us as an ideal tool to help businesses know and understand the underlying rules in a Member state and how to apply them. We would be grateful for updates on your welcome efforts to promote this concept across the EU.

We were disappointed that you did not answer our question as to what efforts you were undertaking to ensure that the UK system of VAT returns was used as a model and benchmark. Neither did you indicate how the aims of this proposal could be met, if not via a legislative approach. We would be grateful for a response to both of these points.

We note that negotiations are at an early stage, and will therefore continue to hold the document under scrutiny. However we would be grateful for an update on the next Council Working Group, scheduled for mid-January, as well as an answer to our questions, by 27 January 2014.

17 December 2013

Letter from David Gauke MP to the Chairman

Thank you for your letter dated 17 December 2013 on the proposal for a standard EU VAT return.

You asked whether, in the event that the technical detail can be resolved, the Government would be minded to support the proposal. We would support an outcome that offered real benefits for UK businesses trading across the European Union and at the same time ensured there was no increase in the overall burden for UK businesses. That fits with the Government’s overall objective to cut red tape for businesses and to encourage them to increase their cross-border trade. The UK is therefore actively engaged in discussions on the technical detail.

Given that comitology is an issue for us and for some other Member States, we are promoting an alternative approach to resolve the technical details tied into the comitology procedure and so minimise the inherent risks there.

This would involve examining and working up the missing technical detail by a technical group before final agreement in Council rather than afterwards. This approach would enable Council to fully consider the outcome and preserve the unanimity principle. It will ensure we have a clear understanding of the end product and its impact on UK businesses. We have already had indications of support and interest in such an approach from others, including the EU Commission and the Greek Presidency.

We welcome your support for the EU Web Portal concept. The UK continues to press the Commission and other Member States for speedy progress on this project. Some have expressed concerns about set up costs and viability. HMRC is therefore currently reviewing potential low cost options based on the use of existing IT systems. The aim is to feed the findings from that work back into the EU discussions in the near future.

You asked about our efforts to promote the UK VAT return as a model and benchmark. HMRC has been proactive in presenting the benefits and philosophy of the UK approach to our EU partners. For example, HMRC and HMT attended and presented the UK model at a Fiscalis event focussed on the standard VAT return idea before the proposal emerged. Officials continue to promote the UK approach at relevant conferences and meetings. That said, although Member States can learn from each other and develop best practice, this is an area where a degree of flexibility is needed both within and across tax jurisdictions. This is to enable tax administrations to respond to changing risks and national circumstances. This goes to the heart of the concerns some Member States have on subsidiarity and proportionality.

You asked how the aims of this proposal could be met other than by way of a legislative approach. There is the potential for some limited headway if Member States with more complex returns were committed to simplifying their approach. Indeed, some have now signalled an intention to amend their national VAT return irrespective of the outcome here. But the key non-legislative approaches involve development of the EU Web Portal, to provide more and better information, and the EU VAT Forum to discuss and exchange ideas on information content and on best practice more generally in this area. For example, some businesses have suggested that we might collectively look at box mapping or coding, similar to the coding system already in place in relation to European driving licenses. The results, in the form of a transposition table or matrix, could be made available in all languages, and
accompany the information on Member States’ VAT rules on the Web Portal. We need to see how
the discussions in Council Working Group develop, but this is an alternative which may deserve more
consideration in due course.

The EU Web Portal and EU VAT Forum can also address the challenge of the wider issues faced by
businesses trading within the EU, which is the lack of readily available information about the
underlying rules in a Member State and how to apply them.

Finally, you asked for an update on the 15 January Council Working Group. The Greek Presidency
organised the discussion around the themes of payment and submission of returns; periodicity;
additional information and corrections. Discussions are at an early stage and many Member States are
still considering the impact of the proposal. But it was clear from the meeting that many do have
concerns about particular issues. For example, many Member States expressed concern at the level of
the threshold, EUR 2,000,000 (£1,800,000), below which quarterly returns would have to be allowed
by the tax administration. Although this threshold corresponds roughly to the thresholds we use in
the UK for other small business simplification schemes, it is far too high for many of the smaller
Member States. In some cases, most of their businesses would fall below it and it would therefore
have a significant potential impact on their national VAT revenue flows.

Further meetings will continue with this themed approach, examining electronic submission; annual
returns; scope of taxpayer obligations and the content of the return.

The Greek Presidency plan to return the dossier to Council after the European Parliament elections.
23 January 2014

Letter from the Chairman to David Gauke MP

amending 2006/112/EC on the common system of Value Added Tax as regards a Standard VAT
Return Decision. The House of Lords European Union Sub-Committee on Economic and Financial
Affairs considered this document at its meeting on 4 February 2014.

We are grateful to you for your detailed response to the Committee’s queries. We are pleased to
note that the UK is actively involved in negotiations. We note from your letter that many Member
States have concerns about the proposal. We also note that the proposal is not expected to return to
Council until after the European Parliament elections in May. As such we will continue to hold the
document under scrutiny. In the meantime we would be grateful for an update on negotiations as and
when further progress is made.

4 February 2014

STATUTORY AUDITS OF ANNUAL ACCOUNTS AND CONSOLIDATED ACCOUNTS
(16971/11, 16972/11)

Letter from Jenny Willott MP, Parliamentary Under-Secretary for Employment
Relations and Consumer Affairs, Department for Business, Innovation and Skills, to the
Chairman

I write to update you on the negotiations on this dossier. On 18 December the Committee of
Permanent Representatives to the EU agreed a text of the Directive and Regulation containing only
limited changes, which had been agreed with representatives of the European Parliament.

On 21 January, this text was the subject of a vote of approval by JURI Committee of the European
Parliament. Though this has enabled a first reading deal, I have delayed writing to you until now, as the
formal plenary vote in the Parliament has followed a period in which the Directive and Regulation
have been translated into the official languages of the European Union.

At a plenary vote last Thursday 3 April the Parliament adopted in plenary session the amended
Directive on Statutory Audit and the Regulation on specific requirements regarding the statutory
audit of public-interest entities. The vote was 332 in favour, 253 against with 26 abstentions. At
Annex A [not printed], I attach the text of the Regulation and of the Directive as adopted. This is the
first text to be made public, following what will now be a first reading deal.

The Council will need to confirm its agreement by accepting this European Parliament first reading
text, without debate, as an “A point” at a meeting of the Council of Ministers on Monday 14 April.
The final text differs in only limited respects from that which formed the basis for the mandate, granted by the Council, for informal trilogues on 8 October. At Annex B [not printed] I set out those areas where the Presidency’s compromise has developed. These developments are very limited, which demonstrates the extent of the consensus between the Parliament and the Council. The resulting framework is well within the UK’s negotiating objectives. I am pleased with the outcome, which will introduce measured though significant reforms to UK corporate audit regulation.

8 April 2014

STRUCTURAL REFORMS OF EU CREDIT INSTITUTIONS (6022/14)

Letter from the Chairman to Sajid Javid MP, Financial Secretary, HM Treasury

Thank you for your Explanatory Memorandum 6022/14, dated 26 February 2014, on the proposal for a Regulation on structural measures improving the resilience of EU credit institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 March 2014.

We are grateful to you for this useful summary of the proposals. However, it gives rise to a number of questions. You state that, overall, the Government are in favour of the proposal as a means to reduce the implicit taxpayer guarantee which distorts the Single Market. We would be grateful for more details of your view of the proposal. Overall, is the proposal an improvement on or a step backwards from the recommendations of the High Level Expert Group on reforming the structure of the EU banking sector, chaired by Bank of Finland Governor Erkki Liikanen? Does this matter?

You state that the timetable for consideration of this proposal has not been announced and no working groups have been scheduled. This is unsurprising given that the proposal has been adopted so close to the end of the European Parliament’s legislative term. The Chair of the European Parliament Economic and Financial Affairs (ECON) Committee, Sharon Bowles MEP, has reportedly described this timing as an insult. Do you share her concern at the delay in the Commission bringing forward this proposal? Are such structural reforms urgently needed? Do you believe that there is sufficient political momentum to ensure that agreement is reached, or has the moment for such structural reforms now passed? Can you give us any indication of when substantive progress in negotiations will occur? Do you share the view expressed in media reports that agreement is unlikely before December 2015 at the earliest? You state that you have consulted with UK financial institutions. What is their view of the proposals? What is the position of the Prudential Regulation Authority as the UK’s competent authority? We note that the regulation will apply to credit institutions identified as being of global systemic importance under Article 131 of the CRDIV Directive and to credit institutions with total assets of at least €30 billion and trading activities amounting to at least €70 billion or 10 per cent of their total assets. Are such criteria sufficiently comprehensive to ensure that the stability of the EU financial system is protected?

Turning to the main provisions of the proposal, we note that the regulation seeks to place a ban on proprietary trading by certain categories of credit institution. You state that you will be scrutinising the legislation to ensure that the ban is effective while avoiding unintended consequences such as preventing helpful market making activity. What is your initial assessment of the proposals, including the proposed definition of proprietary trading? Is it possible to disentangle proprietary trading from market making? Do you believe that the narrower definition proposed by the Commission will succeed in making this distinction and in avoiding some of the regulatory difficulties encountered in the US? Or will it be so narrow as to have a negligible effect on the day-to-day activity of most institutions?

The proposal to ban proprietary trading echoes the Volcker model in the USA (albeit more tightly defined), but is at variance with both the Liikanen recommendations and the UK’s reforms as contained in the Banking Reform Act 2013. Are you concerned by the lack of consistency in relation to this vital issue in the US, EU and the UK itself? To what extent does such inconsistency matter? You state that the Banking Reform Act provides for an independent review of the case for a prohibition of proprietary trading in UK law to be undertaken in 2021. Noting the Government Impact Assessment’s statement that the impact on the UK is likely to be limited, how would you summarise the likely impact of the ban on the UK and its credit institutions?

On the structural separation proposals, you appear to support the degree of supervisory discretion proposed. Is this correct? The discretionary model is also at variance with the Liikanen recommendations. Does this matter? Where does the balance lie in terms of the benefits and risks of such a model? Does it raise any issues regarding a consistent approach across the EU, in particular...
given that responsibility within Banking Union participants will be split between the ECB and national authorities depending on the size of the institution? How does the proposal compare with the models pursued in other Member States, such as Germany and France? What is their view of the proposal? How will it affect their models and banking institutions? What is the practical impact of such inconsistency of approaches to the question of structural separation across the EU?

In terms of the impact on the UK, you state that the proposal will provide for structural reform of credit institutions throughout the Union “in a slightly different way” to the Banking Reform Act 2013. Aside from those identified above, what would you identify as the most important differences? To what extent are the two models compatible? What will be the impact on credit institutions? What is the practical impact of such inconsistency of approaches to the question of structural separation across the EU?

In terms of the UK, you state that the proposal will provide for structural reform of credit institutions throughout the Union “in a slightly different way” to the Banking Reform Act 2013. Aside from those identified above, what would you identify as the most important differences? To what extent are the two models compatible? What will be the impact on credit institutions? What is the practical impact of such inconsistency of approaches to the question of structural separation across the EU?

In addition to the derogation provisions, the EM states a number of times that the Government will be seeking to secure certain safeguards in the course of negotiations. On fundamental rights compliance, you state that “the UK will be closely scrutinising compliance during negotiations to ensure that interferences with the conduct of business and the exercise of property rights which are permitted by the regulation are proportionate and fair, and that the decision-making powers conferred on competent authorities are consistent with fair-trial rights”. Is there any reason to believe that this will not be the case?

In terms of third country equivalence, you note that the impact will be different from the Banking Reform Act in that it applies to all branches and subsidiaries of EU credit institutions wherever they are located. It also applies to EU branches of credit institutions established in third countries. You state that the Government will work to ensure that undue costs are not placed on non-EEA firms establishing branches within the EU, nor on third country branches or subsidiaries of EU banks. How significant are the costs likely to be if the regulation as currently proposed is agreed? What amendments do you wish to see made to reduce such costs? Taking the third country provisions as a whole, are you content with the process by which the Commission will deem whether third country legal frameworks are equivalent? What has been the reaction to the proposal in other major global financial centres?

With regard to the impact on UK institutions, you state that the UK will work to ensure that the role of the ECB under the regulation will not undermine their independence. Is there anything in the regulation as drafted that gives you cause for concern that UK authorities’ independence is under threat?

You note that the extensive use of delegated acts in the proposal will give the EBA an important role and leave much of the detail uncertain. Are you proposing to reduce the use of delegated acts and limit the role of the EBA? If so, which specific changes do you wish to see?

Finally, you state that it is important that the legal basis for the regulation is sound, and that the Government continue to scrutinise whether Article 114 TFEU is an appropriate basis in light of the provisions made in relation to remuneration policies. What is the view of the Commission and other Member States in relation to your concerns? In the event that you conclude that the Article 114 legal base is not appropriate, is there another legal base that you would deem to be acceptable?

We will continue our scrutiny of this important proposal in the weeks to come, and would be grateful for a response to our questions by 8 April 2014. In the meantime we will hold the document under scrutiny.

11 March 2014
Thank you for your letter on 11 March, relating to the Commission proposal on Bank Structural Reform. In my response I have endeavoured to answer as many of your questions as possible, although you will recognise that there is limited clarity on a number of issues at this stage of the negotiation.

The first matter you raise relates to the Liikanen Report, in response to which the Commission presented its proposal on Bank Structural Reform. Many of the policy measures within the Commission proposal are brought forward as a direct consequence of the report’s recommendations; for example the prohibition on proprietary trading and the application of structural separation. You will be aware that some of the report’s other recommendations have been introduced through other pieces of EU legislation which specifically apply ‘bail-in’ measures (the BRRD) and capital requirements (the CRD4 package).

You go on to ask about the timing of the proposal, recognising that some have criticised its lateness in the legislative calendar. The proposal has been released very close to the European Parliament elections and as a result, as you will be aware, the EP has not appointed a rapporteur for this dossier. We would expect the dossier to be allocated after the EP elections. With respect to Council negotiations, the Greek Presidency has signalled their intention for the first working group to take place on 28 April and others will likely follow regularly afterwards. Based on the complexity of the proposal, and the level of Member State interest shown up to this point, we expect the negotiation to be lengthy. The Commission estimates that the negotiation will be concluded in 2015, which we believe is a realistic timetable as it is quite normal for a financial services dossier of this complexity and importance to take up to two years to be fully agreed between the co-legislators.

In informal consultations, UK banking firms have expressed an interest in this dossier, particularly where it differs from the Banking Reform Act 2013. They are less concerned about the concept of structural separation, but more interested in potential misalignments on scope, overlap of rules between the two frameworks, and the uncertainty created by the number of provisions still to be formed through delegated acts and other forms of level 2 legislation.

On the substance of the dossier, we are confident that it will contribute to European efforts to tackle the implicit taxpayer guarantee that globally systemic banks will receive state aid if they are at risk of failing, by making banks more resolvable and helping to protect depositors. The Government believes this will significantly improve the functioning of the Single Market by helping remove the resulting competitive distortion that allows systemic banks to access cheaper funding and pursue more risky and competitive business strategies than medium sized firms, under the implication that they will be rescued by the taxpayer if they come to need it. This rebalancing of funding costs will represent a fairer pricing of bank funding and more efficient allocation of resources in the economy and help to further reduce market segmentation in the eurozone, a key concern of many member states.

Moving on to your questions about the substance of proposal, you ask whether its criteria of application are appropriate. Further to the analysis contained in the Explanatory Memorandum and Impact Assessment, the Government agrees that to ensure proportionate application of the proposal, it is appropriate for there to be criteria based on an institution’s size and activity so that only firms above a given threshold are captured. As the negotiation progresses, we expect to cover in detail what these thresholds should be.

You also ask about the value of supervisory discretion in applying these thresholds. While clear thresholds are appropriate to ensure the proportionate application of the proposal, given its application across a diverse set of national banking sectors in the EU, then supervisory discretion is appropriate. This supervisory assessment will help ensure separation occurs where necessary to support financial stability. This could include requiring separation in exceptional circumstances where banks don’t meet the thresholds based on trading activity, but nonetheless are systematically important in the economies where they operate.

In its own explanatory memorandum, the Commission notes the difficulties in defining proprietary trading and distinguishing it from other activities such as market making. In response to this, the definition of proprietary trading is intentionally drawn narrowly, so as to make the prohibition proportionate and enforceable.

The prohibition of proprietary trading in the proposal is at variance with the UK Banking Reform Act 2013 but it is unlikely to impair legitimate market making services or significantly impact UK banks at currently proposed. In its report on 5 March 2013 the Parliamentary Commission on Banking Standards found that there is little to suggest the practice is widespread in the UK’s main banks. As the definition clearly refers to overt proprietary trading that is undertaken by divisions, desks or
individuals, it is not expected at this early stage to be interpreted in a way that could impair the provision of legitimate liquidity services. In addition, I would note that the Commission proposal includes a provision for third country equivalence, which would mitigate the impact of different regulatory approaches.

With respect to the compatibility of the Commission proposal with the Banking Reform Act, the derogation will allow firms to implement the UK measures without having to implement the proposed EU rules too. This removes the risk of a duplicated compliance burden. The approach taken to structural reform by the Commission proposal is slightly different to the UK measures, with separation being based on the size of trading activities instead of deposit taking. In addition under UK ring-fencing larger corporate depositors and high net worth individuals will be permitted to bank outside the ring-fence whereas the commission proposal does not contain similar provisions (although the UK policy can continue for firms that are granted a derogation). However, the outcomes of ring-fencing and the Commission proposal are broadly similar, with the deposit taking institution separated from the trading institution.

The French and German structural reform measures are considered further away from the Commission proposal than the UK reforms, as they focus on the separation of proprietary trading activities alone. Those countries will need to consider the implications of this divergence as the negotiations progress.

You also ask about the position of the derogation provision in negotiations and its functioning. The derogation has drawn some criticism from some Member States because of a misconception that it would allow for a weaker standard to be adopted and that this may raise the possibility of regulatory arbitrage. Other Member States have raised concerns that the derogation undermines the principles of using a regulation instead of a directive to harmonise rules across the EU. The derogation allows some Member States the flexibility to maintain their own legal frameworks after the regulation takes effect, even though regulations are meant to achieve a very high level of harmonization by directly entering national legislation and replacing previous rules covering the subject. The Government is proactively defending the derogation in EU discussions and widely seeking to correct misconceptions by making it clear the provisions are there to allow those Member State who have already begun implementing stricter structural reform measures to continue to do so.

As the derogation only applies to firms subject to separation, and not the proprietary trading ban, in our view the opportunities for regulatory arbitrage are minimal. On the means by which the derogation is granted, we agree it is appropriate that the decision is made on the basis of equivalence. It is very important that the process for agreeing the derogation is clear and strikes an appropriate balance between the role of the Commission and the applicant Member State.

With respect to safeguards, and in particular fundamental rights compliance, we believe that these are important issues that deserve close scrutiny in all EU negotiations. The Government considers that the proposals as published are compatible with fundamental rights, and will scrutinise any proposals to amend them to ensure that this continues to be the case. There is no reason to think that there will be serious problems in this area.

You also raise questions about the third country and extra-territorial impact of the proposals. This is an area where the proposal would benefit from further development and clarification, which I expect to occur as part of negotiations. With much of the detail still to be discussed, and working groups yet to begin, much is uncertain about the size of the costs emerging as a result of the impact on 3rd countries and the functioning of the Commission’s equivalence regime. However, at this early stage we can see advantages to the equivalence provision in relation to the prohibition on proprietary trading. As the US Volcker Rule also has extra-territorial impact on the EU, and is strongly expected to fully cover the provisions of the prohibition proposed by the Commission, the proposed 3rd country equivalence regime will help lower compliance costs for firms by requiring them only to be bound one of the two prohibitions and reporting requirements.

On the role of the home supervisor (the supervisor of the Group Parent) in the proposal and its implications for the independence of UK supervisors, we are conscious that the proposed role for home Competent Authorities, including the European Central Bank, represents a departure from the conventional allocation of supervisory tasks to home and host supervisors in relation to banking groups and group entities. The conventional allocation of tasks is recognised in the BRRD and the CRD4 package, so the Government expects the issue of home and host supervisors to be addressed at a technical level. It will work to ensure that the role of home supervisors, including the ECB in this regulation does not undermine the role of host supervisors. In addition, we currently consider that because of Article 139(2) TFEU (as further reflected in Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank) the ECB does not have a legal mandate.
to perform any supervisory or other tasks in relation to banks established in states that are not participating in the Euro. Regarding whether article 114 is an appropriate legal base for the provision regarding remuneration (article 7 of the regulation), the views of other Member States on the legal basis or the desirability of including such clauses are not yet known. It is arguable that the more appropriate legal base is Article 115 TFEU. Alternatively, if the remuneration provisions represent an incursion into the sphere of social policy the appropriate legal base may be Article 153 TFEU; or, if no other treaty basis is available, Article 352. However, given the different procedures associated with these alternative bases there would likely be significant resistance to this position.

I hope this response provides some clarity on the issues you raise in your letter. You will also be aware that my officials are providing private evidence and will be able to expand on the matters you have raised.

4 April 2014