Why London cannot go it alone

Talk of the City taking a pick and mix approach to the EU's FSAP ignores the contribution London should make to European regulation, writes René Smits.

The Financial Regulator has often given prominence to contributions on the costs and benefits of financial regulation. The article "Could London go it alone?" by David Lascelles in the December 2006 issue calls for a response. There is much to be said, of course, on the place of the City in the European Union's (EU) evolving regulatory landscape. I will only discuss a few main themes. An underlying legal assumption in Lascelles's contribution does not hold or, at least, has not been made explicit and discussed. Furthermore, policy arguments in favour of Britain playing an active part in the development of, and staying a partner in, EU regulation deserve to be highlighted in response to increasing misgivings about the EU. This contribution summarises my response.

A first remark to be made is that the EU regulatory landscape is part and parcel of Britain's membership of the Union. Proposals to "go it alone" should make clear that they are based on withdrawal from the European Union or, at least, negotiation of another opt-out.

Legal ties

Legally, all 27 member states are bound to follow community rules which they, through their ministers in the EU Council and their representatives in the European Parliament, helped shape. Of course, the European Commission, as initiator of regulation and guardian of its implementation, also has a British national among its members. A way out exists. It requires negotiations with the other member states on a treaty setting out the terms for Britain to leave the EU.

Short of such whole-scale abandonment of EU membership, an option that is politically

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unthinkable, but might legally be possible, is a treaty amending the EU and community treaties. This would give Britain an opt-out from financial regulation. This opt-out would come on top of the monetary union opt-out, secured at Maastricht, and the special position for the UK and Ireland in respect of the Schengen rules on passport-free travel elsewhere in Europe. It would make the treaties ensure that Britain could keep its own currency for as long as it wishes and keep or, rather, re-introduce, its own regulation for the City.

No more opt outs!

It is hardly feasible that the other member states would agree to this or to another – third – option, which would consist of making exemptions for the City when adopting financial regulation. Such a status might be obtainable by including special rules for London in EU financial-market regulation, just as Britain has special rules that respect its practices in the labour market (deviation from the working hours' rules). However, even this third option of making permanent exemptions in secondary legislation for Europe's most important financial marketplace will be difficult to achieve legally, let alone politically. In this context, Lascelles's mentioning of the common fisheries policy as another area from which the UK might opt out is disconcerting: this concerns one of the few exclusive competences of the European Community and an important element in our common endeavour to preserve our shared (natural) heritage.

More importantly, beyond the legal field, Lascelles's underlying assumption seems to be that London has much to lose from being part of the EU – at least from being bound by financial regulation at Union level. Now I, for one, agree with a lot of criticism about the lack of clarity of some EU rules, or about the absence of full transparency in the process leading up to their adoption. Although successive amendments to the original treaties have greatly remedied the so-called "democratic deficit" and have made influencing the EU regulatory landscape far more easy, the continued lack of public availability of material discussed in the council is deplorable. As an aside, the proposed EU constitution would make further progress towards democratic and efficient decision-making in Europe.

Protectionist problems

On a more practical level, the commission's tradition, borrowed from British practice, to consult widely with industry and other concerned parties through green and white papers, ensures that their concerns are heard from the outset. As a further criticism of the current regulatory landscape, I also find fault with the EU's regulatory regime's continuing

reliance on national implementation of European rules for financial services. This leaves far too much scope for "gold plating" – the adoption of additional national rules when implementing European directives. The combination of "gold plating" and national enforcement give national lawmakers and supervisors opportunities to prevent out-of-state competition entering the domestic markets. As is well-known, retail banking and other financial markets are still "national" when defined under merger rules.

Moreover, maintaining national demarcation of financial markets through these combined aspects of EU regulation places financial institutions under multiple reporting requirements, thereby increasing bureaucracy and stifling efficiency. In this respect, the article rightly mentions protectionism and hostility to opening banking markets as continued features of the EU. The on-going sector inquiry by the commission into financial services will highlight constraints to competition, both regulatory and industry-bred.

London's key role in Europe

Yet, the general thrust of Lascelles's article – that the EU is bad for the City – seems widely overstated. Before discussing some of his arguments, I should like to mention an inconsistency. The author argues for withdrawal from EU regulation whereas, to prevent a new round of regulatory change, most of the current rules would be retained, since he says: "the FSAP is not all bad, and many of its measures could be retained with little modification." I would agree with the first part of the quoted sentence. In my view, any alterations to current laws should take place within the EU context (or that of the G10, where EU regulation largely translates international standards, such as Basel II). Before going into the arguments proposed by Lascelles on the kind of regulation he would favour for the City, let me remind readers of the valuable contribution made by the City in the context of an area of law and policy from which Britain enjoys an opt-out. In the run-up to the introduction of the single currency in the late 1990s, specialists from the financial services industry and their legal advisers made numerous contributions to the legal instruments adopted in that context.

David Lascelles

British input

The financial services industry associations, the Financial Law Panel, the Bank of England and the Treasury all helped shape legislation on economic and monetary union (EMU) for the better. Their practical input and advice

based on the financial industry's own experience have been much valued on the continent and continue to shape the way the European Central Bank (ECB) and the single currency function.

In the context of proposals for London to "go it alone", it is useful to remember that even now UK nationals are employed by the commission and the ECB. They work in areas of EMU from which their member state is exempt. Even British members of the European Parliament (MEPs) vote on secondary legislation in the area of EMU, ie, rules adopted by the council in such areas as monetary policy, balance-of-payments reporting and payments services. It is only in very limited circumstances that British ministers are excluded from voting in the council – even then British MEPs still do.

All this has not only been to the benefit of "the continentals" (and the Irish), but also to British companies: London firms can compete across the euro area and beyond on the basis of a European passport. This is granted pursuant to the same financial regulation that is so much criticised, and following rules applying elsewhere that have had ample input from British practices.

Deceptive appeal

Assuming that there would be a possibility for Britain to opt out from EU financial regulation and, thus, working from this unlikely point of departure, the picture painted by Lascelles is not complete. His reference to the General Agreement on Trade in Services and Basel II as sufficient regulation is deceptive. Neither GATS nor Basel II translate into rules that can be directly applied in the marketplace. Opting out of the FSAP would require adoption of market rules to replace the European implementation of Basel II, for instance.

One may doubt whether special UK legislation to that effect will put an end to the cries of the banking industry about over-regulation of the City. I cannot escape the impression that some of this criticism is due to the accumulation of measures to be implemented simultaneously. The year 2007, with the Market in Financial Instruments Directive (MiFID) and Basel II, is an example of bad timing in this respect.

The transatlantic debate

Still, assuming a legal possibility for the UK to go it alone, one cannot envisage that British interests are well served when, in the context of negotiations on a transatlantic community, Britain would have to join ranks with Canada and Mexico in order to join a US/EU common market.

It seems to me that London is better placed within the EU to help shape transatlantic regulatory standards, as

previously proposed by industry and now taken up by Angela Merkel, Germany's chancellor. This initiative bodes well for the City: aligning US and EU regulatory standards may minimise the costs of doing business across the Atlantic and help influence EU standards towards a less intrusive level of regulation. After all, a more principles-based approach will be pitted against the American rules-based approach. I see a chance for the City to influence this international agreement (and others), through EU policymaking, for the better.

Towards harmonisation

My view of EU regulation of financial services is that effective and efficient community rules should replace scattered and divergent national ones, thereby relieving the bureaucratic burden for industry rather than increasing it. This would entail much more use of regulations – a directly effective European law – than nowadays.

Thus, the need for national implementation with all its variations will diminish, and the clarity of a single set of rules applying across the continent may help financial business to expand. Ideally, a close alignment of supervisory policies and practices and, in certain areas, enforcement of rules through a common decision-making agency with decentralised offices, would complete this approach.

Of course, this requires that due account is taken, when adopting legislation and tailoring its enforcement, of the special needs of Europe's (and the world's) largest marketplace: London.

This is a point Lascelles rightly makes. I would even go further and state that the continent needs British input in regulation and should borrow from the FSA's approach to enforcement.

This would not only make the EU's supervisory standards even more practicable and efficient, but would also allow British firms to penetrate markets elsewhere in Europe, thereby introducing efficiencies and innovations that enhance consumer welfare.

Strength in numbers

Consumers in retail markets, who have hitherto been shielded from the positive aspects of competitive market pressures, would benefit, as would economic growth outside as well as inside Britain, assuming repatriation of profits made elsewhere in the internal market.

This vision of an integrated financial market is a far cry from a further Balkanisation of the European regulatory landscape when London would "go it alone". It requires a broad perspective that takes in a European and a transatlantic horizon.