



Britain's financial services industry in a changing Europe

A Policy Network Report for the City of London Corporation



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1. Introduction

In 2008-2010, shortly after the outbreak of the financial crisis, the focus of attention inevitably turned for the City of London and its alleged role in the collapse of European economies. Widespread resentment against financial capitalism translated into a strong regulatory reaction. This new pressure raised concerns in the UK over the future competitiveness of the financial services industry. British policy-makers started to complain that the huge asymmetries in both size and nature between London and other EU financial centres were overlooked in Brussels.

Today's context appears less dramatic and unsettling for three main reasons. An impressive range of new regulations have been adopted at EU and national levels, and the next few years are thus likely to see, if not a pause, at least a slowdown in new legislation. Secondly, governmental elites are caught in a dilemma between the wish to protect taxpayers' money, on the one hand, and the desire to boost lending to the economy on the other. They have increasingly mixed feelings about capital requirements and levies that risk crippling the economic recovery and damaging the EU's single financial market. Finally, significant reforms in the governance of the Eurozone have been enforced without any fundamental alteration in the institutional design of the EU. After the ECB's decisive moves in 2011 and 2012, talk about 'the remorseless logic' of integration has receded, while ad-hoc incremental arrangements, both within and outside the currency union, seem to remain the preferred option, at least as long as there is no further explosion of the Eurozone crisis.

Financial services have nevertheless remained an area of tension between the UK and its partners, and it has become a focal point in the debate about Britain's future place in the EU. Tensions over bankers' bonuses and the Financial Transaction Tax have received a lot of media attention, and fed negative attitudes against the EU's role as financial regulator. Moreover, the current governmental coalition sees integration in the Eurozone as a major shift which bears significant threats that need to be addressed by an equally important adjustment of the UK-EU relationship. This was formally expressed in David Cameron's 'Europe speech' in January this year, with the commitment to renegotiate the terms of British membership before submitting it to a referendum by 2017.

In this report for the City of London Corporation, Policy Network seeks to offer fresh and informed insights about the current state of play on banking and

financial regulation, and what we believe are the risks of the new uncertainty surrounding the UK's place in the EU. Drawing on over thirty face-to-face interviews with senior politicians, political advisers, civil servants and experts, the study gives an overview of opinion trends across the EU.¹ It aims to provide guidance on how the City can pursue the objective of maintaining a strong financial sector in London as a key component of an integrated Single Market and a competitive EU.

The report addresses **three main questions**:

1. How has EU legislation in the banking and financial sectors affected the City's interests in the last few years?
2. Has the perception of financial markets and Britain's role changed across the EU? Do European policy-makers share the idea that an efficient financial sector based in London is a key component of a vibrant EU economy?
3. Does the UK need special treatment from the EU in the context of euro area integration? What are the EU partners of the UK ready to countenance after David Cameron's speech on Europe?

Based on the analysis that follows Policy Network makes the **following key recommendations**:

- The City should emphasise in the UK and on the Continent that London is and should remain **the natural financial centre of Europe, unambiguously attached to the Single Market's regulatory framework**. The City must convince wider opinion that it offers large economies of scale to the benefit of the whole EU, and that it represents a force for good, namely for jobs, investment and growth, in the same way as Germany is the natural industrial core of Europe. Non-bank financial actors such as private equity, venture capital and investment funds are of particular relevance in today's context of capital shortage and the need for a more innovation-based economy.
- Changes in the Eurozone have a less clear-cut impact on Britain's place than what is usually assumed. The City should renew its case for **a constructive and leading British presence in Brussels, drawing on the**

¹ Interviews were conducted in Berlin, Stockholm, Paris, Brussels and The Hague between June and September 2013. A dozen of informal and phone conversations with officials and experts in other EU capitals including Warsaw, Rome and Athens also took place. The key findings of the report are also based on primary and secondary literature such as EU legislation and documentation, press and journal articles, comment pieces.

significant share of sympathy enjoyed by the UK across the EU. In the field of bank and finance regulation, the UK can draw on widespread understanding about the asymmetry characterising EU financial markets and continuing acceptance by other member states of the need to ‘take good care’ of London, provided they remain convinced that the British political class is determined to uphold Britain’s EU membership as a vital national interest. Britain can also lead on an agenda that would enable the Single Market to realise its full potential. The UK should finally avoid the appearance of making systematic legal challenges against EU regulations that have already been adopted, an attitude that does not go down well among partners and a tactic that should only be deployed in the most exceptional circumstances.

- In the debate opened by David Cameron’s speech on Europe, the UK elite should **avoid making unilateral and what comes across to our partners as patently self-interested claims.** Instead, it should seek improve the quality of EU policy-making, a discourse on which London has many allies. There is a strong case for better application of the principles of subsidiarity and proportionality, as well as for a greater involvement of national parliaments. This might not require a treaty change, rather a change in practices as much in Brussels as in London.

2. EU regulation of financial services and UK interests: convergence or tensions?

In the last few years, the EU has passed or tabled an impressive list of legislative pieces in the field of financial services as a response to the financial crisis. An overview of this agenda is available on the European Commission's website². Given the size of the financial industry in the UK economy, the claim that the City is at risk from excessive or misplaced EU legislation has gained traction in the UK media and political spheres. Many imagine that London exerts less and less influence against a background of strengthening integration among Eurozone members, a fact that justifies demands for non-discrimination guarantees.

Banking and financial reform, however, is by no means an isolated EU initiative. Not only has the UK government initiated significant amounts of new legislation on its own, but all national and European initiatives are embedded in the post-crisis international coordination. G20 summits conclusions have entailed a significant section on financial supervision and regulation since 2008, an agenda which the EU is only implementing. G20 leaders have committed in particular to³:

- Extend regulation and oversight to hedge funds over-the-counter (OTC) derivatives, securitization markets, credit rating agencies
- Implement tighter compensation standards as a way to avoid excessive risk-taking
- Increase international consistency of capital in the banking system, which was the subject of the Third Basel Accord (Basel III) signed in December 2010 and focused on the capital adequacy and liquidity of banks
- Address the resolution of systematically important financial institutions.

This section focuses on the most significant pieces of EU legislation recently passed or currently under discussion as a way to implement the G20 agenda. It asks whether the UK has, indeed, faced increasing isolation in the last few years in the field of banking and financial regulation, supervision and taxation.

A. Banking regulation

On banks, the UK, once the strongest advocate of 'light touch' regulation, has moved its policy to positions which its critics had not expected. Due to the disruptive potential to the wider economy of its large investment banking sector,

² European Commission, 'Towards a stronger financial sector to support growth', State of play 27/09/2013, http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf

³ 'G20 Leaders Statement: The Pittsburgh Summit', G20 Information Centre, <http://www.g20.utoronto.ca/2009/2009communique0925.html>

the UK has been keener and more successful than many other EU countries in tightening regulation in the last few years. Yet banks are known to be a major risk factor for EU member states. Eurozone banks' assets are worth €33 trillion, nearly three and half times the currency union's GDP (Britain is similarly over-exposed) against twice in Japan and Australia, and the same size in the US⁴. The EU has been pressing hard to reform the banking sector, but results have been limited so far.

- Capital Requirements (CRD IV)

Following the Third Basel agreement (Basel III) in December 2010, the EU launched a revision process of the Capital Requirements Directive. Basel III aimed to ensure that banks have better and more capital, more balanced liquidity, a leverage backstop and capital buffers. The CRDIV/CRR package was adopted in Spring 2013 after two years of legislative procedure. The final outcome tells a mixed story for the UK.

First, the UK has not been isolated at all in the CRD IV debate, on the contrary. As most interviewees in Brussels underlined, British MEPs played a key role all along the legislative process. In the European Parliament, both the Chair of the Committee on Economic and Monetary Affairs, Sharon Bowles (from the Liberal Democrat group), and Shadow Rapporteur Vicky Ford (from the Conservative and Reformist group), exerted significant influence. A source close to the Rapporteur (from the centre-right European People's Party), insisted that special care had been given to British demands, up until the specific question of bonuses (cf. infra).

Secondly, on the core of the legislation, namely the definition of capital and the level of required capital, London was tougher than Berlin and Paris. The UK asked to be able to go beyond the 7% ratio envisioned by Brussels for 'Core Tier-1' type of capital. This can be explained by the structure of national banking systems.⁵ In Germany and several continental member states, investment banking is not as developed as in the UK. Basel III was seen there as a threat for numerous solid public-sector (German 'Landesbanken'), savings and mutual banks. Also, the early deleveraging undertaken by British banks explained a more relaxed attitude to applying stringent capital requirements than in France and Germany. This 'tough' British attitude was really appreciated in smaller countries. A Belgian MEP told us:

⁴ Thompson, C. 'EU banks still pose systemic threat', *Financial Times*, 21 July 2013, <http://www.ft.com/cms/s/0/d23922de-f08c-11e2-929c-00144feabdc0.html#axzz2ZyoHTpvN>

⁵ Howarth, D., Quaglia, L. 'Economic governance and the chimera of financial system stability: the political economy of new capital requirements in the European Union' in 'Scotland Debates EU Economic Governance Conference Proceedings', Thursday 31 May to Friday 1 June 2012,

'The British are the only ones to be serious with banking regulation. The French and the German political elites are much too close to their big banks.'

Only on the specific question of bonuses did a rift emerge between British policy-makers and politicians and their Continental counterparts. From 2014 onwards, bank managers' bonuses may not exceed 100% of the individual fixed salary, or 200% with the board's approval. The legislative proposal was perceived as a threat and counter-intuitive in the City, hence it proved instrumental in the negative vote of George Osborne at an ECOFIN meeting in June. All Labour and Liberal MEPs but one voted in favour of the text, which was adopted by a very large majority.⁶ Sweden, a country almost always on the same line as the UK in Single Market regulation, eventually voted yes. According to a senior Dutch official, a restrictive approach on bonuses was adopted under pressure from the Labour Party (PVDA) in coalition with the right wing Liberal VVD. As the highly regarded specialist of banking regulation Nicolas Véron commented:

'So far, the main piece of legislation on which the City's interests have clearly been affected negatively by the anti-market stance that is more common in continental Europe is the bonus cap (CRD IV). This is significant, but the government knew that it could not rally the UK population against such a cap, hence they could not afford to veto the proposal.'

In September, the UK Treasury launched a legal challenge against plans to cap bankers' bonuses, on the ground that it was likely to 'act counter to the stated objectives of the legislation, which are to ensure banks are safer, more stable, and prudentially sound.'⁷ For another Brussels-based expert in financial services:

'The recent new court case on the bank bonuses is an example of how not to do it. You better intervene early on in the decision process, as Angela Merkel does on issues affecting the car industry.'

- Resolution regimes

Another G20 commitment, harmonised resolution rules were proposed by the Commission in June 2012 (Bank Resolution and Recovery Directive). This would allow banks to fail more systematically and prevent bail-outs to happen again, by

⁶ In the European Parliament, UKIP MEPs voted against CRD IV, Conservative MEPs abstained and Liberal-Democrat and Labour MEPs voted yes. British MEPs accounted for 17 of the 40 no votes, and for 24 of the 76 abstentions.

⁷ Petson, R. 'UK Treasury in legal challenge to EU bonus cap', *BBC News Business*, 25 September 2013, <http://www.bbc.co.uk/news/business-24273838>

setting out a clear hierarchy among shareholders, shareholders and creditors regarding potential losses.

Agreement in principle was reached in the Council in June this year. Positions varied a lot across member states, and there was no clear-cut divide between Eurozone and non-Euro countries. It appears, for instance, that Sweden and France sided with the UK on national flexibility, whereas Germany and the Netherlands pushed for strict and automatic application of common rules.⁸

The final text is expected to be adopted in early 2014 after a vote in the European Parliament. Business have reacted mildly to the progress made in the Council: some actors stress that the flexibility allowed and the failure to contemplate the creation of a single resolution authority (cf. 'Banking Union' below) will undermines EU rules and the desire to break the vicious circle between banks and states. Also, rules will not apply before 2018, hence the sense that political discretion will prevail until then.⁹ Others have observed that 'bail-in' rules would accelerate the reallocation of capital from Southern European countries, where banks are expected to be restructured, to Northern European banks.

- Deposit Guarantee Schemes

The initial Deposit Guarantee Schemes Directive (DGS) in 1994 did not require much harmonisation between national schemes in place to protect depositors. Quick-fix amendments were adopted in 2008, notably the increase of the coverage level to €100,000 (£85,000) which sought to address the problem of capital flights and to avoid financial contagion when a bank goes bust. A more robust proposal, DGS II, was adopted by the Commission in July 2010 and has been facing disagreements between the Council and the European Parliament since then.

The main point of contention regards the level of prefunding that should be made available. Current schemes in the UK, the Netherlands and Italy do not have any ex-ante funds at all, as opposed to Germany and France.¹⁰ Again, UK banks might have the same interests on this matter as some continental counterparts. However the debate is overshadowed by the banking union prospect.

⁸ Barker, A. 'EU reaches deal on failed banks', *Financial Times*, 27 June 2013, <http://www.ft.com/cms/s/0/9d667e18-debb-11e2-b990-00144feab7de.html#axzz2b5FHuVRY>

⁹ Barker, A. 'Improvisation the rule in bank bail-in deal', *Financial Times*, 27 June 2013, <http://www.ft.com/cms/s/0/dd534582-df3e-11e2-a9f4-00144feab7de.html#axzz2b5FHuVRY>

¹⁰ Verma, S. 'Germany's rejection of a pan-European deposit guarantee scheme is no disaster', *EuroMoney.com*, 25 April 2013 <http://www.euromoney.com/Article/3197194/Germanys-rejection-of-a-pan-European-deposit-guarantee-scheme-is-no-disaster.html>

- Banking Union

In June 2012, EU leaders committed to building a fully-fledged ‘banking union’ going beyond a harmonised rulebook as a way to ‘break the vicious circle between banks and sovereigns’. The case for banking union predates the crisis since the EU Single Market in financial services was not matched by a convergence of national policy frameworks, a fact that led to fragmentation of the EU’s financial space.¹¹ A functioning banking union would prevent such fragmentation by the means of four main pillars:

- A single prudential rulebook: Basel III rules and their translation into EU law.
- A single supervision mechanism (SSM): The ‘SSM regulation’ was adopted in March 2013. The ‘handover’ of supervisory powers to the ECB is scheduled by mid-2014.
- A single resolution mechanism: the Commission tabled a proposal in July, which, if adopted as such, would give the Commission the right to enforce resolution. A €60bn rescue fund would be set up.
- A single deposit insurance mechanism. Such an option has long been contemplated by the Commission (in place of DGS II) as a way to deal more effectively with cross-border resolution.

Although the EU Commission and the ECB are determined to complete these four building blocks, it has now become clear that political resistance and legal challenges will slow down the advent of a single resolution and insurance instrument. In April, Angela Merkel declared that there would be no common European deposit insurance scheme ‘in the foreseeable future’. Likewise, Berlin’s reaction to the Single resolution proposal was chilling. It revealed once again deep-seated anxiety about further risk mutualisation, and it highlighted the need for a treaty change. Indeed, such moves would require revising the European insolvency regime (today, a national competence) and the building up of a European fiscal capacity.¹² Therefore, German leaders insist on their preference for a two-step approach, which would see a coordinated regime of national resolution schemes prevail in a first time.¹³

On this issue, there are deep disagreement between France and Mediterranean countries on the one side, which support centralisation, and Northern European countries on the other, fearing mutualisation. In the UK, the Banking Union is

¹¹ Véron, N. ‘A realistic bridge towards European Banking Union’, Bruegel Policy Contribution, Issue 2013/09, June 2013, <http://www.bruegel.org/publications/publication-detail/publication/783-a-realistic-bridge-towards-european-banking-union/>

¹² Véron, N. (2013), op. cit.

¹³ See Franco-German position as expressed in joint communication ‘Together for a stronger Europe of stability and growth’ 29 May 2013, http://www.bundesregierung.de/Content/DE/Anlagen/2013/05/2013-05-30-dt-frz-erklaerung-englisch.pdf?__blob=publicationFile&v=3.

strictly seen as necessitated by the euro crisis and therefore irrelevant to the UK as a Euro-out, although the UK has chosen to ignore the stated objective set out by EU heads of states and governments as the creation of a 'financial union' directly linked to the Single Market. The UK government has been adamant that it would never join any common resolution and deposit mechanism, and it gave the impression of having achieved a significant victory after negotiating successfully a 'double-majority' system in the European Banking Agency, which will coordinate supervisory tasks alongside the ECB.

However, experts doubt the significance of this achievement. As a senior official at the European Commission said:

'Ultimately, it is in the City's interest that UK banks participate in the Banking Union. The BU is a key component of a functioning Single Market before being a stabilisation tool for the Eurozone.'

Financial expert Nicolas Véron went further:

'These are mostly papier mâché concessions. At the EBA, the ECB has now a supermajority and the UK position has become weaker than before.'

Interestingly, Sweden explored joining initially by seeking a status of associate membership, and has not absolutely ruled out joining in the future. However, there was no joint approach with the UK. Both might have got some concessions if the UK had tabled some proposals as well.

The question whether British regulators, in particular the Bank of England, might suffer from the domination of the ECB raises eyebrows in Brussels. Officials at the German Representation think that all national regulators are likely to lobby the ECB more aggressively. Against this new background, the voice of the Bank of England will matter a lot. A senior adviser at the European Council said:

'The argument that the ECB will gain excessive influence over UK policy-making is not relevant. You can easily argue that the Bank of England had excessive influence during the last decade.'

- Structural reform of the banking sector

A parallel but not less strategic debate is the design of the banking sector. The US moved ahead with the 'Volcker rule' banning proprietary trading, which was translated into law through the Dodd-Frank Act. As noted in Policy Network's 2010 study, the UK was leading in the EU with the Independent Commission on Banking and the resulting Vickers report calling for a 'ring-fence' between retail and investment activities of banks. In November 2011, the European Commission

put in place her own ‘High-level Expert Group on Bank Structural Reform’ chaired by Erkki Liikanen, who delivered a report in October 2012. Although recommendations’ details diverged from Volcker and Vickers, they reflected overall the influence gained by British experts on the matter.

The European Commission seems eager to initiate new legislative proposals on the back of the Liikanen report.¹⁴ Any initiative would be likely to trigger a similar ‘battle of systems’ as for CRDIV. Whereas the UK banking landscape is dominated by investment banks, investment bank activities only account for 5 to 10% of the balance sheet of French banks. The French and German governments moved ahead this year with their own banking reforms, which were criticised for their lack of ambition given the possibility to continue carrying out trading activities for the account of clients within ‘universal’ banks.¹⁵ As a British MP remarked in a public debate about European banking reforms in the House of Lords in June 2013:

‘Different regulatory rules within the EU are a problem. Regulatory arbitrage is a sensitive issue. The lack of a basic EU structure is a threat.’

B. Financial products markets

Opacity on financial markets was identified as one of the main factors of the pre-crisis bubble, which left supervisors unalarmed. The EU, in line with G20 recommendations, has taken initiatives to make sure that trading and clearing of these instruments happen on well-regulated and transparent platforms.

In this very complex field, defining the UK’s interests might prove even more difficult. London is host of a myriad of financial actors, from the UK and overseas, such as the trading branches of big Continental banks. The British government has often adopted a principled position, which consists in combatting too stringent regulation for the adjustment costs it could represent for City-based operators. This has for instance been the case on the Alternative Investment Fund Managers Directive (AIFMD, adopted in December 2012), which targets mainly hedge funds, private equity funds and real estate funds. Germany, France and Italy were the strongest advocates of the directive, whereas the UK and Northern European governments and the US successfully lobbied to remove the most costly provisions.¹⁶

¹⁴ There is currently a ‘stakeholders’ consultation’ phase, see the European Commission’s website: http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm

¹⁵ Cf. for instance Schumpeter, ‘Do not pass go, do not collect £200’ *Economist*, 25 April 2013, <http://www.economist.com/blogs/schumpeter/2013/04/german-bank-reform>

¹⁶ Quaglia, L., ‘Financial regulation and supervision in the EU after the crisis’, *Journal of Economic Policy Reform*, July 2013, 16:1, 17-30

A similar battle happened on the European Market Infrastructure Regulation (EMIR, passed in March 2012). Another one is going on regarding the revamp of the 2007 Markets in Financial Instruments Directive (MiFID II), which aims at fixing resolutely the opacity of over-the-counter (OTC) trading. The House of Lords published a particularly critical report in July 2012¹⁷, and in June 2013 the UK obtained the inclusion of a non-discrimination clause drafted as such: no proposal from any regulator should *'directly or indirectly, discriminate against a member state... as a provision of investment services and activities in any currency'*.¹⁸

Other passed or pending pieces of legislation include the Credit rating agencies Regulation, the revamp of the Solvency Directive for insurers, the creation of European venture capital funds. On credit rating agencies, Commissioner Barnier had to withdraw under pressure in November 2011 a controversial proposal according to which rating activities could be banned under bailout circumstances. Moreover, attempts to create an EU public rating agency throughout the parliamentary discussion failed.

These very technical issues do not arouse as much interest and as many sharp reactions by EU politicians and policy-makers as banking regulation does. There is nevertheless the perception that the City does not always defend its interests for the right reasons. A former banker and an advocate of tighter financial regulation who is an MEP remarked:

'Things look different from banking regulation when talking about financial regulation. I'm eager to see what will be London's position on the current discussion about shadow banking.'

C. The legal disputes around financial supervision

The EU also responded to the pre-crisis weakness of supervision and to the inadequacy of nationally-based supervisors by creating a European System of Financial Supervision made of four new bodies, which started to operate in 2011. The main innovation is the European Systemic Risk Board in charge of macro-prudential supervision. It is chaired by the President of the ECB, with the Governor of the Bank of England as his First Deputy, and composed principally of central bank governors. It can issue early warnings and recommendations to policy-makers. In parallel, three micro-prudential supervision agencies were created for banking (the EBA based in London), insurance and pensions (EIOPA

¹⁷ House of Lords, European Union Committee, 'MiFID II: Getting it Right for the City and EU Financial Services Industry', 10 July 2012,

<http://www.publications.parliament.uk/pa/ld201213/ldselect/ldecom/28/28.pdf>

¹⁸ Editorial 'A good day for Britain in Europe', *Financial Times*, 18 June 2013,

<http://www.ft.com/cms/s/0/aa65c53a-d810-11e2-9495-00144feab7de.html#axzz2bST1N6tH>

based in Frankfurt), and securities and markets (ESMA based in Paris). These bodies draw on existing ‘Lamfalussy’ committees, which lacked legal and budgetary autonomy and had few teeth to take on national regulators.

On this debate, not only the UK, but France and Germany resisted too large transfers of supervisory powers from national to European bodies.¹⁹ The new EU agencies still depend a long way on the judgement of national actors, hence the weakness of the EBA’s stress tests on banks. The UK government has been particularly pro-active, and successful, in combatting any extension of the EU watchdogs’ reach. This has been visible on three cases:

- **LIBOR:** After the manipulation scandal, the European Commission was thinking about handing the oversight of LIBOR (London inter-bank offered rate) to the ESMA based in Paris. The UK Treasury launched an intense lobbying campaign in Brussels against this move. In September this year, an amended version of the proposal for a regulation on ‘indices used as benchmarks in financial instruments and financial contracts’ dropped the Commission’s initial idea.²⁰
- **Short-selling:** at the same moment, the European Court of Justice issued a negative preliminary opinion on the capacity of the ESMA to ban short-selling of financial instruments. The opinion is yet to be endorsed by the Court in its final judgement.²¹
- **Clearing houses:** in February 2012, the UK challenged an ECB’s policy initiative according to which large chunks of euro-denominated business should be located in the Eurozone. Judgement is still pending.

For some, the resolution of these disputes will prove a key test to the capacity of the UK to defend its interests against a background of deeper integration in the Eurozone. Yet others tend to relativize the issues at stake. A member of the Dutch Parliament said he believed the clearing house issue was more exceptional than representative of a broader trend. A Brussels-based financial sector expert observed:

‘On the clearing houses dispute, the Court of Justice is likely to rule in favour of the ECB. The UK should not cry foul: this is an inevitable result of the UK not being a member of the Eurozone.’

¹⁹ Quaglia, L (2013), *ibid.* p.8

²⁰ Barker, A. ‘Libor control to remain in London’, *Financial Times*, 11 September 2013, <http://www.ft.com/cms/s/0/137c2e5e-1b0c-11e3-b781-00144feab7de.html#axzz2gSIZ5cEX>

²¹ Barker, A. ‘UK wins backing on clash with EU over short selling rules’, *Financial Times*, 13 September 2013, <http://www.ft.com/cms/s/0/93ed1ea2-1b86-11e3-b678-00144feab7de.html#axzz2gSIZ5cEX>

D. Financial transaction tax

Though not directly linked to the regulatory agenda, the FTT takes a significant part in the current UK-EU tensions. After the G20 failed to agree on a global tax in 2010, the European Commission introduced her own proposal in 2011. By late 2012, 11 member states agreed to implement the tax on enhanced cooperation basis.

The decision sparked controversy, notably because of the 'residence' principle suggested by the Commission's proposal, which would impact on trading places in non-participating countries such as the City. In April this year, The British government, supported by Luxembourg, launched a legal challenge against the tax. In September, the legal service of the Council of the EU deemed that the tax proposal infringed on EU treaties and was discriminatory against non-participating member states.

However, critiques also come from inside the eleven. In July, French finance minister Pierre Moscovici voiced concerns that the tax could threaten the competitiveness of the Paris trading place and called for a substantial revision of the Commission's proposal. According to the French financial markets authority, transactions have fallen by 15 to 20% since France introduced her own FTT last year.

The German view is that the FTT will stay for political reasons but that it will be minuscule in its effects. A lot will depend on the outcome of coalition discussions in the wake of the September elections. In June 2013, a prominent German official commented:

The future of the FTT depends on the German elections (and by implication the SPD attitude). Mrs Merkel cannot go to the Bundestag and say she has abandoned the whole idea. But there is plenty of pressure within the EU and Germany (let alone the City of London) for a substantial revision of the Commission proposal. The eventual impact of the FTT will probably be quite small.

By any means, there has never been such thing as a Eurozone block supporting the FTT and targeting it deliberately against the City's interests. A senior Dutch official was very critical and sceptical:

'We attached three conditions which were not met and therefore we did not join the enhanced cooperation. First, revenues flowing back to MS rather than feeding the EU budget; second, pension funds exempted; third, no harm to competitiveness.'

E. To sum up

It is difficult to draw any clear-cut conclusion from this overview of very diverse and complex pieces of regulation and institution-building. If anything, it is unfounded to claim that EU legislation in the field of financial services has been geared systematically against the City's interests. Not only should the EU's action be understood in the context of G20 recommendations and, hence, fall very often in line with British interests. An active presence in Brussels might also be enough to prevent any slippery slope towards anti-London legislation. As Nicolas Véron commented: *'The EU system contains sufficient checks and balances for a bad policy proposal to be generally amended or rejected, at least as many as most parliamentary systems including the US congress and the UK itself.'* Resort to the ECJ might be a powerful instrument; however, it comes at the cost of portraying the City and London as anti-EU-regulation.

3. Perceptions of the Eurozone crisis, the role of the City and the UK's attitude

Interviews with Continental policy-makers and experts revealed an ambivalent attitude towards the City's weight in the European economy and the British stance over the EU. The current uncertainty surrounding the future of EU-UK relationship often fuels negative reactions, from disappointment to blame. And yet, elites in the main Continental partners of the UK remain convinced of London's importance in the EU regulatory debate.

We find **four leading trends** in the opinions of national leaders in France, Germany, the Netherlands and Sweden:

- A debate focused on the Eurozone crisis
- A strong consensus against financial capitalism
- Growing awareness about the costs of financial regulation
- Mixed feelings regarding the City

A. A debate focused on the Eurozone crisis

Most interviews revealed the extent to which the management of the Eurozone crisis and the reforms it has propelled have absorbed the political energy of governments and leaders on the Continent. A major difference from the situation three years ago, the Eurozone crisis has lessened the focus on banking and financial reform.

In France: a centralised banking union is a priority for French policy-makers, a 'federalist' move that goes beyond traditional French intergovernmentalism while remaining rather unnoticed by the public. This is also not unrelated to the fact that Germany would lose its veto right in the ruling institutions. A high-level financier in Paris stressed that the banking sector strongly supported this view, and that the City would increasingly be seen as an off-shore centre if the UK did not join. Conversations with two senior members of the French Parliament were focused on the governance reforms in the Eurozone and the shape of future institutions. Both displayed a high degree of confidence in the ability of Eurozone member states to pool further sovereignty and to build a strong and centralised regulatory framework at EU level. Finally, interviews with governmental advisers stressed the hope placed in a recent Franco-German communication, which opens the door to a wider agenda of policy coordination among Eurozone governments, covering issues such as unemployment, wages and social

protection.²² This corresponds to a long-standing French claim according to which a genuine level playing field between export-based and consumption-based economies should prevail. The EU should not only police excessive increases of wages and labour costs, but also tackle too weak demand and social dumping.

In Germany: German politicians and governmental advisers express a lot of concern about the legacy of the debt crisis. There is widespread awareness that the debt of Southern countries will have to be either mutualised or written off. However views diverge depending on the political position. An influential SPD member of the Bundestag said:

‘Eurozone integration is inevitable. Germany will do whatever it takes to keep the euro, but it is going to be very costly for Germany. I am in favour of a Debt Redemption Fund. And I think we should use the interest bonus that Germany is getting from money attracted to Germany as a safe haven, as a contribution to helping the South recover.’

This MP however conceded that the debate was very confused in Germany, and that few of his colleagues had a clue about the banking union and what it would take to put the Eurozone back on its feet.

On the CDU/CSU’s side, Angela Merkel has been adamant that she would reject Eurobonds or any other form of debt mutualisation in the near future. However, the incoming grand coalition in Germany could possibly lead Angela Merkel to adopt a more lenient tone on a new restructuring of Greek and, possibly, Portuguese debts. Some of the SPD claims regarding the completion of the Banking Union will also probably be given more consideration. Her attitude towards crisis resolution is otherwise likely to remain unchanged, with a particular insistence on structural reforms underpinning competitiveness. Senior German officials stressed the importance of new forms of coordination in the EU:

‘Eurobonds would only take away necessary market pressure to get countries to act. We need an intelligent mix of market and peer pressure needed. On competitiveness the Germans are strongly committed to the idea of legally binding contracts between member states to cover issues like pensions and labour market reform. Germany and Britain strongly share this commitment to enhance competitiveness. But Britain does not want to submit itself to European economic policy coordination.’

²² ‘France and Germany, Together for a stronger Europe of Stability and Growth’, 30 May 2013, http://www.bundesregierung.de/Content/DE/Anlagen/2013/05/2013-05-30-dt-frz-erklaerung-englisch.pdf?__blob=publicationFile&v=3.

They added:

'For stronger economic coordination a bigger debate is needed about how EU wants to live and earn its money in the future. We need stronger consensus around policy priorities important for enhancing Brussels legitimacy and effectiveness. Will Britain join such a debate about future economic model and path to prosperity?'

In the Netherlands, the EU as such has been increasingly seen as a source of problems; hence high-level politicians seem to adopt an extremely cautious approach to integration in the Eurozone. Opinion polls reveal that Europe is one of three drivers of public lack of trust in politics alongside Islam and impotence over the economy, an attitude that is not helped by the severe economic downturn experienced for over a year. Interviews with members of the Government revealed widespread anxiety about the situation in the Eurozone, and the ability of struggling EU member states to undertake key reforms. A senior Dutch official took in a particularly harsh anti-French stance, fearing an increasing domination of the Paris protectionist instincts and the potential dreadful consequences if French banks went bust.

As a consequence, Dutch leaders are wary of any move towards closer integration that would mean further risk sharing. They were initially very critical of the Banking Union, but support it strongly today because of the new insistence on bail-ins, which makes it less likely to see it slipping into a transfer union. They insist that they do not want the Single Market to become a collateral victim of integration in the Euro Area.

In Sweden, the debate about the way forward for the Eurozone has obviously much less intensity than in core Continental countries. Swedish members of government, parliament and experts stress unanimously that there is no appetite at all, neither among the elite, nor among the public for the country to adopt the euro (80% of Swedes are against). This attitude logically explains a distant feeling towards the ongoing reforms of economic governance. As the head of the Swedish Institute of international affairs, Anna Jardfelt, put it:

'Eurozone countries having to send their budget to be ratified by the Commission is not something Sweden would be interested in'.

As a result, there is similar unease in Stockholm as in London with the idea of a Eurozone-led EU. Ana Jardfelt noted that Sweden tried to keep all options open by maintaining a strong relationship with the US and the UK, and fostering Nordic and Baltic cooperation. She suggested that this attitude was shared by Finland despite being a member of the Eurozone. A high-level Swedish official observed:

'Some (inc. France) want to strengthen Eurozone integration for political reasons – to create a hard core.'

A social-democratic leader also expressed concern that the German SPD was *'too federalist'*.

This critical stance, nevertheless, is tempered in three ways. First, although Britain is a more natural partner, Sweden is closely integrated with Germany economically. Secondly, there is a sense that Stockholm must remain closely engaged in the banking union project. The same leader commented:

'On the banking union, the government has closed the door a bit too hard'.

Thirdly, there is widespread acceptance of the costs of EU membership and the view that the EU is a much-needed vehicle to boost growth and jobs remains consensual. Sweden's priorities for the EU consist in deepening the Single Market and completing trade negotiations with the US. Determination to advance these projects and to avoid discrimination against non-Eurozone members will drive Swedish elites' attitude towards the EU in the next few years. As a result, Swedish elites fear that a UK referendum, and a possible exit from the EU, could reactivate public opposition to Sweden's EU membership. The Dutch elites share similar fears despite their position as one of the founding Six.

Poland offers the very interesting picture of a non-Eurozone member which has become a fervent supporter of EU integration. Warsaw does not share London's and Stockholm's concerns about discrimination, and is keen to demonstrate its pro-EU credentials and to place itself at the core of EU policy-making by closing ties with Berlin. The UK lost influence in Warsaw also due to its tough and inflexible stance on the EU budget at the beginning of 2013.

The desire to join the euro has been made clear on several recent occasions by the Polish government, although there is a sense that the country needs to undertake more reforms. A third of Poles want to join the euro, a relatively high level given the poor performance associated with the single currency at present in the aftermath of the Eurozone crisis. In March this year, Prime Minister Tusk announced a referendum on the euro by 2015. He stated that *'by the end of the decade, being in the euro will mean being in the European Union'*.

That being said, Poland's priorities for the EU remain UK-friendly. According to informed economic and political experts based in Warsaw, free-market instincts still dominate among the governmental elite, hence their strong support to the Transatlantic Trade and Investment Partnership (TTIP) and to deepening the Single Market.

B. A strong consensus against financial capitalism

While not going into the details of member states' positions regarding the EU legislative package of financial services regulation, interviews revealed a consensus over the view that more needed to be done on the agenda of banking and financial regulation. **French** and **German** interviewees in particular insisted on their determination to tame the risks posed by the financial sector and by 'too big to fail' banks for tax payers and the real economy. Such an attitude also seems to be a key component of the discourse of political parties, especially on the centre-left. A Social-democratic spokesperson in the Bundestag said:

'The critique of financialisation is central to the SPD's political position. The general framing of our position is that we do not want to live in a market driven democracy, but rather in a world where markets are properly/democratically regulated. The FTT is therefore a crucial symbol of political differentiation for us.'

Another SPD Bundestag member went on:

'There is a consensus in Germany that tighter regulation is necessary to stabilise financial markets because unregulated markets end up costing the taxpayer much more. In particular, high frequency trading is disconnected from the real economy and serves little productive purpose.'

The electoral dimension of an anti-finance stance was highlighted in the run-up to the French presidential election. In January 2012, a campaigning François Hollande saw his rate jump after declaring during his famous Bourget meeting:

'My true enemy has no name, no face, no party. He will never stand for election and will never be elected. Despite all this, he is in charge. My enemy is the world of finance.'

Such emotional charge help explain the tough stance adopted by French and German politicians on highly symbolic issues such as the cap on bonuses and the Financial Transaction Tax. These were seen as unavoidable in order to tame popular anger and to show that politics still had a grip on finance. A diplomat at the Quai d'Orsay in Paris observed that an agreement had to be found as quickly as possible since the FTT was a political issue.

Attitude towards banking and financial regulation seems to be more relaxed in **Poland**, where the financial sector is relatively small in terms of share of GDP

(4.6%) and share of employment (3.8%) compared to Western European countries.²³

Stakes are higher for **Sweden** and **the Netherlands**. The Dutch, in particular, have been coming to terms with the burst of a housing bubble, which occasions, like in the UK, a lot of deleveraging. As a senior governmental figure commented:

'In the Netherlands, rebalancing away from financial services is already well under way. Dutch had four international banks. Two are now state owned and contracting to home base. ABN/AMRO has been sold in part to RBS. 30,000 jobs have already been lost in Amsterdam. ING is still an international bank but ranks 40th out of 40 in size.'

The Dutch, therefore, can be seen as supporting a strong approach to bank resolution and regulation alongside the UK.

In Sweden, the need for regulation was widely acknowledged in the aftermath of the 2008 crisis, and this feeling is still persistent. A prominent leader of the Social Democrats expressed concern about tax fraud, and said that the fight against it should be an EU priority. Leading EU expert Anna Jartfeld observed:

'The public opinion is against the banks. Interest rates in Sweden are enormously low. The banks are earning increased amounts of money due to this. But the public are confident that the finance minister is protecting Swedish interests and financial recovery as well. This is acknowledged by the left too.'

C. Growing concern about the impact of regulation on the real economy

The politically attractive idea that it is right to regulate and tax banks and the financial sector does not mean that *actual* regulation should stifle the financial sector. As the recent **French** U-turn on the FTT shows, governments have a more selective approach in practice than in rhetoric. The debate about the nature and the level of capital requirements to be inserted into CRDIV saw the UK adopt the most demanding attitude, while the French and German governments were wary of any negative impact on the financing of the economy.

Unlike in the UK, none of our interviewees expressed the idea that the financial sector was a key driver of their country's future competitiveness. But the current context of lending shortage and financial polarisation in the Single Market is a major concern. A senior regional **German** politician, though a principled supporter of the FTT and regulation, admitted:

²³ TheCityUK, 'Key facts about EU financial and related professional services', August 2013

From a Hamburg perspective, I have concerns about EU financial regulation. No one understands it, while it has a crucial impact on sectors which are important to us. For example, Basel III rules have had a damaging impact on Commerzbank and its activities in shipping finance, which are a key Hamburg interest. We need to slow down the decision making process so that we all have space to think things through better'

In **Sweden**, the nascent banking union is viewed with suspicion. The rationale of a strong single EU rulebook and of better resolution mechanisms is well understood, but the mutualisation dimension is not welcome. As a high-level official commented:

'The banking union is a difficult issue for Sweden like for the UK. The proposed creation of a crisis resolution fund to which Sweden would contribute but gain no guarantees for its own banks is a problem.'

The recent **Dutch** 'subsidiarity review' said a lot about Dutch fears and problems with EU policy-making, but banking and financial regulation did not occupy a major place in the document. However, among the seven points listed for action in the section 'economic and monetary affairs', most of them touched upon tax issues such as the FTT and the proposed Common Consolidated Corporate Tax Base proposed by the Commission in 2011. Like London, the fear in The Hague is one of French-inspired harmonised tax framework that would damage competitiveness.

D. Mixed feelings towards the City and the British government's discourse on finance

Straight after 2008 crash, the City was designated by many, including in the UK, as one of the main culprits for the resulting economic and fiscal mess. It was by then hardly conceivable for the British government to ask for safeguards. Yet the debt crisis and accelerating integration in the Eurozone has prompted a new and defensive attitude against EU initiatives, despite the fact that the UK still shares concerns with Continental partners about getting banking and financial reform right. The dominant view in other EU member states is nevertheless that there is no alternative to the City being part of a highly regulated Single Market on financial services. But some governments display more understanding and are more ready to help than others.

Unsurprisingly, the toughest attitudes are to be found in **France** and on the **German left**. In Paris, governmental advisers warn against the illusion for the UK to claim being part of the Single Market while asking for specific safeguards for its financial sector. A source close to François Hollande captured the mood:

'If the City wants to be the financial centre of Europe, it has to be part of the regulatory framework. If London convinces that they are tough on the regulation of financial services, the spirit of consensus will come back. Otherwise, the UK makes the choice of becoming an offshore centre.'

The view was strikingly similar in Berlin, where an influential figure in the SPD observed:

'The more the City of London is seen to equal the UK, the more difficult it will be to get a fair hearing for the UK's concerns about the EU, some of which many Germans share.'

Most interviewees in France and Germany argued in substance that they had some sympathy for the domestic political constraint faced by David Cameron, but that it was not their problem. An experienced member of the Bundestag said:

'It's for the UK to make up its mind. If the UK were to leave the EU, the economic damage for Britain would be considerable.'

In **Brussels**, experts and policy-makers tend to share the view that London's concerns are exaggerated, and that the consequences of a UK exit would do more harm to London than to the Continent. The Bruegel specialist of banking regulation Nicolas Véron observed:

'The key question in EU negotiations now is: is the UK a member of the European Union? A strategic shift happened when Osborne talked about 'the remorseless logic' of fiscal integration in the Eurozone (July 2011). Before then, the UK's stance was to participate in all EU discussions and influence them. Under the "remorseless logic", the UK excluded itself from some of the most important European financial policy discussions.'

At a Policy Network event in July 2013, Internal Market Commissioner Michel Barnier insisted that the EU was no '*pick and mix*' organisation, but had conciliatory words towards the City:

'I have taken UK objectives into account, not by accident but by design' [...] Eurozone member states do not vote as a block.'

He also stressed that the banking union's single rulebook made sense for UK banks, and that the EU needed to speak with one voice during the negotiations on the TTIP. He finally characterised the current situation as a '*learning process, a period of flux*', thus highlighting the awareness in Brussels that British sensitivities needed careful treatment.

Financial expert at the CEPS think tank Karel Lanoo was particularly blunt:

'The UK question has become an obsession, which has nothing rational. Everyone thinks that the Brits need to be accommodated. The Commission already listens to the UK all the time. The idea that Michel Barnier is anti-City has been "cooked up" by the media, but it is simply not true. That Paris and Frankfurt defend their interests is normal, but there is no deliberate project to undermine the City. [...] If the British vote to go out, I have no doubt that the French and the German will impose non-tariffs restrictions against the UK straight away, especially on financial services. The French would do everything to make Paris financial centre grow.'

Surprisingly, greater understanding for the UK's worries was displayed by an influential Green MEP:

'In the banking and financial regulation debate, Paris and Berlin/Frankfurt clearly intend to weaken the City. I am very critical of this attitude. This is not a way to behave among Europeans. Stuttgart is specialised in cars, as London has been in finance for several centuries. We should not question that.'

The tone is clearly accommodating in **Stockholm**, the **Netherlands**, and in the **German** centre-right. The Swedish elite display genuine concern for the City's competitiveness and understand the pressure felt by UK policy-makers. A rising figure in the Parliament said that the City of London was one of *'Europe's jewels of the crown'*, hence EU regulation in financial services did not only matter for the UK. A leading EU affairs expert assured that there was widespread recognition among Sweden's elite that *'the City of London is keen to ensure it does not lose out.'* The most striking comment was made by a high-level policy-maker:

'On financial regulation, we need to return to the spirit of consensus decision making which has been really lost.'

In Berlin a senior figure in the Chancellery also had conciliatory words towards the current British unease:

'Mrs Merkel sympathises with the main concerns of the Cameron speech. She is up for pursuing a common reform agenda within the EU on the agenda he outlines. We are very critical of too much "life-style" regulation coming out of Brussels. Important that EU looks at its core business in times of crisis and do whatever it can to promote economic development.'

Although financial services and the banking sector were not explicitly mentioned as the EU's 'core business', such a statement implied that the British government could make their case more efficiently in Berlin if they managed to convince that the City is a force for the long-term competitiveness of the EU.

Arguably, one of the most objective and compelling comment on the UK's attitude on financial regulation was delivered by an official at the European Council in Brussels:

Financial integration in the euro area might bring about a rift in the financial Single Market in the long term, hence UK worries are justified. Today, UK demands of special care are largely accommodated. But what will happen in 20 years?

E. To sum up

Continental and Nordic leaders and experts tend to relativize the 'British problem' by insisting on the fact that the necessary steps forward to make in the Eurozone do not impact on EU regulation in the banking and financial sector, and, generally speaking, on the Single Market. For them, as long as the UK will stay on board, there is no reason for London to worry excessively given the numerous checks and balances of the EU decision-making process. The UK will always be able to forge ad hoc coalitions with like-minded partners who are worried, too, about the competitiveness of their financial sector and the attractiveness of their tax regime. That the Eurozone will necessarily develop into a more cohesive entity remains a minority view today. As a result, London is blamed for forcing itself into a corner unnecessarily, and the idea that EU treaties should be changed to come to terms with this new situation is viewed with suspicion.

4. Euro area integration, the UK's referendum, and the scope for EU reform

David Cameron's speech in January 2013 contained three major themes:

- The potential discrimination of non-euro countries by the Eurozone;
- The over-reach of EU regulation onto national policy-making;
- The lack of legitimacy of EU processes and the need for a greater role of national parliaments.

The Prime Minister spelled out an agenda for EU reform allowing greater flexibility and accountability of EU policy-making to national parliaments. Indirectly, such reform would aim to reconquer some aspects of sovereignty considered as lost over the successive waves of new EU treaties since the Single Act signed by Margaret Thatcher, albeit, contrary to the common perception, there was no mention in the speech of repatriation. Ironically, and as former MEP Richard Corbett has stressed²⁴, the desire to return to unanimity on a series of issues runs against the decisions made with the consent of British governments, both Conservative and Labour, since the 1980s. Yet circumstances have changed, and as David Cameron carefully underlined, he is looking for 'a better deal for Europe', not only for the UK.

This section sheds light on how policy-makers and leaders in EU partners view the future of Europe and how they have welcomed the 'Europe Speech'. It examines successively:

- The prospect of further integration in the Eurozone
- The UK's referendum and demands for renegotiation
- Attitudes towards EU democratic reform

A. Euro area integration: towards a treaty change?

At the end of 2012, Presidents Barroso and Van Rompuy laid out respectively their 'Blueprint' and 'Roadmap' for a 'genuine Economic and Monetary Union' upon the request of national leaders. Both documents mentioned the possibility, in the medium to long-term, of common debt issuance and of a fully-fledged fiscal capacity for the Eurozone. These documents acknowledged the rationale of greater sovereignty transfers and resources pooling for euro-in and 'pre-in' countries. They translated the vision of a 'four-fold' economic, monetary, fiscal

²⁴ Foreign Affairs Committee, 'Written evidence from Dr Richard Corbett, advisor to the President of the European Council', 19 March 2013, <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmfaff/87/87we41.htm>

and political union put forward by many experts and policy-makers based in Brussels, as well as suggested in various speeches in Continental capitals.

It matters greatly for the UK debate to have an informed assessment of the solidity of such claims and the nature of Eurozone integration in the years to come. Is there such a thing as ‘the remorseless logic’ of fiscal integration in the views of Continental elites? What does this say about future Eurozone institutions and the bigger EU picture?

Interviews revealed significant divergences as to the way forward and unsurprising gaps between rhetoric and practice.

The **Dutch** are the ones who oppose a treaty change the most vehemently. The governing parties have taken explicit position against any new sovereignty transfer and further EU solidarity. The subsidiarity review published in June describes, for instance, the idea of a ‘shock absorption fund’ for euro area countries as a ‘non-starter’. The explanatory note²⁵ contains the following sentence:

‘NL government is convinced that the time of an ‘ever closer union’ in every possible policy area is behind us.’

Hence, as MEP Andrew Duff recently analysed, some British Conservatives misinterpret the sense of the Dutch subsidiarity review when saying that they have an ally in The Hague.²⁶ A rising Labour (PVDA) figure said that there was no enthusiasm for a treaty change in the Netherlands. A high-level Dutch official went further:

‘We want to support the UK review of balance of competences, and we have done our own initial work. Angela Merkel has promised to join in this work after the election. However our aim is not treaty change. An inter-institutional agreement on how competences are exercised is the way forward. This would spell out what proportionality means in relation to each EU competence. [...] I believe that the Banking Union can be completed without treaty change.’

The attitude in **France** is more ambivalent. The French elite have long developed a strong sense of ownership of the EU project, and tend to think that there is no

²⁵ Dutch government, ‘NL subsidiarity review - explanatory note’, 21/06/2013, <http://www.government.nl/issues/european-union/documents-and-publications/notes/2013/06/21/nl-subsidiarity-review-explanatory-note.html>

²⁶ Duff, A. ‘Why the Dutch version of the balance of competence review will not please the Brits’, *LSE EUROPP Blog*, 27 August 2013, <http://blogs.lse.ac.uk/europpblog/2013/08/27/why-the-dutch-version-of-the-balance-of-competence-review-will-not-please-the-brits/>

alternative to greater EU solidarity in the current situation, on the basis of a more exclusive and smaller Eurozone. Such a principled view was reflected by the very assertive words of a senior bank figure close to governmental circles:

'The ECB's federalism has propagated in other areas. There will be a permanent president of the Eurogroup and a Eurozone Assembly.'

A member of the finance and Europe committees in the Assemblée Nationale was equally unambiguous:

'There is a strong consensus in the French Parliament about the way forward: two-tier Europe around a Eurozone core. The Eurozone needs its own institutions, such as Euro Summits and a parliamentary conference.'

Finally, a leading EU expert at Sciences-Po said:

'The government and the Parti Socialiste avoid the word "federalism", but there is a consensus to say that there is no alternative to integration.'

Within government's circles, however, the focus is much more on practical 'small steps', in particular what can be obtained from Germany given the current balance of power. The prospect of a treaty change that would give a boost to integration in the Eurozone is deemed rather elusive, essentially for political reasons. A governmental adviser commented:

'We will do a treaty change only if we have certainty about a successful ratification process. It would be too embarrassing to fail. The risk is bigger than on the Lisbon Treaty. Stability in the Eurozone is at stake.'

A senior diplomat in the French Foreign Office added:

'The room for manoeuvre is not large. The conditions for a successful treaty change are demanding, therefore most member states are not keen on a treaty change. If David Cameron wants the revision to be validated around 2016, this will clash with the presidential election campaign in France. Also, a simplified revision procedure does not hold water when it comes to non-technical issues.'

Crucially, beyond reassuring comments over the necessity of integration, the French elite know that integration moves such as debt mutualisation or a centralised fiscal capacity, would not be easily accepted by the public. The 2005 referendum was a trauma for ruling political parties. Moreover, recent opinion surveys have revealed that the French have become as Eurosceptic as other

people in Europe.²⁷ It is therefore highly unlikely that President Hollande will sign off the launch of a revision procedure before 2017. In private senior French politicians say they are adamantly opposed to the event of a new referendum in France, which would be a 'gift to Eurosceptics'.

In **Germany**, the question is not so much about the political opportunity rather than about the legal necessity of a treaty change. The German elite do not share the French vision of an exclusive Eurozone club, but they believe that fixing the legacy of the debt crisis will necessitate a treaty change, although limited in scope. A high-level official said:

'Cameron's assumption that that there will be treaty change is almost certainly correct. I am confident that a number of legal routes exist to get through changes in treaties, depending on political constellations. We are not speaking about rewriting the Treaties but making targeted changes or submitting an addendum. It might extend beyond a limited treaty revision under the simplified revision procedure (on the model of the treaty facilitating the establishment of the European Stability Mechanism); but Germany does not want a general treaty revision.'

In other words, it might be necessary to organise a convention in the likely event of a treaty change, but Germany would then attempt to make sure that its mandate would not be open-ended and remain within strictly defined boundaries.

On the content of this revision, he added:

'The revision should focus on the key areas where the crisis has shown the existing arrangements to be deficient: fiscal rules, banking union and competitiveness.'

This vision is not antagonistic with the French one of a fiscal capacity and exclusive institutions, but it suggests other priorities, such as more centralised control over member states' budgets, banks and policies. Any compromise, therefore, might prove difficult to hammer out and is likely to be viewed as half-way progress.

As pre-election analyses highlighted, it seems, nevertheless, that the German are progressively coming to terms with the reluctance of their partners, not the least the French and the Dutch, to engage in a treaty renegotiation. In early

²⁷ According to Pew Research, support to the EU has fallen from 60 to 41% in France between 2012 and 2013, the most spectacular drop in the EU, see 'The New Sick Man of Europe: the European Union', 13/05/2013, <http://www.pewglobal.org/2013/05/13/the-new-sick-man-of-europe-the-european-union/>

September, German officials met in Brussels were displaying a particularly cautious attitude:

'In terms of timeline, the end of 2013 will be marked by the definition of what is exactly needed for an improved framework of economic coordination in the Eurozone. By December, we should have some visibility about the need for treaty change.'

This possible timeline was confirmed in **Brussels** by senior advisers at the European Council, who also emphasised the possible rise of an objective alliance between the UK and Southern European countries like Italy and Spain very keen on treaty change. Indeed, Southerners are prepared to buy the British argument on flexibility. Greater differentiation between euro-ins and euro-outs would lead to more significant risk-sharing and mutualisation in the Eurozone, a direction which corresponds to their interests. They observed:

'Enrico Letta's visit to David Cameron has gone unnoticed, but he was actually offering his support. Southern European countries see treaty change as desirable unavoidable for the Eurozone, and they are ready to accommodate the UK's demands. Countries like France and the Netherlands are reluctant for political reasons and will not help the UK'

Pro-EU voices at the European Parliament, as one leading Green MEP put it, also think that there is a strong case for treaty change:

'They will obviously be a treaty change for the Eurozone, in which case all type of demands will be legitimate, including those arguing for greater EU power. I am for instance strongly in favour of harmonising corporate and wealth taxes.'

The Polish government is likely to support any attempt to bring about more efficient governance in the Eurozone while leaving the door open to 'pre-in' countries. As announced by Foreign Minister Sikorski's famous 2011 speech calling for greater German leadership in Europe, Warsaw would wholeheartedly support any initiative from Berlin that would make EMU more sustainable. Poland did not hesitate to sign the Fiscal Treaty in December 2011, whereas some other Central European governments had more scruples. Furthermore, an influential EU expert based in Warsaw downplayed the risk of exclusive Eurozone institutions:

'France is in trouble economically. Germany will dictate the pace. We feared Sarkozy's style, but we are much more relaxed in the current context'

Finally, there is relative indifference in **Sweden** about the Eurozone debate. If anything, the Swedish elite warn against the tendency towards futile debates and excessive legalism, both in the UK and in Eurozone countries.

As a result, the assumption of UK leaders that Eurozone leaders are determined to move ahead with treaty change need to be qualified. It might well occur as a way to secure the nascent Banking Union and to allow a deal between the German insistence on reform contracts and the French plans for a Eurozone fiscal capacity. But a simplified revision procedure would not leave much scope for anything else. Some argue that a new deterioration of the economic climate and renewed attacks against sovereigns might give the needed external impetus for further integration more quickly than expected. But one should not mix up between settling the legacy of the crisis and building up stronger institutions for the Eurozone. The former task could be 'limited' to one-off measures, such as debt write-offs and a massive investment plan for struggling countries.

B. Reactions to the UK's referendum announcement and demands of safeguards

Regardless of the speed and the depth of integration in the euro area, a key aspect of David Cameron's speech was the announcement of a referendum by 2017 and the demand for safeguards for non-euro countries, especially in the financial sector. As was shown above, Continental leaders like to repeat that the EU is a package, from which it is impossible to pick-and-choose. Nevertheless, many of them understand the need for concessions to the UK and euro-outs if an implosion of the EU is to be avoided.

The view that the EU would be better off if the UK left did not come up in any of the interviews. However they also revealed that any idea of, either repatriation, or return to unanimity on issues decided on by qualified majority voting (QMV), triggers overwhelmingly negative reactions. Symbolic arrangements, such as non-discrimination clauses and limited opt-outs, could be contemplated.

Government officials were particularly firm in **Berlin** and **Paris**. The dominant feeling was well captured by a prominent German MP:

'We want Britain to stay in the EU, but we're not prepared to be blackmailed.'

In that respect, an SPD-CDU grand coalition is not good news for David Cameron. Angela Merkel has displayed sympathy for the British Prime Minister's concerns, but this is not the case among the SPD.

The main difference of approach between Berlin and Paris might be that the latter is allergic to any form of special treatment for the UK on the ground that there is no justification for it. Such a view was explained by a diplomat at the Quai d'Orsay:

'France is open in principle and ready to look at British demands. But looking at the issues one after the other, the negotiation looks pretty difficult. The UK can't get all the advantages of the Single Market without the constraints. Non-discrimination is the sense of the treaty. A Eurozone regulation that would discriminate non-euro area members would not be possible.'

In Paris, a senior governmental adviser was equally categorical:

'The principle of repatriation is not acceptable since it would lead to an inflation of individual requests and to dismantling the Single Market. Regulatory dumping is another form of protectionism. France could also make specific demands.'

At a bilateral meeting between the two leaders in August, François Hollande made David Cameron understand that he would not help him greatly regarding on his 'domestic agenda'.²⁸

This principled attitude is shared by many **Brussels** insiders. A prominent Green MEP declared:

'I am a resolute supporter of British membership, not the least for cultural reasons: British MEPs are often the ones who work the hardest and know best their dossiers. However, I am against any kind of unilateral renegotiation. That is not Europe. One cannot have the best of both worlds and ask permanently for safeguards based on national interests. EU law should apply to all members'.

European Council officials insisted as well on the need for the UK to frame its demands from a multilateral perspective. Still, they disagreed on the necessity to address the UK question by the means of treaty change. One thought that a policy reform agenda could do a lot to accommodate UK demands. But his colleague commented:

'The renegotiation genie is now out of the bottle. It is too late for a policy reform agenda. We will need a treaty change to address the UK question'

²⁸ Hennessy, P. 'François Hollande: France will not help David Cameron with EU reforms', *Daily Telegraph*, 03/08/2013, <http://www.telegraph.co.uk/news/politics/david-cameron/10220581/Francois-Hollande-France-will-not-help-David-Cameron-with-EU-reforms.html>

The German government is keen on displaying openness, albeit the scope for negotiation is not very large. A senior official in Berlin said:

'Germany is sympathetic to British demand for assurances of non-discrimination in single market given Eurozone integration. However this cannot extend to a reversion to unanimity over financial services regulation. [...] In negotiations on a new treaty, I could see the inclusion of a new clause to protect the UK against discrimination as a Euro out. Some limited opt outs might be possible, i.e. not a general repatriation of powers. Germany might be prepared to countenance the abrogation of some secondary legislation.'

The UK's EU membership enjoys considerable support in the **Netherlands** and in **Sweden** since it is seen as a bulwark against Continental anti-liberal instincts. As a result, the announcement of a referendum, which most officials believe to be very risky, was greeted with dismay.

A high-level Dutch official delivered a particularly harsh comment:

'We are making the planning assumption that Britain will leave the EU. We have no sense that the British government has any strategy. Short term opportunism seems the order of the day.' [...] If the UK referendum is lost, there will be demand for an in-out referendum in the Netherlands.'

A senior official in the Swedish Trade Ministry was more sceptical:

'UK is on a dangerous path as it is hard to see a way out. Cameron wants a change of the Lisbon treaty. Not many other states are willing to enter into treaty changes. It is unclear what opt-outs are wanted.'

Hence, how far the Dutch and the Swedes will help David Cameron in his renegotiation attempt is surprisingly unclear. The Dutch subsidiarity review conducted by late 2012 and early 2013 found that EU legislation did not respect the principles of subsidiarity and proportionality in a number of areas, from social and environmental policy to taxation and criminal law. An MP in The Hague commented:

'Key issues for the future of EU policy-making are service liberalisation and free movement. Both have lots of downsides. Right-wing populist Wilders opposes Bulgarian and Romanian free movement, and the left-wing Socialist party demand the reintroduction of work permits. PVDA leader Ludovic Asscher asked for migration to be discussed at EU level.'

Yet these demands are more a call for reform, as the conclusion of the subsidiarity review highlighted:

NL is not aiming at treaty change or opt outs, but at an inclusive process to revise existing legislation and reach political agreement on future priorities for legislation’.

A high-level Swedish official indicated nevertheless that Sweden would make some proposals soon:

‘On Euro-in/Euro-out question, there is the need for minority safeguards but no firm Swedish proposals yet.’

Against this very blurred background – which has also to do with the fact that British requests have not been formulated in a more detailed way – the possibility of informal arrangements, or symbolic concessions, outside the remit of the treaties should not be under-estimated. In June 2012, François Hollande did not manage to ‘renegotiate’ the intergovernmental Fiscal Treaty, one of his key electoral promises, but he obtained a Growth Pact. David Cameron might also face a refusal to open the EU books again if there is no need for it in the Euro Area. But the feeling that the UK membership is at stake and that concessions need to be made might eventually prevail.

Against this background, a recent blog piece by LSE professors Damian Chalmers, Simon Hix and Sara Hobolt suggested that a political declaration could achieve the same results as a renegotiation.²⁹ The authors wrote:

‘Reforms concerning safeguarding the interests of non-Eurozone members can be put in place by either a Joint Declaration of the Council, Parliament and Commission, or by a European Council Declaration. For example, there could be a Joint Declaration that there would be no Council common position adopted at first reading until national parliaments have given the necessary assent or if a member state believes a matter should be referred to the European Council because key strategic interest is at stake.’

²⁹ Chalmers, Hix, Hobolt, ‘Designing a new UK-EU relationship and how it could be achieved’, LSE European Politics and Policy blog, 12 June 2013, <http://blogs.lse.ac.uk/europpblog/2013/06/12/new-eu-uk-relationship/>

C. Attitudes towards an agenda of EU reform

There is much more sympathy on the Continent for the overall idea that the EU needs reform in order to get both more effective and more legitimate. This is certainly the aspect of the Prime Minister's speech that was the most well-received in other EU capitals. Dissatisfaction with 'Brussels' is widespread be it in the Eurozone or outside. Interviews confirmed that there is ample room for consensus regarding the role of the European Commission and of national parliaments and, and this does not require treaty change. Instead, it goes through a reform of how EU institutions work and interact with each other.

- A more focused EU, a more strategic Commission

Several interviewees agreed on the need for the EU to focus on the most strategic and a European Commission reshuffled along these lines. Explicit support to this agenda has already been given by the **Dutch government**, as suggested by the explanatory note accompanying the results of the 'subsidiarity review':

'Underlying objective of this initiative is creating a European Union that is more modest, more sober and at the same time more effective.'

French, German, and Swedish government officials shared the view that the Commission and the European Parliament get involved in too many areas and do not focus adequately on the implementation of directives. In **France**, a senior governmental adviser said:

'We need a Commission focused on key issues. For instance, the Commission gets it wrong with China. It is also unable to work with the European Investment Bank for a coordinated investment strategy. It should not have 28 portfolios, but 5 to 10.'

New initiatives for reform of the Commission would be widely welcomed in Paris, in the spirit of the Franco-British initiatives that took place during the Convention on the Future of Europe. The Lisbon Treaty states that the number of commissioners should be brought down to two-thirds of member states in 2014. However, decision was made to change this provision at European Council summits in 2008 and 2009 after the negative Irish vote on the treaty. In May 2013, the European Council decided to re-conduct the 'one Commissioner by country' rule until 2019. Therefore, any talk about a more strategic Commission from 2014 onwards should focus on other options, such as the possibility of pairing junior and senior commissioners on a single portfolio, or to merge some directorates.

The political elite in **Berlin** share British concern about the intrusive character of EU law, and the feeling of alienation among the voting public vis-à-vis Brussels. A member of the Bundesrat recognised that:

'We're not very happy with the way Brussels works and what comes out of the system. We have thought about calling for a moratorium on new initiatives, at least until the Euro-crisis is properly sorted.'

Strikingly, a senior governmental adviser said:

'There is too much "life-style" regulation coming out of Brussels. It is important that the EU looks at its core business in times of crisis and does whatever it can to promote economic development. Germany might be prepared to countenance the abrogation of some secondary legislation'

Unsurprisingly Brussels insiders have a more balanced view. An expert at the CEPS think tank said:

'Of course, the Commission could do less and interfere less in national policy-making. The UK and the Netherlands have a point. But sometimes things just happen as part of the regulatory process, and Commissioners are not blame. For instance, Barroso was furious when he heard about the olive oil controversy, or, recently, about a project to regulate hairdressers shoes! This is a procedural rather than a political issue. Overall, the impact assessment procedure has been improving.'

A high-level official at the European Council insisted on the efforts that were already being made, but recognised that more could be done:

'Significant decisions have been made to tackle EU bureaucracy: decision to cut the number of EU officials by 5% over the next 6 years, a significant cut in wages and pensions, and the rise of the retirement age. But this does not seem to have an impact on public perceptions. More could be done without treaty change, for instance by sizing down the Court of auditors (which has 28 judges, who all have their cabinet), the Committee of the Regions and the Economic and Social Committee. Sizing down the Commission is impossible following the Irish referendum, but the Commission can be reshuffled by appointing senior and junior Commissioners, and pooling some portfolios.'

- A more important role for national parliaments

There was also significant convergence among interviewees towards saying that national parliaments ought to be more involved as a way to better control the EU

policy making. But the views expressed reflect somewhat different concerns, and suggest different approaches to address the problem.

In **Sweden** and the **Netherlands**, leaders seem likely to support the idea of a greater say for national parliaments, for instance in the form of ‘red cards’ as suggested by William Hague. At a Policy Network conference in February 2013, the Dutch Foreign Affairs Minister Frans Timmermans talked about an ‘*input deficit*’ of national parliaments in European decision-making. In Stockholm, an influential Member of Parliament argued:

‘The red card for national parliaments is a good idea but we should be able to work within the Lisbon treaty. We should seek to avoid judicial approach to such issues.’

In **Germany** and **France**, the debate about a more direct involvement of national parliaments in EU law making has not reached that stage, perhaps as it would be perceived as a risk. But a Bundesrat member suggested that the yellow card could be used more:

‘The ‘yellow card’ mechanism available to national parliaments is important, but at the moment I am not convinced that national Parliaments do their job properly. As a member of the Bundesrat, I am pushing hard to ensure that we take this question seriously.’

In practice, the ‘Early Warning System’ procedure has been successfully activated only twice since 2009. National parliaments have increasingly sent ‘reasoned opinions’ on ground of subsidiarity to the European Commission, hence a possible development of this tool if the one-third threshold is reached more often. Practice varies greatly: in 2011, the UK Parliament submitted one reasoned opinion, against two in France, Germany, Portugal and Spain, five in the Netherlands, eight in Poland and sixteen in Sweden. The yellow (and orange) card system suffers from weak inter-parliamentary cooperation.

A greater say for national parliaments could go along more traditional channels, such as lobbying governments ahead of ministerial or leaders meetings at EU level. The German, Danish and Finnish parliaments hold their government accountable for the positions they take at European Council and Council meetings, a model increasingly duplicated in other countries. This idea was strongly endorsed by a prominent Green MEP:

‘There is a strong case for generalising the German practice of auditioning the head of government ahead of European Council summits. But I’m not in favour of a co-legislative role for national parliaments’

In most **Eurozone countries**, the priority is to strengthen the role which national parliaments can play in EU economic governance, such as during the ‘European Semester’ of coordination.

This rapid overview shows that the Lisbon already provides room for manoeuvre to national parliaments, and that many more initiatives can be taken at national level to ensure a greater degree of scrutiny and accountability on EU affairs.

5. Conclusions

There are significant asymmetries among EU member states regarding the nature and the size of their financial markets. This places the UK in a delicate situation as financial regulation is decided upon at EU level by qualified majority voting. Yet there is no compelling evidence of the UK being increasingly marginalised at EU level on Single Market issues, especially in the field of banking and financial regulation. A vigilant UK presence in Brussels, and the strong support of several like-minded countries, provides ample guarantees against any discriminatory treatment. The argument that the Eurozone is turning into an anti-UK block is unfounded at this stage, although one cannot discard the long-term impact of further integration on the Continent.

Elites in most UK partners display immense sympathy for London’s membership of the EU. Schadenfreude is quasi-absent, except maybe on the margins of the French Left. Also, beyond the initially negative reaction, David Cameron’s speech seems to have opened up a debate on EU reform which most UK partners welcome. Frustration with how Brussels works is common currency. Excesses in ‘life-style regulation’ and intra-EU migration rules are the sources of particular complaint.

There is, however, no room for blackmail. EU member states will neither rescue the UK’s membership by abandoning qualified majority voting in the financial sector, nor by granting the UK additional opt-outs. They are ready to contemplate policy and institutional changes of common interest, in order to make the EU more attuned to the public’s expectations. What can be renegotiated can be a bit more than a mere symbolic package, but certainly less than repatriation and opt-outs. The treaty change, if any, is likely to proceed by a simplified revision procedure and will be dictated by Eurozone needs, not by UK demands.

Based on these key findings, Policy Network here proposes the following **recommendations** to the City:

- In the absence of evidence supporting the idea that the City and the UK would be better off outside the EU, the Corporation should continue to position itself strongly in defence of the UK membership of the Single Market, and, by implication, the EU. This case needs to be made on the basis of the jobs created and the markets accessed by British firms thanks to the participation to the Single Market rather than by focusing only on the City's interests.
- The City should renew its case for the British government to assert a leading British presence in Brussels in order to ward off any risk of losing votes which matter disproportionately for its interests. The UK government can count on a lot of like-minded allies to defend an open Single Market that fulfils its untapped potential. For this stance to be credible, an attitude of long-term constructive engagement must be restored.
- The British Parliament needs also to take greater ownership of the regulatory debates going on at EU level: the opportunity for questioning before Parliament of the Prime Minister and of ministers ahead of European Council and Council of Ministers' meetings would for instance contribute to increasing the understanding of EU processes by the British public.
- Negotiating ad hoc non-discriminatory clauses for non-euro countries or for countries not participating in the Banking Union should be encouraged further. These are useful tools when there is a doubt about the long-term impact of new regulation or of an institutional innovation at EU level. However, systematically filing complaints against EU institutions risk portraying Britain as anti-EU-regulation and irritating partners further. The attempt should be made to move from a negative and reactive to a preventive and constructive approach.
- There is a strong case to be made for a better implementation of the subsidiarity and proportionality principles in the light of the Review of the Balance of Competences and the Dutch review. Yet improving the quality of EU policy-making does not necessarily require treaty change. It is part of a constant negotiation about what the EU should and should not do, and requires a strong voice in Brussels.

- The City should finally pursue its efforts to change its image on the Continent and to position itself as the natural financial centre of Europe. The concentration of European finance in London provides significant economies of scale, which deserve being recognised across the continent. The City also plays a key role in non-bank finance, a potentially important bridge for channelling available capital towards investment in innovation. It should be seen as a force for good.