

Economic and Financial Affairs, and International Trade (Sub-Committee A)

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AUDIT: COMMISSION DECISION (EC) CONCERNING A TRANSITIONAL PERIOD
FOR AUDIT ACTIVITIES OF CERTAIN THIRD COUNTRY AUDITORS AND AUDIT
ENTITIES (OTNYR)

Letter from Malcolm Wicks, Minister of State for Energy to the Chairman

On the 15 February 2008 Gareth Thomas submitted an unnumbered Explanatory Memorandum regarding a draft Commission decision, to be made under comitology arrangements in Statutory Audit Directive (2006/43/EC), which was subsequently cleared from scrutiny by the Committees of both Houses. I am writing on his behalf to update you on the progress of that decision.

I am pleased to inform you that a final decision was agreed unanimously in the Audit Regulatory Committee. The decision was formally adopted on 29 July 2008 following a period for consideration by the European Parliament. A copy is enclosed for information (2008/627/EC).

Although the decision was amended in some respects since it was first considered by the Scrutiny Committee, it meets the UK's key objectives set out in the Explanatory Memorandum. It provides a good basis for introducing the Audit Directive provisions on the regulation of third country auditors without disrupting the operation of the London capital markets.

The registration and oversight of third country auditors in the UK is the responsibility of the Professional Oversight Board (POB) at the Financial Reporting Council, operating under the Statutory Auditors and Third Country Auditors Regulations 2007 (SI2007/3494). To enable the POB to operate in line with the Commission decision, we plan to make some amendments so that the UK legal framework for registering the auditors covered by the decision complies with it.

21 August 2008

BANKS AFFILIATED TO CENTRAL INSTITUTIONS, CERTAIN OWN FUNDS ITEMS, LARGE EXPOSURES, ARRANGEMENTS, AND CRISIS MANAGEMENT

Letter from the Chairman to Ian Pearson MP, Economic Secretary, HM Treasury

Thank you for your Explanatory Memorandum 13713/08 dated 21 October 2008 which Sub-Committee A considered at its meeting on 6 November 2008. The Sub-Committee decided to hold this document under scrutiny in conjunction with its forthcoming report regarding EU financial regulation. The Sub-Committee would like to request that you keep the Committee updated regarding developments to these proposals.

The Sub-Committee would also like to request clarification of the Government's position in relation to the amendments proposed. The Explanatory Memorandum explains the Government will continue to "seek adjustments to further improve outcomes": which proposals in particular does the Government wish to change and what outcomes are desired?

6 November 2008

BUDGET: FIRST READING OF THE 2009 EC DRAFT BUDGET (DB) AND AMENDMENTS TO THE PRELIMINARY DRAFT BUDGET (PDB)

Letter from Ian Pearson MP, Economic Secretary to the Treasury, HM Treasury to the Chairman

The European Parliament (EP) recently concluded its first reading of the 2009 EC Draft Budget (DB) and I am pleased to update you on the amendments adopted by the EP in plenary session on 23 October. In addition, this update covers three Amending Letters to the Preliminary Draft Budget (PDB) presented by the Commission since Council's first reading, which will be considered during the 2009 budget negotiations.

Tables summarising the changes between the PDB, Draft Budget and the EP's first reading amendments, and the Amending letters are set out in Annex 1 to this letter.

THE EUROPEAN PARLIAMENT'S AMENDMENTS

The EP first reading proposes a total of €136.0 billion (£107.0 billion¹) in commitments, and €24.5 billion (£98.0 billion) in payments, representing increases of €2.1 billion (£1.6 billion), or 2%, in commitments and €9.5 billion (£7.5 billion), or 8%, in payments respectively, compared to the DB. Payment levels correspond to 0.96% of total EU Gross National Income (GNI), within the relevant own resources ceiling².

Within Heading 1a (Competitiveness for growth and employment), the EP's first reading proposes a total of €1,769.0 million³ in commitments and €1,383.8 million in payments. This represents

¹ Sterling converted from Euros at 31 October rate of €1 = £0.7869

² As established in Council Decision of 29 September 2000 on the system of the European Communities' own resources (2000/579/EC, Euratom)

³ For Sterling equivalents of key figures quoted, please refer to the tables in Annex 1

respective increases of €57.3 million and €1,569.9 million, compared to the DB, leaving a margin of €3.0 million below the relevant Financial Framework (FF) ceiling for commitments.

The EP amendments restore the PDB in many areas and increase appropriations relative to the PDB in others, particularly for payments. The largest payment increases compared to the PDB are for: the Galileo Programme – a €26.6 million increase; Financial support for projects of common interest in the trans-European transport network – a €14.8 million increase; and Cooperation in the field of Nanosciences, nanotechnologies, materials and new production technologies – a €9.0 million increase.

Within Heading 1b (Cohesion for growth and employment), the EP first reading proposes commitments of €48,422.9 million and payments of €9,006.9 million. This represents respective increases of €8.9 million and €4,342.8 million, compared to the DB, leaving a margin of €5.1 million below the relevant FF ceiling.

The EP amendments restore commitments to PDB levels whilst increasing payment levels above those set in the PDB in a number of areas. The largest increases in payments relative to the PDB, are in the following areas; the European Social Fund convergence objective – a €82.4 million increase; the European Regional Development Fund convergence objective – a €22.4 million increase; and the Cohesion Fund – a €77.0 million increase.

Within Heading 2 (Preservation and management of natural resources), the EP first reading proposes a total of €8,727.6 million⁴ in commitments and €6,667.0 million in payments. This represents respective increases of €1,584.0 million in commitments and €2,329.2 million in payments compared to the DB, leaving a margin of €11.4 million below the relevant FF ceiling.

The EP amendments largely restore the PDB across Heading 2, however the EP also increase allocations in several areas above the levels set in the PDB, including; LIFE+, the financial instrument for the environment – a €9.3 million increase in commitments and €31.2 million increase in payments; and the deprived persons programme – €5.0 million increase in commitments and payments. The EP first reading also creates a new budget lines for; a fund for milk restructuring – with €600 million in commitments and payments, the provision of school fruit and vegetables – with €81.0 million in payments and commitments in the reserve.

Within Heading 3a (Freedom, security and justice), the EP first reading proposes a total of €63.9 million in commitments and €64.1 million in payments. This represents respective increases of €31.2 million and €1.2 million in payments, compared to the DB, leaving a margin of €8.1 million below the relevant FF ceiling.

The EP's amendments restore the PDB in many areas, but also increase allocations in several areas above the levels proposed in the PDB, including: External Borders Fund – a €23.2 million increase in payments; the European Refugee Fund – a €10.0 million increase in commitments and €1.4 million increase in payments; and FRONTEX, the European Agency for the Management of Operational Cooperation at External borders – a €5.0 million increase in payments and commitments.

Within Heading 3b (Citizenship), the EP first reading proposes a total of €51.0 million in commitments and €701.3 million in payments. This represents an increase of €6.2 million in commitments and €66.5 million in payments compared to the OB, leaving just €37,000 below the relevant FF ceiling.

The EP amendments mostly serve to restore PDB appropriation levels across Heading 3b, but also introduce additional increases relative to the PDB, including: Youth in Action - a €3.0 million increase in commitments and a €1.5 million increase payments respectively; and Europe for Citizenship – a €3.0m increase in commitments and payments.

Within Heading 4 (The EU as a global partner), the EP first reading proposes commitments of €7,683.9 million and payments of €8,157.0 million. This represents respective increases of €129.8 and €70.2 million compared to the DB, leaving a margin of €9,640 below the relevant FF ceiling.

The EP amendments restore the PDB in a number of areas, and increase allocations in several areas above the levels set in the PDB in others, including: Assistance to Palestine – an increase of €139.0 million in commitments and €180.0 million in payments, in line with additional amounts requested in Commission's Amending Letter 1 (further details provided below); Cooperation with Eastern Europe - a €39.1 million increase in payments; Transition and Institution-building to potential candidate countries – a increase of €80.0 million in commitments and €19.7 million in payments, including the €40.0 million in commitments towards institution-building and development in Kosovo, as proposed in Amending Letter 1 (see below).

⁴ For Sterling equivalents of key figures quoted, please refer to the tables in Annex 1

Within *Heading 5 (Administration)*, the EP first reading proposed commitments and payments of €7,700.9 million. This represents an increase of €148.0 million in both commitments and payments compared to the PDB, leaving a margin of €76.1 million under the relevant FF ceiling.

The EP amendments largely restored the PDB but also increased allocations above PDB levels in for EP officials and temporary staff remunerations and allowances - a €1.3 million increase.

The EP also moved commitment and payments for some areas of *Heading 5* into the reserve pending further information or action by the Commission including: a proposal for legislation on preventing the market for timber derived from illegal and destructive resources; a follow-up staff screening report; an analysis of the possibilities of redeployment of administrative and coordination functions; a plan on improving EU communications; and proof that the initial assumption on posts freed/frozen following the establishment of Executive agencies were accurate.

The EP made no amendments to *Heading 6 (Compensations)* and appropriations remain at €209.1 million for both commitment and payment appropriations.

AMENDING LETTERS

The Commission has presented three amending letters to the budgetary authority, the Council and EP, over the course of the 2009 negotiations:

Amending Letter No.1 was presented by the Commission on 10 September. It requests increases within *Heading 4 (EU as a Global Partner)* of €179.0 million in commitments and €180.0 million in payments, compared to the PDB, leaving €64.6 million under the relevant FF ceiling. *Amending Letter No. 1* amends the PDB to incorporate:

- €40.0 million increase in commitments for stability and development in Kosovo, to meet part of the shortfall between funding pledged by the Commission and the levels met programmed under the Instrument for Pre-Accession assistance (IPA) and Macro Financial Assistance (MFA);
- €139.0 million increase in commitments and €180.0 million increase in payments for Palestine, reflecting the worse than expected economic conditions and the state of the Palestinian public finances;
- the creation of a new budget line relating to Consular cooperation, to provide for Commission delegations to provide logistic support to Member state missions;
- the budgetary adaptations arising from the extension of the mandate of the Education, Audiovisual and Culture Executive Agency (EACEA) to Tempus and ICI programmes; and
- the lifting of the reserves entered in the PDB after approval of the extensions of the Executive Agency for the Public Health Programme (PHEA), and the Trans-European Transport Network Executive Agency (TEN-T EA).

Amending Letter No.2 was presented by the Commission on 28 October. It seeks agreement for a reduction within *Heading 2 (Preservation and Management of Natural Resources)* of €1,030.2 million in commitments and €377.7 million in payments, compared to the PDB, increasing the margin for commitments under the FF ceiling to €3,143.5 million. It adjusts the level of agricultural expenditure in the PDB on the basis of the Commission's latest assessment of market factors and legislative decisions or potential proposals since the PDB was presented, and includes:

- an overall reduction of €1,306.7 million commitments and payments for market interventions and direct aids compared to the PDB; and
- an increase of €250.0 million in commitments and €900.0 million in payments for a new budget lines relating to a food facility for the provision of food aid to developing countries.

Amending Letter No.3 incorporates the transfer of resources from the Council's contingency reserve to provide €1,060.0 million to cover the operational costs of a new reflection group⁵, following approval of proposals relating to the group's composition at the 15 -16 October European Council.

⁵ Established to identify the key issues and developments which the Union is likely to face and to analyse how these might be addressed

UK POSITION

In the forthcoming Council discussions, the Government's approach will remain consistent with the approach outlined to your committee in previous correspondence and with our position in the earlier stages of the negotiations – principally to reach agreement in as many areas as possible in a way that maintains budget discipline and does not compromise sound financial management. The Government will seek to reduce the overall level of payment appropriations to bring the budget closer to the likely implementation rate and to reduce the likelihood of large surpluses, which represent an opportunity cost to the UK Exchequer.

The Government supports the additional resources for EU External Action priorities in Kosovo and Palestine incorporated in Amending Letter 1 and Commission's downwards revision of agricultural expenditure to reflect the latest market factors, contained in Amending Letter 2. The Government is content with Amending Letter 3, and welcomes the fact that the additional requirements will be met from within existing budgetary allocations.

With respect to Amending Letter 2, the Government has strong concerns on budget discipline grounds with the Commission's proposal to use expected EC budget underspend from within Heading 2. The Government intends to work with other Member States to ensure that alternative proposals and financing mechanisms for Food facility are fully explored to allow for a collective EU response to the food crisis that will be effective in delivering additional resources required. The Government also has concerns about the inclusion of budget lines in the Amending Letter 2, for which no legal base has yet been agreed and intends oppose the inclusion of these budget lines in the negotiations.

NEXT STEPS

The EP amendments and will be considered, along with Amending Letters 2 and 3, at Budget ECOFIN on 21 November, when the Council will agree a Second Reading position on the EC budget and both the Council and EP will attempt to reach consensus on the elements of the EC Budget is expected to be obtained. The budget will then pass back to the EP for agreement on its second reading position on 15-16 December, at which point the 2009 EC Budget will be finally adopted.

15 November 2008

TABLE 1: SUMMARY OF 2009 PDB, DRAFT BUDGET (DB) AND EP FIRST READING - EUR MILLION

Heading	FF Ceiling	2009 PDB		Amending letters (3)				2009 DB		EP 1 st Reading		Diff: EP 1 st Reading – DB	
				AL1		AL2						CA	PA
		CA (1)	PA (2)	CA	PA	CA	PA	CA	PA	CA	PA		
1. Sustainable Growth	59,700	60,104	45,199	-	-	-	-	59,526	44,478	60,192	50,391	666	5,913
1a. Competitive for Growth and Employment	11,272	11,690	10,285	-	-	-	-	11,112	9,814	11,769	11,384	657	1,570
<i>Margin</i> ⁶	-	82	-	-	-	-	-	160	-	3	-	-	-
1b. Cohesion for Growth and Employment	48,428	48,414	34,914	-	-	-	-	48,414	34,664	48,423	39,007	9	4,343
<i>Margin</i>	-	14	-	-	-	-	-	14	-	5	-	-	-
2. Preservation and Management of Natural Resources	59,639	57,526	54,835	-	-	-1,030	-378	57,144	54,338	58,728	56,667	1,584	2,329
<i>Margin</i>		2,133	-	-	-	3,143	-	2,515	-	911	-	-	-
3. Citizenship, Freedom Security and Justice	1,523	1,468	1,266	-	-	-	-	1,447	1,208	1,515	1,365	67	158
3a. Freedom, Security and Justice	872	839	597	-	-	-	-	833	573	864	664	31	91
<i>Margin</i>	-	33	-	-	-	-	-	39	-	8	-	-	-
3b. Citizenship	651	629	669	-	-	-	-	615	635	651	701	36	66
<i>Margin</i>	-	22	-	-	-	-	-	36	-	0	-	-	-
4. European Union as a Global Partner ⁷	7,440	7,440	7,579	+179	+180	-	-	7,554	7,187	7,684	8,157	130	970
<i>Margin</i>	-	244	-	65		-	-	130	-	0	-	-	-
5. Administration ⁸	7,669	7,648	7,648	-	-	-	-	7,553	7,553	7,701	7,701	148	148
<i>Margin</i>	-	129	-	-	-	-	-	232	-	76	-	-	-
6. Compensation	210	209	209	-	-	-	-	209	209	209	209	0	0
<i>Margin</i>	-	1	-	-	-	-	-	1	-	364	-	-	-
TOTAL (4)	136,211	134,395	116,736					133,933	114,972	136,028	124,489	2,095	9,517
Appropriations for payment as % of GNI	1.04%	-	0.90%					-	0.89%	-	0.96%	-	-

Notes:

(1) CA = commitment appropriations

(2) PA = payment appropriations

(3) Amending letter 3 has no impact on overall commitment or payment levels and is not included here.

(4) Due to rounding, the sum of the lines may not equal the total

⁶ The margin for Heading 1 (sub-heading 1a) does not take into account the appropriations related to the European Globalisation Adjustment Fund⁷ Excludes €244 million from the Emergency Aid Reserve⁸ The Margin for Heading 5 includes additional €78 million for staff contribution to pension scheme.

TABLE 2: SUMMARY OF 2008 PDB, DRAFT BUDGET AND EP FIRST READING –GHP MILLION

Heading	FF Ceiling	2009 PDB		Amending letters (3)				2009 DB		EP 1 st Reading		Diff: EP 1 st Reading – DB	
				AL1		AL2						CA	PA
		CA (1)	PA (2)	CA	PA	CA	PA	CA	PA	CA	PA	CA	PA
1. Sustainable Growth	46,978	47,296	35,567	-	-	-	-	46,841	35,000	47,365	39,652	524	4,653
1a. Competitive for Growth and Employment	8,870	9,199	8,093	-	-	-	-	8,744	7,723	9,261	8,958	517	1,235
<i>Margin</i> ⁹	-	65	-	-	-	-	-	126	-	2	-	-	-
1b. Cohesion for Growth and Employment	38,108	38,097	27,474	-	-	-	-	38,097	27,277	38,104	30,695	7	3,417
<i>Margin</i>	-	11	-	-	-	-	-	11	-	4	-	-	-
2. Preservation and Management of Natural Resources	46,930	45,267	43,150	-	-	-811	-297	44,966	42,758	46,213	44,591	1,246	1,833
<i>Margin</i>	0	1,678	-	-	-	2,489	-	1,979	-	717	0	-	-
3. Citizenship, Freedom Security and Justice	1,198	1,155	996	-	-	-	-	1,139	950	1,192	1,074	53	124
3a. Freedom, Security and Justice	686	660	470	-	-	-	-	655	451	680	523	25	72
<i>Margin</i>	-	26	-	-	-	-	-	31	-	6	-	-	-
3b. Citizenship	512	495	526	-	-	-	-	484	500	512	552	29	52
<i>Margin</i>	-	18	-	-	-	-	-	29	-	0	-	-	-
4. European Union as a Global Partner ¹⁰	5,855	5,855	5,964	141	142	-	-	5,944	5,655	6,046	6,419	102	763
<i>Margin</i>	-	192	-	51	-	-	-	102	-	0	-	-	-
5. Administration ¹¹	6,035	6,018	6,018	-	-	-	-	5,943	5,943	6,060	6,060	116	116
<i>Margin</i>	-	102	-	-	-	-	-	183	-	60	-	-	-
6. Compensation	165	165	165	-	-	-	-	165	165	165	165	0	0
<i>Margin</i>	-	1	-	-	-	-	-	1	-	286	-	-	-
TOTAL (4)	107,184	105,755	91,860					105,392	90,472	107,040	97,960	1,649	7,489
Appropriations for payment as % of GNI	1.04%	-	0.90%					-	0.89%	-	0.96%	-	-

Notes:

(1) CA = commitment appropriations

(2) PA = payment appropriations

(3) Amending letter 3 has no impact on overall commitment or payment levels and is not included here.

(4) Due to rounding, the sum of the lines may not equal the total

Sterling converted from Euros at 31 October rate of €1= £0.7869

⁹ The margin for Heading 1 (sub-heading 1a) does not take into account the appropriations related to the European Globalisation Adjustment Fund¹⁰ Excludes €244 million from the Emergency Aid Reserve¹¹ The Margin for Heading 5 includes additional €78 million for staff contribution to pension scheme.

BUDGET: PUBLIC CONSULTATION PAPER IN VIEW OF THE 2008/2009 BUDGET
REVIEW

**Letter from Kitty Ussher MP, Economic Secretary to the Treasury to the Chairman of Sub
Committee A**

At the oral evidence session on 11 June, I said that I would keep you informed about any response that the Government makes to the European Commission on this issue. As you know, the Government considers that this review is an important opportunity to progress towards a reformed budget.

The Government has now submitted a response, and with this letter I am enclosing several copies for Sub-Committee A [not printed]. The central message is that the budget needs fundamental re-orientation to address the key challenges that matter to citizens in the 21st century. Spending on agricultural support should be reduced, and funds re-oriented towards ED action in three priority areas:

- building a prosperous Europe within a strong global economy;
- addressing the challenges of climate change; and
- ensuring security, stability and poverty reduction.

Alongside these changes, the Government believes that Structural Funds in the richer member states should be phased out, and that improvements to the design and administration of spending programmes should be considered to ensure that outcomes are achieved effectively and efficiently.

At the oral evidence session on 11th June, I committed to write to you on several other matters, and will be doing that in due course.

18 June 2008

Letter from the Chairman to Kitty Ussher MP

Thank you for your letter dated 18 June enclosing a copy of the Government's submission to the European Union consultation paper. This was considered by Sub-Committee A at their meeting on 15 July and the consultation paper was cleared from scrutiny.

The Sub-Committee would be interested in the Government's latest assessment of the timetable for the next stages of the review. When does the Government expect to receive a formal summary of the responses to the consultation, and when are formal proposals expected? Has any indication been given of the timetable for consideration of the proposals?

The Sub-Committee are concerned that the timetable has slipped behind that originally suggested when the Review was announced, and may slip further owing to the European Parliament elections and the new Commission next year. Is the Government content with the new timetable?

16 July 2008

Letter from Kitty Ussher MP to the Chairman

Thank you for your letter dated 16 July, acknowledging receipt of the Government's submission to the European Union consultation paper. In your letter you also asked about the next stages of the review.

The Commission has agreed to report back on the budget review in 2008/09. As you know, the original deadline for responses to the Commission consultation was extended from 15 April, to 15 June. The Commission has now announced that President Barroso will host a budget review conference in Brussels on 12 November where Commissioner Grybauskaite will present the results of the consultation. The Commission has promised to provide more details of this event later this month. There has been no indication that the Commission will not be reporting back by 2008/09, as was originally agreed, but I will inform you if this timetable changes.

The Government continues to attach great importance to the budget review, and is looking forward to working further on this with EU partners in the period leading to the next financial perspective negotiations.

11 September 2008

CONSOLIDATED STATEMENT AND AUDIT OPINION ON THE USE OF EU FUNDS;
2006-07

Letter from Kitty Ussher MP, Economic Secretary, HM Treasury to the Chairman

I have the pleasure of providing you with a copy of the UK Consolidated Statement along with the Comptroller and Auditor General's (C&AG) audit opinion and report on the use of EU funds in the UK in 2006-07, which I presented to Parliament on 17 July. This follows the commitment made by the Government in November 2006 that as part of its work to improve the accountability for EU funds across the EU, HM Treasury would prepare an annual Consolidated Statement, audited by the NAO, on the use of EU funds in the UK.

The Comptroller and Auditor General's report gives an unqualified opinion on Regularity showing there has been no evidence of material irregularity in the payments made to beneficiaries in this period. However, it places limitations of scope on a number of areas of the Statement indicating the consistency of the recording and the accounting of EU funding by UK central government bodies needs to be improved. We are working to address these issues and improved guidance is being developed to ensure that all future EU transactions and balances are recorded consistently and separately in the accounts of all the relevant entities.

The Government hopes this Statement and the C&AG's audit opinion will be helpful to the European Court of Auditors and the Commission when they are performing their own audits and controls. I have sent copies of this Statement to both institutions. I will also be sending a copy to my counterparts in other Member States and will continue to work to build momentum for similar action to be taken by our EU partners.

16 August 2008

COUNTERFEITING OF THE EURO

Letter from Ian Pearson MP, Economic Secretary, HM Treasury to the Chairman

The then Economic Secretary wrote to the European Scrutiny Committees on 1 April 2008¹² about a proposed EU Regulation relating to Counterfeiting of the Euro (reference 28956).

In a letter which you sent on behalf of the Committee on 29th April 2008 you shared our anxieties and expressed reservations about the legal basis for the proposal, the appropriateness and proportionality of the measure, and asked about the Government's efforts to achieve a more acceptable outcome, particularly on the ECB's suggestion that the proposal be split into two parts.

It may be helpful to explain to the Committees that since April there has been continuing close engagement between HM Treasury and the UK's Permanent Representation to the EU [UKREP] and the European institutions, in working groups and in writing via a written response to a Presidency questionnaire submitted on 1 August 2008. There have additionally been discussions between other Member States and UKREP, and with interested parties within the UK, including banks and other firms.

I attach a copy of the emerging compromise texts.

LEGAL BASIS - THE UK VIEW

The UK has made clear that EU Regulations should be taken forward on an appropriate legal basis if they are, to apply to non-members of the euro-zone (or 'euro-outs'), as set out in our previous submission to the Committees. The Presidency has accepted our arguments and the Commission has agreed to provide an additional legal base. Therefore the provisions only apply to euro-out Member States by virtue of a second regulation made under Article 308, which is subject to unanimity of all Member States. This approach is satisfactory to the UK: it is more legally appropriate, more consistent with previous practice and in line with the provisions of the UK Protocol to the EC Treaty. .

POLICY ISSUES

The UK emphasised that it accepted the need to identify and remove from circulation counterfeit notes and coins of all kinds. But we were concerned that a widely applicable measure imposing potentially burdensome and expensive requirements on UK firms was disproportionate to the actual risks faced in

¹² CORRESPONDENCE NOT YET PRINTED

the UK. And the UK was concerned that any measure should not have the effect of deterring small firms from accepting euro notes or coins, for example as a service for overseas visitors.

PROGRESS ACHIEVED AND THE REVISED PROPOSAL

The continuing process of engagement with the European institutions culminated in a revised proposal of 1 October 2008.

The revised proposal constitutes a major step forward, for four main reasons.

First, the revised proposal adopts a lengthy lead in period – with the measure not taking effect until the end of 2011 (this can be compared to the two years usually allowed to adopt a Directive). As a result, firms will be able to adapt their procedures over time to reflect the terms of the regulation, without the need for sudden measures or immediate disruption to their business.

We believe this will be a helpful feature of the regulation.

Second, the proposal resolves the issue of the legal basis, as set out above, and sets out the requirements on the face of the legislation rather than leaving wide discretion to the Commission and the ECB. This addresses one of the UK's main reservations about the proposal.

Third, the proposal proceeds on the basis of separate measures addressed to the euro zone members and non-members, which allows the different circumstances to be taken to account with respect to the principle of proportionality.

Finally, the proposal allows flexibility as to how the checks are to be carried out, which is by either using technology (in the form of approved machines), or by trained staff.

We expect this freedom will fit well with the two main business sectors that may be effected by this measure - the large cash processing centres owned and operated by banks, cash-in-transit firms, and at least one large retailer, and small bureaux de change. Cash processing centres already use machines to undertake bulk checking. We understand that there are just over two dozen centres of this kind.

The alternative procedure will be for trained staff within firms to undertake checks. We believe this model should fit easily with the procedures one would expect to find at any prudently run business that handles foreign currencies,

Additionally it will be for the UK to supplement the measure by taking appropriate measures to ensure the regulation is properly applied in the UK. HM Treasury envisages there will be close discussions with UK stakeholders on those issues going forward to ensure that the costs and impacts of the measure are minimised.

CONCLUSION

The latest form of the proposal goes a great way to address previous concerns. Proper recognition has been given to our concerns about the need for a proper legal basis for the measure that is to apply in the UK, about the need for proportionality and flexibility, and about an adequate lead in time. HM Treasury is committed to continuing to working closely with UK stakeholders and with the European institutions as the proposal is finalised.

I hope the committee will be able to clear the proposal.

17 October 2008

Letter from Ian Pearson MP, Economic Secretary to the Treasury, HM Treasury to the Chairman

Kitty Ussher MP, my predecessor as Economic Secretary, wrote to the European Scrutiny Committees on 1 April 2008 about a proposed EU Regulation relating to Counterfeiting of the Euro (reference 28956).

In your letter of 29 April 2008 you expressed reservations, which we shared, about the legal basis for the proposal as well as the appropriateness and proportionality of the measure. You asked about the Governments efforts to achieve a more acceptable outcome, particularly on the ECB's suggestion that the proposal be split into two parts.

Since April there has been continuing close engagement by HM Treasury and UKREP with the European institutions in working groups and through a written response to a Presidency questionnaire submitted on 1 August 2008. We have also had discussions with other Member States, and with interested parties within the UK, including banks and other firms. Our efforts concerned both the legal basis of the proposals and the wider policy issues.

On the former, the UK made clear that EU Regulations should be taken forward on an appropriate legal basis if they are to apply to non-members of the euro-zone (or 'euro-outs'), as set out in our previous submission to the Committees.

On the substance of the proposal, the UK emphasised that it accepted the need to identify and remove from circulation counterfeit notes and coins of all kinds. But we were concerned that a widely applicable measure imposing potentially burdensome and expensive requirements on UK firms was disproportionate to the actual risks faced in the UK. We also sought to ensure that any measure would not deter small firms from accepting euro notes or coins, for example as a service to overseas visitors.

PROGRESS ACHIEVED AND THE REVISED PROPOSAL

The continuing process of engagement with the European institutions culminated in a revised final text of 15 October 2008, which will now go for consideration by the European Parliament. It is a significant improvement in four respects.

First, the proposal resolves the issue of the legal basis. The Presidency accepted our arguments and the Commission agreed to provide an additional legal base. Therefore the provisions only apply to euro-out Member States by virtue of a second regulation made under Article 308, which is subject to unanimity. The requirements are set out on the face of the legislation rather than leaving wide discretion to the Commission and the ECB. This approach is satisfactory to the UK: it is more legally appropriate, more consistent with previous practice and in line with the provisions of the UK Protocol to the EC Treaty.

Secondly, the revised proposal adopts a lengthy lead in period - with the measure not taking effect until the end of 2011 (compared to the two years usually allowed to adopt a Directive). As a result, firms will be able to adapt their procedures over time to reflect the terms of the regulation, without the need for sudden measures or immediate disruption to their business. We believe this is a helpful change.

Thirdly, the proposal proceeds on the basis of separate measures addressed to the euro zone members and non-members, which allows the different circumstances to be taken to account with respect to the principle of proportionality.

Finally, the proposal allows flexibility as to how the checks are to be carried out. This can either be using technology (in the form of approved machines), or by trained staff.

We expect this freedom will fit well with the two main business sectors that may be affected by this measure – the large cash processing centres (owned and operated by banks, cash-in-transit firms, and at least one large retailer) and small bureaux de change. Cash processing centres already use machines to undertake bulk checking whereas the alternative, for trained staff within firms to undertake checks, should fit easily with the procedures one would expect to find at any prudently run business that handles foreign currencies.

In addition, it will be for the UK take any appropriate steps to ensure the regulation is properly applied in the UK. HM Treasury intends to discuss possible measures with UK stakeholders to ensure that the costs and negative impacts are minimised.

CONCLUSION

The latest form of the proposal goes a great way to address our previous concerns and we will continue to work closely with UK stakeholders and the European institutions as the proposal goes through the final stages. I hope the committee will feel able to clear the proposal.

28 October 2008

CUSTOMS BINDING TARIFF INFORMATION SYSTEM: EU COURT OF AUDITORS REPORT ON THE CUSTOMS BINDING TARIFF INFORMATION SYSTEM (8256/08)

Letter from the Chairman to Rt Hon Jane Kennedy MP, Financial Secretary to the Treasury

Thank you for your Explanatory Memorandum 8256/08 which was considered by Sub-Committee A on 20 May 2008. The Sub-Committee held the document under scrutiny. The Sub-Committee support the Government's approach on the issue of BTIs that are invalidated for reasons other than administrative error, and would be interested to hear of the outcome of your discussions on the case that you highlight in the EM.

The Sub-Committee would also be grateful if you could clarify the Government's position on BTIs that are invalidated because of an administrative error. In such cases, would the Government accept that a Member State should be financially responsible for any resulting financial loss to the EU?

20 May 2008

Letter from Rt Hon Jane Kennedy MP to the Chairman

Thank you for your letter of 20 May about the above report.

I note Sub-Committee A's support for the Government's approach on the issue of BTIs that are invalidated for reasons other than administrative error. I also note that the Sub-Committee would like to hear the outcome of the Government's correspondence with the European Commission about the particular invalidated BTIs mentioned. The current position is that HMRC are still awaiting a response from the Commission to the points made in their latest letter. I will advise you of the outcome as soon as it is known. However, this issue is being progressed separately and is expected to continue for several more months before a conclusion is reached.

The Government's position on BTIs that are invalidated because of an administrative error is also that Member States should not be held responsible for any financial loss. Support for this view was shown by some other Member States during discussions at the EU Customs Code Committee (BTI Sector) meeting in April this year. The Government acknowledges that the position regarding financial responsibility and BTIs is unclear and that there is legal precedent which supports the alternative view. However, the case used by the Auditors in the report to justify their position does not appear relevant as it concerns a case where the Danish authorities maintained their interpretation of a particular customs scheme after the Commission had challenged it.

The Government accepts financial responsibility for any financial loss to the EU in cases of administrative error not involving BTI.

The Commission has yet to advise its intentions regarding the financial responsibility recommendation. However, we are encouraged by the draft conclusions of the Council following their consideration of the report. These indicate that the Council agrees that invalidation is a legitimate process related to BTIs and considers that the possible financial responsibility of Member States, if any, should be assessed with the utmost caution.

The ECA presented the report to the Council (COREPER) and the European Parliament (Committee on Budgetary Control in the European Parliament – COCOBU). Discussions are taking place in the Council (COREPER asked the Customs Union Group to examine the report) with adoption of the conclusions tabled for 23 June but it is still not known when the COCOBU Committee is going to discuss the report.

I shall keep you informed of progress.

14 June 2008

**DEPOSIT GUARANTEE SCHEMES: COVERAGE AND PAYOUT TIME FOR
DEPOSITORS (14317/08)**

Letter from the Chairman to the Lord Myners, Financial Services Secretary, HM Treasury

Thank you for your Explanatory Memorandum 14317/08 about deposit guarantee schemes. This was considered by Sub-Committee A at its meeting of 18 November 2008. The Sub-Committee cleared the item from scrutiny. The Sub-Committee would like to ask about certain issues raised by the proposed amendment. How does Directive 94/19/EC define 'credit institutions' and does this prevent customers recovering deposits in separate banks which are part of the same banking group? Does the UK FSCS guarantee deposits (a) per person, per "brand", (b) per person, per institution or (c) per person, per group? Do the proposals modify this status and will any modification require a subsequent change to United Kingdom primary legislation?

The Sub-Committee would also like to ask when the FSA expect to publish the results of its consultation paper on compensation limits referred to in paragraph 14 of the Explanatory Memorandum.

18 November 2008

Letter from Lord Myners to the Chairman

Thank you for your letter of 18 November 2008. I would like to respond to the questions raised by Sub-Committee A and update you on the progress of the negotiation.

I am grateful to the Sub-Committee for clearing the proposal. As you will know, the Presidency intend to seek agreement to it among several financial services dossiers at the ECOFIN Council on 2 December in order to allow negotiations with the European Parliament to proceed.

Sub-Committee A has asked how Directive 94/19/EC defines 'credit institutions' and what effect this may have on depositors in separate banks which are part of the same group. The Directive defines a credit institution as 'an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account'. This embraces banks and building societies.

The Directive applies the guarantee to deposits with separate companies within the same group. Depositor protection in the UK is framed in terms of all the accounts held in a firm operating under a single authorisation by the FSA.

The FSCS protection limit therefore applies on a per-person, per-authorised institution basis. The European proposals would not modify this, except insofar as the Commission is tasked, among other things, with reporting by December 2009 on the scope of products and depositors covered.

Any future modification is likely to be implemented through changes to FSA rules not through primary or secondary legislation to amend the Financial Services and Markets Act 2000. The FSA has invited comments on the per-authorised institution criterion in its consultation on compensation schemes, published in October (CP08/15). It has said that it will consider simplifying the eligibility criteria and may bring forward proposals in a further consultation in the New Year. The Sub-committee has asked when the FSA expect to publish the results of its consultation paper on compensation limits. That is a matter for the FSA. However, I understand that the consultation closes on 5 January 2009 and rule changes and a policy statement will be published later in 2009.

I would also like to update you on the progress of the negotiations on amendments to the Directive. The Government has continued to support an increase in the minimum level of compensation, a shorter pay out deadline and the move to compensate 100 per cent of eligible deposits.

Member States have reached agreement, subject to the views of the European Parliament on an increase to €50,000 when the Directive enters into force and to €100,000 by 31 December 2011. The limits will be inflation-linked. The payout delay should be reduced from three months to 20 days, with a further 10 days in exceptional circumstances, by December 2010. Compensation will extend to 100 per cent of eligible deposits. Further measures include a requirement for guarantee schemes to cooperate and schemes must be stress tested regularly.

A provision authorising the Commission to propose temporary increases in a crisis has been withdrawn. Instead there is a commitment to further work in a number of areas. The Commission is tasked with reporting by December 2009 on:

- the effectiveness of payout procedures
- the determination of contributions to schemes
- the effectiveness of cooperation arrangements
- the potential impact of increasing the limit to €100,000
- whether €100,000 should become an upper limit, it will do so unless the report finds against.

I believe that, taken together, these changes represent a significant improvement in the protection afforded to depositors and the effectiveness of the Directive. Further improvements are likely to follow the Commission's report in December 2009.

24 November 2008

EC BUDGET: EUROPEAN COMMUNITY FINANCES 2008

Letter from Kitty Ussher MP, Economic Secretary, HM Treasury to the Chairman

I have pleasure in enclosing the Government's Annual White Paper on the EC Budget - European Community Finances: Statement on the 2008 EC Budget and measures to counter fraud and financial mismanagement.

This is the twenty eighth Annual White Paper in the series, This year's report covers annual budgetary matters and includes details of recent developments in European Community financial management and in countering fraud against the Community Budget. It also describes the EC Budget for 2008 as adopted by the European Parliament, and details the United Kingdom's gross and net contributions to the EC Budget for calendar years 2002 to 2008 and financial years 2002-2003 to 2010-2011.

9 September 2008

ECOFIN DECEMBER 2008: SOLVENCY II, CAPITAL REQUIREMENTS DIRECTIVE,
UCITS, DEPOSIT GUARENTEE SCHEME DIRECTIVE

**Letter from Lord Paul Myners, Financial Services Secretary to the Treasury, HM Treasury to
the Chairman**

I am writing to update you with regard to the upcoming ECOFIN Council. We have now received the draft agenda for the meeting on 2 December, when the French Presidency plan to seek agreement to several financial services dossiers which are still subject to scrutiny.

These dossiers are Solvency II, the Capital Requirements Directive, UCITS and the Deposit Guarantee Scheme Directive. The Presidency is seeking agreement from ministers to general approaches to allow negotiations with the European Parliament to proceed.

You have been, quite rightly, concerned that the impact of these dossiers should be considered both on their own merits and in the light of the current financial turmoil. The Government agrees that the current climate justifies ensuring that the detail of these dossiers is carefully scrutinised because of the significant potential impact on UK and European customers, businesses and public finances. We have continued to work hard with other Member States and the Commission to ensure that these dossiers meet our specific aims and also link in with our wider ambitions for improvements to regulatory and supervisory systems.

However, this consideration must be balanced with the need for the UK to play a full part in shaping these Directives at ECOFIN. We are now reaching the endgame on all four dossiers and we fully expect that the Presidency will pursue its aim of asking Member States to agree general approaches on all four on 2 December.

On that basis I have annexed to this letter detail on the three dossiers on which you and Michael Connarty have requested further information: Solvency II, the CRD and UCITS. I hope that this information will be sufficient to enable your Committee to clear the dossiers from scrutiny in time for the December ECOFIN.

11 November 2008

ANNEX A

SOLVENCY II (EXPLANATORY MEMORANDUM 11978/07)

This annex provides an update on the Government's views of the Solvency \I project in the light of the current global financial turmoil. It gives information in particular in respect of attitudes towards risk and suitable levels of capital. This annex sets out that information.

The Solvency \I Directive sets a calibration standard for the main Solvency Capital Requirement which insurers will have to meet on an on-going basis under Solvency II. This standard is that an insurer should have no more than a One in 200 probability of failure over a one-year period. Subject to meeting this standard, Solvency II allows insurers to adopt the risk appetite which their board and senior managers determine is appropriate as long as they have in place systems to manage those risks effectively and of course adequate capital given the chosen risk profile. This is in line with the current approach adopted by the FSA and remains appropriate.

It should be noted that any given capital requirement imposed by the authorities is a minimum standard which in general will be exceeded, often by a significant margin. The great majority of firms will hold an additional buffer of capital for several reasons. These include the desire to avoid regulatory intervention subsequent to any capital shortfall against the regulatory minimum and, for larger companies, to maintain a given credit rating.

Further, the Solvency II Directive has two capital requirements and when the lower of these, the Minimum Capital Requirement, is breached, the insurer's authorisation to write new business will be withdrawn. This should ensure that well before an insurer's capital comes close to being depleted, its existing policyholders are fully protected from the risks inherent in writing new business. We expect that the Minimum Capital Requirement will typically be in the range 20-50 per cent of the main Solvency Capital Requirement. It is reasonable to expect that companies will in general still have significant amounts of capital at the point when they are prevented from undertaking new business.

Our conclusion is that the calibration standard for the capital requirements under Solvency II remains appropriate.

However we have also considered the issue of the quality of capital which is eligible to meet those capital requirements. In the European Commission's proposal for the Solvency II Directive, the minimum amount of Tier One or highest quality capital that a firm is required to maintain is one third of the amount of the Solvency Capital Requirement. By way of comparison, in the banking sector the equivalent requirement is that one half of the minimum regulatory capital must be matched with eligible Tier One capital.

One key lesson emerging from the impacts of the global financial turmoil is that financial companies require high quality capital to maintain the confidence of counterparties and other financial market participants, as well as of their policyholders. At present in the UK insurance companies are required by the FSA to hold at least half of the regulatory minimum capital requirement in the form of Tier One capital. In practice in many firms the share of Tier One in total capital held is significantly higher.

Since the current FSA capital requirements are calibrated to achieve a similar prudential standard to that proposed for the Solvency Capital Requirement under Solvency II, it follows that, on the basis of the current proposal, Solvency II would permit a material dilution in the overall quality of capital held by UK insurers.

Of course it need not follow from the change in regulatory requirements that insurance companies would necessarily alter the share of Tier One capital in their total capital held. Nevertheless, given the events of the past year the Government's view is that it would not be appropriate to choose a lower minimum for the amount of highest quality Tier One capital. We therefore propose to advocate with the Presidency and other Member States that under Solvency II insurance companies are required to maintain Tier One capital equal to at least one half of the Solvency Capital Requirement.

The fourth Quantitative Impact Study

The purpose of the fourth Quantitative Impact Study (QIS 4) is to analyse the impact on insurance companies of the proposed quantitative elements of the Solvency II framework. At the time the specification of QIS 4 was developed by CEIOPS and then agreed by the Commission - late 2007 through to early 2008 – global financial markets had not yet experienced the extraordinary disruptions we have recently witnessed. As a result the specification of QIS 4 is of course consistent with the Directive as proposed by the Commission but has not been altered in the light of the recent events in global financial markets.

Nevertheless, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has produced analysis of the financial stability of the insurance sector at EU level, including an assessment of its exposure to US sub-prime mortgage risk either via holdings of Asset Backed Securities, or through investment in hedge funds. The conclusion reached is that across the exposures to this risk category is modest for the EU insurance sector as a whole¹³.

Further, the fact that it was not possible for QIS4 to reflect the implications for policy of the global financial turmoil does not imply that that cannot be taken into account in the Solvency II legislation.

The Solvency II framework has the flexibility to be adjusted to the lessons of the financial crisis once the policy implications are fully analysed. As you are aware Solvency II adopts the Lamfalussy arrangements for developing financial services legislation. This means that the Directive currently under negotiation provides a framework and core principles but leaves considerable areas of the detailed technical legislation for so-called 'level two' implementing measures.

The Lamfalussy arrangements were deliberately designed to achieve flexibility in EU financial services legislation so that it could respond to significant changes in the financial sector. This will allow lessons that are relevant to the insurance sector to be applied in the detailed legislation of Solvency II. However, we must avoid knee-jerk reactions to the current financial problems and in particular we need to be careful to ensure that the economics of the insurance sector, which is fundamentally different from the economics of banking, is taken into account fully where any read across between the sectors is envisaged.

Along with other Member States' authorities, HM Treasury and the FSA have a central interest in ensuring that the level two implementing measures in Solvency II provide the technical requirements to deliver a robust prudential framework while also being proportionate in the regulatory burden imposed on industry.

ANNEX B

¹³ As outlined in CEIOPS Spring 2008 Report on financial conditions and financial stability in the European Insurance and Occupational pension fund sectors 2007 – 2008
http://www.ceiops.eu/media/docman/public_files/publications/reports/CEIOPS-FS-10-08.pdf

This annex sets out further information on the proposed reforms of the UCITS Directive, and in particular information on developments on a management company passport following the advice requested from the Committee of European Securities Regulators (CESR) and for information on the views of UK consumers.

On the former, CESR published its advice to the Commission on 31 October¹⁴. This advice set out a framework which a majority of CESR members believed would deliver the management company passport while maintaining an appropriate level of investor protection and supervisory oversight. The key points of this framework are:

- that the management company's home Member State should be the state in which it has its registered office;
- that the UCITS home Member State should be the state in which the UCITS is authorised;
- the depositary (the institution responsible for safekeeping of the fund assets and some oversight of the management company) should be located in the UCITS home Member State and should have an information sharing agreement with the management company to ensure ready access to necessary information;
- where the management company is making use of the passport, it should appoint the depositary or another financial institution to act as a local point of contact in the UCITS home Member State for the UCITS supervisor and investors;
- that management companies using the passport should be subject to the rules of their own home Member State for matters relating to their general conduct as a management company (for example conduct of business, risk management), but that the rules of the UCITS home Member State should be observed for matters relating directly to the operation of the specific UCITS fund (for example investment policies and limits);
- that supervisors should have the power to conclude cooperation agreements in respect of their supervision of UCITS managed by non-local management companies;
- that the UCITS and the management company should be subject to independent audits and that when the two are audited by different auditors, those auditors should conclude an information sharing agreement; and
- that the UCITS supervisor should have the power to take enforcement action for breaches of its rules whether or not the UCITS is managed by a local management company.

The Government believes CESR's advice represents a good basis for the introduction of a management company passport. The advice is broadly consistent with the proposals currently being developed in Council working groups and the Presidency is now going through the advice to consider where changes need to be made.

The main point on which the Council's proposal may differ from CESR's advice is on CESR's proposal for a local point of contact it is likely that the Council's position will focus on ensuring that there are adequate procedures to allow investors of a UCITS to make complaints about the management company, even where that management company is not local. The balance of opinion in the Council is that this is the key point for ensuring investors' rights are protected and that the necessity for a local point of contact for supervisors is adequately dealt with i) by the provisions to allow UCITS supervisors to request a wide range of information about the running of the fund; and ii) by the broad provisions for co-operation between supervisors.

Your second question was on the information the Government has on the opinion of consumers. The area in which consumer views are perhaps most important is on the proposed reforms to the information provided to potential investors (to be known as 'key investor information'). The Commission held workshops with strong representation from consumer bodies when developing its high-level proposals, and CESR has also consulted consumer representatives in the course of developing advice to the Commission on detailed rules on the form and content of this information. The Commission is in the process of testing CESR's draft proposals directly with consumers, and the

¹⁴ <http://www.cesr-eu.org/index.php?page=groups&id=28>

results of that testing will in turn inform the final version of CESR's advice. The Government believes this will deliver a real improvement to consumer information in the UCITS market.

Concerning the other issues in the package, it would be difficult to collect views directly from consumers since these are largely technical amendments relating to the way UCITS are run and do not substantially affect the nature of UCITS as a product. However, in its response to the Commission's earlier consultation on its proposals, the UK Financial Services Consumer Panel¹⁵ agreed that the UCITS review was "both timely and appropriate". Of the consumer protection issues raised by the panel in its response, the Government believes the large majority have been addressed. Concerning the management company passport specifically, the Panel expressed some concern about the potential for confusion around the Commission's initial proposal for a "partial" passport which would have allowed some activities to be passported but not others. The Government shared this concern and believes it will be addressed through the replacement of the partial passport proposal with a full management company passport, backed up by full and effective provisions for supervisory co-operation.

ANNEX C

CAPITAL REQUIREMENTS DIRECTIVE (EXPLANATORY MEMORANDUM 13713/08)

This annex sets out how negotiations on the Capital Requirements Directive are developing and gives a clarification of which outcomes the Government desires and which aspects it wished to change.

It sets out updates on negotiations and the proposed timetable for completion. Firstly, on the timetable. There is a high probability that the French Presidency will seek to achieve a general approach among Member States at the December meeting of Finance Ministers. While this timetable poses significant challenges, especially in regard to the ongoing scrutiny process, negotiations have progressed well in a number of areas.

On the negotiations themselves, the proposal covered four main areas:

- The large exposures regime: limits to ensure financial institutions are not exposed too heavily to any single or connected counterparty;
- The supervisory framework and supervisory colleges: reinforcing the efficiency and effectiveness of supervision of cross-border banking groups by formalising supervisory colleges in legislation and requiring closer cooperation on the determining of group capital levels;
- The definition and limits on hybrid capital: providing a common interpretation of the three main eligibility criteria that correspond with 'higher quality' capital: permanence, loss absorption and flexibility in payments, and establishing harmonised quantitative limits for the extent to which hybrids may be accepted as firms' original own funds; and
- Securitisation and risk transfer activities: revisions aimed at improving risk management by better aligning potentially misaligned incentives, disclosure and diligence requirements on the investor before they can invest and monitoring requirements on an ongoing basis, alongside transparency requirements on originators before they can sell.

In terms of the large exposures regime, the current approach sets a maximum limit for all exposures from banks to non-banks and all interbank (bank to bank) exposures over one year, but contains a national discretion on interbank exposures for less than a year.

So far in negotiations the main thrust of the Commission's original proposal, to extend the current limit for inter-bank exposures to all exposures regardless of maturity, has been maintained. Further to this, our key negotiating objective, that of ensuring a proportionate regime for the UK's smallest banks and building societies, has also been maintained.

The Government believes this will represent a significant improvement to the stability of the financial sector in the UK, decreasing the risk of large systemic linkages between institutions. The original Commission proposal aimed to reinforce the efficiency and effectiveness of supervision of cross-border banking groups by formalising supervisory colleges in legislation. It also required agreement between supervisors on entities in the same group on issues for the whole banking group such as total capital for the group, the distribution of capital across subsidiaries, liquidity in subsidiaries and branches and reporting requirements, and where agreement is not reached, a mediation mechanism was proposed

¹⁵ Available at http://ec.europa.eu/internal_markets/investment/docs/consultations/2007consult/63.pdf

using CEBS¹⁶ as an advisory body. Ultimately it was proposed that the consolidating supervisor (that is the supervisor responsible for the parent institution or holding company) would take the final decision.

This approach would produce significant benefits for cross-border banking groups, and potentially deliver more efficient supervision and reduced burdens. The current draft of the compromise text maintains this general approach, which the UK has broadly supported. Furthermore, on the issue of determining the total required capital for the group, the text now proposes that the final decision on key supervisory issues shifts back to the local supervisor. The Government believes this approach strikes the right balance between efficiency of supervision and the distribution of supervisory powers and responsibilities, and will be seeking to ensure this option remains in the text, which will allow the Financial Services Authority to remain ultimately responsible for the capital levels of UK institutions.

The Commission's original proposal on hybrid capital was to introduce a common interpretation of the three main eligibility criteria that correspond with 'higher quality' capital: (permanence, loss absorption and flexibility in payments), and establish harmonised quantitative limits for the extent to which hybrids may be accepted as firms' original own funds has largely been maintained. Subject to some modifications to ensure that instruments issued by mutuals (who cannot issue pure equity) can, in some circumstances, be deemed as comparable to equity, this is an approach the Government continues to support, and one that will bring significant benefits to cross border financial institutions.

Finally, the Commission has proposed revisions aimed at improving risk management by better aligning potentially misaligned incentives, specifically by requiring investor institutions in the EU to only invest in credit risk transfer products if the originator has committed to holding a net economic interest of at least five per cent. It has also proposed disclosure and diligence requirements on the investor before they can invest and monitoring requirements on an ongoing basis, alongside transparency requirements on originators before they can sell.

The Government initially had concerns over the scope of the quantitative retention requirement, which would effectively cover a wide range of instruments beyond simply securitised assets. Negotiations are progressing well, and the scope is being narrowed. This will help to ensure that the requirements reflect a proportionate response to the financial market disruption. We hope to see continued progress on further refining the scope as negotiations proceed. In terms of the disclosure and diligence requirements, the Government was supportive of these improvements, but has agreed amendments to ensure they are workable in practice and are less burdensome on the industry.

ECONOMIC PARTNERSHIP AGREEMENTS (11852/08, 11862/08, 11913/08, 11959/08, 13314/08, 13386/08)

Letter from the Chairman to Gareth Thomas MP, Minister of State, Department for Business, Enterprise & Regulatory Reform

Thank you for your Explanatory Memoranda 11852/08, 11862/08, 11913/08, 11959/08, 13314/08 and 13386/08. These were considered by Sub-Committee A at their meeting on 28 October 2008. The Sub-Committee have cleared Memoranda 11852/08, 11862/08, 11913/08 and 11959/08 (i.e. those relating to EPAs with Ghana and Central Africa) from scrutiny but have held 13314/08 and 13386/08 (i.e. those relating to the EPA with Southern Africa) under scrutiny in connection with the Sub-Committee's current inquiry into EU trade policy.

The Sub-Committee noted and shared your concerns about the impact of the proposed Southern Africa EPA on intra-regional trade, and would be grateful if you could provide updates on the outcome of discussions in the Working Groups. The Sub-Committee would also be interested to know what is the Government's assessment of the views of the governments of Namibia, Botswana, Lesotho, Swaziland and Mozambique of the interim EPA as it is currently drafted.

29 October 2008

ELECTRONIC MONEY INSTITUTIONS: TAKE UP, PURSUIT AND PRUDENTIAL SUPERVISION (14201/08)

Letter from the Chairman to the Lord Myners, Financial Services Secretary, HM Treasury

Thank you for your Explanatory Memorandum dated 31 October 2008. This was considered by Sub-Committee A at its meeting of 18 November 2008. The Sub-Committee decided to hold the document

¹⁶ Committee of European Banking Supervisors

under scrutiny. The Sub-Committee would like to ask that the Government keep the Committee updated regarding developments to these proposals and that the Government provide the Sub-Committee with a copy of the Impact Assessment on United Kingdom business once this is completed.

18 November 2008

EXCESSIVE DEFICIT IN THE UNITED KINGDOM (11300/08, 11302/08)

Letter from the Chairman to Ian Pearson MP, Economic Secretary, HM Treasury

Thank you for your predecessor's Explanatory Memorandum 11300/08, 11302/08 dated 25 September 2008. This was considered by Sub-Committee A at its meeting on 21 October 2008.

The Sub-Committee noted that the economic outlook has changed in the last few weeks. Given the actions taken by the Government and other EU Member States to combat the recent events in the financial markets, will the Government be able to stick to the forecasts that your predecessor made in the Explanatory Memorandum for the UK budget deficit in 2009-2010? Have any arrangements been made to temporarily amend or suspend the rules of the Stability and Growth Pact to reflect the interventions made by several Member States?

21 October 2008

EXTERNAL TRADE WITH NON-MEMBER COUNTRIES (15055/07)

Letter from Rt Hon Stephen Timms MP, HM Treasury to the Chairman

I refer to my predecessor's letter of 23 March 2008¹⁷ regarding the above proposal.

I am now able to update you further on the negotiations regarding the proposed regulation which has been discussed at both the Council Statistics Working Party in Brussels and the European Parliament.

Following their consideration, the European Parliament made 35 amendments to the proposed regulation. Most of these related to minor changes to the wording or presentation to tidy up the regulation. Other more notable amendments removed the requirement for quota information from the regulation, a deletion supported by several Member States (including the UK), as well as defining more clearly the responsibilities for data exchange between Customs authorities and national statistical authorities. The proposal also provides a quality framework for the production of more consistent statistics across the EU.

Unfortunately despite concerns raised by the UK about providing data on the Nature of Transaction Code and the Currency of Invoicing for exports, these aspects remain in the proposal. However, the Nature of Transaction Code is not required where it is not collected on the customs declaration so this will not impose a change on the UK. The UK recognises that the Currency of Invoicing for exports data is required by the European Central Bank and the EC Finance Directorate to monitor the share of the euro in international merchandise trade. The trade will be consulted in the UK to ascertain the least burdensome method of collecting the Currency of Invoicing data.

The Council Statistics Working Party has reached agreement on the final draft of the regulation and it has now been passed to COREPER as an A point. HMRC are recommending that the UK supports the proposal.

16 October 2008

HOLDING AND MOVEMENT OF ALCOHOL, TOBACCO AND ENERGY PRODUCTS IN DUTY SUSPENSION (6615/08)

Letter from Rt Hon Stephen Timms MP, Financial Secretary to the Treasury, HM Treasury to the Chairman

Thank you for your letter of 2 April 2008¹⁸. I am writing to provide an update on this issue.

Under the French Presidency, meetings on this dossier began in July and considerable progress has been made very quickly in Council working group negotiations, particularly since September. The

¹⁷ CORRESPONDENCE NOT YET PRINTED

¹⁸ CORRESPONDENCE NOT YET PRINTED

issue is on the agenda for the 4 November ECOFIN, where the Presidency hopes to reach agreement on a "general approach". A final text is due to be circulated following a debate in COREPER on 29 October, though we have not currently received this.

You will recall that the Government broadly supported the Commission's proposal, which was necessary to provide the legal framework for the new computerised Excise Movement Control System (EMCS). We made it clear, however, that we would oppose any changes that made it more difficult to counter fraud or smuggling; that facilitate avoidance or evasion; or that sought to introduce unjustified additional burdens on business.

In particular we were opposed to the provisions in the original proposal relating to the 'distance-purchasing' of alcohol and "gifts" of excise goods sent from one Member State to another. In both of these scenarios, under the original proposal, tax would have been due in the Member State from which the goods were sent - not, as at present, where they were ultimately to be consumed. I am pleased to say that these provisions have now been removed from the proposal and the current arrangements for distance purchasing of all excise products will remain unchanged.

The original Commission proposal would also have resulted in the removal of "Minimum Indicative Levels", which are an important 'indicator' of whether the amount of excise goods transported by crossborder travellers within the EU is reasonable for personal use. That would have significantly hindered UK enforcement efforts, as smugglers, using the regulations to mask their activities, would be potentially indistinguishable from legitimate shoppers. We said that we would firmly challenge these proposals and were prepared to vote against them if necessary. However, I am pleased to say that the Minimum Indicative Levels have now been restored and will remain unchanged.

In addition to the key issues mentioned above, we have managed to negotiate a number of new or amended provisions where we felt the new Directive could usefully either strengthen protection against excise fraud or simplify arrangements for businesses. In particular, the latest compromise text clearly cites those persons liable to pay excise duty in all circumstances, and particularly in the event of an irregularity or offence. This includes provisions for joint and several liability in appropriate cases. The current Directive and the original Commission proposal were deficient in this respect, so this is a welcome change.

We have also managed to resist changes to arrangements on the distance selling of excise goods, which we believe would have increased administrative burdens on businesses in this sector.

Finally, I would like to inform you that, during the course of negotiations on the proposal, many Member States, including the UK, expressed concerns about the timetable for the introduction of the computerized Excise Movement Control System, the first phase of which was due to go live on 1 April 2009. They felt that, given the amount of time that would be required to transpose this Directive into national legislation, to develop detailed implementing provisions, and to roll out the system in an orderly fashion to businesses, this timetable was no longer feasible. It has therefore been agreed that the "go live" date will be postponed to 1 April 2010. This will still be extremely challenging for some Member States, particularly if the Directive is not now agreed as soon as possible.

The French Presidency is pushing very hard for agreement to a general approach at the ECOFIN Council on 4 November. It is unclear at present whether all other Member States will be in a position to lift remaining substantive reserves on specific aspects of the proposal at this Council. However, there is a strong possibility that they will, in which case the UK will come under concerted pressure to lift our Parliamentary scrutiny reserve to allow a general approach to be agreed.

I appreciate that, due to the speed at which the negotiations have progressed, the proposal has not yet cleared the scrutiny process. However, if other reserves are lifted I may need to proceed with agreement to the general approach on 4 November and I wanted to inform the Committee now of this possibility. While it would be unfortunate if scrutiny procedures were not to be completed I hope that you can understand the importance of agreeing the proposal at the earliest opportunity, bearing in mind the timetable for implementation of the Excise Movement Control System, which is highly beneficial to our business sector.

30 October 2008

Letter from the Chairman to Rt Hon Stephen Timms MP

Thank you for your letter dated 30 October 2008, regarding EM 6615/08. This was considered by Sub-Committee A at its meeting on 11 November 2008. The Sub-Committee recorded the item as a scrutiny override and expressed its concern at the delayed response to our letter of 2 April. While it is understandable that negotiations might have concluded at a rapid rate, the Sub-Committee is surprised that an update was not sent sooner, possibly avoiding the need for a scrutiny override. The House continues to attach the utmost importance to the scrutiny reserve.

11 November 2008

INTERNATIONAL ACCOUNTING STANDARD 39

Letter from Ian Pearson MP, Economic and Business Minister, Department for Business, Enterprise & Regulatory Reform to the Chairman

I am writing to bring to your attention the recent changes adopted at EU level to accounting standards. I regret that, due to the urgent nature of these changes, it was not possible to allow a period for your Committee to consider the proposals before they were agreed.

The Government has been working with other Member States on a package of measures intended to mitigate the consequences of the recent turbulence in financial markets. International Accounting Standard 39 (IAS 39), which sets out "fair value" rules, has presented particular difficulties for UK and other EU firms in the current economic climate. We are therefore pleased that the International Accounting Standards Board (IASB) and the European Commission, in agreement with Member States, have acted expeditiously to introduce the necessary changes to that standard. Unfortunately, the entire process has moved, and continues to move, too quickly to allow for prior consultation of the Committee.

The amendments to IAS 39, announced on 15 October 2008, aim to improve the application of the fair value rules in the preparation of firms', and especially banks', financial reports. The amendments ensure that EU companies have the same flexibility as their American competitors to reclassify assets held-for-trading into the held-to-maturity category. As a result, financial institutions in the EU will no longer have to reflect market fluctuation in their financial statements for these kinds of assets. These changes will apply as from the third quarter of 2008.

I should explain the steps leading up to the amendments being agreed. International accounting standards are set by the IASB. These in turn are adopted in the EU by the Accounting Regulatory Committee (ARC) – a comitology committee in which the European Commission takes decisions in agreement with Member States. This process was accelerated considerably due to the urgent nature of the changes. The IASB deliberated and finally pronounced upon amendments to IAS 39 on 13 October. A proposal to endorse the amendments was presented to ARC members by the Commission late in the day on 14 October, for approval at the emergency ARC meeting called for 15 October.

At the same time as announcing the changes to IAS 39, the European Commission also made a Declaration stating that it would continue to closely monitor all accounting issues that could impact on the stability of financial institutions and financial markets, and would keep under constant review the implementation of the changes. The full text of the Declaration is attached for your information.

It is likely that there may be more very rapid changes to IAS 39 in the near future. These possibilities are being closely monitored by my officials, and I shall endeavour to keep you updated on significant developments.

22 October 2008

Letter from the Chairman to Ian Pearson MP

Thank you for your letter dated 22 October 2008 regarding International Accounting Standards which Sub-Committee A considered at its meeting on 6 November 2008. The Sub-Committee would like to thank you for your letter regarding the changes to the IAS, which was both informative and useful. These changes are of great interest to Sub-Committee A, especially in light of the Committee's current inquiry regarding EU financial regulation.

6 November 2008

MEDIUM-TERM FINANCIAL ASSISTANCE FOR HUNGARY (14949/08)

Letter from Ian Pearson MP, Economic Secretary to the Treasury, HM Treasury to the Chairman

I am writing to alert you to a forthcoming vote in Council on a Decision approving the granting of €6.5bn from the EU Medium-Term Balance of Payments Facility to support Hungary and to the possibility of a vote on amending the Facility's founding Regulation to increase the annual ceiling of the facility from €12 billion to €25 billion.

Full details of the proposal on granting assistance to Hungary are set out in the accompanying unnumbered Explanatory Memorandum. Following Hungary's approach to the European Commission for assistance, negotiations took place in an accelerated time frame and final agreement is likely to be reached in ECOFIN on 4 November. The unfortunate consequence of this is that the Government has been unable to alert Parliament until now to the proposal in sufficient time to accommodate the Parliamentary scrutiny process, which it regrets. However, given the exceptional circumstances and the urgency of providing rapid and effective support to Member States in crisis to prevent wider ramifications, I believe that it would be inappropriate for the UK to stand in the way of the assistance being granted. The UK would therefore wish to vote in favour of this proposal at ECOFIN.

Secondly, given possible approaches from other Member States to the Commission for use of this Balance of Payments Facility, there is broad consensus that the overall size of the Facility should be increased from €12 billion to €25 billion. This will be done through amendment to the establishing Regulation (EC) No 332/2002 of the Facility. Although it is as yet unclear precisely when this decision will be taken, there is a possibility that it will be once again at very short notice. The Government believes that it is crucial that international institutions such as the EU have sufficient tools in place to assist member states in difficulty and would therefore vote in favour of the proposed increase in light of the exceptional circumstances facing our economies. The Government will, of course, do its utmost to submit further information to your committee in advance of any such similar proposals.

3 November 2008

Letter from Ian Pearson MP to the Chairman

I am writing to alert you to a forthcoming vote in Council on a Decision approving the amendment to Council Regulation (EC) 332/2002 on establishing a medium-term financial assistance facility for EU Member States balance of payments. The proposal seeks to amend the regulation to raise the ceiling on the facility enshrined in (EC) 332/2002 from €12bn (£9.4bn) to €25bn (£19.7bn), and further establish a mechanism to enable the European Commission to raise this cap, after consultation with the Economic Financial Committee, when an urgent need to do so arises. The UK is in support of raising the cap from €12bn (£9.4bn) to €25bn (£19.7bn), in recognition of the severe economic situation facing Member States. The Government also proposes to remove the amendment that establishes a mechanism to allow the Commission to raise the ceiling without a decision from the Council. Full details of this proposal and the UK's policy on the revision are outlined in the accompanying Explanatory Memorandum.

As outlined in the previous letter of 3 November 2008 that accompanied the Explanatory Memorandum on European Community Decision to Provide Financial Assistance to Hungary (Explanatory Memorandum 14949/08), which indicated that we would be in favour of voting to raise the cap on the facility from €12bn (£9.4bn) to €25bn (£19.7bn), and following the approval of balance of payments assistance to Hungary, the Commission has sought to amend Regulation (EC) 332/2002 as soon as possible. The unfortunate consequence of this is that the Government has been unable to alert Parliament to the proposal in sufficient time to accommodate the Parliamentary scrutiny process, which it regrets.

Given the exceptional circumstances and the urgency of providing rapid and effective support to Member States in crisis to prevent wider ramifications, I believe that it would be inappropriate for the UK to stand in the way of approving this proposal. The UK is therefore likely vote in favour of this proposal, with our sought amendments, at either the Education, Youth and Culture Council (20/21st November) or Budget ECOFIN (21st November). Details of exact process for voting will be made clear following the meeting of Financial Counsellors working group on 13th November.

The Government believes that it is crucial that international institutions such as the EU have sufficient tools in place to assist member states in difficulty and would therefore vote in favour of the proposed increase in light of the exceptional circumstances facing our economies. The Government will, of course, do its utmost to submit further information to your committee in advance of any such similar proposals.

14 November 2008

Letter from the Chairman to Ian Pearson MP

Thank you for your letter dated 3 November 2008, regarding EM 14949/08. This was considered by Sub-Committee A at its meeting on 18 November 2008. The Sub-Committee recorded the item as a scrutiny override and would like to accept, for the reasons you give, that the use of the scrutiny override was justified in this particular case, so as to not impede the financial rescue package for Hungary. However, the Sub-Committee would like to emphasise that this should not set a precedent for similar rescue packages and that the override should only ever be used as a last resort.

The Sub-Committee would like to ask the Government about the possibility of Hungary defaulting on the loans. Has the Commission considered the impact on the EC Budget of a default on the loans, and made allowance for this possibility? Have the Government noted the contingent liability for HM Treasury?

The Sub-Committee would also like to ask if the Government believe any further Member States are likely to require this facility in the near future.

27 November 2008

NATIONAL CENTRAL BANKS: PROPOSAL TO END THE DEPOSIT OF DOCUMENTS RECOMMENDING EXTERNAL AUDITORS OF EU MEMBER STATES' NATIONAL CENTRAL BANKS

Letter from Kitty Ussher MP, Economic Secretary, HM Treasury to the Chairman

As you are aware, the central banks of member states in the Eurozone, along with the European Central Bank (ECB) are part of the 'Eurosystème', which carries out tasks related to monetary policy. Article 27.1 of the Statute of the European System of Central Banks, and of the European Central Bank (ECB) states that "*the accounts of the European Central Bank (ECB) and of the national central banks of the Eurosystème are audited by independent external auditors recommended by the ECB's Governing Council and approved by the Council of the European Union*". The formal recommendation of the ECB takes the form of a written document which is submitted to Council for a vote.

The current arrangements for UK Parliamentary scrutiny of ECB documents which recommend external auditors for the National Central Banks' of EU member states in the Eurozone reflect the normal Scrutiny process. Once these documents are deposited in Parliament the scrutiny process is triggered and HM Treasury is required to submit an Explanatory Memorandum detailing the content of the document and the UK Government's position.

I would like to propose that these documents should no longer be deposited in the UK Parliament for scrutiny. The UK is not a member of the Eurosystème and therefore does not have a significant interest in the external auditors appointed to audit other member states' national central banks. Nor is the UK entitled to vote on the ECB recommendations when they come to Council for approval. Furthermore, the majority of the recommendations made to date by the ECB have not posed any difficulties and have been agreed by Council without discussion. I therefore suggest that ending the deposit of these documents in Parliament would remove an unnecessary burden on both my department and your committee.

23 May 2008

Letter from the Chairman to Kitty Ussher MP

Thank you for your letter of 23 May regarding the deposit of documents recommending external auditors of EU Member States' national central banks. I agree with your proposal that the documents should no longer be deposited for scrutiny. However, I should make it clear that, should any steps be taken towards UK membership of the Eurosystème or adoption of the Euro, we would expect to see the deposit of these documents commence again.

9 June 2008

NATIONAL REFORM PROGRAMME

Letter from Rt Hon Jane Kennedy MP, Financial Secretary to the Treasury to the Chairman

I am writing to you to announce publication of the 2008 UK National Reform Programme (NRP).

Following the relaunch of the EU's Lisbon Strategy at the Spring 2005 European Council, the UK submitted its first NRP to the Commission in autumn 2005, setting out the key reforms the UK is undertaking to promote growth and jobs. NRP updates were submitted in 2006 and 2007, and now in 2008, with the launch of a new governance cycle for the Lisbon Strategy, a second NRP has been prepared. It has been compiled with the valuable input of a number of Whitehall departments, the Devolved Administrations and external stakeholders.

The 2008 NRP describes the approach the Government is taking to promote macroeconomic stability and sound public finances, stronger productivity growth and higher employment, consistent with the

Lisbon Strategy, the Integrated Guidelines of the EU, and the priorities identified by successive European Councils. It also responds particularly to the country specific recommendation addressed to the UK, which was agreed at the 2008 Spring European Council.

The 2008 NRP is complemented by a reporting grid required by the European Commission, which sets out as full a picture as possible of main reform measures undertaken by the Government and the Devolved Administrations.

The UK is at the forefront of economic reform in Europe, and as such it is vital that we meet the EU-level NRP publication date of 15 October. As last year, unfortunately publication during recess is the only way to ensure this deadline is met.

Copies of the 2008 NRP will follow by post.

28 September 2008

SOLVENCY II: THE TAKING-UP AND PURSUIT OF THE BUSINESS OF INSURANCE AND REINSURANCE (SOLVENCY II) (RECAST) (6996/08)

Letter from the Chairman to Angela Eagle MP, Exchequer Secretary, HM Treasury

Thank you for your Explanatory Memorandum 6996/08 which was considered by Sub-Committee A at their meeting on 20 May. The Sub-Committee held the item under scrutiny. You will recall that the Sub-Committee reported on the original proposed Directive in February and highlighted some areas of concern. The Sub-Committee have not yet received the Government's Response, which is now overdue. I would be grateful if you could send the Response as soon as it is prepared.

20 May 2008

Letter from Kitty Ussher MP, Economic Secretary, HM Treasury to the Chairman

I am writing to provide an update on the progress made in the negotiations in which HM Treasury have been participating in the Council of Ministers on the Solvency II Directive.

Solvency II is the project to develop an EU-wide system of prudential regulation for insurers and reinsurers (equivalent to the Capital Requirements Directive for banking which implements the Basel II accord in the ED). The Commission presented its legislative proposal for the Solvency II framework Directive to the Council and the European Parliament on 19 July 2007 (with an amended proposal published on 28 February 2008). Overall the Directive proposal is consistent with the view of the Government, and is in line with the Financial Services Authority's current prudential regime for insurers. It has also been welcomed by the ABI, the CEA (European insurers' trade body) and the CRO Forum (group of the fifteen largest EU insurers and reinsurers).

Negotiations began in Council last summer under the Portuguese presidency. Good progress was made on going through the articles. No material changes were made to any of the key policy areas, which was in line with our objective. Some minor, sensible changes were made, for example to ensure a level of consistency with other financial services directives such as the Markets in Financial Instruments Directive and the Capital Requirements Directive.

Negotiations have been continuing this year under the Slovenian presidency. These have included discussions on the key political issues of the Directive, outlined briefly below.

MINIMUM CAPITAL REQUIREMENT

The Minimum Capital Requirement (MCR) is the main outstanding quantitative issue that needs to be resolved in the framework Directive but where there is currently no consensus. The MCR is the lower of the two capital requirements in

Solvency II (the higher is the Solvency Capital Requirement - SCR) and if an insurer's capital falls below this level it will be prevented from wanting new business. This is a severe step for the regulator to take and therefore it is essential that the MCR is set appropriately.

The two key elements are that the MCR needs to be a risk-based measure, reflecting the overall risk-based approach to Solvency II, and also that it is calibrated to ensure a sensible difference between the MCR and the SCR - a so called "ladder of supervisory intervention" - which gives supervisors and firms time to act to address a breach in capital requirements.

There are several views on the best way to calibrate the MCR and there is likely to be further debate on this issue in Council to attempt to achieve a compromise. The results of the ongoing 4th Quantitative

Impact Study (QIS 4), which is testing a newly devised separate calculation for the MeR, will be key in influencing the debate. The QIS 4 specification includes a proposal that where the MCR is calculated independently of the SCR the results should be subject to a "corridor" so that the MCR can never be less than X per cent or more than Y per cent of the SCR.

EQUITY RISK

Solvency II includes, as part of the higher capital requirement (the SCR), an amount of capital that must be set aside to cover risks inherent in holding a portfolio of shares. Under Solvency II insurers need to have enough capital to be able to withstand a loss that has a 1 in 200 probability of occurring over one year. This means that capital requirements are significantly higher for equity holdings than, for example, government bonds, because equities are much more volatile.

There has been debate over the level at which to set this equity stress test. There is some concern that if capital charges for equities are too high it will lead their insurers to sell equities in large quantities (potentially in times of falling equity markets) and buy bonds. On the other hand if the capital charge relating to equities is not sufficiently high then insurers may not be sufficiently well capitalised to withstand a loss which has a probability of 1 in 200 over one year. Agreement has not yet been reached on this issue and further alternatives are being considered.

SURPLUS FUNDS

Surplus funds are a feature of with-profit life insurance policies used in some of the other Member States. Essentially they are bonus funds belonging to policyholders that can be used by the firm to meet general losses that could occur. The Directive allows these surplus funds to be used as capital (to meet capital requirements). This is inconsistent with the usual treatment of policyholder bonuses in Solvency II, which must under normal circumstances be treated as a liability (so not available to be used as capital).

The Solvency II Directive therefore includes a specific derogation given to the few Member States whose law allows the use of these surplus funds to meet general losses. We are continuing to explore this issue and consider possible caveats (for example, ensuring that surplus funds are limited to the jurisdictions in which they apply, and so cannot be used cross-border).

GROUP SUPERVISION

The current approach to supervising insurance groups in the EU involves supervising each company within the group as though it were a separate entity. Solvency II changes this with a new proposal that looks at the group as a whole, treating it as a single economic entity (that is, it treats insurance groups with subsidiaries akin to an insurance firm operating through branches).

The new proposal on groups includes a streamlined approach to group supervision, led by a group supervisor who is given certain powers derogated from supervisors of subsidiaries. The proposal also allows groups to hold some regulatory capital centrally and transfer it to where needed across the group (known as group support). This allows a group to benefit from diversification between different risks, not just within a company, but across the companies in the group. This increases efficiency for no increase in risk.

The proposal developed by the Commission has to a large extent followed a proposal developed by HMT and FSA, which was outlined in a joint Discussion Paper published in November 2006. We are therefore strongly in favour of the Directive's approach, which is also supported by the industry and broadly by other Member States.

However, some concerns have been raised with regard to the proposal. Under the Directive proposal an insurance subsidiary might well be relying on group support from a parent company which is located in another Member State. This means that the subsidiary's supervisor is dependent on the group supervisor to a greater degree, in particular to ensure that capital flows into the subsidiary promptly when it is needed. It is important to ensure that the regime operates well in practice and that capital will flow cross-border. Due to the openness of UK financial markets the FSA will be the local supervisor i.e. the supervisor of the subsidiary – rather than the group supervisor - for many firms.

HM Treasury has recently published a Discussion Paper jointly with the FSA¹⁹ which outlines how we see the groups regime operating in practice as well as proposing some limited changes to the Directive proposal to address directly some of the concerns raised. The proposals in this Discussion Paper do not change our overall policy on group supervision.

¹⁹ The Discussion Paper is available at: http://www.hm-treasury.gov.uk/media/9/8/solvencyii_enhancing_220408.pdf

At the heart of the proposed changes is an enhanced role for the college of supervisors as the mechanism for supervising an EU insurance or reinsurance group. Mentioning colleges specifically, and outlining high-level, non-prescriptive requirements for their use would address the concern held by many of the smaller Member States that their supervisors will be excluded from the group supervision regime. Crucially, these proposals are consistent with the position set out by the Chancellor of the Exchequer in his non-paper to Ecofin colleagues on 3 March 2008²⁰, in which the UK proposed mandating the use of supervisory colleagues for all cross-border financial institutions with a significant presence in more than one Member State.

Other proposals contained in the Discussion Paper also include provisions to address some of the perceived imbalance between the powers of the group supervisor and the supervisors of subsidiaries; and the introduction of 'early warning' systems to identify emerging risks in subsidiaries. We will continue to debate these issues in Council over the coming months, as we attempt to secure the compromises necessary to achieve political agreement on the Solvency II Directive.

In addition, attached to this letter is the partial impact assessment on the likely costs and benefits of implementing Solvency II in the UK which will be published shortly.

23 May 2008

Letter from the Chairman to Ian Pearson MP, Economic Secretary, HM Treasury

Thank you for your predecessor's letter dated 7 July 2008²¹, which was considered by Sub-Committee A at their meeting on 14 October. The Sub-Committee were grateful for the detailed answers provided to the issues that they had raised in their report on Solvency II.

In the light of the recent disruptions to the financial markets, the Sub-Committee decided to continue to hold the documents under scrutiny. Has there been any change in attitude towards risk and suitable levels of capital that insurance companies should hold? If so, did this occur in time to feed into the fourth Quantitative Impact Study, and what impact has this had on the Solvency II negotiations?

15 October 2008

STATISTICS

Letter from Tom Watson MP, Parliamentary Secretary, Cabinet Office, to the Chairman

I am writing to you, as Minister responsible for statistics, to apologise for the delay in the consultation process with Devolved Administrations concerning the Opinion of the European Central Bank on a proposal for a Council Regulation on European Statistics.

The Regulation on European Statistics is arguably the most important piece of statistical legislation to be proposed by the Commission. ONS has been leading on this matter and has been shaping its development from an early stage. The dossier is likely to remain under discussion at Council for the rest of the year.

ONS successfully consulted the Devolved Administrations on the Regulation itself but did not, in the first instance, seek their views on the Opinion of the European Central Bank. This has now been done and is reflected in an Addendum to the associated Explanatory Memorandum – attached.

As already reported to the Committee, I have been assured that ONS takes matters of parliamentary protocol very seriously and generally has a good record in this area. ONS has and will continue to take every available measure to prevent events of this nature happening in the future.

4 June 2008

TAXATION: UPDATE ON THE EUROPEAN COMMISSION'S PROPOSAL TO PARTICIPATE IN THE WORK OF THE INTERNATIONAL TAX DIALOGUE

Letter from Rt Hon Jane Kennedy MP, Financial Secretary to the Treasury to the Chairman

I wrote to you in December 2007²² setting out the Government's objections to the Commission's proposal to participate in the International Tax Dialogue (ITO) on the following grounds:

²⁰ The Chancellor's letter and the accompanying non-paper are available at: http://www.hm-treasury.gov.uk/media/3/D/ukchxletter_ecofin030308.pdf

²¹ **CORRESPONDENCE NOT YET PRINTED**

- i. The potential extension of Community legal competence in the area of tax;
- ii. The duplication of effort with the existing members of the ITO; and
- iii. The marginal benefit given the costs associated.

I recorded in that letter that the Commission's initial proposal was discussed at the Council's Tax Working Group on 19 September where the UK Government presented our arguments in opposition to the Commission's proposal. We were strongly aligned with the majority of other Member States and the Presidency concluded that there was no merit in further discussion of the proposal.

It has recently become apparent to my officials that the Commission is now proposing to sign a revised Memorandum of Understanding with other ITD participants and participate with the ITD on a different legal basis: Article 302 of the Treaty (on maintaining relations with international organisations).

The UK has not yet seen the latest draft Memorandum of Understanding on the basis of which the Commission proposes to sign. My officials are pursuing this and will assess this proposal over the summer. I wanted to write to you to make you aware of this latest development and confirm that the Government will continue to explore the Commission's basis for this proposal. I will of course keep you informed of further developments.

17 July 2008

Letter from Rt Hon Jane Kennedy MP to the Chairman

I wrote to you before recess this year informing you about the progress on the Commission's proposal for joining the International Tax Dialogue (ITO) and the Government's position on it. I promised then that I would keep you informed of any future progress on this proposal.

Back in summer 2007, when this proposal first came to light, the UK Government opposed it together with a number of other Member States. As you will recall our main arguments against it were as following:

- The potential extension of Community legal competence in the area of tax;
- The duplication of effort with the existing members of the ITO; and
- The marginal benefit given the costs attached.

We have pursued these points over the course of last year, as a result of which the Commission has altered its approach. Whilst it has persisted in its desire to participate in the ITO, in the face of our opposition it has recognised that the Council would not give it a mandate to represent the Community's interests. Instead, the Commission has decided to participate in its own right as an institution, which it is permitted to do under Article 302 of the Treaty, for the purposes of "maintaining relations with international organisations". This legal base means the Commission no longer needs a mandate from the Council, as it will join the ITO in its own capacity rather than representing the views and positions of the Member States. Equally, the Commission would not be representing the Community in the formal sense of exercising the external competence of the Community, as would be the case under Article 300 (initially applied to this proposal).

The Government continues to monitor the work of the Commission closely and you may wish to know that legal advisers across government are separately looking into the wider issues of the Commission's use of non-binding agreements. My interest is, of course, especially where these involve sensitive areas of policy such as taxation.

However, as a result of the above outlined progress on this proposal, I am content that we have achieved a satisfactory outcome in the circumstances. On each specific point of contention that we have previously raised:

- THE POTENTIAL EXTENSION OF COMMUNITY LEGAL COMPETENCE IN THE AREA OF TAX- has been protected by ensuring the Commission is represented at the ITD as an institution rather than representing the views of the Member States. This is secured by the amendment of the legal base through which the Commission has joined the ITD. Article 302 enables the Commission to enter into agreements and maintains relations with international organisations but does not extend that power into representing the Community or the positions of the Member States.
- THE DUPLICATION OF EFFORT WITH THE EXISTING MEMBERS OF THE ITD – has been somewhat diminished as we are assured by the existing ITD

members that explicit efforts are made for avoiding duplication wherever possible. And because the Commission is not acting in the name of Member States like the UK who are also OECD members, we do not find ourselves in the position of being represented twice. In fact, the UK's Department for International Development (DfID) is also in the process of joining the ITD in order to make better use of combined resources aimed at sharing of information and best practice with developing countries. This would further enhance HM Government's ability to monitor the Commission's participation in the ITD.

- THE MARGINAL BENEFIT GIVEN THE COSTS ATTACHED – the Commission's membership of the ITO will not impose additional burdens on the Member States' financial contributions to the EU budget, as the Commission's membership costs will have to be met from prioritisation within the current annual budget. In addition, we feel more confident that our influence over the ITD's allocation of resources will be even more effective with the DfID's membership for the ITD.

The outcome of this proposal is an unusual one, insofar as the Commission have withdrawn from the negotiation and pursued an approach we are not in a position to influence. Nevertheless I am content that the outcome of the Commission's proposal for joining the ITD and the legal powers adopted to support it meets the objectives I set out to you in our previous correspondence.

28 September 2008

TERRITORIAL COHESION (14059/08)

Letter from the Chairman to Pat McFadden MP, Minister for Employment Relations and Postal Affairs. Department for Business and Regulatory Reform

Thank you for your Explanatory Memorandum 14059/08. The Sub-Committee cleared this item from scrutiny at its meeting of 18 November 2008. The Sub-Committee would like to express its agreement with the Government on their concerns over the suggestions raised in the paper.

The Sub-Committee strongly supports your argument that the majority of activity under the heading of territorial cohesion should be undertaken at a Member State, rather than European, level. It is not the present intention of the Sub-Committee to respond to the consultation of the Commission, unless it becomes clear that it would be of benefit to do so, in order to show support for the Government's position.

27 November 2008

TRADING OF GOODS BETWEEN MEMBER STATES (6366/08)

Letter from Rt Hon Stephen Timms MP, Financial Secretary of the Treasury, HM Treasury to the Chairman

You cleared EM 6366/08 on 11 March 2008. However I am now writing to inform you of subsequent changes to the proposed regulation which has been discussed at both the Council Statistics Working Party in Brussels and the European Parliament.

Following their consideration, the European Parliament made 9 amendments to the proposed regulation. Most of these related to minor changes to the wording or presentation to tidy up the regulation. However there is one notable amendment which reverses the Commission proposal to move the percentage coverage requirement into the Implementing Provisions (although it does give the Commission more power to make changes in the future) and proposes coverage of 95 per cent for arrivals and 97 per cent for dispatches.

The amendment to reduce coverage from 97 per cent to 95 per cent for the arrivals flow does not go as far as the reduction on both flows that the Government was originally pressing for. However, there was limited support for this reduction from other Member States and there was a strong argument for keeping the coverage at 97 per cent for the dispatches flow. This is the flow that will be maintained if the Single Flow system (where Member States would collect data on either dispatches or arrivals and use data from all other Member states to produce statistics for the other flow) is introduced. A new recital has been added to the proposal to re-affirm the long-term move to a Single Flow system.

The Government now supports the Commission proposal and also supports the other European Parliament amendments which are not substantial and provide added clarity and accuracy.

17 November 2008

**UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE
SECURITIES (UCITS): COORDINATION OF LAWS, REGULATIONS AND
ADMINISTRATIVE PROVISIONS (12149/08)**

Letter from the Chairman to Ian Pearson MP, Economic Secretary, HM Treasury

Thank you for your predecessor's Explanatory Memorandum 12149/08, dated 18 September 2008. This was considered by Sub-Committee A at its meeting on 21 October 2008.

The Sub-Committee noted that several issues regarding the proposal have yet to be resolved, particularly the Commission's reservations regarding the management company passport. In view of this fact, Sub-Committee A decided to hold the proposal under scrutiny pending more information on the passport and the publication of the Impact Assessment.

21 October 2008

VAT: REDUCED RATES (11635/07, 11695/07)

**Letter from Rt Hon Jane Kennedy MP, Financial Secretary to the Treasury, HM Treasury to the
Chairman**

An Explanatory Memorandum issued by HM Treasury relating to 11635/07 FISC 109, 11635/07 ADD 1 FISC 109, 11695/07 FISC 110, and 11695/07 ADD1 FISC 11 0, was sent to the Committees on 24 July 2007. The Commons Committee requested to see a copy of the UK Government's response to the Commission's Communication (11695/07).

No formal response to the Communication was submitted to the Commission. However, please find attached [not printed] the UK Government's response to the Commission's public consultation reviewing the existing legislation on VAT reduced rates. This response will be submitted to the European Commission on behalf of the UK Government by HM Treasury on 12 May 2008.

I hope you find this information helpful.

10 May 2008

**Letter from the Rt Hon Stephen Timms MP, Financial Secretary to the Treasury, HM Treasury
to the Chairman**

Following the Committee's request for further information regarding elements of this proposal, I am pleased to provide you with an update on the progress of these negotiations.

The French Presidency has held five Working Group meetings on the Commission's proposal. Several Member States have urged the European Commission to produce a new, more detailed impact assessment on the proposal, which would fully consider the potential impact of some of the "technical amendments" proposed, such as a reduced VAT rate for audiobooks. This request was rebutted by the Commission, on the basis that it had followed the Commission's impact assessment procedures, and no further impact assessment has been produced.

However, Working Group discussions of the "technical amendments" have centred on their potential impact on the Single Market, and underlined the importance of clear legal drafting to minimise any potential impacts, should these changes be agreed. Technical discussions of the proposal are still ongoing; however the Government's final assessment of the "technical amendments" will be based upon our principled approach of supporting the flexibility of Member States to apply their own choice of VAT rates in support of their domestic priorities and social objectives, provided that this does not materially affect the functioning of the Internal Market.

Following discussions of the "general principles" of reduced VAT rates at the September and October ECOFIN meetings, the French Presidency intends to submit a compromise proposal for formal ministerial discussion at the 4 November ECOFIN. We anticipate that this will be a preliminary political discussion, to allow further technical work in preparation for a more comprehensive discussion at the 2 December ECOFIN, where the Presidency hopes to reach agreement on a general approach, pending receipt of the European Parliament and European Economic and Social Committee's opinions.

I will keep you informed of developments on this dossier.

3 November 2008

VAT: COMMON SYSTEM OF VALUE ADDED TAX TO COMBAT TAX EVASION CONNECTED WITH INTRA-COMMUNITY TRANSACTIONS (7688/08)

Letter from the Chairman to Rt Hon Jane Kennedy MP, Financial Secretary HM Treasury

Thank you for your Explanatory Memorandum 7688/08 dated 4 April 2008 which Sub-Committee A considered at its meeting on 6 May 2008. The Sub-Committee decided to hold this document under scrutiny and would be grateful if you could forward the Impact Assessment as soon as it is available

In its report *Stopping the Carousel: Missing Trader Fraud in the EU*, published last year, the Sub-Committee expressed its support for enhanced administrative co-operation and information exchange as an effective tool in the effort to combat tax fraud.

The Sub-Committee noted that the Government has reservations towards the impact of the Commission's proposed measures. We would be interested to hear to what extent the Government estimates the Commission's proposals will impact upon levels of VAT fraud and tax evasion.

The Sub-Committee disagreed with your statement that issues such as the frequency and medium of submission of VAT returns are matters for Member States to decide and implement and is concerned that should it be left to Member States to decide the frequency and medium of submission of VAT returns, serious co-ordination problems might arise which would undermine the enhanced administrative co-operation that is needed to tackle this fraud. The Sub-Committee would be grateful if you could provide further detail of the Government's analysis of this issue.

9 May 2008

Letter from Rt Hon Jane Kennedy MP to the Chairman

Thank you for your letter of 9 May 2008 about Explanatory Memorandum 7688/08. I am today submitting a Supplementary Explanatory Memorandum with the Impact Assessment for these proposals.

You asked to what extent the Government estimates the Commission's proposals would impact upon levels of VAT fraud and tax evasion. As noted in the Impact Assessment, the Government considers that the proposal for monthly instead of quarterly submission of recapitulative statements, with reduced time for submission and the exchange of data between Member States, would potentially help tax administrations to tackle VAT fraud, mostly that related to supplies of goods. It would enable earlier comparison of data with VAT returns to identify anomalies for further investigation, for example to identify missing traders or defaulting traders participating in fraud in the UK and those businesses in other MS who supply them. This would enable attempted fraud to be detected more quickly, thereby preventing the building up of revenue losses. However, as VAT fraud is much more prevalent in relation to intra-Community trade in goods, rather than services – very little, if any, MTIC fraud takes place using supplies of services, because these are generally not capable of being traded on - the benefit of this measure would come from its application to trade in goods, not services. It is nevertheless difficult to quantify the size of that benefit. The impact on VAT fraud of this aspect of the proposal relating to services is unlikely to be significant.

The Government also considers that the other elements of the proposal compulsory monthly VAT returns for businesses with significant intra-Community trade, an additional box to show the purchase of reverse charge services on the VAT return and changes to rules relating to the time of supply for reverse charge services - would not have a significant impact on VAT fraud.

Bearing in mind also the costs to business of implementing the various aspects of the proposal, as set out in the Impact Assessment, the aspect of these proposals which the Government welcomes is the proposal, in relation to supplies of goods, for monthly submission of recapitulative statements, with reduced time limits for submission and exchange of data.

You also asked for further detail of the government's analysis in relation to the Sub Committee's concerns that, should it be left to Member States to decide the frequency and medium of submission of VAT returns, serious co-ordination problems might arise which would undermine the enhanced administrative co-operation which is needed to tackle this fraud.

The Government believes that the frequency and medium of submission of VAT returns is a matter for Member States because the information shown on the VAT return is primarily used by the tax administration of the Member State receiving the VAT return, as part of its checks that the correct

amount of VAT has been accounted for in that State. The information shown on the domestic VAT return is not sufficiently detailed to be of direct benefit to other tax administrations in enabling them to undertake standard checks on intra-Community supplies or to detect VAT frauds being perpetrated against them. Recapitulative statements were therefore introduced for intra-Community trade, so that tax administrations in receiving Member States could obtain, from the exporting businesses, sufficient information to enable them to track arrivals of goods in their Member State.

The Government therefore sees a distinction between recapitulative statements and VAT returns. Recapitulative statements primarily benefit other Member States, and therefore the Government would accept that there is a case for Community rules on their frequency and level of detail. However, VAT returns primarily benefit the Member State where the trader is located, and therefore it should be free to set the return periods as it sees fit. If Member States wish to align their VAT return periods to ESLs it is open to them to do so under the current VAT Directive. Our view is that subsidiarity should apply in this case.

12 July 2008