

**GOVERNMENT RESPONSE TO THE TREASURY
COMMITTEE'S SEVENTH REPORT FOR SESSION 2005-06
(HC 778)**

EUROPEAN FINANCIAL SERVICES REGULATION

The Government welcomes the publication of the Committee's report and notes its conclusions.

European Commission's financial services policy

The FSAP was a wide-ranging and ambitious programme of new legislation. As the FSAP comes to an end, the Commission has placed greater importance on ensuring consistent and workable implementation of the existing financial services legislation. We welcome this change of emphasis under President Barroso.

We agree. The Government has consistently supported the consistent, proportionate and timely implementation of the FSAP. This is essential if the FSAP is to deliver its full benefits.

Creating an EU Single Market in Financial Services

Based on the evidence that we received, there is some evidence of financial institutions expanding through the acquisition of banks and insurers in other European countries. However, a single market in European financial services, with comparable products and services available to consumers direct across borders, does not appear to be a realistic proposition in the near future. The industry should look for ways to manage the non-regulatory barriers to cross-border sales of retail financial services products, particularly in areas in which the UK market has a product offering that is unavailable elsewhere in Europe. However, we recognise that, in some markets, such as the mortgage market, the non-regulatory barriers are significant and so, even in a consistent regulatory environment, there is unlikely to be significant cross-border growth. In these circumstances, the Commission should ensure that, in evaluating the likely costs and benefits of future proposals, it takes account of the fact that growth in cross-border sales is likely to be limited as a result of the non-regulatory barriers.

The Government believes that facilitating greater cross-border consolidation in the EU represents an effective means by which to increase integration in retail financial markets.

The Government welcomes Commissioner McCreevy's pledge to conduct rigorous *ex ante* impact assessments ahead of considering any new regulatory proposals, especially in retail markets. Such impact assessments should consider the costs and benefits of both legislative and non-legislative options for action.

European cross-border consolidation

It is essential that the United Kingdom, through the European Council, supports moves by the Commission to prevent countries from erecting artificial barriers against consolidation in the financial services sector and exerts pressure on European countries that attempt to thwart cross-border merger and acquisition activity for unacceptable reasons.

The Government will support the Commission in attempting to prevent Member States blocking cross-border mergers and acquisitions on non-prudential grounds, both through a revision of existing EC legislation in the financial services sectors and in the robust application of competition rules.

Better Regulation

A change in the working culture at the Commission towards more proportionate, risk-based, policy making will not happen immediately. We welcome Commissioner McCreevy's assurances that the Commission will prove that new regulation will have a clear benefit to the European economy. It is essential that European policymakers ask and receive answers to the simple questions that McCreevy is posing: Is there a case for action? Is it the EU that is best placed to act? Is a regulatory proposal the only possible solution? To ensure growth and competitiveness in the European financial services industry, the Commission must now deliver on its promise to ensure better regulation principles are followed in its policymaking.

The Government strongly welcomes Commissioner McCreevy's emphasis on the Better Regulation agenda, and will continue to

press for the use of market-led or non-legislative solutions to be considered ahead of any proposal for EU legislation.

National parliaments, national governments, the Lamfalussy committees, the Commission, the Council, the European Parliament and businesses themselves must all recognise that we have a joint responsibility towards ensuring that European financial services legislation is justifiable and proportionate.

The Government agrees that Better Regulation is a shared responsibility for public administrations at all levels and business has a key role to play in providing evidence to them.

Implementation and Enforcement

We are encouraged by Commissioner McCreevy's work to place greater emphasis on enforcement and implementation across the European Union, which entails a cultural change within the Commission. It is essential that the implementation and enforcement of MiFID and the other existing legislation become the priorities of the Commission in relation to financial services, rather than focusing on drafting and negotiating new legislation. We believe that there is the need for a period of 'bedding down' of European financial services legislation.

Implementation and enforcement of financial services legislation is an essential element in realising the FSAP's benefits. The Government fully supports the Commission's efforts to implement and enforce the agreed FSAP measures in a consistent, proportionate and timely manner, and has consistently argued this should be the top priority for the next five years.

Consumer Representation and Protection

As European retail financial services markets become more open, it is important to ensure that consumers have the chance to have more input into the European legislative process. Presently, companies are organized into their trade associations, generally articulate and strong lobbyists, whereas consumers, particularly in Brussels, tend to be less well represented. We welcome the move in the Commission's recent White Paper on Financial Services Policy towards establishing a permanent group of consumer representatives from across Europe and would commend the

Financial Services Authority's Consumer Panel as a possible framework to enable the consumer voice to be heard at all levels.

The Government welcomes the Commission's announcement that it intends to establish a permanent consumer panel, underlining the importance of ensuring the interests of consumers are represented in the policy making process. (In the UK, the FSA Consumer Panel provides an excellent and necessary input to policy formation in the UK, particularly in respect of EU proposals where it is difficult to secure evidence based user input.)

The Lamfalussy Structure

Based on the evidence received by the Committee, the Lamfalussy structure appears to be functioning reasonably effectively. The main difficulties appear to stem from the tight timeframes that the Commission has typically imposed on the Lamfalussy committees to deliver advice. The Commission should consider slowing the legislative process where necessary, in order to ensure that the committees are able to fully investigate and resolve the issues involved. In addition, it is essential that the Treasury attempts to ensure that any clearly political matters are resolved in the Level 2 committees—with genuinely technical input provided by the Level 3 committees at this stage—rather than leaving them for the FSA and other European regulators to debate later in the Level 3 discussions.

The Government welcomes the Treasury Committee's assessment that the Lamfalussy arrangements appear to be functioning reasonably effectively. Like the Committee, the Treasury believes it is important that the Commission allows adequate time for the so-called Level 3 Committees to consult and to prepare their advice taking into account the principles of better regulation. Nevertheless, it is also important to balance this against the need for timely changes to legislation.

The Government also agrees with the Treasury Committee that political agreement on European Directives should be brokered through co-decision at Level 1, leaving detailed implementing measures to be agreed at Level 2. To the extent that some of these measures take on a degree of political importance, we agree that decisions should be taken at Level 2, not Level 3.

The Role of the European Parliament

It appears to us that the Lamfalussy structure is developing well. We consider it important that the present ambiguity regarding the role of the European Parliament in the process is removed. The evidence we have received indicates that the European Parliament is playing a constructive role in the legislative process for financial services, particularly in its contribution to scrutiny of delegated implementing measures in the Lamfalussy structure. We consider that the European Parliament should have a formal role in examining Lamfalussy level 2 implementing measures within a reasonable timeframe, with the ultimate sanction of blocking or "calling back" any measures which it considers unacceptable.

The UK Presidency was instrumental in establishing the work on a new comitology decision which would reflect the informal agreement between the EU institutions (as set out in the so-called Prodi declaration) within the current treaty. We therefore welcome the fact that an agreement has been reached. This will permit responsive and flexible regulation of the financial sector through the Lamfalussy process, which is essential to ensuring that the EU's financial markets remain competitive, liquid and innovative.

We recommend that the Government should, in its response to this report, provide full details of the draft inter-institutional agreement

on comitology procedures, together with the Government's assessment of the agreement and its application to the Lamfalussy process.

The Foreign Office has detailed the new Comitology agreement in EM 10126/1/06 Rev 1 laid before Parliament on 10 July 2006. It will apply to the Lamfalussy process in the same manner as in other policy areas.

Case Studies: Markets in Financial Instruments Directive

Cost- benefit analysis

Whilst we recognise the difficulty in estimating the costs and benefits of one part of an overall policy framework, the work involved in undertaking a cost-benefit analysis undoubtedly furthers and enriches the debate around what a measure is supposed to achieve and what changes firms will need to make to implement the measure. Accordingly, we are concerned that, to date, there has been no formal evaluation of the costs and benefits of MiFID by the Commission and will be extremely interested in the cost-benefit analysis on MiFID to be prepared by the FSA. We also welcome the new approach to cost-benefit analysis being taken at the Commission, which will require full assessments to be carried out on future proposals of this sort.

The Government also believes the cost-benefit analysis is central to making progress with better regulation in respect of EU financial services work. Whilst acknowledging the significant efforts the Commission has made to consult on MiFID and its implementing measures, without a proper cost-benefit analysis it can be difficult to weigh the merits of particular arguments. Such analysis needs to be at the core of decision making.

MiFID Implementation in the UK

Whilst we applaud the leading position that has been taken by UK-based financial services companies with regard to MiFID, there is a clear risk that the Directive will not be promptly and fully implemented in all other European countries. It is also important that 'passporting' rights are recognised across Europe, in order to more readily allow UK-based firms to set up branches in other European countries and to ensure that the responsibilities of home and host regulators are clearly delineated. It is therefore essential

that the Commission demonstrates its new focus on implementation and enforcement through ensuring that MiFID is implemented consistently across Europe.

The Government agrees that in respect of MiFID, the challenge now facing the Commission and Member States is to achieve a prompt and consistent implementation of the directive. In this respect, we welcome the transposition workshops that the Commission has convened for Member States to discuss issues connected to the implementation of the directive. In this forum we have had useful discussions of a number of issues, including how best to ensure the transition between the passporting rights under the existing directive and those under MiFID.

Furthermore, the implementation of MiFID by national regulators will be a strong test of the Lamfalussy framework. Following the implementation of MiFID, we would encourage the FSA to consider reviewing the way in which the Lamfalussy process has worked in order to identify lessons for the future.

The key aspect of the Lamfalussy framework that MiFID has tested so far has been the arrangements for implementing measures. Overall the Government believes that the arrangements here have worked well. The Committee of European Securities Regulators produced serious and comprehensive advice. This formed the basis for the legislation agreed by the European Securities Committee which strove to find a political compromise which took proper account of the need to protect investors and minimize burdens on business. This approach was endorsed by the European Parliament's Economic and Monetary Affairs Committee, and subsequently, by the plenary of the European Parliament itself. The challenges will be different once the directive is implemented and regulators have to use it as the basis of their supervisory work. We would expect the FSA and its colleagues in CESR to strive to ensure that they work together in the most effective ways possible to help ensure its consistent application and enforcement.

Possible directive regarding mortgage credit in the EU

It would be undesirable for the UK mortgage sector to implement new regulation as a consequence of European legislation if it has

little or no incremental benefit to consumers. The case for a new mortgage directive remains unproven.

The Government supports the Commission's continuing focus on the principles of better regulation in this area. As stated in the UK's response to the Commission Green Paper, alternatives to regulation should be fully explored before any decisions are made on legislative interventions. Rigorous cost-benefit analysis will be required to justify any specific action. Without this analysis, the case for a Directive on mortgages remains unproven.

Possible directive in the area of cross-border clearing and settlement

It is therefore important that the additional cost associated with clearing and settlement across borders is reduced over time. We are pleased with the approach taken by the Commission in this area, which appears consistent with their 'better regulation' agenda. The Commission has indicated that it is willing to step aside if a market-led solution starts to appear in this area, and the Commission must deliver on this promise if a sensible solution emerges. We note that clearing and settlement has a systemic importance to a financial services market, although this is not a reason for inaction within a single European market for financial services. If the market cannot or will not address the high costs of clearing and settlement in Europe, it can have no complaints when policymakers start to become involved.

The Government agrees with the Committee's preference for a market-based solution, and endorses the challenge outlined by Commissioners Kroes and McCreevy to industry to bring forward proposals that would obviate the need for legislative action.

HM Treasury
24 July 2006