BANK OF ENGLAND

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Rt Hon Andrew Tyrie MP
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House of Commons
London
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Dear Andrew

During Andrew Bailey's appearance at the Treasury Select Committee (TSC) on 3rd February you requested that the Bank provide its view on those areas of the agreement reached on 19th February by Heads of State or Government on *'A new settlement for the United Kingdom within the European Union'* ('the Settlement'), which are relevant to the Bank's ability to achieve its statutory responsibilities. You also requested the Bank's views on an effective subsidiarity mechanism and the overall cost of EU regulation.

This letter is the Bank's response to these requests. It summarises the Bank's assessment of how EU membership affects the Bank of England's ability to achieve its statutory objectives, which is contained in its report on *'EU membership and the Bank of England'* ('the Report'). It then considers how the Settlement may influence this. Annex A to the letter includes the Bank's view on an effective subsidiarity mechanism and Annex B contains material from the Bank's Report which is relevant to your request on the overall cost of EU regulation.

Impact of EU membership on the Bank of England's delivery of its objectives[1]

The Bank's Report identified three main areas in which EU membership affects the Bank of England's objectives.

- First, to the extent it increases economic and financial openness, EU membership reinforces the dynamism of the UK economy. A more dynamic economy is more resilient to shocks, can grow more rapidly without generating inflationary pressure or creating risks to financial stability and can also be associated with more effective competition.

[1] The Bank of England's statutory objectives are set out in section 2A (the financial stability objective), section 9C (the FPC objectives) and section 11 (the objectives relating to monetary policy) of the Bank of England Act 1998. The Prudential Regulation Authority's statutory objectives are set out in the section 2B (the PRA's general objective), section 2C (the insurance objective) and section 2H (the secondary competition objective) of the Financial Services and Markets Act 2000.

- Second, increased economic and financial openness means the UK economy is more exposed to economic and financial shocks from overseas. In recent years, as a result of closer integration with the EU and, more recently, with the euro area, this may have increased the challenges to UK economic and financial stability.

  These challenges must be set against the benefits of the recent comprehensive reform of the UK's institutional framework for financial stability. This new framework creates a coherent architecture of national macroprudential and microprudential regulators and supervisors. It provides a solid foundation for the UK to maintain and develop its role as the world's leading international financial centre, one which can safely be home to the largest global, systemically important financial institutions and markets.

- Third, EU Regulations, Directives and rules define many of the Bank of England's policy instruments particularly in relation to financial stability. These must be sufficiently flexible and effective to manage the consequences for the United Kingdom of shocks originating in both the domestic and global economy and financial system.

The Report recognises that, although there have been some limits on flexibility in certain areas, the need for national regulators and supervisors to have the flexibility in applying EU rules to address the particular risks they face has, in the main, been respected. Looking ahead, it is important that any future EU legislative measures, designed to meet the needs of deeper integration in the euro area, do not adversely affect the Bank of England's ability to ensure the stability of the UK financial sector or compromise the single market. The Report underscores the desirability—particularly given the weight of the ECB and of the members of the single currency within the EU—of clear principles to safeguard the interests of non-euro member states while allowing differential integration consistent with the single market. In addition, the Report stresses that the future direction of EU financial reform should recognise that the EU comprises multiple currencies with multiple risks.

The Report concludes that EU membership has likely increased the dynamism of the UK economy and correspondingly its ability to grow without generating risks to the Bank's primary objectives of monetary and financial stability. The greater dynamism resulting from UK membership also contributes to the Bank's secondary objectives of supporting strong, sustainable and balanced growth and facilitating effective competition. Greater openness to the EU, however, has probably increased the external challenges to UK monetary and financial stability, as seen in recent years with the euro crisis.
The Report judges that, given the UK's institutional arrangements and policy framework for price stability, the Bank has been able to manage these challenges to maintain price stability.

The Report concludes that the combination of the UK's reformed framework for financial stability and the EU's reformed regulatory framework means the Bank of England currently has the tools necessary to achieve its Financial Stability objectives. The Report also concludes that, looking forward, it is important that arrangements are put in place to ensure that the Bank can continue to meet its financial stability objectives given the need for the future development of the EU financial framework to facilitate further integration of the euro area.

As described in the balance of this letter, the Settlement delivers a number of protections and additional tools that will help safeguard the Bank's ability to continue to achieve its statutory objectives.

EU membership and the Bank of England

This section sets out the main findings of the Bank of England's Report. This is then used to assess the impact of the Settlement on the Bank's ability to achieve its statutory objectives and responsibilities in the next section of the letter.

To the extent it increases economic and financial openness, EU membership reinforces the dynamism of the UK economy

The UK has become much more open over the past forty years and is now amongst the most dynamic advanced economies in the world. There are number of reasons for this, but the Report acknowledges that the EU is likely to have contributed by establishing the world's largest single market with free movement of goods, services, capital and labour. As a single bloc the EU is the largest economy in the world: EU GDP was worth £11.3 trillion in 2014, just larger than the US at £10.5 trillion. The UK has accounted for the largest share of foreign direct investment (FDI) inflows into the EU, and has the EU's largest financial centre, with almost a quarter of all EU financial services income and 40% of EU financial services exports.[2]

The rest of the EU is more important to UK trade and investment than the converse. For example, UK exports to the EU represent 13% of UK GDP, whereas exports from the rest of the EU to the UK represent only 3% of rest-of-EU GDP. Similarly, FDI from the rest of the EU accounts for 27% of UK GDP, whereas UK FDI to the rest of the EU accounts for about 4% of rest-of-EU GDP.[3]

The Bank's Report notes substantial evidence that openness supports economic dynamism through a range of channels, thereby raising economic growth and boosting living standards. Openness promotes innovation and the adoption of new technologies through the free movement of capital and labour. The EU is either the destination or source for over two-fifths of the UK's cross-border investments.[4] Openness allows firms to specialise in a narrower range of products and to exploit economies of scale, raising efficiency. Increased competition from operating in a larger market reinforces these dynamics. Greater competitive pressure favours more productive domestic firms, enhancing economic dynamism in the long

[2] See Bank of England report, *EU Membership and the Bank of England*, (October 2015)

[3] The figures within this paragraph are based on data for 2014. Calculations for the UK's exports to, and FDI from, the rest of the EU relative to UK GDP are based on data from the ONS. Those for the rest of the EU's exports to, and FDI from, the UK use ONS data on exports and FDI, together with IMF data, converted at the average market exchange rate for 2014, for Rest of EU GDP.

[4] See Bank of England report, *EU Membership and the Bank of England*, (October 2015)

run as production shifts to them. Greater financial openness facilitates matching of savers with borrowers which lowers financing costs, boosts investment and ultimately growth.

However increased economic and financial openness means the UK economy is more exposed to economic and financial shocks from overseas

As the UK has become increasingly open its interdependence with other economies, including the member states of the euro area, has increased. The Report finds that, other things equal, this has the potential to improve UK stability through greater risk sharing and a more diversified financial system. But since risk sharing is never perfect, greater openness can also create challenges. The global financial crisis and the euro-area crisis showed that openness can increase the exposure to, and the impact of, foreign shocks, particularly in the absence of a sound domestic and international regulatory framework. [5] The UK economy was materially affected by the euro-area crisis. The euro area accounts for over 85% of the GDP of the rest of the EU, it is the largest destination in the world for the UK's exports, and its financial system is tightly linked with that of the UK. This had implications for both UK monetary and financial stability during the crisis.[6]

The Report finds that a successful and sustainable Economic and Monetary Union (EMU) is therefore important for the dynamism and financial stability of both the euro area and the UK. The European Commission's 'Five Presidents' Report', acknowledges as much stating that the euro area is "unfinished business." Much has been accomplished since the crisis including a range of measures to enhance the resilience of the euro area's banking system, notably significant increases in capital and liquidity requirements, improved resolution arrangements and the establishment of the Single Supervisory Mechanism (SSM) and Single Resolution Board (SRB). Notwithstanding this considerable progress, further financial and fiscal integration within the euro area will be necessary over time to strengthen EMU. In particular, closer financial integration requires increased risk sharing in the public and private sector. Much of that risk sharing can be achieved by the development of a more complete Banking Union in the euro area. The development of a Capital Markets Union may also improve financial integration in the euro area.

EU financial legislation defines many of the Bank's policy instruments; these must be sufficiently flexible and effective to manage financial stability in the UK

The Report describes how participation in the single market means that the majority of regulation applying to the financial sector in the UK is determined at EU level. However, as the Bank's Report stresses, financial stability is ultimately a national responsibility. The Bank of England is charged with promoting UK financial stability and is accountable to the UK Parliament. The UK taxpayer is the ultimate backstop of the UK financial system. As home to the world's largest international financial centre, it is of particular importance that UK authorities are able to apply the highest international standards and to take action to

[5] *Ibid*
[6] *Ibid*

address the particular financial stability risks associated with a scale, complexity and degree of global financial activity unmatched elsewhere in Europe. More subsidiaries and branches of foreign-owned banks operate in the UK than any other EU country, and around half of the world's largest financial firms have their European headquarters in the UK. The UK has the largest global share of cross-border bank lending, foreign exchange trading and interest rate OTC derivatives. It has the third largest insurance industry and the second largest asset management industry in the world. The assets of the UK banking sector are four times GDP and non-bank financial institutions are of a similar size.

UK authorities need the flexibility to react to and manage financial stability risks effectively appropriately and to supervise the system as a coherent whole. The creation of the Financial Policy Committee (FPC) and Prudential Regulation Authority (PRA) within the Bank of England and the Financial Conduct Authority (FCA), provide the UK with a coherent architecture of national macro-prudential, micro-prudential and conduct authorities to address the risks that the UK's large financial sector and high degree of financial openness can entail.

The need for national regulators and supervisors to have the flexibility in applying EU rules to address the particular risks they face has in the main been respected in the past. Looking to the future, the Report concludes that as EU financial regulation evolves – particularly in the context of the necessary further integration of euro-area member states – it will be important for the Bank of England in to retain the flexibility and overall supervisory coherence necessary to meet its financial stability objectives.

The Report states that the future direction of EU financial reform should recognise that the EU comprises multiple currencies with various risks. In addition, it is important, particularly given the weight of the ECB and of the members of the single currency within the EU, that arrangements are put in place so that the future development of the EU regulatory framework aids the necessary deepening of integration in the euro area without impairing the ability of the Bank of England to meet its financial stability objective or compromising the single market.

A new settlement for the United Kingdom in the European Union

On the 19th February the EU Heads of State or Government agreed a new settlement concerning "certain issues raised by the United Kingdom in its letter of 10 November 2015". The intention of the Settlement is to clarify these issues:

> *...so that such clarification will have to be taken into consideration as being an instrument for the interpretation of the Treaties; intending as well to agree arrangements for matters including the role of national Parliaments in the Union, as well as the effective management of the banking union and of the consequences of further integration of the euro area.*

The Settlement recognises "possible different paths of integration for different Member States, allowing those that want to deepen integration to move ahead, whilst respecting the rights of those which do not want to take such a course". In this respect, the Settlement recalls that the UK has no obligation to adopt the euro. All 28 member states agreed as part of the Settlement that, "Measures, the purpose of which is to further deepen economic and monetary union, will be voluntary for Member States whose currency is not the euro and will be open to their participation wherever feasible."

The Settlement goes on to clarify that different approaches are anticipated for member states whose currency is the euro and the non-participating states:

> *Member States not participating in the further deepening of the economic and monetary union will not create obstacles to but facilitate such further deepening while this process will, conversely, respect the rights and competences of the non-participating Member States. The Union institutions, together with the Member States, will facilitate the coexistence between different perspectives within the single institutional framework ensuring consistency, the effective operability of Union mechanisms and the equality of Member States before the Treaties, as well as the level-playing field and the integrity of the internal market.*

As a whole, the Settlement acknowledges the need to safeguard the interests of the non-euro area member states and their authorities. In light of the weight of the euro area in the EU and the need for further integration amongst euro area member states, this is an important commitment.

The Impact of the new Settlement on the Bank of England's Objectives

This section provides a high-level assessment of how the Settlement may impact the key issues identified in the Bank's Report, focusing only on those with a direct impact on achieving the Bank's statutory objectives. Other elements of the Settlement with limited direct impact on the Bank's objectives are not commented on in this letter.

The Settlement commits EU Heads of State or Government to amend the Treaties of the EU in particular by incorporating the substance of the provisions on economic governance, ever closer union and the economic governance emergency brake. The section on economic governance and the emergency brake are clearly intended by the parties to be legally binding and will enter into force upon notification of the UK's intention to remain in the EU, which would be expected to occur if there is a vote in the referendum favour of doing so. The International Law decision is an agreement concluded in accordance with Article 31 of the Vienna Convention on the Law of Treaties and consequently has interpretative effect. The European Court of Justice accepts that such international agreements entered into by the signatories to the Treaties are instruments of interpretation which must be taken into account[7]. The Government's view of the legal effects of the settlement is set out in detail in the paper of 22 February, *The best of both worlds: the United Kingdom's special status in a reformed European Union*[8].

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[7]Case C-135/08 *Rottmann*, paragraph 40.
[8]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504220/The_best_of_both_worlds_the_UKs_special_status_in_a_reformed_EU_print_ready.pdf, p33-36.

The Settlement states upfront that there should be respect for "the powers of the central banks in the performance of their tasks, including the provision of central bank liquidity within their respective jurisdictions". This acknowledges the operational independence of the Bank of England in the conduct of monetary policy and financial stability, including the provision of liquidity which has been an important tool for the Bank to deliver its statutory objectives. By recognising the powers of central banks, this statement reinforces other provisions in the Settlement which recognise that the EU is a multi-currency union.

Section A, economic governance, bears most on the Bank of England's objectives. This section contains a number of provisions that set out principles in relation to future EU and euro-area actions. It is intended that "Mutual respect and sincere cooperation between Member States participating or not in the operation of the euro area will be ensured by the principles recalled in this Section, which are safeguarded notably through the Council Decision referring to it." The statement sets a procedural mechanism – the "emergency brake" - to deal with any perceived breaches of the principles in the economic governance section.

Policy making framework for financial regulation

The two provisions of Section A most relevant to the Bank's objectives are paragraphs 2 and 4. These relate to the policy making framework for financial regulation.

Section A, paragraph 2

One of the key conclusions of the Bank's Report is that euro area member states will need to integrate more deeply in future, in order to increase the sustainability of the common currency area. This is likely to require more uniform financial sector regulation within the euro area than would be necessary for the single market to operate effectively across the EU as a whole[9]. As a result, the Report notes that it would be important in future that EU financial services legislation strikes the right balance between the harmonisation necessary to make the euro area more effective and preserving the flexibility to allow non-euro area member states to safeguard financial stability in their jurisdictions[10].

Paragraph 2 of Section A recognises this point. It states that under European Union law, which will be applied in the euro area by euro-area bodies and institutions, the rules for the Banking Union "may need to be conceived in a more uniform manner than corresponding rules to be applied by national authorities of Member States that do not take part in the banking union". The paragraph makes clear that it covers "prudential requirements for credit institutions and other legislative measures for the purposes of ensuring financial stability". The paragraph recognises that this may require future European Union legislation on financial regulation to have "specific provisions", (i.e. for the Banking Union member states). This tailored approach would allow for non-euro area member states, like the United Kingdom, to have the flexibility necessary to meet its needs to safeguard financial stability, including setting requirements above the

[9] See Bank of England report, EU Membership and the *Bank of England*, (October 2015)
[10] *Ibid*

minimum standard, if needed to manage financial stability appropriately. This would be precisely the flexibility the Bank sought in its Report given its responsibilities to oversee the prudential aspects of the UK's very large and complex financial sector.

This flexibility could be achieved in practice, for example, by having regulatory rules composed of Directives that set minimum standards for non-euro area member states (thereby ensuring a level playing field within the single market) and a directly applicable regulation that would impose a higher level of uniformity (while still meeting the minimum standard) across the euro area only.

Section A, paragraph 4

A second key conclusion of the Bank's Report is the need to maintain overall regulatory coherence and responsibility at a national level in the UK[11]. The UK is home to the largest international financial centre in the world. This brings with it risks to UK taxpayers who are the ultimate backstop for the system. In light of this the Bank's Report stresses that financial stability is ultimately a national responsibility and that UK authorities such as the Bank – who are accountable to the UK Parliament – should remain responsible for supervising its financial system and ensuring financial stability in the UK.

Paragraph 4 of section A is clear that the UK retains responsibility for the implementation of regulation including "supervision or resolution of financial institutions and markets, and macro-prudential responsibilities". These responsibilities are recognised explicitly for non-euro member states as "a matter for their own authorities". This is, for the Bank, a particularly welcome element of the Settlement in the light of its responsibilities for macroprudential policy and for the supervision and resolution of banks, investment firms, insurers and financial market infrastructure.

This explicit recognition that for the UK supervision, resolution and macro-prudential responsibilities are matters for their national authorities is without prejudice to the development of the single rulebook, to European mechanisms for macro-prudential oversight, or to the existing powers that the EU has to take action in response to threats to financial stability.

The EU institutions, agencies and bodies have a significant range of existing powers. The European Commission is a European institution and has the power to propose legislation. The Council of Ministers and European Parliament generally decide EU financial service legislation by qualified majority voting and co-decision. Recent examples of financial services legislation that the EU has adopted include the Banking Recovery and Resolution Directive (BRRD); Capital Requirements Directive (CRD) 4 and Capital Requirements Regulation and Markets in Financial Instruments Directive (MIFID) and the Short Selling Regulation.

The EU also has a number of agencies and bodies which were created by European legislation. The most relevant agencies for financial services are the European Supervisory Agencies (ESAs). These are the

[11] *Ibid*

European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA). The PRA represents the UK at the EBA and EIOPA, the FCA is the UK's representative on ESMA. The ESAs have a number of powers. Primarily their aim is to create a single EU rule book. They do this by developing draft technical standards, which are adopted by the European Commission as EU law. The ESAs also issue guidance and recommendations with which national supervisors and firms must make every effort to comply. Other powers include the ability to ban activities temporarily and to ensure EU law is properly implemented.

The European Systemic Risk Board (ESRB) is an EU body, based in the ECB. The ESRB provides macro-prudential oversight in the EU. Its membership is made up of the central banks of EU Member States, the ECB, the Commission as well as the ESAs. The Governor of the Bank of England is the First Vice Chair of the ESRB. The ESRB has a range of responsibilities including monitoring risks, issuing warnings and making recommendations (on a comply-or-explain basis within the EU).

The Bank plays an active role in the development of financial services regulation in the EU in a range of fora, and the current EU financial services framework allows the Bank to meet its objectives. The Settlement will not alter the powers of the EU institutions, agencies and bodies. However it will guide how these powers are used. For example the economic governance principles establish that euro area member states may require a greater degree of uniformity than is needed in Member States that are not part of the Banking Union. This principle should guide the decisions made by the European Commission prior to adoption of future banking legislation and the discussions in the EBA.

Other elements of Section A relevant to the Bank of England's objectives

In line with the Bank's Report, the Settlement formally recognises that there are multiple currencies in the EU, acknowledging that "not all Member States have the euro as their currency". For the benefits from openness and free trade not to be undermined, it is important that UK businesses and individuals do not face discrimination on the basis of a different currency within the single market. Therefore, it is welcome that the Settlement reinforces the principle that discrimination, including on grounds of currency, is not permitted in the EU. Taken together with the existing Treaty prohibitions on discrimination on the grounds of nationality, paragraph 1 of Section A also provides protection against discrimination based on place of incorporation or the currency of the place of incorporation:

> *Discrimination between natural or legal persons based on the official currency of the Member State, or, as the case may be, the currency that has legal tender in the Member State, where they are established is prohibited. Any difference of treatment must be based on objective reasons.....Legal acts...directly linked to the functioning of the euro area shall respect the internal market, as well as economic and social and territorial cohesion, and shall not constitute a barrier to or discrimination in trade between Member States.*

Giving greater force to the Settlement

In addition to being part of an International Law Decision the economic governance principles in Section A of the Settlement have been given greater force in two ways. First, it has been agreed that the substance of those principles will be included in the EU Treaties when they are next amended. This will give the economic governance principles greater legal force, in particular before the European Court of Justice. Second, the separate EU Heads of State or Government Statement on Section A provides that if a member state outside of the banking union considers that a piece of legislation is about to be agreed which breaches any of the principles contained in the economic governance section, they can pull an emergency brake. The UK can do this alone, without the need for a minimum number of other member states to invoke the safeguard mechanism. This notifies the Council of Ministers, which will discuss the issue. Whilst the emergency brake does not provide a veto over European legislation or over-ride existing voting rules, it does require the Council to "do all in its power" to try and find a satisfactory outcome for that member state within a reasonable period of time. There is also the possibility for the UK to request the Presidency of the Council[12] to refer the matter to the European Council to seek to reach a satisfactory outcome.

Other sections relevant to the Bank of England's objectives

Dynamism and Openness of the UK

There is considerable evidence, cited in the Bank's Report, that openness supports economic dynamism. The UK is one of the world's most open economies, and is a member of the world's largest single market with free movement of goods, services, capital and labour. It is reasonable to expect that any measures in the Settlement that protect and enhance the integrity of the single market and increase its competitiveness will support the dynamism of the UK economy, thereby raising economic growth and boosting living standards.

Section B of the International Law Decision makes a commitment for member states to

> *Exploit fully the potential of the internal market in all its dimensions, to reinforce the global attractiveness of the Union as a place of production and investment, and to promote international trade and market access through, inter alia, the negotiation and conclusion of trade agreements, in a spirit of mutual and reciprocal benefit and transparency.*

This is supplemented by a European Council Declaration on Competitiveness in which the Heads of Government or State commit that "Europe must boost its international competitiveness across the board in services and products and in key areas such as energy and the digital single market'[13]. To the extent that these commitments increase the EU's competitiveness and openness of the single market they should

[12] The Presidency of the Council rotates amongst Member States on a six monthly basis.
[13] European Council declaration on competitiveness (2016)

have a positive bearing on the dynamism of the UK's economy, in particular if steps are taken to increase trade with third countries further.

Exposure to economic and financial shocks from overseas

Another key theme identified by the Bank's Report is the impact of financial instability in the euro area on the UK economy. The importance to the UK of a stable euro area is underscored by the importance of the EU as a trading partner. Around half of all UK exports and imports – in total worth 60% of GDP – are with the rest of the EU[14]. A more stable and prosperous EU will have positive effects on the UK economy. The Settlement recognises the need for the euro area to integrate further, for the benefit of the euro area and of the wider EU. Because the Settlement acknowledges that the euro area and the rest of the EU may need different levels of integration, it may improve the stability of Banking Union and the euro area as a whole through a more uniform set of rules for the Banking Union. A more stable euro area would reduce the likelihood of negative spillovers affecting the UK's financial stability.

The UK agreement is not however a substitute for other wider initiatives such as the Five Presidents report – with which the Bank's Report is highly consistent – which are focused on improving the broader sustainability of the euro area. The Bank's Report also emphasises the importance of the EU faithfully implementing international standards. This is something which has, with some exceptions, largely been achieved in the EU, but is not directly addressed by the Settlement.

The members of the single currency have taken steps to reinforce the stability of the monetary union. Risk-sharing arrangements, such as the European Stability Mechanism, have been developed to provide a safety net for the countries of the euro area. The Settlement clarifies that in relation to such arrangements, from a fiscal perspective "Emergency and crisis measures designed to safeguard the financial stability of the euro area will not entail budgetary responsibility for Member States whose currency is not the euro, or, as the case may be, for those not participating in the banking union." On balance, these fiscal protections enhance the financial stability of the UK.

Other issues

The response to your question of Andrew Bailey for the Bank's views regarding an effective subsidiarity mechanism is covered in Annex A.

Finally, you also asked Andrew Bailey for a view on the overall cost of EU regulation. Several comments are in order. While HM Treasury is not generally required by statute to consult before transposing EU law, in practice, it does consult, and it will conduct an analysis of the costs and benefits and explain this in setting out its approach to the transposition of EU legislation.

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[14] See Bank of England report, *EU Membership and the Bank of England,* (October 2015)

The PRA consults on any rules before they are adopted and as part of the consultation it includes an assessment of the costs and benefits of the proposed rules. Before finalising any new rules, it takes into account any responses to the consultation which provide evidence as to likely costs or benefits of the proposal. Public law obligations also lead the Bank and PRA to consult on new policy initiatives which could have a material impact on firms or individuals and generally such consultation includes an assessment of the costs and benefits of the proposed approach.

The Bank is not in a position to make an assessment of the cost of the EU's overall regulatory framework, as doing so has not been part of its remit. Producing such an assessment would not be straightforward since it requires a comparison to the counterfactual regulatory framework if the UK were outside of the EU. In this regard, while the Bank has not conducted a comprehensive review of regulation, it should be recognised that the regulatory approach of the EU is both in the main consistent with international best practice and with what would be necessary to meet the Bank's objectives even if the UK were not a member of the EU. For example, it is hard to conceive that the UK would not implement Basel III or resolution arrangements that were substantially equivalent to those contained in CRDIV and the Bank Recovery and Resolution Directive (and into which UK authorities gave considerable input). The Report does outline a few areas where UK regulation would likely differ somewhat from EU legislation. Specifically, these are the bonus cap, AT1 conversion triggers and the extent of supervisory judgment permitted under Solvency II legislation. As noted in the previous section, the Settlement includes a commitment by the relevant EU institutions and the member states to review periodically relevant regulation and legislation to assess proportionality and subsidiarity.

Moreover, as the Report notes, the UK has actively contributed to the development of the new international regulatory framework in areas ranging from the bank capital framework to resolution to the rules governing financial market infrastructure such as CCPs. Its ability to do so is enhanced by close coordination with the Commission and with other member states. In addition, as the Report concludes, overall the EU has carried out a major legislative and regulatory programme that implemented and often exceeded the internationally agreed G20 post crisis reform agenda. The resulting legislation has substantially raised the quality of regulation in the EU overall. By ensuring that those strengthened standards apply EU-wide with the force of law, this helps support financial stability in the UK. This is particularly important given the UK's high degree of financial openness[15].

Finally, the Bank's Report provides some context on the overall regulatory burden in the UK by comparing the flexibility of the UK economy on a number of metrics to its G7 peers. The box, reproduced in Annex B, suggests that the UK is, joint with the US, the most flexible major advanced economy, and it is consistently and considerably more flexible than its European peers.

[15] See Bank of England report, *EU Membership and the Bank of England,* (October 2015)

Conclusion

The Settlement addresses the issues the Bank identified as being important, given the likely need for further integration of the euro area, to maintaining its ability to achieve its objectives. In line with a main conclusion of the Bank Report, the Settlement explicitly recognises the needs of the UK to supervise its financial stability, while not impeding the implementation of necessary, further integration amongst members of the euro area. It makes clear that the UK retains responsibility for supervising its financial stability, financial institutions and markets as well as maintaining responsibility for the resolution of failed financial institutions within its jurisdiction. At the same time, it acknowledges the existing powers of the Union to take action that is necessary to respond to threats to financial stability. The Settlement recognises that EU financial services legislation may need to be conceived in a more uniform way for Banking Union member states than for member states like the UK that are not participating. It recognises that there is more than one currency in the EU and makes a legally binding commitment to ensure non-discrimination in the single market on the basis of currency. Finally, it makes a series of commitments to improve the competitiveness of the EU economy—commitments, to the extent they are fulfilled, that would reinforce the positive impact of EU membership on the Bank's secondary objectives.

Jon Cunliffe and I look forward to discussing in detail these and any other issues the TSC may wish to raise during our appearance on the 8th of March.

Yours sincerely,

Annex A – subsidiarity and proportionality

The TSC asked for the Bank's view on what would constitute an effective subsidiary mechanism.

Section B of the international law decision provides that: "the relevant EU institutions and the Member States will take concrete steps towards better regulation, which is a key driver to deliver the above-mentioned objectives. This means lowering administrative burdens and compliance costs on economic operators, especially small and medium enterprises, and repealing unnecessary legislation as foreseen in the Declaration of the Commission on a subsidiarity implementation mechanism and a burden reduction implementation mechanism".

The Commission's Declaration commits it to "establishing a mechanism to review the body of existing legislation for its compliance with the principle of subsidiarity and proportionality". Section C reaffirms the need to "ensure that decisions are taken as closely as possible to the citizen". And in assessing compliance with the subsidiarity principle the EU institutions must give consideration to where there are "transnational aspects which cannot be satisfactorily regulated by action by Member States and on whether action at Union level would produce clear benefits by reason of its scale or effects compared with actions at the level of Member States".

Section C of the Heads of State or Government Decision reinforces the existing Treaty provisions on national parliaments and the principle of subsidiarity by introducing a 'red-card mechanism' which enables national parliaments to block EU legislative proposals with reasoned opinions representing more than 55% of the votes allocated to national parliaments under Protocol No 2. Under the new mechanism the representatives of the member states acting in their capacity as members of the Council commit to discontinue the consideration of the draft legislative act in question unless the draft is amended to accommodate the concerns expressed in the reasoned opinions.

The Bank of England welcomes the commitments in sections B and C of the Heads of State or Government Decision, and the accompanying European Council declaration on Competitiveness and Commission Declaration on a subsidiarity implementation mechanism and a burden reduction implementation mechanism.

To ensure its effectiveness, a subsidiarity mechanism should be a completely independent check on the legislative process and separate from the institutions involved in that process. If the mechanism were located within the Commission, it would be important that it has the capability and capacity to form and make public an independent view, and for it to have its own dialogue with the other actors of the legislative process, the European Parliament and the Council of Ministers. It should also have dialogue with the European Council and national parliaments.

The Bank of England supports the steps that the Commission is already taking to comply with the principle of subsidiarity and proportionality. The European Commission's agenda on Better Regulation, overseen by a dedicated First Vice-President responsible for better regulation, includes a package of reforms aimed at improving law-making, including better regulation guidelines covering the preparation, implementation and evaluation of policies and measures (and associated Better Regulation 'Toolbox'). The Commission has also decided to create a Regulatory Fitness and Performance (REFIT) platform, composed of high-level experts from member state authorities with expertise in better regulation, and stakeholders with practical expertise in Union policy areas (appointed on 16 December), to advise the Commission on simplifying and making EU laws more effective and efficient. The Regulatory Scrutiny Board, set up on 1 July last year, additionally provides a central quality control and support function for Commission impact assessment and evaluation work. The Board has already provided a number of opinions (including an Impact Assessment on a proposal for a Regulation on Securitisation in July 2015). While the previous Commission did undertake work to make EU law simpler and to reduce regulatory costs (notably through the launch of the REFIT programme established in 2012), we welcome the new Commission's strengthened efforts in this area.

This trend is evident in the sphere of financial regulation. For example, the Commission Call for Evidence on the EU Regulatory Framework for Financial Services[1] seeks input and evidence on legislation that may damage the economy, create unnecessary burdens, are incoherent or conflicting, or give rise to unintended consequences. In short, this comprehensive review is aimed at ensuring that the regulatory regime is proportionate and effective. The Bank's response noted in particular the importance of maintaining the existing macroprudential flexibility in CRDIV, and highlighted the possible unintended consequences of including client clearing and central bank reserves within the leverage ratio.[2]

In addition, the European Commission is currently undertaking a comprehensive review of the proportionality of the application of the Capital Requirements Directive and Capital Requirements Regulation for smaller banks. The Bank of England's response to the Call for Evidence advocated a more proportionate approach to capital regulation, which would in effect devolve more authority for the banking rule book (on top of existing responsibilities for supervision) to national bank regulators for smaller, domestically focused banks. A more proportionate approach would also support competition and growth.[3] Initial work suggests that this could cover the application of requirements for reporting, disclosure, remuneration and the net stable funding ratio (NSFR). The Bank of England is continuing to engage with the European Commission on this work, which is expected to result in a legislative proposal before the end of 2016.

It is standard practice for EU regulations and directives to contain review clauses. They constitute a means to ensure that legislation is achieving its objectives, with the review normally coming in the form of a public consultation. This enables a diverse group of stakeholders, including EU member state governments and regulators, in addition to private bodies and individuals, to set out their views. While the Commission is not required to propose amendments as a result, it is very often the case that they do. However in the past such review clauses have been used to widen the scope of regulation, whereas

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[1] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf
[2] http://www.bankofengland.co.uk/financialstability/Pages/regframework/response.aspx
[3] http://www.bankofengland.co.uk/pra/Pages/crdiv/updates.aspx

the recent shift in the Commission's focus and the commitments of the EU Heads of State or Government and the European Commission's Declaration in the Settlement signal that far greater weight will be placed on the need to justify the ongoing proportionality of measures taking into account their impact on business, growth and the wider economy. A welcome example of a legislative review leading to a decision to propose amendments to legislation is the European Commission's consultation on the possible impact of CRR and CRDIV.

Annex B- Productivity and product and labour market regulation

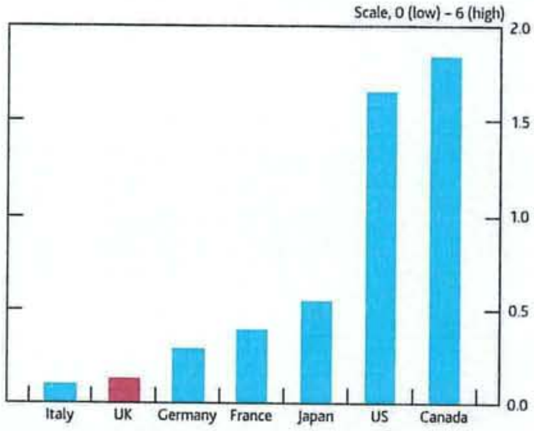
This Box looks at indicators of regulation in EU and non-EU countries. The charts are ordered such that economies with the most flexible policies are on the left-hand side. While this is not an exhaustive survey, it does show that there is a significant diversity of policy settings across EU member states, arising because overall regulation depends on a combination of legislation made at the national and EU level. The EU has played a greater role in some areas, such as product market regulation (where harmonisation in some areas has led to consistency in rules across member states), and a smaller role in others, such as labour markets. In some instances, EU countries have some of the most flexible legislation across G7 economies. In other instances, the range of policy settings in the EU is similar in diversity to the rest of the G7, suggesting that EU membership does not in itself lead to a stricter degree of product and labour market regulation than in other similar advanced economies.

Charts A-D cover product market regulation, in which the EU has played a significant role. **Charts E and F** relate to labour market regulation, which is primarily set at the national level. Looking across this range of metrics, the UK has low levels of regulation across most measures. This suggests that the UK has adopted more flexible regulation than many of its EU and non-EU peers and is thus well placed to benefit from greater openness both within the EU and globally.

Chart A measures the extent to which foreign firms are treated differently from domestic ones, through policies such as taxation, subsidies and public procurement rules. A high score on this measure would indicate a barrier to foreign entry, which could weaken innovation and reduce the incentives for domestic firms to specialise. **Charts B** and **C** measure the extent to which countries have policies that make it harder to set up new firms, or which protect existing firms, both of which could act as barriers to the entry and exit of firms and impede specialisation. **Chart D** is a summary measure of product market regulation, which aims to capture the degree of protection in product markets. A high score would be associated with policies being in place that could stifle competition and innovation.

Chart E measures the degree to which employees are protected, with higher entries suggesting there are extensive procedures and costs involved in dismissing individuals or groups of workers. **Chart F** presents responses by firm executives to the question "how would you characterise labour-employer relations?"; a higher score indicates greater cooperation.

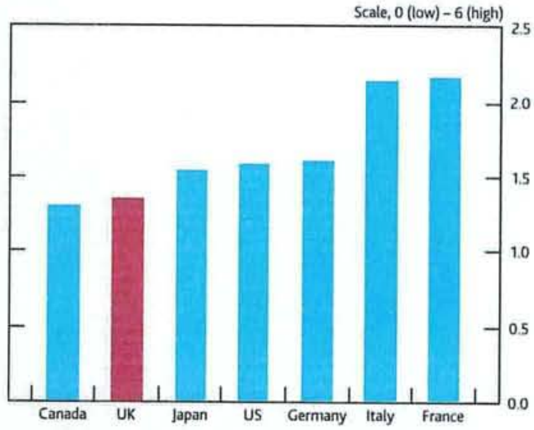
Chart A: Differential treatment of foreign suppliers



Source: OECD (2013), Product Market Regulation Database.

Notes: US data relate to 2008, all others 2013. The index is a composite indicator of differential treatment for foreign firms with respect to taxes, subsidies, public procurement, entry regulation and appeal and procedures.

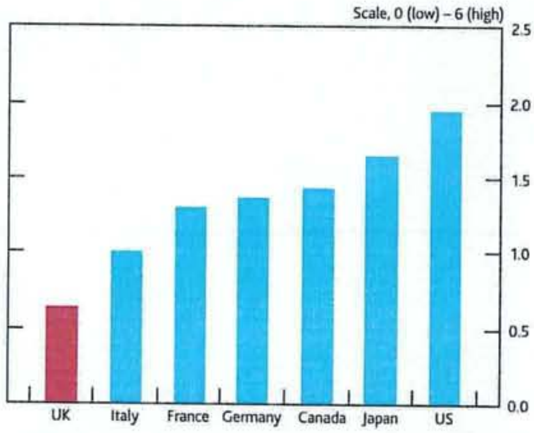
Chart B: Administrative burden on start-ups



Source: OECD (2013), Product Market Regulation Database.

Notes: US data relate to 2008, all others 2013. The measure is a composite indicator of the regulatory burden for establishing new firms or entering the service sector.

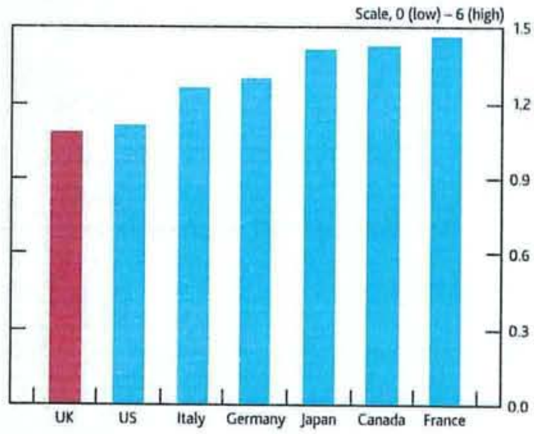
Chart C: Regulatory protection of incumbents



Source: OECD (2013), Product Market Regulation Database.

Notes: US data relate to 2008, all others 2013. The measure is an indicator of exemptions from competition policy and barriers to entry.

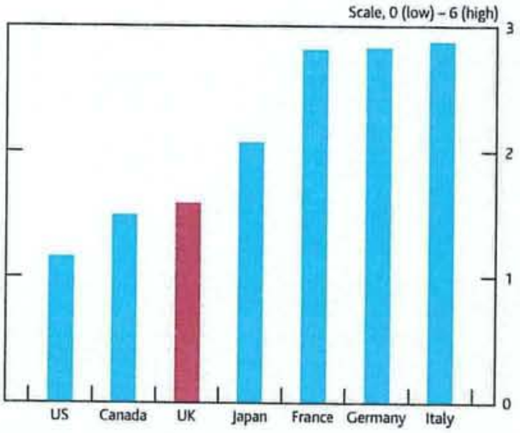
Chart D: Product market regulation



Source: OECD (2013), Product Market Regulation Database.

Notes: US data relate to 2008, all others 2013. The measure is an indicator based on scores across 18 lower-level categories.

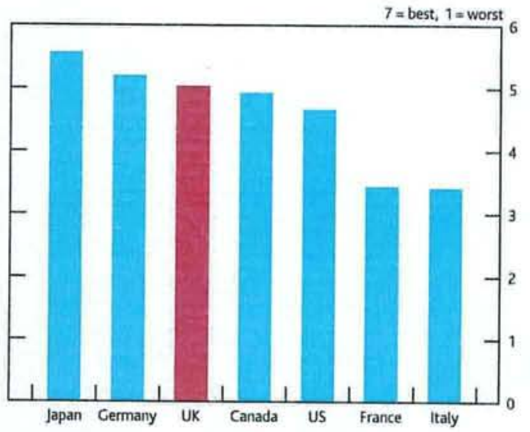
Chart E: Employment protection legislation



Source: OECD Employment Protection Legislation.

Notes: UK data relate to 2014, all others 2013. Measure based on indicators of the stringency of regulation, case law and collective bargaining concerning individual and collective dismissal.

Chart F: Labour-employer relations



Source: WEF Global Competitiveness Report 2014

Notes: Indicator based on responses to the following question in the WEF Executive Opinion Survey: "In your country, how would you characterize labour-employer relations? (1 = generally confrontational; 7 = generally cooperative)".