HOUSE OF LORDS

EU Financial Affairs Sub-Committee

Corrected oral evidence: Financial Services after Brexit

Wednesday 29 January 2020

10.10am

Watch the meeting

Members present: Lord Sharkey (The Chair); Lord Bruce of Bennachie; Lord Cavendish of Furness; Lord Desai; Baroness Liddell of Coatdyke; Lord Thomas of Cwmgiedd; Viscount Trenchard; Lord Turnbull; Lord Vaux of Harrowden.

Evidence Session No. 1 Heard in Public Questions 1 - 11

Witnesses

I: Professor Niamh Moloney, London School of Economics and Political Science; Professor David Miles, Imperial College London.

Examination of witnesses

Professor Niamh Moloney and Professor David Miles.

Q1 **The Chair:** Professor Moloney and Professor Miles, welcome to the EU Financial Affairs Sub-Committee's public evidence session on the future of financial services after Brexit. You have before you a declaration of Members' interests.

The session is being broadcast on parliamentlive.tv. A full transcript is being taken and will be made available to you to make any corrections shortly after the session. That is the formal health warning that I am obliged to deliver to make sure that we are all in the right room before the session starts.

I will kick off by asking the first question, to establish some context. It would be good to have a sense of how important the EU is for UK financial services. To what extent does the EU rely on UK financial services?

Professor David Miles: In some areas, the EU relies very heavily on UK financial services. For example, probably 60% or 70% of foreign exchange transactions that are relevant to the euro come through London. I think I am right in saying that a very substantial proportion of new equity issues by non-financial companies in the European Union are organised through London. It is probably 50%, maybe even slightly more than 50%.

A very high percentage of total European transactions in over-the-counter derivatives that go through clearing exchanges do so through London, maybe 70% or 80%. In certain areas, a very high proportion of the total European transactions go through London.

Flipping the question around slightly, and asking what the significance is to the UK of this activity, I have seen reasonably consistent estimates from different sources that the size of net exports of financial services from the UK to the European Union is of the order of £30 billion, about 1.5% of UK GDP. That is significant, and it is a significant proportion of the total output of the financial services sector in the UK.

The financial services sector in the UK produces a level of contribution to GDP that is not far off that of the manufacturing sector at about 8% or 9% of GDP is financial services. It is about the same for manufacturing. The net exports to the EU bit of that would be about 1.5% of GDP.

Professor Niamh Moloney: One often sees a reliable figure that about 35% of financial services activity in the EU takes place in the UK. A lot of that, as Professor Miles noted, is very risk-management based. There is a very strong specialisation in the UK market around derivatives, clearing and trading of specialised securities. We also get pockets of very deep activity in the UK; in asset management, around 40% of assets under management in the EU are managed in the UK. There is certainly a very close relationship across the board with pockets of specialisation in key areas.

Q2 **Lord Vaux of Harrowden:** I have a slightly broader question. How do you

envisage the future UK-EU relationship in financial services? What is the process that is outlined in the political declaration to get us there?

Professor Niamh Moloney: Inevitably, it is very hard to predict at the moment. It is hard to envisage a situation where there will not be a close relationship as a matter of sheer trading practicality. We have two very large markets interacting closely together, with a long history of similar regulatory traditions and so on. That is a matter of practical trading relationships.

The political declaration is based on three categories. First of all, it talks about the aspiration for a broad and deep agreement. That aspiration is very clearly mentioned. In the financial services area, it gets a bit more specific but not hugely so. It talks about both parties respecting key principles around market integrity, investor protection and competition, which one would expect. I do not think that is in any way unusual.

We begin to see the clues coming through where both parties refer to the importance of regulatory autonomy. In EU-speak, autonomy is a powerful principle. It is the notion of protecting the integrity of the rules and having a self-governing aspect over financial services regulation. It also states, along with that, that both parties respect their equivalence process, which is of course the key issue.

Then it gets a bit more procedural, that both parties will endeavour to run their equivalence processes by June/July 2020. That is quite specific. Then it goes back to a more general aspiration that both parties will seek strong co-operation in the future. There is a little bit of a road map, but it is perhaps quite general at the moment.

Lord Vaux of Harrowden: Do you think that June/July date is realistic?

Professor Niamh Moloney: That is a very good question. In some respects, yes, it is. The equivalence process is pretty well oiled by now. We have some 280 equivalence decisions, 30 countries and 40 segments of the financial services area. There is a system that runs. The Commission gave a presentation in January 2020 where it talked about best endeavours, machinery already up and running, and seeking to do this.

The regulatory side of equivalence really should be straightforward, with the rulebooks aligned. Where there is a bit of room for discussion is with supervision and enforcement. There again, the EU is very familiar with the UK system, so my sense is, yes, for that point in time, but what happens thereafter is where it will get complicated with equivalence.

Professor David Miles: I very much agree with what Professor Moloney has just said. You might have thought that the initial judgment on equivalence would be relatively straightforward. After all, the UK has been in the European Union for decades.

The big issue is how it plays out going forward. That depends on whether the European Union and the Commission interpret equivalence in the way the UK would like it to be interpreted, which is that as long as you have

the same overall goals it does not matter whether your rules, regulations and procedures are identical line by line. That would be how the UK would like equivalence to be viewed: pragmatic and somewhat flexible. That is versus a more rigid interpretation that equivalence means you have the same rules almost line by line. If the European Union is more inclined to the second way—the more rigid interpretation of equivalence—I can see lots of problems coming down the road. If it adopts a more pragmatic UK approach, it might all be relatively smooth and there will not be much disruption to trade.

The Chair: Would you care to speculate which way the wind is blowing?

Professor David Miles: I do not have any particular inside track on it. Simply reading things in the media that are available to everybody, I would not be terribly optimistic that the Commission's position is anything other than pretty rigid and hard line, and equivalence means that you had better have pretty much exactly the same rules and procedures as are enforced in the EU. I would not be terribly optimistic.

Lord Turnbull: You have set out, Professor Miles, the extent to which the EU is using UK financial services. In the EU, do they regard this as a vulnerability or an opportunity? Is it a priority, therefore, to onshore it? They may want to onshore it because they want the business or because they want to be in control of it. As the Governor of the Bank of England has occasionally remarked, a lot of the business conducted in the UK is very risky and requires a great deal of capital. They may well be better off leaving it in the UK and leaving the UK with all the responsibilities of backing that business. Which is going to predominate: their mercantilist view that they want to get the business and be self-sufficient, or that there is a specialist out there just across the channel and they might as well carry on using it?

Professor David Miles: There may be three positions, not just two. I absolutely recognise the ones you have outlined. There is the mercantilist, the opportunity that we will get some business. There is clearly a constituency that believes all that, maybe more in some countries than others. Then there is, "Leave these difficult things that need lots of capital in the UK and, if it goes wrong, the UK can be in the forefront of the fallout from all that".

I think there is a third position, which is, "We might want to leave it to the UK to deal with it if things go wrong. On the other hand, if the UK looks like it is going down the road of deregulation and diverging from the EU rules in a lax direction, we do not want that to happen". It is not so much a mercantilist set of perceived opportunities commercially, but a fear that the UK will deregulate too much and that it will all go wrong in that sphere.

What is the balance of those three positions? I am not sure. It varies a bit across countries. Maybe in places where there are already fairly large, established financial centres, there is a bit of the mercantilist, "Let's get some of that to Paris, to Dublin or to Frankfurt". In places where there are

no established financial centres, maybe there is more the view, "Well, the Brits seem to do this quite well so let's leave it where it is".

I suspect there is fear that the Brits will deregulate and deviate in a lax direction from the rules. But my own view—for what it is worth—is that there is little evidence historically that the UK has ever used whatever discretion it has to move in a lax direction. In fact, on the occasions where the UK has lost battles on regulatory issues, it seems to me that it has generally lost them because the UK wanted the discretion and the flexibility to go beyond the rules.

If I remember correctly, when the Basel agreements were passed into European law—the capital requirements directive—rather bizarrely that ended up as maximum harmonisation. You could not have a laxer rule if you were in the EU on how much capital your banks needed, but neither were you, in principle, allowed to have a tighter or tougher rule either. I think the UK position was, "That's bonkers; we want the ability to go beyond it", and it lost. Although I think there is fear in parts of the European Union that the Brits will take advantage of the flexibility they may have outside the EU to be lax, history does not provide many examples of that.

Lord Desai: The US is the only other important financial centre, almost comparable to London. How does the EU act with the US as a third country? Is that relevant to us? If not, it does not matter; we can move on to the next question.

Professor Niamh Moloney: Not at all. It is very similar, Lord Desai. There is no free trade agreement in place allowing for financial services access, so it runs through the equivalence process in different ways. It very much reflects what Professor Miles has been saying. It comes down to the interest at stake at a given point in time.

For example, the negotiations with the US around clearing and CCPs were quite fraught. The US had a view and the EU had a view, but ultimately both sides needed access to each other's markets, so a deal was done politically. In other areas, where member states are less concerned about attracting US business, or US business is repatriated to the EU, the energy goes out of it. It is very much dependent on particular interests.

If I may, I will give a short example of how those interests work. Last year, when we were approaching the cliff edge, the EU agreed to an exceptional emergency equivalence decision for CCPs. That was a financial stability interest that the EU was protecting. At the same time, it did not give a temporary equivalence decision for share trading. There were very similar issues, but there it is much more about competition. There is less of a stability interest, and certain member states, as Professor Miles was saying, had particular interests in pulling back trading from London. It really does vary.

Q3 **Viscount Trenchard:** We have already started to discuss my question on the change in the EU's rules on equivalence. Many people have said that

the ideal outcome for the UK would be some form of outcomes-based equivalence, which I understand from what you have been saying is now considered rather unlikely. There is not much evidence that the EU would agree to that.

There is some evidence, indeed, that the EU's attitude to equivalence and the rules has been tightened or strengthened since the referendum. Do you think the delay in the approval of the Channel Islands regimes as being equivalent is partly to do with the fact that, if the EU approves them, there is less logical reason for it to refuse to recognise the UK? There is also the behaviour of the EU towards Switzerland. Do you think that the EU would already have reached agreement with Switzerland were it not for the fact that it knows that, if it is flexible with the Swiss, it will have to be more flexible than otherwise with us?

Professor Niamh Moloney: It is interesting. Since June 2016, there has been a lot of activity in the equivalence area. It is about trying to decode what is business as normal and where the signals are being sent, and it can be quite hard to do that.

The Swiss situation is revealing for a couple of reasons. First of all, we see a bit of tension within the EU. The European Parliament has been quite vocal in saying, as it were, "This was politicised. We should have been more closely involved. We want more transparency around equivalence". There you see the Commission, the Council and then the Parliament slightly pushing back on that. It is a clear example of the risks of equivalence. It is contingent; the Swiss only got a year. It was discretionary, so it was dependent on a much wider institutional framework.

The house did not cave in. Equivalence was withdrawn from Swiss trading venues. Trading found a way. The market adjusted to it. It is difficult to read that other than there being somewhat of a signal.

At the moment, all the equivalence decisions are being very closely monitored for impact. I am not fully aware of what is happening with the Channel Islands, but it would not surprise me that there is great care being taken in how equivalence decisions are being presented.

Another thing that happened over the summer was that equivalence decisions for rating agencies were withdrawn, for the first time ever. Interestingly, again it was a quiet process. The market adjusted to it. The relevant countries had been on notice for four years. It happened quite smoothly.

On the wider point, which Professor Miles alluded to, on the direction it is going in, it is becoming much more austere, much more technical and much more onshore. What I mean by that is that there have been two or three reforms over the last two years where equivalence was tied to actual supervision in the EU. Previously, there was dependence back in the home country, on onshoring regulation: "Yes, you're equivalent, but you're also going to have to follow exactly this element of the rulebook". We see that happening.

If I could trouble you with one small piece of technical detail, which I think is positive, in the area of central clearing counterparties, which are hugely important for the UK, there has been a very interesting change. There is a new system coming in for CCPs having access to the UK. Famously, for the systemic ones, the idea is that they "may" be required to relocate; we do not know. I am not convinced that will happen, but it is possible.

The bigger issue is around what are called systemic CCPs, ones that the EU has a close interest in. What is interesting is that it is using a new technique called comparable compliance: "Yes, we need to see that you're equivalent and do that assessment. But before then we bring on all the supervision and all the EU rules, and we will look for comparable compliance. If your compliance is comparable to the EU rules, we will defer back to where you have come from, in effect". That is the first time we have seen that in EU equivalence regulation. It is a very interesting way forward, so that could be a hopeful direction of travel.

The Chair: You mentioned Switzerland, and that trade found another way of continuing. In a sentence or so, could you say what those ways were?

Professor Niamh Moloney: It applied to particular trading venues. Trading moved on to different types of trading venue that did not fit within the equivalence model.

Q4 **Lord Cavendish of Furness:** It might be thought that equivalence has been exhausted as a topic, but I am going to stick to the question for the sake of good order. Given that the UK is already fully aligned with EU rules, is it likely that the UK will be granted equivalence in all areas currently covered by EU law? How might these decisions become politically motivated?

Professor Niamh Moloney: My instinct is that it is very likely that the first phase of equivalence decision will be quite straightforward, not least because it will be closely monitored. There will be real concern to show that the process is transparent and operating correctly. Right now, it would be challenging to make the case that the UK is not equivalent.

I think the political risks will come two or three years down the line. Inevitably, there will be some degree of divergence. Let us assume that the UK does not diverge instantly. But EU law is constantly changing. The decision is, if the UK moves a little, does the EU not do anything or does it decide, "Well, no, actually here is a political moment where we may want to do something on equivalence"? The risk is very much two to three years out.

Professor David Miles: I have a slightly pessimistic point. It comes back to the balance of motivations in the European Union between, on the one hand, seeing that maybe the Brits actually have a comparative advantage in these things because they can do some of these things more effectively and therefore it is in the interests of non-financial companies, and maybe households, in the European Union to have access to the cheapest and most effective way of providing financial services, versus the mercantilist

view: "Well, we could get some more investment bankers in Paris, Frankfurt or wherever".

A reason to be slightly pessimistic on this is that the benefits of letting economic activity be provided from the place where it is most efficiently done are very widely dispersed among millions of non-financial companies and hundreds of millions of households who get financial services ever so slightly cheaper than they otherwise would in ways they probably do not get noticed one way or the other. On the other hand, the narrowly defined benefits of pinching some activity from London are very concentrated among financial institutions and among people who want to do the jobs in Paris, Frankfurt or wherever. Based on that, you might think that the mercantilist incentives will have more impact on how this plays out than the overall net benefit to all the citizens of the EU. I am slightly pessimistic about how it will play out.

Q5 **Baroness Liddell of Coatdyke:** I am hearing a mix of scepticism about the prospect for change and fluidity in what has happened since the referendum in June 2016. In your very interesting paper, Professor Moloney, you referred to the fact that it is unlikely that there will be bespoke agreements. How probable is it that, in looking at equivalence decisions, practicality will lead partners to look at a new or reformed set of EU-UK institutional arrangements? How probable is that and, if it is probable, what shape should it take?

Professor Niamh Moloney: I would probably take a pessimistic view of the probability of a bespoke, redesigned system for a couple of reasons. Equivalence of course has a wider, political and trade context. On the other hand, it is a deeply procedural single market, inward-looking tool. It is interesting that an awful lot of the Commission's papers around equivalence start off with, the equivalence process is a single market tool designed to protect EU financial stability. Then they usually go on to say that it may also at the same time lead to market access.

If you take aside the very particular context of the moment, that is what is driving it. It is trying to protect potential stability, and linked to that there is a market access context. It is deeply embedded in legislation, so it is very rooted in EU single market law. Thirdly, it has become very proceduralised over the last four to five years, so the agencies—the European Securities and Markets Authority, the new European capital markets agency—are very involved. The process has become more sophisticated. Of course, once you have a process, the process tends to run.

For those reasons, there is a very big technological investment in how equivalence works. The institutions are comfortable with it and, of course, it applies to more than 30 countries. For all those reasons, there is a commitment to the equivalence process and not building a parallel one.

Baroness Liddell of Coatdyke: Let me ask a lateral question related to how we go forward practically. An awful lot of UK financial institutions have now established bases in EU countries. You only need to look at the skyline

of Dublin and the number of cranes to see what is happening. Does that reduce the significance of equivalence in all this debate?

Professor Niamh Moloney: I absolutely think it does. It is interesting. An awful lot of the debate here is in and around equivalence, but, as is so often the case, the market finds a way. Markets are extremely good at working around rules and frictions. Over the last two and a half years, we have seen subsidiaries moving and back-to-back trading. There are all sorts of different techniques that firms can use to get around equivalence.

Equivalence is very important in some areas but not at all important in others. Retail banking operates in a very particular way. The investment fund sector works off delegation structures. It is key in certain areas but not in all by any means. As I say, there are other routes.

Q6 **Lord Bruce of Bennachie:** We talk about pursuing equivalence, but at the same time we discuss how inadequate it is, both in what it covers and in the fact that it is short term and can be withdrawn. The first part of my question is, how important is it that we get hung up on equivalence? Can we get away from it?

As Baroness Liddell said, do you get around it by relocating what is affected? In that case, we have been told that the big problem is that having had a critical mass delivering expertise and value for money, and all the other things in London, you are going to have it scattered and broken up.

Is it in the UK's interest in that context, if we have to relocate, to relocate to fewer destinations rather than fragment across? What is the most likely behavioural consequence for UK financial institutions of all these equivalence negotiations, or are they going to say, "Let's forget about this"? Can they afford to forget about it?

Professor Niamh Moloney: It is a live issue. The behaviour we have seen since June 2016 has been all about certainty. Of all things, markets value certainty. The difficulty with equivalence is that it is contingent. You may have equivalence on day one, but one cannot predict what is going to happen three years down the line. That is driving a lot of these decisions. If I move my subsidiary or if I have back-to-back trading, at least I know. It may not be ideal; we may be breaking up pools of liquidity; we may be breaking up IT infrastructures, but I have a clear path through the next five or 10 years in terms of how my business model is organised.

For certain kinds of activity, however, such as the breaking-up of the risk pool—classically, clearing, trading and derivatives—there are real downsides to everything pooling across the EU. That is something that the ECB and the Commission have picked up on. They see it from a financial stability perspective. If the derivatives pool starts breaking up, that might be good from the mercantilist perspective in the EU, but are you undermining stability? It is a key trade-off in equivalence access and subsidiary access.

There is a general sense that group structures can be very efficient. They can manage information flows and liquidity better and better. Perhaps this would be less of a risk than we think, but that is the trade-off. I think that is right.

Q7 **Lord Bruce of Bennachie:** Are there any particular equivalence decisions that we have or need to go with, to prioritise?

Professor Niamh Moloney: My sense is that one of the priorities for equivalence should be the MiFID to MiFIR space—investment services trading and sophisticated counterparties. That is where the UK has a huge competitive advantage, and right now there is not that depth of capacity in the EU. For example, although investment funds, private equity and various kinds of pockets of capital market activity are building very strongly in the EU, there is still a big gap. For me, that is where the political risk would be less, because it is very difficult for the EU to replicate that kind of capacity right now. It would be very advantageous for the City.

Lord Bruce of Bennachie: That is my final point. The 30-day rule with equivalence seems to be unsatisfactory. Of course, it is a two-way process. The UK can presumably withdraw equivalence with 30 days' notice.

Professor Niamh Moloney: Absolutely.

Lord Bruce of Bennachie: How important is that in negotiations, or is it likely to be?

Professor Niamh Moloney: It is very important. When one looks at how the equivalence system is designed, there are all these checks in it. One example is the credit rating equivalence system. Yes, the EU can withdraw it, but there is a lot of stuff in there about notification to the market and whether the Commission has checked that financial stability is not interrupted. In all of this, the EU is speaking to a global constituency. If equivalency is pulled very sharply, everybody is watching: the US, Singapore and Hong Kong. All those signals are being transmitted, so politically and practically, although it is possible, it is practically unlikely.

Professor David Miles: There is a point about how serious, economically, the damage to the UK might be if things do not play out in a particularly good way. I suspect they may not play out in a particularly good way for many of the reasons we have been talking about. If companies are relying on equivalence, they will not have much certainty about how things will play out in the future. If the EU makes a unilateral decision about whether rules are equivalent or not, that puts a company that is relying on it and based in the UK in a slightly tricky situation. We may see quite a lot of activity moving, and that basically means people moving.

The economic question is, how bad is that? At the risk of sounding a bit blasé, I think the answer is not really that bad. I will spend one minute explaining that. First, if a lot of firms that are currently in London, and provide services to the European Union from London, move into the European Union, my guess would be that the impact on financial services

delivered to UK households and UK non-financial companies is almost literally zero.

Then you are left with what it does to GDP in the UK. If I am roughly right that the UK has net exports of financial services to the EU of £30 billion, you might lose a significant chunk of that. You might lose half of it—£15 billion. That is not a small number, but, of course, you have not lost the whole of the £15 billion because there will be people, maybe predominantly Brits, currently based in the UK providing financial services to the EU whose activity gets moved; some of them will move, but many of them will decide not to move. Maybe they will do something else outside the financial services sector. These are people on the whole who are smart and highly paid. The idea that they are going to be unemployed and do nothing is extremely implausible. They might go and do things that are even more valuable than what they do in the City. Therefore you have not lost the whole of the value added that they currently create.

You start out with £30 billion in net exports. Even if you lose half, you are at £15 billion. A chunk of people will then do other things and stay in the UK, so you have not lost all their GDP. Of course, a substantial number of people will move to other places in the European Union. The loss to the UK is the tax revenue that they would have paid. Say they pay on average 40% tax; we are talking about 40% of half of £30 billion, and some fraction of that which is the bit that moves because the people move. I think you can quite quickly get down to a number, which is not a trivial number, but that might be of the order, on a crude back-of-the-envelope calculation, of £3 billion or £4 billion a year. It is obviously unhelpful. That is if you lose half of the activity. It is perhaps sometimes easy to exaggerate how significant all this really is economically.

Lord Vaux of Harrowden: That makes sense, but one of the things one hears is that, once people start to relocate, it starts to snowball a bit over time. Groups of key people get established and that tends to mean they hire there rather than here. Is there a risk that over a longer time that becomes a worse impact, and obviously a worse impact on the fiscal situation as well?

Professor David Miles: You are right; there is a risk of that. Therefore I prefaced what I was saying by noting that I was in danger of sounding a bit blasé about it. I guess it is possible. If there were to be another European financial centre where most of the activity ends up, and it does not get fragmented across lots of different places, maybe the economies of scale that that generates will mean that it becomes a much more efficient place to do all kinds of business from. Then the numbers would look more serious than I have suggested. It is a risk.

Lord Turnbull: I think you are probably in the blasé area. You could go for exactly that logic for any sector you care to name. It may be small for financial services, but if it is then repeated with a whole series of sectors it all adds up and comes to a lot of things.

When people move abroad, there are two things they can do. They can

brass-plate themselves as being in Paris, for instance, but if they want legal services they just phone Slaughter and May as they always did or use the same accounting firm that they always used. Does it mean that all the ancillary services, which are very valuable in London, get taken with them as well? It is not simply the bankers, but all the things that bankers buy.

Professor David Miles: True, but the £30 billion of net exports reflects the value added in all the other bits that contribute to the GDP generated by the activity. I have counted them in there already.

Lord Cavendish of Furness: I have reached the point in the discussion where I feel a bit lost, taking into account Professor Moloney's wonderful paper. What I am not clear about is this. Does the EC have a clear policy? Professor Moloney, you made reference to the deftness and political astuteness of the people building these new institutions, remarkably quickly in my view compared with the way institutions get built here. I cannot understand from what has been said and from your paper whether this is defensive or whether it is aggressive.

Professor Niamh Moloney: Probably two things are happening. There is the inevitable trajectory of EU financial regulation, regardless of the UK-EU relationship. It is deepening. It is becoming more sophisticated. It is building institutions. The euro area is becoming more interconnected. There is a constant pull into the centre as regards the single rulebook and the institutions around it. Part of that is growing sophistication in how the EU interacts with the rest of the world and the autonomy of that process.

I would probably pin my cards to the table and say that is how the EU is going to interact with the UK and with the rest of the world on the equivalence model. What is very difficult to predict is the question of politicisation. It is quite clear how the process will work. What is very unclear is whether it will become more politicised. With the exception of the Swiss scenario, it has more or less been a technocratic system. If it stays more or less a technocratic system, we can more or less see how it is going to play out. That is the real uncertainty.

One of the uncertainties attached to it—I do not know the answer to this—is how deep the EU's commitment is to capital markets. The EU is a bank-based economy. MiFID II and EMIR and all the rules are trying to encourage, embed and deepen market-based finance. Without the UK, which was driving a lot of the rules and articulating the case for very strong market finance, it is difficult to predict how deep that commitment is. In other words, will it just stay a very technocratic process and something to do with market finance, or is it, "No, we really need to repatriate this stuff; we really need to build substitutes for capital markets, and this is a way we are going to do that"? I find that difficult to predict.

Q8 **Lord Thomas of Cwmgiedd:** I want to ask you about regulatory alignment and the risks of the UK diverging or not. I think there may be a preliminary question. To what extent are we concerned with a difference between rules-based equivalence and outcomes-based equivalence? Secondly, there is the level of detail in what you mean by outcome. To

make it slightly more complicated, could you answer the question by saying what are the risks of maintaining regulatory alignment if one is talking about a rules-based system, and, alternatively, if there is an outcomes-based system or a high-level outcomes-based system? I may have made a series of false differentiations, but I am not sure that it is.

Professor Niamh Moloney: No, not at all. What is interesting is that the EU regards equivalence as an outcomes-based system. That is the language in all the texts and in a lot of the policy around it. Outcomes-based, risk-based, proportionate: that is the frame. It is exactly as you say, Lord Thomas. Against what is that being applied? It is outcomes as against a rules-based system. In the EU, they are looking through all the rules and, if it happens that you do not have X rule but you have Y rule, whether that is the same outcome.

What is not happening is that, if we disaggregate the 1,500 rules, we have 10 principles, and you have those 10 principles too. That is not what is happening. They are looking for substitute outcomes but it is in the rules-based framework. In some ways, it is a positive story around that framework because, for example, they have done it in rating agencies and they have done it with CCPs. They find substitutes. Interestingly, ESMA, which is the European authority that helps the Commission on all of this, has said it is not a zero-sum game. It is not, "You are equivalent or you are not. We will look for the substitutes. We will look for reasonable alternates, but it is against the rules".

If it is against the rules, the regulatory divergence question is troublesome because there will be the exercise of, "You do not have X; we need to find Y". Maybe Y is easy to find, but maybe it is not. It makes it more complicated.

If you move towards, "Well, your system has 15 principles about X and we have 1,500 rules about Y", that is a very different way of thinking. It is not how the EU has traditionally done that. If you go back to the notion of protecting autonomy that is in the political declaration, how deep in the DNA of the equivalence process are the technical rules? There are an awful lot of them. If they become absolutely central, divergence becomes quite a big issue. That is one question. Diverging at the technical level could be problematic.

Diverging at the directional, how-you-regulate-your-market level could be significantly problematic. There the EU will be worried about level playing field issues. That is my initial sense of context.

On the wider risks to the UK from diverging, briefly the UK has been good at shaping the EU rulebook. EU capital markets right now have been hugely influenced by the UK. It looks, in very large degree, like what the FCA or the Bank of England would write. The UK has had a very strong influence on it. That is one point.

A second point is that regulation, for good or ill, since the financial crisis, has become hugely procedural, operational and data-driven. It is

engineered into how firms work. There comes a point when the transaction costs of undoing your wiring are not worth the effort. One may have redesigned it better at the start, but we are where we are. There is an element of that.

A third point about the regulatory alignment issue, and it is a bit of a hostage to fortune, is that we have had the big directional shifts in financial regulation. An awful lot has been done. There is work to be done on fintech and sustainable finance and so on, but most economies operate on a not dissimilar set of rules. One would be surprised to see the EU doing very strange things and the UK having to stay aligned with it.

Lord Thomas of Cwmgiedd: Taking the distinction we have made, where are the risks in maintaining regulatory alignment? Am I right in saying that, if it is a very tightly rules-based system, the risks are much greater than if it is a high-level outcomes-based system?

Professor Niamh Moloney: There are a couple of risks. One is resource. It is going to take an awful lot of procedural, institutional systems to stay very close to the EU; just to watch it, there is an exercise in seeing what is happening. The pace at which the EU changes its administrative rules is very significant. There is a whole exercise in watching that and staying with it.

There is, of course, the devil in the detail argument. This frequently happens. Rules come in and they have peculiar side-effects that do not become obvious until later. In the case of the UK, because it has a highly sophisticated market and because the technical rules will be set without the UK, and that empirical sophistication will not be driving the rule-setting process, things could fall between the cracks. There will be complicated rules that could have unforeseen effects.

Lord Thomas of Cwmgiedd: Could I ask for Professor Miles' views?

Professor David Miles: There are very significant potential costs if the UK feels it has to maintain regulatory alignment, particularly if regulatory alignment, as it is perceived in the EU, is, "You have to have pretty much the same rules as we have over here". That may be more likely if there is a bit of scepticism among many people in the EU about the true motives of the UK Government and the regulators in the UK. And I think there is scepticism about that. For example, my impression is that the UK's opposition to caps on bankers' bonuses was perceived very differently in other countries than it was perceived here. Here, the motivation for it was clear and, I think, correct, which was that if you have bonus caps on bankers you will have higher fixed salaries in the financial system, and that will make banks much less able to deal with bad shocks because they cannot reduce the salary bill (or the remuneration bill) as quickly as they could if they could just cut people's bonuses very quickly.

The motivation in the UK, which seemed to be the right one, was, "This bankers' bonus rule is extremely unhelpful in preserving stability in the

banking sector". None the less the UK lost on the bankers' bonus caps and that is where we are.

While I very much agree with Professor Moloney that the UK has on the whole been very influential in moulding the system of rules that is in place in the EU, there have been a few big losses and there may be even more losses in the future with the UK not there. To feel that you have to try to keep in line with all this is, I think, potentially extremely costly.

Q9 **Lord Thomas of Cwmgiedd:** If we diverge either on the detailed rules, which I think you both feel are very constraining, or outcomes, where would you diverge?

Professor David Miles: The optimistic view is that if you had a flexible approach to what equivalence means, and it is all about high-level outcomes, it is hard to see that there is likely to be much disagreement about what high-level outcomes you want from financial supervision and regulation. You want financial stability. You do not want firms becoming bankrupt or triggering financial crises such as those ghastly ones in 2007 and 2008, and their aftermath. If you have very high-level principles, it is hard to see that there is going to be much disagreement on what they should be, and that looks like an optimistic way forward.

I suppose my overall pessimism is that I rather doubt that that is how equivalence will be viewed, and it will be much more down in the weeds of individual rules.

Professor Niamh Moloney: I agree. Outcomes-wise, I think the EU and the UK will be in a very similar position on protecting financial stability, investor protection and so on. Where you might get a slight divergence in outcomes is in the relative weight the EU and the UK might put competition. One might imagine a slightly less regulated environment that privileges competition, whereas the EU might say, "No, it's more dirigiste. We are more worried about risks".

I think it is right that the outcomes will be very similar. One thing that is possibly worth putting in the mix is that in the last couple of years capital markets rules in the EU have become a bit more deregulatory. They are becoming a bit more tailored to particular segments. It is all about building a capital markets union. If that gets a little bit exhausted and off the agenda, and there is an impulse towards more control and a more dirigiste system, it could cause difficulties with the UK.

Lord Thomas of Cwmgiedd: I have one final question. Why is there this philosophical difference between wanting a rules-based system and an outcomes-based system? It seems to shine through what you are saying.

Professor Niamh Moloney: My theory is that the EU is doing two things at once when it regulates. When the UK regulates, it is regulating for stability, investor protection and so on. When the EU regulates, it is doing that but it is also constructing a single market. A lot of what it is doing is saying, "Look, when this service crosses a border, fear not because this service is following a mutually agreed set of rules". The more contested,

the riskier and the more troublesome an area is, the more nervousness there will be in every member state about what is coming into its playground. There is always the sense that, if you are in a particular member state, you are anchoring the 27. One of the jobs the rulebook does is to deal with that sort of nervousness about detail.

Viscount Trenchard: I have one supplementary; apologies for labouring the point. On areas where the UK may wish to diverge, I was surprised in the discussion on question 2 to hear Professor Miles say there was no evidence that the UK would seek in some areas a less bureaucratic and less cumbersome regulatory system.

It is certainly true that the bulk of financial services regulation by the three European regulators has been driven by the UK, but there is a large number of examples where the reverse has been the case. I would include Solvency II; people still think today that it was very inappropriate for UK insurance companies to have had to comply with that. There is AIFMD, which has decimated a number of small investment management companies, and even now causes them a huge amount of difficulty. There are parts of MiFID II that we resisted.

In some cases, our regulators have taken a slightly stricter line and been more willing than the practitioners wanted to go along with the more dirigiste approach being put forward by their continental colleagues. If you look at the consequences of MiFID II, huge damage has already happened to small investment management companies, many of which have gone out of business or been forced to merge.

Of course there are risks, but do you agree that there are huge potential benefits to the UK financial markets of diverging? I have given three examples on which I rest my case.

Professor David Miles: I do not think there is much difference between us. My point was that there is not much evidence from the past that, where the UK has disagreed with rules that then get agreed at EU level, the UK disagreement was a reflection of wanting to be much laxer because we are less concerned about financial stability risks.

The reason why the UK has sometimes wanted to diverge from the rules is that it thinks they were simply misguided and were not preserving financial stability; they were not doing what the intention seemed to be. That is why I think there is not much evidence that the UK wants the flexibility to be much laxer on things because we are less concerned about financial stability risks. That was my point.

Lord Desai: I am not a practitioner, as the noble Lord is, but the paradox is that the system was designed with a big UK contribution. It was all in the interest of financial stability, as supervised by the Financial Stability Board. There is a clear danger that as these things split, and as the UK splits, things are done foolishly out of mercantilism or whatever that might endanger stability. Is there nobody in the global financial system who can come in and say, "Look, fellows, I am here to see to it that you don't get

out of control and you don't endanger global financial stability"? Paul Volcker is dead, but is there not somebody like Paul Volcker who could say, "I am not for the EU or for the UK. I care for global financial stability. Don't do anything silly"?

Professor Niamh Moloney: That is a powerful point. In the EU system, I would point to the ECB. The European Central Bank has financial stability in its DNA. It is constantly at the forefront of how the bank thinks and what it does. It is one of the sources of slight tension in the European structure. There are the single market institutions, the single market and so on, and the ECB as almost a kind of defensive force behind that. Probably the best example of that is the emergency CCP decision. The ECB was very much in favour of that: in effect, "We can't let this become a big political football. We need CCP clearing activity to run effectively".

The global environment is a point very much worth raising. The Financial Stability Board, the Basel committee and all our regulators in the UK and the EU sit together. There are reputational risks. There are legacies. There is a discipline, and it is absolutely right that it operates at an international level in how all these debates take place. That is right. It is very much a high-level check on how these decisions operate.

Lord Cavendish of Furness: Professor Moloney, your paper suggests to me that the EU is saying to the outside world, "You do business with us on our terms and only our terms". That is the impression I get. To what extent would the EU be vulnerable to eurozone underperformance in the first place and, perhaps more significantly, individual member states rebelling?

Professor Niamh Moloney: It is a really interesting question. Right now, we are at a bit of an inflexion point. Professor Miles will be much more able to speak to this than me. There is global nervousness around trade. There is global nervousness around protectionism. Regulation is part of that. My instinct is that there is a sort of wariness internationally right now about who moves first in the deregulation space. Regulation is a powerful tool for managing frictions, but it is all about the first mover. Who moves first? My instinct is that the EU's internal operating system is not geared that way, but it will not and cannot be immune to how global systems approach their regulatory architecture.

As I said a few minutes ago, the ECB is a constant check—a sort of ferocious watchdog—on financial stability within the eurozone. It will be very alert and wary of deregulation. Having said that, where the EU economy is most vulnerable in the financial services base is banking. It is a bank-based system. If euro area banks are compromised, that is where the challenge is. The market space is less acute when it comes to the EU economy.

Professor David Miles: I am a little less optimistic about the role the ECB plays in all of this, in being the good cop that keeps things in order. Maybe what I am about to say is slightly unfair, but one area where I think the UK stands out as having much more successfully responded to the financial crisis than is true, on average, in the European Union is in the position of

the banks. The capital of UK banks is much stronger. It is stronger than it was and stronger than it is on average in many European Union countries. I do not think the ECB has been very successful here. Maybe it does not have the power or the unity to do what has been done better in the US and in the UK in putting the banks in a firmer position to face the next set of problems, whenever they come.

Q10 **Lord Turnbull:** There has been a migration in this debate, it seems to me. We started with many in the financial services sector believing in the single market. Then they said, "We cannot be in the single market if we have this big sector and somebody else is setting the rules". Then equivalence grows up and they realise it is pretty much the same thing, because if you start with equivalence and they move and we do not, or we move and they do not, we are no longer equivalent, so it is effectively their rules.

Basically, we are faced with the awful truth that we are a third country, What is the relationship we can find as a third country? In the case of trade, we say that is what we want to be because we value the ability to do deals with other people. Can you see a scenario, either good or ill, that comes out of starting from the third country premise? What is the best we can make of this, and what opportunities does it create for our relationship with other financial sectors such as the US? We do not particularly want to diverge from the US too much because it could then steal our business, just as the EU could.

Professor Niamh Moloney: It is a moment of opportunity, challenge and threat. It is all those things together. As a general context point, pretty much every developed capital market internationally will have a version of equivalence. Everybody does. Interestingly, the EU model is seen as a deference-based model, in that once you are equivalent it tends to allow you to operate off your own rules, whereas a lot of other systems say, "No, if you are going to come into our house, it is our rules and our supervision". Everybody has some version of it.

One of the challenges is that there are 280 or so equivalence decisions globally, and all of those jurisdictions are familiar with the EU system. If the UK system is very different from that, it will complicate bilateral equivalence-type discussions internationally: "We recognise this bundle of rules, but we do not recognise those so much". There is an issue. It is not insurmountable by any means because the different systems work differently; it is simply reality. That was by way of context.

Where the opportunity lies is around the dynamism of financial markets. There is currently huge competitive advantage for a market that is really good at sustainable finance and in the developing climate change markets, where markets are trying to figure it out, with carbon trading and all the rest of it. An innovative, flexible and attractive scheme for regulating could be a powerful export that the UK could use internationally.

The cautionary note is that it is less about regulation and more about the depth of the UK market, and the attractiveness of the UK market to its trading counterparties. The depth of the UK market depends on all sorts of

other things, such as regulation tax and all the rest of it. That is what drives the attractiveness of bilateral relationships, not just regulation.

Professor David Miles: I am sounding very pessimistic about lots of things, but I am not sure that there is much upside to the UK having flexibility to diverge and set different rules in the future. That is partly because the UK is already very successful in selling financial services and dealing with countries all over the world. It is not obvious that we are markedly held back by rules that we are suddenly free to change, and now we are going to do a lot more business with China and South America.

There is a kind of negative upside of having more flexibility, in a sense. If there are EU rules that would be put in place on financial services that the UK really thinks are misguided—there have been a couple of examples in the past—obviously you have the flexibility to decide, at some cost in losing equivalence, that you are not going to impose those rules.

My guess is that the bottom line of all this is that in the area of financial services it will end up being a situation where the EU and the UK both lose. It is going to be lose, lose. There is some activity that is currently done in London because we have a comparative advantage, and a chunk of that will get done somewhere else a little bit less well. Households and non-financial companies across the European Union will end up paying a little bit more every year for a whole range of financial services. The UK will lose a little bit because some jobs will move from the UK. It comes back to my calculation earlier, when I thought that you could start with £30 billion and then you would lose half of it, and then some of the people would do other things. Some people would move and you would lose their tax. You end up losing a non-trivial amount of money; it could be of the order, on the back-of-my-envelope calculation, of between £3 billion and £5 billion a year. It is not good; it is lose, lose, but it is not a huge loss.

Lord Vaux of Harrowden: I am not sure if this is quite the right place for this. We have been talking about equivalence in one direction only for most of this discussion, but it goes both ways. We will have to look at granting equivalence to the EU. How important is that?

Professor Niamh Moloney: I think it is. It is there in the background in the interests at stake and how they play out in particular discussions. We saw it last year. The EU did not or would not give equivalence on share trading. The UK said, “Well, okay, this is what we are doing”. We ended up with a slight stand-off and it was not clear what shares could trade where.

I agree with Professor Miles that there is no winner; everybody is in an asymmetric stand-off. Getting the two sets to link together is almost certainly not going to happen because the UK’s system is somewhat different from the EU’s. It is less rule based. Nobody will win from a stand-off. This is where wider considerations will come into play.

Lord Vaux of Harrowden: Will there be benefit to us from being much freer with granting equivalence to the EU and going for pure outcomes?

Professor Niamh Moloney: It is a very interesting point. Right at the start of this, at the end of 2016 and early 2017, the Bank of England and the PRA made a very outward-looking statement: "This is our position on inward-coming firms. We are not changing it. You are welcome. We value the liquidity and the services. Here is how we do it". At the time, it was seen as brave, welcome and a very important global signal. There is little to be gained from cutting off the EU pipeline, and potentially an awful lot from which to benefit.

Q11 **Lord Desai:** Now that we are free, we will have to see whether our own financial regulatory system is fit for purpose. Are there any improvements we could make? For example, could we have parliamentary scrutiny of the financial regulatory system as they do in the US? What are your thoughts on that?

Professor Niamh Moloney: Some careful thought will need to be given to the legitimacy and accountability frameworks around financial regulation. That is simply functional. For many years, so much of the rule-making has gone to the EU, so we have been using the EU structures for doing that, for good or ill; they are not ideal in many respects. For example, when ESMA, the European regulator, is involved in rule-making, there is Commission oversight and Parliament oversight, and legislative obligations for impact assessment, consultation and so on. That will have to be migrated back because it is not embedded to the same extent in the UK system; it has not been necessary. It will have to be repatriated and careful thought given to how it works.

My view is that financial regulation is central to how we run the welfare system, how the economy works and how households benefit or not. It is very much a critical part of how we run society. I would have thought that, for legitimacy, a rethink of the parliamentary oversight system is indeed an important moment, a benefit and an opportunity to think about how financial regulation is designed. That is partly functional, because it has to go somewhere, but there are very big questions about whether we diverge or not and, if we do, how it is done. These are big questions, and there needs to be a system that can contain those questions.

My personal view is that political accountability is really important in this area. Inevitably, a political process that contains specialist analysis is part of that.

Professor David Miles: It seems to me that because there will be more decision-making at the level of the FCA, the PRA and the Bank of England than there is at the moment, where to a significant extent it is implementing EU rules, you would want there to be proportionally more oversight of those institutions in Parliament. Obviously, there is significant oversight already. The governor and the head of the FCA and senior people at the PRA regularly give evidence at Select Committees. Maybe they need to give evidence more often, and for longer.

Lord Bruce of Bennachie: You mentioned this point and we have had evidence before on it. The role of the European Parliament, by comparison

with what the UK Parliament has done, has been colossal, with the expertise and the resource it has. I want to press a bit further. It is not just about more evidence. The capacity of Parliament to ask intelligent questions requires resource. Are we going to get it? Is it your view that that should be the case?

Professor Niamh Moloney: That is quite right. There are two things. It is a rethink of what is happening at agency level—looking at the PRA and the FCA and thinking, for example, about technical oversight boards at that level. As regards parliamentary scrutiny, it is immense. Financial regulation is a huge portfolio. In the reorganisation of how the financial services sector in the UK is regulated, part of the cost and opportunity is strengthening the political system. That is costly, but it is a cost that has to be borne.

The Chair: I recall that the last time we had a financial services Bill before Parliament we abolished the oversight committee in the Bank of England. We may need to rethink some of those decisions.

Is there anything else that you think we should take account of, or that you would like to tell us that you have not told us already? That is the usual invitation towards the close of a meeting. If there is not, thank you very much for your time. It has been enormously helpful, very interesting and occasionally depressing. I was struck by Professor Miles's notion of a negative upside. I shall use that phrase fairly frequently. Thank you for your time.

The public evidence session is now closed. The Committee will resume its private deliberations. Thank you very much indeed.