TAKING BACK CONTROL OF THE CITY

Seven Reasons Why The UK Is Better Out

The debate on the UK's membership of the EU is often characterised as a balance between the long term threat to the control and economic prosperity of our nation versus the short term risks of leaving.

City firms have been active in championing the short term financial benefits of remaining in the EU but there has been little discussion of the wider, long term UK interests in relation to financial services: Does the EU act in the Eurozone's or the UK's interests? Can we really protect the UK banking system from the next Euro-crisis? Is the EU fundamentally antagonistic towards the City? Is EU membership driving business from London to other global financial centres? Where does the longer term interest of the UK lie?

The Governor of the Bank of England has used his appearances before the House of Commons Treasury Select Committee to focus on the potential short term risks of leaving. By choosing not to get involved in the wider debate on the merits or otherwise of leaving, the Bank has, perhaps unwittingly, given the impression that all the risks lie on the leave side. In our opinion the Bank's own pre-referendum publications and speeches clearly show that it too has serious concerns about the long term risks of remaining in the EU.

Over the course of many years the UK Government has failed to stop damaging EU financial sector regulation, has ceded control to the Eurozone and has suffered an erosion of its sovereign powers in areas such as taxation.

The authors, as people with experience in the City, have written this paper to provide some balance to the debate by highlighting the risks of remaining in the EU. Our conclusion is that a vote to leave would allow the UK to take back control over the City, would reduce the risk of future euro-contagion to the UK financial services sector and the wider UK economy, would return primacy over areas such as taxation to the UK and, over the long term, would make the City a more competitive, prosperous global financial centre.

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Biographies

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SUMMARY

The UK is a major global financial centre: it has the largest global share of cross-border bank lending, foreign exchange trading and interest rate products. It has the third largest insurance industry and the second largest asset management industry in the world. The future of the City matters to the UK because it creates jobs, generates tax revenues and is an important source of exports. The competitiveness of the City over the long term is vital to the nation's prosperity. But it is also essential that the UK has proper and prudent control over a financial sector which, due to its size and complexity, has the potential to be a significant source of risk to the wider UK economy.

Access to the single European market is not fundamental to, nor the reason for, London's success. The City's global position derives from its institutions, experience, location, language, pool of talent, legal system, reputation and international reach. This is why London is not only Europe's financial capital, but a major global centre.

Although the EU single market is important to the UK – it accounts for one third of our financial service exports - the rest of the world accounts for two thirds and is growing more rapidly. The UK has to weigh up whether the benefit of unfettered access to the single market is really worth the constraints, costs and risks which result from our EU membership.

There is a growing body of evidence which shows that EU membership comes at a significant and increasing cost to the UK: EU regulation driven by the need to harmonize and protect the Euro, an encroachment of the UK Parliament's right to tax and spend, damage to our international competitiveness and a loss of international influence.

The EU looks inwards, not outwards. EU rules are designed to deliver faster integration and to preserve the Euro, not to deliver growth or improve international competitiveness. The UK Government has tried to hold back a tide of Euro-centric, politically motivated and just plain bad EU financial sector legislation, but the UK's influence within the EU has dramatically weakened over the past twenty years. Evidence shows that the UK is becoming increasingly isolated within an EU dominated by the Eurozone. Unlike the French, who have a veto over EU legislation relating to agriculture, the UK has no such control over a key part of its economy – financial services. As Lord Mandelson noted in 2012 the UK will progressively become an EU outsider, lacking influence but still bound by the EU's rules[1].

The UK Government's attempts to protect our interests have failed: a new voting mechanism designed to protect our interests against those of the Eurozone will evaporate by 2018 as more countries adopt the Euro[2]. The UK has turned to the EU courts on a number of occasions to overturn bad or discriminatory EU rules. Invariably it has lost. David Cameron has argued for safeguards against future discrimination and in favour of more flexible regulation. The pre-referendum reform package he negotiated allows only for extra discussion: the UK cannot block new rules – the EU, dominated by the Eurozone, will continue to take decisions by majority vote.

The UK is set to become the victim of progressively more intense and costly discrimination. We have no effective way to prevent it. As George Osborne said in 2014:

"*If we cannot protect the collective interests of non-Eurozone member states then they will have to choose between joining the euro, which the UK will not do, or leaving the EU."*[3]

[1] Mansfield College, Oxford "The Hands Lecture by the Rt. Hon. Lord Mandelson" (May 4 2012).

[2] Europe Economics "EU Financial Regulation" (2014), page 1

[3] Open Europe "Chancellor's speech to the Open Europe Conference" (15 January 2014).

The City: Seven Reasons Why The UK Is Better Out

1. **LEAVING means taking back control of our financial sector**
   REMAINING means being outvoted by the Eurozone

2. **LEAVING means the UK parliament retains sovereignty over taxes**
   REMAINING means EU multi-£bn tax raids on the UK

3. **LEAVING means more UK influence on international bodies**
   REMAINING means sharing a voice with the EU

4. **LEAVING means promoting the City as a truly global centre**
   REMAINING means the risk of more damaging EU intervention

5. **LEAVING means empowering the Bank of England**
   REMAINING means inflexible, rule-based regulation from Brussels

6. **LEAVING means better regulation of our financial sector**
   REMAINING means accepting poor quality EU rule making

7. **LEAVING means we will be better prepared for the next Euro-crisis**
   REMAINING means greater exposure to the Eurozone

1. LEAVING means taking back control of our financial sector
REMAINING means being outvoted by the Eurozone

Britain's influence within the EU's institutions has been in steady decline. In the first European Elections in 1979, the UK had 20 per cent of the seats in the European Parliament. By 2015, that had declined to 9.5 per cent. Likewise, while the UK had 17 per cent of the votes in the Council of Ministers in 1973, that has declined to 8 per cent.

Changes to EU regulatory rules are now controlled by the Eurozone block through its 65% share of votes at the Council of Ministers. In an attempt to regain influence over EU rule making George Osborne agreed a 'double majority lock' with the European Banking Authority. This forced laws passing through that institution to go through two rounds of voting: Eurozone states and non-Eurozone states. This system allows a majority of non-Eurozone countries to effectively vote down laws that would harm their interests. While the non-Eurozone states are a heterogeneous group, this initially appeared to be a satisfactory solution. But it has subsequently emerged that – were the number of non-Eurozone states to fall to four or lower – the 'double majority lock' would expire. In a recent report Europe Economics noted that:

"Although such measures may offer some protection in the very short term (up to around 2018) they are unlikely to be sustainable over the longer term because almost all current non-Eurozone members of the EU intend to join the euro by 2020, meaning 'double majority voting' would become very close to a UK veto on any new financial regulation – and thus unacceptable to Eurozone members."[4]

The UK's capacity to block financial sector legislation is set to diminish further over time. It is interesting to note that France retains a right of veto over EU agricultural legislation but no such concession has been offered to the UK in financial services.

The ability of the UK to influence regulation is increasingly secondary to the needs of the Eurozone which is driven by the goal of harmonization. The Bank of England ("BoE") commented:

"..the general movement away from setting minimum standards in favour of 'maximum harmonisation', which prevents national authorities from strengthening regulation to meet particular risks in their jurisdiction, has in some instances been problematic."[5]

In 2014 the General Council of the Bar of England and Wales was much starker in its warnings:

"*EU legislation since the 2008 crisis has tended increasingly to encroach on member states' competences, and towards prescriptive, centralised decision-making. This gives rise to cause for significant concerns about subsidiarity and the balance of competences, as well as legal basis and institutional balance*."[6]

The UK's lack of influence over rulemaking has not only led to poor regulation, but also EU rules which actively favour the Eurozone's interest over the UK's. As the FT's Wolfgang Munchau noted:

"if the Eurozone has a collective interest in anything, it is to stop the City acting as its main financial centre."[7]

There is already direct evidence that the Eurozone has begun working as a group to undermine the UK's influence. A good example was the creation of the European Financial Stabilisation Mechanism

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[4] Europe Economics "EU Financial Regulation" (2014), page 1.

[5] EU membership and the Bank of England" (October 2015), Page 84

[6] HM Government "Review of the Balance of Competences between the United Kingdom and the European Union The Single Market: Financial Services and the Free Movement of Capital" (2014), page 79.

[7] Financial Times "Bonus issue marks start of a long battle", W. Munchau (3 March 2013).

("EFSM") in May 2010 which was forced through by Eurozone states voting together. Although the decision was nominally approved under qualified majority voting at a meeting of the Council of Ministers on 9 May 2010, Eurozone leaders had already outlined the creation of the EFSM at their own meeting on 7 May. As George Osborne put it in 2014:

"*If we cannot protect the collective interests of non-Eurozone member states then they will have to choose between joining the euro, which the UK will not do, or leaving the EU."*[8]

Former EU trade Commissioner Lord Mandelson made his views clear in 2012:

"I believe there will be an inevitable gravitational pull of decision-making towards the inner Eurozone core. Britain will be invited to support this evolution but if we refuse we will be ignored… It is certainly not inconceivable – indeed I think it is likely – that Britain will find itself a decade from now the only state in the EU, certainly the only large state, outside the Eurozone. Effectively the EU will have been rebooted, with the UK on the outside."[9]

Supposed safeguards for non-Euro countries formed part of David Cameron's pre-referendum reform settlement. However as the FT pointed out in February 2016 these safeguards[10]:

"…only allow for extra discussion; the EU could still take decisions by majority vote."

The FT further reported that[11]:

"…for the City of London, Paris, Berlin and the European Central Bank, [the safeguards] practical impact remains a mystery. "I've no idea what it means," said one senior eurozone official working on the issue. "I change my mind every day." "

The UK's ability to protect its own interests has been increasingly undermined at the expense of the Eurozone. The only sensible course of action is for the UK to leave the EU.

[8] Open Europe "Chancellor's speech to the Open Europe Conference" (15 January 2014).

[9] Mansfield College, Oxford "The Hands Lecture by the Rt. Hon. Lord Mandelson" (May 4 2012).

[10] http://www.ft.com/cms/s/0/ca8376d2-ca5c-11e5-be0b-b7ece4e953a0.html#axzz47y9XKlNE

[11] http://www.ft.com/cms/s/0/ca8376d2-ca5c-11e5-be0b-b7ece4e953a0.html#axzz47y9XKlNE

2. LEAVING means the UK parliament retains sovereignty over taxes REMAINING means EU multi-£bn tax raids on the UK

The EU is encroaching upon the rights of sovereign nations. A current example is the proposed EU tax on financial transactions ("FTT") which, if implemented as proposed, would require the UK to levy taxes against the UK's sovereign will on behalf of other EU states.

The FTT was first proposed by the EU in 2010 as a means to reduce future market volatility and as a way to make banks contribute towards the cost of the last Eurozone crisis. Negotiations over the tax have been tortuous, but have not yet been abandoned. The E10 group (Germany, France, Italy, Austria, Belgium, Greece, Portugal, Slovakia, Slovenia and Spain) is due to reconsider the issue at the end of June 2016, shortly after the UK's EU referendum.

Even if the UK does not sign up to the FTT it will still be forced by the EU to collect and remit taxes under what is called "EU enhanced co-operation". This is the first example of a truly supranational EU tax imposed by Brussels. In its current form the tax has been vigorously opposed by the UK Government. George Osborne has said many things about the FTT including:

"*It's not a tax on bankers, it's a tax on jobs, on investment, on people's pensions."*[12],

"it is a bullet aimed at the heart of London"[13] and described it as

"*unlawfully extraterritorial.*"[14]

The CBI believes that the FTT[15]:

- *will reduce European economic growth*
- *will directly capture and penalise corporate activities; increasing the cost of risk management*
- *will increase the cost of raising finance for investment and undermine the capacity of the financial sector to support activities in the wider economy*
- *has wide extraterritorial impact beyond the FTT-Zone member states*

Even if the UK does not participate in this scheme it will still be a significant tax burden on the UK with revenues being sent to other EU countries to spend as they wish. It is estimated that if the EU FTT is implemented by the EU10 it will:

- cost the UK government (i.e. taxpayers) an additional £4bn each year in higher interest rates[16]
- cost UK savers and pensioners another £4bn in transaction costs[17]
- raise funding costs for UK business and put up mortgage rates by up to 1%[18]
- do nothing to improve financial stability and possibly increase market volatility[19]
- damage EU GDP by up to 1.76%[20]

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[12] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10810978/UK-anger-over-secret-EU-financial-transaction-tax-plan.html

[13] Open Europe "Chancellor's speech to the Open Europe Conference"(15 January 2014).

[14] http://www.bloomberg.com/news/articles/2013-06-05/osborne-says-transaction-tax-unlawfully-extraterritorial

[15] Financial Transaction Tax: CBI Position Paper May 2013.

[16] "The Impact of a Financial Transaction Tax on Corporate and Sovereign Debt." The City UK

[17] "The Effects of a Financial Transaction tax on European Households' Savings", The City of London Corporation

[18] https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/Impact-of-FTT-on-corporate-and-sovereign-debt-Final-PDF.pdf

[19] "Financial Transaction Tax: The impacts and arguments", PriceWaterhouseCoopers November 2013

[20] http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/impact_assessment.zip

- drive business from the UK to New York, Hong Kong and Singapore[21]

The House of Lords Committee on the European Union in their report entitled “The Financial Transactions Tax: Alive and Deadly” said the following:

“This Committee has consistently warned of the potential impact of an FTT on non-participating Member States, including the UK.”[22]

George Osborne took the EU to the European Court over the FTT – and lost. Even the new mayor of London, Sadiq Kahn, has described the tax as “madness”[23].

A number of other EU countries are now wondering whether this highly political piece of EU legislation is sensible but Germany, France, Italy and Spain are keen to press forward.

The House of Lords, George Osborne and the CBI all believe that EU rules such as the Financial Transactions Tax will have a devastating impact on the City, hit UK industry, savers, pensioners and people with mortgages but not the intended target – bankers. Such EU rules not only damage our international reputation, but encroach upon the primacy of the UK Parliament to make decisions in areas such as taxation.

[21] TheCityUK website, accessed 07/04/2015 at: <www.thecityuk.com/research/ourwork/infographics/>.

[22] House of Lords European Union Committee: “Financial Transaction Tax: Alive and Deadly”

[23] http://www.cityam.com/233803/editors-interview-christian-may-meets-labours-mayoral-candidate-sadiq-khan

3. LEAVING means more UK influence on international bodies REMAINING means sharing a voice with the EU

The EU's international role has grown over time as it has been able to send representatives to organisations such as the G7 and G20. There have, therefore, been two people claiming to represent Britain's interests: the European Commission President and the British Prime Minister. If the UK left the EU, the British Prime Minister would be the only person in the meeting who could speak for the UK[24].

Discussion by the G20 as to whether the proposal for an EU Financial Transaction Tax ("FTT") is acceptable under international law is a good example of why this influence is so important. The centrality of international bodies in financial services rule-making is further demonstrated by the G20's push to change 'over-the-counter' derivative trading regulation. This stems from a commitment made in April 2009 by the G20 nations to "promote the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision". The growing role of these groups in financial regulation was also shown during the financial crisis. At a G20 summit held in London in 2009, member states agreed to introduce new rules on hedge funds, bank traders' pay, rating agencies, and bank capital requirements, a blacklist of tax havens and a review of accounting rules.

Having a strong, independent British voice at the table, who can speak without fear of reprisal, is vital to the UK's interests. The UK would also remain a member of the International Monetary Fund enabling it to avoid moves to have its position merged into a single EU seat (the issue of EU member's representation in the Fund has been examined by Ecofin, the EU Council of Finance Ministers, on two occasions).

The UK will have more influence and can protect its interests more effectively by having a single voice on international bodies rather than having joint representation through the EU. Leaving the EU would avoid future moves by the EU to remove member countries from international bodies such as the IMF.

[24] "Change or go", Business for Britain

4. LEAVING means promoting the City as a truly global centre REMAINING means the risk of more damaging EU intervention

The EU has a record of imposing market restrictions against the wishes of the UK which have had a detrimental effect on the UK's reputation as a global financial centre.

In 2012 the EU introduced restrictions on the short selling of bank equities and sovereign credit default swaps. At that time the equity and bond markets were subject to large swings due to market sentiment about the Eurozone. Many countries in the EU felt that there was unreasonable speculation against the Eurozone countries and their banks and that excessive trading was contributing to a downward credit spiral.

The UK's position is that it is better to keep markets open which, although volatile, are still trading with some liquidity. Shutting markets means that traders are left holding risks thereby potentially making the situation worse and secondly it sets a precedent which deters trading in locations which are liable to unexpected regulatory interventions.

George Osborne made it clear that he saw the ban as wholly unreasonable, lodging a complaint at the European Court against the regulation[25]. The Court rejected the UK's case in January 2014.

The UK's position as a global financial centre depends upon customers and financial institutions being able to rely upon a consistent and sensible regulatory approach. The EU's approach is significantly more interventionist than the UK's historic style which, combined with an inbuilt Eurozone majority, leads to regulation which damages the international reputation of the UK.

By leaving the EU the UK can re-establish its free market credentials and maintain the UK's pre-eminent position in global finance.

[25] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9304559/Osborne-sues-EU-over-plan-to-ban-short-selling.html

5. LEAVING means empowering the Bank of England
REMAINING means inflexible, rule-based regulation from Brussels

The drive for great EU harmonization gives UK regulators little room for flexible interpretation of EU rules. The BoE, which is responsible for regulating a large, diverse and very complex financial system, has argued vigorously that the rigid interpretation of the EU Single Rulebook is a risk to the financial stability of the UK. For example the BoE noted that EU capital adequacy rules:

" *… do(es) not permit national authorities to require a higher conversion threshold, if in their opinion, that is required to help safeguard domestic financial stability.*"[26]

The BoE has complained that EU capital rules do not allow regulators to take into account structural differences in insurance markets across EU states. This reduces the ability of the BoE to account for UK or firm specific risks. There are no provisions to allow the BoE to impose its own stricter rules on the insurance sector.

The BoE has such serious concerns about EU regulation that demands for greater flexibility were a key part of David Cameron's proposals for EU reform. As Cameron set out in his letter to Donald Tusk on 10th November 2015: *"Our concerns really boil down to one word: flexibility."*[27]

Mr Cameron wanted recognition that:

"Just as financial stability and supervision has become a key area of competence for Eurozone institutions like the ECB, so financial stability and supervision is a key area of competence for national institutions like the Bank of England for non-Euro members."

However, as the BBC reported[28], Mr Cameron ran into firm resistance from France who wanted to underline that Britain would not win any "exceptions to the rules of the EU" – particularly in relation to regulation in the City – hence the addition of the following sentence at the insistence of France:

"The single rulebook is to be applied by all credit institutions and other financial institutions in order to ensure the level-playing field within the internal market."

Some in the EU clearly view the BoE's desire to interpret the EU's Single Rulebook more flexibly as a form of unfair competition against its EU neighbours, rather than a reasonable desire to improve the stability of the UK's financial sector.

Without additional regulatory flexibility the UK's financial sector is more risky than the BoE believes is prudent. Given the size and scale of the UK's financial sector this means that the wider UK economy is put at risk. If we vote to leave the BoE can adopt more stringent and rigorous capital requirements where it believes they are necessary.

[26] "EU membership and the Bank of England" (October 2015), Page 81

[27] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/475679/Donald_Tusk_letter.pdf

[28] BBC http://www.bbc.co.uk/news/uk-politics-eu-referendum-35622105 - "What Cameron wanted and what he got"

6. LEAVING means better regulation of our financial sector REMAINING means accepting poor quality EU rules

The UK Government's own review into EU financial sector law-making concluded that the quality of EU legislation is often poor:

"*The shift in focus from market-opening to financial stability in the last five years has raised questions regarding the quality of the policy-making process and the resulting rules. Although there is broad consensus about the need for EU-level regulation to underpin the Single Market in financial services, evidence from stakeholders raised significant concerns regarding the recent pace, volume and focus of EU legislation, the failure to differentiate between financial services sub-sectors, the lack of proportionality, and insufficient recognition of the subsidiarity principle, especially in the retail sector."*[29]

The EU regulatory regime for insurance has come in for particular criticism. Nigel Wilson, chief executive of Legal & General, said at a conference in 2013 organised by the Association of British Insurers that:

"*the European [regulatory] system is one of the worst. Pretty much everyone in this room is not investing in Europe for that reason*"[30]

UK style regulation has traditionally been a combination of written rules backed up by qualitative assessments (i.e. the personal judgements of experienced professionals). The EU drive towards harmonization and a fear of unfair competition means that national regulators are not permitted to take a more considered, high level view of financial institutions. This is a particular drawback for the BoE which is responsible for regulating a very large, sophisticated and diverse group of financial institutions.

Leaving the EU will allow the UK to create a regulatory regime which matches the complexity of our financial sector. Reducing financial sector risk is good for the UK taxpayer.

[29] HM Government "Review of the Balance of Competences between the United Kingdom and the European Union The Single Market: Financial Services and the Free Movement of Capital" (2014), page 7.
[30] Financial Times "L&G chief brands EU regulatory framework 'worst in world", A. Gray (2013).

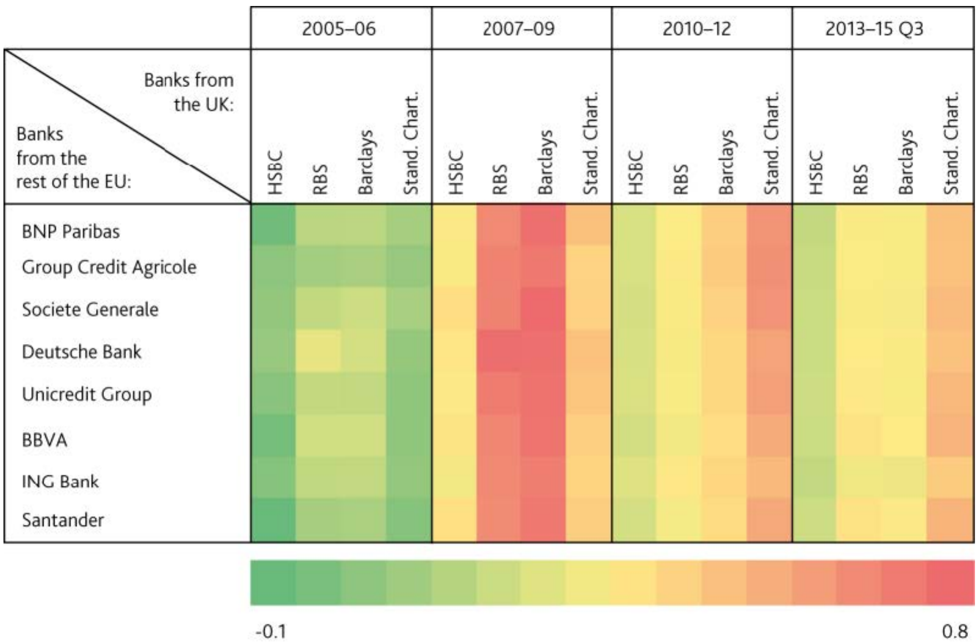
7. **LEAVING means we will be better prepared for the next Euro-crisis REMAINING means greater exposure to the Eurozone**

The former Governor of the Bank of England Mervyn King fears that a break-up of the Euro is inevitable:

"*Germany faces a terrible choice. Should it support the weaker brethren in the euro area at great and unending cost to its taxpayers, or should it call a halt to the project of monetary union across the whole of Europe? The attempt to find a middle course is not working. One day German voters may rebel against the losses imposed on them by the need to support their weaker brethren, and undoubtedly the easiest way to divide the euro area would be for Germany itself to exit. But the more likely cause of a break-up of the euro area is that voters in the south will tire of the grinding and relentless burden of mass unemployment and the emigration of talented young people*."[31]

The Bank of England has provided convincing evidence of how the fortunes of UK banks and those in the rest of the EU have become increasingly intertwined. The growth of cross border bank lending has led to a convergence in the credit-worthiness of UK and EU banks:

Correlation between UK banks credit-worthiness and banks from the rest of the EU:[32]



Sources: Thomson Reuters DataStream, Markit Group Limited, Bloomberg and Bank calculations
Note: Chart shows correlations between changes in 5-year senior CDS for UK banks and those located in the rest of the EU. Red (green) indicates high (low) correlation. Banks in the sample are selected based on data availability and whether they are classified as a Globally Systemically Important Bank (GSIB) by the Financial Stability Board.

The BoE gives evidence that during the 2011 Euro-crisis the cost of credit insurance for UK banks showed similar spikes to EU banks – a trend that had not been seen in earlier periods.

The BoE has explained how the ability of EU banks to set up operations in the UK without capital or UK regulation had led to more risk to the UK financial system. The BoE concluded that EU banks setting up UK branches:

[31] Mervyn King ,"The End of Alchemy" 2016
[32] "EU membership and the Bank of England" (October 2015), page 59

"…….. *are not generally required to hold capital and liquidity in the country in which they operate and were more reliant on short-term interbank funding. During the crisis, foreign banking groups exhibited a degree of home bias – in the face of scarce funding and capital, some of these banking groups used the balance sheet of their UK branches to support lending in their home market*."[33]

The BoE's view is that over time the UK's and EU's financial systems will become even more connected. The Bank predicts that any future Euro crisis will have a significant impact on the UK's financial stability:

"given the degree to which the UK economy and financial system is intertwined with the euro area, a more severe crisis – particularly if it prompted renewed concerns about euro-area break up – would almost certainly have a material impact on UK economic and financial stability."[34]

The BoE has explained in clear terms how the UK's membership of the EU and the Single Market regulatory regime is a source of risk to the UK's financial sector.

Outside the EU the Bank of England would be released from the constraints of the EU Single Rulebook, giving it much greater freedom to properly prepare for the next Euro crisis.

[33] "EU membership and the Bank of England" (October 2015), page 55
[34] "EU membership and the Bank of England" (October 2015), page 67