Response to the EU Commission:

Call for evidence on EU regulatory framework for financial services

February 2016
Response to the EU Commission:
Call for evidence on EU regulatory framework for financial services
# Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Chapter 1</td>
<td>Unnecessary regulatory constraints on financing</td>
<td>9</td>
</tr>
<tr>
<td>Chapter 2</td>
<td>Market liquidity</td>
<td>15</td>
</tr>
<tr>
<td>Chapter 3</td>
<td>Investor and consumer Protection</td>
<td>21</td>
</tr>
<tr>
<td>Chapter 4</td>
<td>Proportionality / preserving diversity in the EU financial sector</td>
<td>27</td>
</tr>
<tr>
<td>Chapter 5</td>
<td>Excessive compliance costs and complexity</td>
<td>33</td>
</tr>
<tr>
<td>Chapter 6</td>
<td>Reporting and disclosure obligations</td>
<td>37</td>
</tr>
<tr>
<td>Chapter 7</td>
<td>Contractual documentation</td>
<td>41</td>
</tr>
<tr>
<td>Chapter 8</td>
<td>Rules outdated due to technological change</td>
<td>45</td>
</tr>
<tr>
<td>Chapter 9</td>
<td>Barriers to entry</td>
<td>49</td>
</tr>
<tr>
<td>Chapter 10</td>
<td>Links between individual rules and overall cumulative impact</td>
<td>53</td>
</tr>
<tr>
<td>Chapter 11</td>
<td>Definitions</td>
<td>59</td>
</tr>
<tr>
<td>Chapter 12</td>
<td>Overlaps, duplications and inconsistencies</td>
<td>63</td>
</tr>
<tr>
<td>Chapter 13</td>
<td>Gaps</td>
<td>65</td>
</tr>
<tr>
<td>Chapter 14</td>
<td>Risk</td>
<td>69</td>
</tr>
<tr>
<td>Chapter 15</td>
<td>Procyclicality</td>
<td>73</td>
</tr>
</tbody>
</table>
Foreword

Promoting innovation and competition though a strong and effective regulatory framework

The UK welcomes this call for evidence which supports the UK government’s priorities for the financial services sector. A strong and stable financial sector is critical to ensuring long-term economic growth, delivering for customers and helping people achieve their aspirations. The European Union must also be internationally competitive and one of the best places in the world to do business.

A timely exercise with strong potential

We have agreed at the G20 and implemented in the European Union a financial regulatory regime to which the UK is strongly committed. This exercise is a valuable opportunity for the European Union to consider the future direction of financial services regulation and how the financial services industry can best serve consumers and businesses.

Since the Global Financial Crisis there have been 48 pieces of European Union legislation in financial services and many more delegated and implementing acts. As Lord Hill has said, given the quantity of legislation it is unsurprising that there are inconsistencies and unintended consequences. In the UK’s view, these are creating a barrier to the effective implementation of the financial stability regime and to the delivery of jobs and growth.

Much of the regulation put in place since the onset of the crisis is yet to be implemented and reviewed. The UK is keen for this call for evidence to provide the basis for a continuous process of examining the effectiveness and unintended consequences of legislation.

For Europe’s financial services sector to continue to both lead globally and support jobs and growth it must be innovative, flexible and globally competitive, and our regulation must support this. Equally we must work to identify, remove and prevent barriers to the operation of the fundamental freedoms and the smooth functioning of the Single Market.

Therefore the UK government strongly supports this timely exercise and is pleased to attach its detailed response. The Bank of England and the Financial Conduct Authority are
making separate and independent responses. This cover note provides an overview of the UK Government’s main points, covering first, a set of technical issues to ensure the smooth functioning of the single market and second, some wider issues which we believe need to be addressed to support a competitive, innovative sector supporting economic growth.

**Technical issues preventing the smooth functioning of the single market**

The UK government has identified a number of technical issues across a wide range of financial services regulation from asset management to banking and from insurance to market infrastructure that, if addressed, would help strengthen the functioning and competitiveness of the Single Market. Where possible we have proposed specific changes. Across all these issues the UK looks forward to working collaboratively with other Member States, the Commission and market participants to deliver solutions which will be effective across the European Union.

While the UK believes all of the individual issues we have raised are important, there are some over-arching themes which, by virtue of their impact across sectors and the Single Market, present themselves as priorities.

1. **Synchronisation of reporting and disclosure requirements**

   Reporting and disclosure requirements are misaligned within and across many pieces of legislation. Single firms and activities may be subject to multiple reporting and / or disclosure requirements which are not coherent. Poorly aligned data requirements are a cost burden for firms and obscure risk management for both regulators and consumers.

2. **Uniformity of definitions**

   The inconsistency of definitions within and across pieces of legislation generates regulatory risk and increases the cost of regulation relative to the benefits they bring. Addressing this issue would reduce the potential for regulatory arbitrage, enable more effective regulation and reduce unnecessary costs.

3. **Connecting legislation**

   Many financial firms are subject to regulation via multiple legislative acts. This inherently increases the risks of unintended consequences and cross-legislative inconsistencies in comparison to regulation contained in a single or limited number of pieces of legislation.
Combining legislation such as the Payment Services Directive and the E-Money Directive or ensuring connected files are updated together will help minimise discrepancies and inconsistencies.

4. Regulatory proportionality

The financial services sector is extremely diverse in terms of its activities, the risks posed to consumers and to the financial system, and in terms of the size and connectedness of firms. Differentiating the regulatory approach, in particular with respect to smaller and less complex firms, would make it more effective in targeting their specific risks and needs.

Wider issues – regulation to deliver a competitive, innovative sector supporting economic growth

This exercise has illustrated a range of broader issues which should be the focus of longer-term work to which the UK looks forward to contributing. Some of these concerns will require Member States and the Commission to take a lead in global fora to find international solutions. In particular we consider that the following issues merit sustained collective consideration:

- The long-term decline in market liquidity and its implications for market making and the efficiency of financing the real economy;
- Building on the work done in Capital Markets Union, how financial services regulation can support long-term investment across the sector including banks, funds and insurers; and
- How best to support the openness of European and global markets as they adjust to new regulatory regimes.

The Commission should take this opportunity to work with Member States to articulate its long-term plan for financial services activity, given its effect on the role the sector plays in the wider economy. The European Union must continue to operate to high standards of regulation and work closely with global groups to implement global standards. Its regulatory system should facilitate and promote competition. And we should be working towards ensuring financial services play a full role in wider policy objectives supporting
growth, boosting productivity, raising living standards and securing Europe’s place in a changing global economy.

To achieve this the UK is also keen to build on the reforms of President Juncker to maximise synergies between different programmes of work across the Commission. We should also connect to industry and academia to benefit from developments such as behavioural economics.

The Commission and Member State authorities must also ensure we are equipped with the correct tools for effective policy making and impact assessments. Ensuring policy implementation is supported across the Union and developing post trilogue/implementation impact assessments are central to achieving this.

The European financial services regulatory framework must be critically examined if it is to remain effective. We hope the evidence gathered will be used by the Commission to work with Member States to deliver a flexible regulatory framework that ensures stability for the future and fosters an open, innovative and globally competitive financial services industry that delivers jobs and growth for firms and consumers throughout the European Union.
Unnecessary regulatory constraints on financing

The Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.

1.1 – Qualifying portfolio undertakings

**Directive(s) and/or Regulation(s):** European Venture Capital Fund Regulation 345/2013 (Article 3) and European Social Entrepreneurship Fund Regulation 346/2013 (Article 3).

**Summary:** The criteria used for the definitions of a “qualifying portfolio undertaking” within both the European Venture Capital Fund Regulation 345/2013 (Article 3) and the European Social Entrepreneurship Fund Regulation 346/2013 (Article 3) exclude businesses which would benefit from access to financing from these investment funds.

**Evidence:** EuVECA s are only able to invest in companies which fulfil a specific set of criteria, including that the company is unlisted and has fewer than 250 employees. These requirements exclude many businesses which would otherwise be eligible for investment, such as labour intensive companies, for example those in services, or a business listed on a growth market such as the Alternative Investment Market.

Within the European Social Fund Entrepreneurship Fund Regulation, the definition of a “qualifying portfolio undertaking” requires that the social enterprise use its profits primarily to achieve its social objective over and above distributing to shareholders. Evidence from sources such as the Social Impact Investment Taskforce set up by the G8 suggests that more entrepreneurs are seeking to set themselves up as businesses where they “lock in” their social mission, without using a lock on profit or asset distribution.

**Suggested solution:** The UK suggests the Commission considers relaxing the severity of these limitations. In the case of EuVECA, this could be done by only requiring investments to satisfy two out of three eligibility criteria. A change in this requirement would increase choice for SMEs seeking funding, as well as investors. In the case of EuSEF, we suggest the Commission removes the requirement for a lock on profit or asset distribution, with the focus to be placed elsewhere,
for example the social mission being locked into the governing principles of the business. This will allow access to funding for more social enterprises.

1.2 - UCITS

**Directive(s) and/or Regulation(s):** Undertakings for Collective Investment in Transferable Securities (UCITS) directives.

**Summary:** The UCITS product is a European success story where well managed and sympathetically developed regulation has helped grow the investment sector and enable funds to flow from investors to the wider economy.

**Evidence:** UCITS funds now have more than €8 trillion of assets under management and account for more than 70 per cent of the assets under management in Europe. Outside Europe, the UCITS framework has been successful in creating a global investment standard and structure based on European norms; UCITS have brought substantial flows of capital into European markets. More than 70 per cent of funds sold in Hong Kong for example are branded as UCITS and formed under this legislative framework.

There are nevertheless areas where the current approach could be further improved and developed. Currently, notice of a merger must be given in writing to all unit holders of the receiving UCITS, even where the merging fund is extremely small. This can lead to the cost of merging a small, inefficient fund into a well performing vehicle becoming prohibitive.

**Suggested solution:** The UK would like to see the success of UCITS continued, with sixth and subsequent UCITS directives building on the global and European success of the industry, by further enabling growth in the retail fund market while ensuring a high level of investor protection and market stability. To ensure the continued success of the UCITS product, sixth and subsequent UCITS directives should seek to make targeted improvements that will enable further growth and improve efficiency in the UCITS market. For example, UCITS VI could consider improvements to the process for merging smaller, inefficient funds in order to ensure that funds are more efficient and better able to attract and retain investment.

1.3 – Asset segregation

**Directive(s) and/or Regulation(s):** European Market Infrastructure Regulation (EMIR); Central Securities Depositories Regulation (CSDR); Alternative Investment Fund Managers Directive (AIFMD); Undertakings for Collective Investment in Transferable Securities (UCITS).
Summary: Various pieces of EU legislation since the financial crisis have tended to encourage or require increased segregation of client assets. Although there are, in each instance, arguments to support these provisions, there should be an assessment of the potential unintended consequences of the cumulative impact.

Evidence: Increased client asset segregation has arisen (or will arise) from the following legislative provisions. EMIR Article 39 requires central counterparties / clearing members to offer both omnibus segregated accounts and individually segregated accounts to clients. CSDR Article 38 requires CSD participants to offer both omnibus segregated accounts and individually segregated accounts to clients and requires CSDs to keep records and accounts that enable this. For example, recital 40 and Article 21 in AIFMD and Recital 22 and new Article 22 under UCITS V contain language on asset segregation and consideration of how segregation should apply throughout the custody chain is ongoing.

Client asset segregation clearly has benefits in some circumstances. However, the wide range of requirements in existence will create a more segregated financial system which could also have unintended negative cumulative consequences in terms of complexity, impact on liquidity, delays in market settlement and reductions in securities lending which overall could contribute to higher costs feeding through to the wider economy.

Suggested solution: The UK suggests that a high level, cross-cutting assessment of this issue is undertaken to better understand the potential benefits, risks and unintended consequences of a system-wide increase in client asset segregation and that the cumulative impact is considered when introducing individual asset segregation measures.

1.4 – Loan origination

Directive(s) and/or Regulation(s): European Venture Capital Fund Regulation 345/2013 (Article 3).

Summary: Restrictions on loan origination pose a disproportionate burden and discourage investment in EuVECA s.

Evidence: EuVECA s are not able to provide loans to a business if they do not already have equity investment in the company, preventing SMEs from gaining access to the full range of equity and debt financing throughout their growth cycle. The funds can only use up to 30 per cent of their capital to invest in the form of a loan, which is unattractive to managers and investors.

Suggested solution: The UK suggests the Commission considers both allowing EuVECA s to originate loans to qualifying portfolio undertakings without requiring equity investment and increasing the proportion of capital which can be used for loan origination. Allowing managers
to use a larger proportion of loan notes would provide protection for investors and increase the attractiveness of these investment opportunities.

1.5 – Green finance

**Directive(s) and/or Regulation(s):** Green Finance.

**Summary:** The UK believes that European endorsement and support for the private ‘green finance’ markets could help to significantly increase the total capital available to tackle climate change. Supporting the industry-led development of robust standards and processes for green bonds will be particularly important to mobilise the capital managed by long-term institutional investors such as pension funds and life insurers. The green bonds market has been growing rapidly, and is developing its own standards to ensure proper appraisal and disclosure of the climate-related benefits of the use of proceeds.

The Commission can best catalyse further growth and refinement of the asset class by encouraging European institutions to finance green capital expenditure through the issuance of green bonds that demonstrate the highest standards of transparency and environmental credibility. Doing so will illustrate best practice and help to set standards and build depth in the market to promote the development of norms led by organisations such as the International Capital Markets Association with the ‘Green Bond Principles’. Various European institutions, including the European Investment Bank, have already taken important steps in this area which could be built upon further. In addition the Commission should use its convening power to facilitate the transfer of relevant expertise across different industries and disciplines and promote public-private dialogue about green finance.

At present a European legislative intervention could be misguided and potentially counterproductive. The asset class is still relatively new and legislation could inadvertently mandate a suboptimal approach, disincentivise issuers of green securities by creating prohibitive legal costs, or stifle the market in other unforeseen ways.

**Evidence:** Total green bond issuance reached nearly $37 billion by the end of 2014, up from less than $5 billion in 2012, but data from 2015 so far indicates growth could be plateauing, suggesting a need for further market development. A significant increase in issuance by non-financial corporate issuers and municipal authorities helped to drive recent growth. Membership of the International Capital Markets Association’s ‘Green Bond Principles’ has also been steadily growing with 104 different investing, issuing, and underwriting organisations signed up as of 7 December 2015.
**Suggested solution:** The EIB should further expand green bond issuance programmes by, wherever possible, seeking to finance green capital expenditure through the issuance of highly transparent green bonds that demonstrate best practice.
2 Market liquidity

Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.

2.1 – Short selling bans

Directive(s) and/or Regulation(s): Short Selling Regulation (SSR) (Article 23).

Summary: The use of short selling bans to prevent prices from falling is not effective and instead reduces liquidity at times of price falls which impacts the efficient functioning of markets.

Evidence: SSR introduced a power for competent authorities to impose a temporary ban on short selling a particular financial instrument where its price has fallen significantly, in order to prevent a disorderly decline in the price of that instrument. However, imposing a temporary ban removes potential sellers and also those that use shorting techniques as part of wider trading strategies. This in turn significantly widens bid-ask spreads and decreases trading volumes which reduces liquidity and prevents markets from operating more smoothly and efficiently. Furthermore, the bans come too late as most of the price movement happens prior to the introduction of the restrictions, by which point the market has already adjusted to the new information.

Solution: To achieve the market impact that a temporary short selling ban seeks to address, the conditions in which these bans are imposed must be carefully defined by the Commission in consultation with ESMA to avoid diverging interpretations and too wide an application.

2.2 – Settlement discipline

Directive(s) and/or Regulation(s): Central Securities Depositories Regulation (CSDR) (Article 7).

Summary: Settlement discipline measures (especially when applied to less liquid securities) may have the unintended consequence of a negative impact on markets by reducing liquidity and increasing costs.

Evidence: The settlement discipline regime in CSDR provides greater flexibility for less-liquid securities by allowing a longer buy-in period. It also allows for asset type and liquidity to be considered when determining the cash penalties that apply to settlement fails. However, it remains that less-liquid securities are proportionately more likely to result in a settlement fail and for the cash penalties to accrue over a longer period while the buy-in is taking place. Market makers or
liquidity providers will be most exposed to these disproportionate costs. This can be expected to lead to a reduction in liquidity or increased transaction costs as a result of the cost of settlement fails being priced into the transaction. This will lead to a poorer outcome for market participants in markets where there is little evidence that settlement fail rates are high or are the result of a deliberate and voluntary action on the part of the failing party.

For transactions that are not cleared by a Central Counterparty (CCP) or traded on a trading venue, the buy-in obligation falls on the Central Securities Depository participant rather than the trading party. This raises the real concern that CSD participants would seek to protect themselves from the high potential cost of buy-ins by requiring collateral from their clients. Given the volume of transactions, these collateral costs would be significant for the EU market and it would be an unintended consequence for CSDR to raise the cost of settlement in this way.

**Suggested solution:** The buy-in regime should only operate at the request of the receiving party, with the alternative of cash compensation being available, and the obligation for the buy-in should fall to the trading party, rather than the CSD participant.

2.3 – Non-equity transparency

**Directive(s) and/or Regulation(s):** Markets in Financial Instruments Regulation (MiFIR) non-equity transparency (Articles 2, 8, 9 and 18).

**Summary:** The proposed Markets in Financial Instruments Directive (MiFID) II regulatory technical standards (RTS) on non-equity transparency could damage the efficient functioning of Europe’s bond and derivatives markets through the calibration of the thresholds and requirements to provide firm quotes on market liquidity. The effect of poorly calibrated transparency requirements in secondary markets may have a significant impact on the costs of financing and hedging risks in the wider economy. Issuers could face higher funding costs to attract investors and the costs to corporates of hedging in derivative markets could increase.

**Evidence:** The Size Specific to the Instrument (SSTI) methodology for bonds and derivatives. MiFIR Article 9(S) (d) requires that these are set by reference to ‘undue risk’. The RTS sets the bonds and derivatives pre- and post-trade SSTI at the 60th and 80th percentiles respectively, but there is no evidence that these percentiles were based on an assessment of undue risk. Undue risk was introduced as a concept because liquidity providers are only willing to provide market liquidity and facilitate client transactions to the extent that they are able to cover themselves from market risk that they take on their own balance sheets when executing a trade. Their ability to exit positions or hedge against risks without significant market movements against them is therefore key for the effective functioning of the market. Under MiFID II, liquidity providers will need to trade out of,
or hedge, a position immediately to avoid the market moving against them because, under pre-trade transparency, quotes are published instantly and for systematic internalisers they must be firm quotes. This is different to current trading and hedging, which can be executed over time in a series of transactions to achieve the best price. If larger trades have to be published, liquidity providers will have to immediately execute parts of their hedges at the second, third, and fourth best prices. At these levels the ‘immediacy’ that will be required under MiFID II where there is not sufficient market depth will raise the cost of the trade or hedge, which the liquidity provider can be expected to reflect in the price quoted to the original client by widening the spread. Analysis on interest rate swaps shows evidence that the level at which the best price is achieved, before tipping onto the second or third best prices, is significantly lower than the 60th percentile. As a result, at the 60th percentile, the bid-offer spread quoted to clients could increase markedly.

The liquid market definition for bonds, MiFIR Article 2(17)(a) and Article 9(5)(e), will be assessed using a classes of financial instrument approach (COFIA) for newly issued bonds and using an instrument by instrument approach (IBIA) thereafter. Under IBIA bonds will be assessed at the end of every quarter, taking the previous quarter as the observation period. A bond that is traded on average at least twice a day, on 80% of trading sessions, at a notional amount of at least €100,000, is defined as liquid. This threshold does not reflect a liquid market where there are ready and willing buyers on a continuous basis as required by the definition. Various market studies (for example, by the IMF and Bank of International Settlements) indicate that as depth in fixed income markets has been declining, execution strategies have increasingly been carried out using more trades with smaller ticket sizes. This is a sign of deteriorating liquidity, but the liquidity criteria in MiFID capture this as increased liquidity. These market conditions have not been properly considered in setting the two trades a day threshold. Certain markets also exhibit significant seasonality, and for example a bond that is liquid in Q2 and Q4, but illiquid in Q3 due to low summer trading, will be misclassified as illiquid in Q4; and vice-versa in Q3.

The COFIA threshold to determine liquid markets for newly issued bonds is being used up to the point of the first IBIA assessment – which could be up to 5.5 months from issuance. The COFIA liquidity thresholds (RTS 2, Annex 3, Table 2.2) are based on issuance size of at least €500 million for non-sovereign bonds and €1 billion for sovereigns. These thresholds result in significant misclassification errors which will apply to a large volume of bonds for a prolonged period of time after issuance.

**Suggested solution:** The Size Specific to the Instrument (SSTI) methodology does not need to be altered. However, it is vital that the actual percentile that will introduce pre-trade transparency is based on the evidence. Where the evidence is difficult to come by, the calibration should be suitably cautious to ensure no unintended damage to the provision of liquidity.
It would be appropriate to make IBIA threshold the calibration less sensitive to volatility in trading and minimise misclassification errors. The thresholds need to be set to a level that is robust enough in classifying bonds correctly throughout the whole year.

ESMA looked closely at the pros and cons of COFIA criteria, in particular with respect to the implications on classification errors given that the liquidity of an instrument declines significantly after a certain time from issuance. ESMA, in its final report (page 97, paragraph 71), accepted that to minimise errors the issuance size thresholds should be increased to: €1billion for corporate bonds after two weeks of issuance; €2billion for sovereign bonds after 3 months from issuance; and €1.25billion for convertible and covered bonds after three months from issuance. The draft RTS took a step backwards from this approach without explanation.

2.4 – Bond market liquidity

**Directive(s) and/or Regulation(s):** Capital Requirements Directive (CRD IV).

**Summary:** Fixed income market participants, including national debt managers, are observing declining market liquidity across all major bond markets. The EU’s application of Basel agreements on bank capital requirements (in particular, the non-risk based Leverage Ratio measure) has been commonly cited as a cause of poorer liquidity in fixed income instruments.

**Evidence:** Bond markets, including sovereign bonds, have seen increased volatility over 2015, with intra-day data showing the frequency and magnitude of relatively volatile days increasing since the crisis. Market participants increasingly report a strong sense of fragility in bond markets, although for the UK gilt market traditional measures of liquidity (including turnover volumes and bid-offer spreads) appear to be holding up.

Feedback from financial institutions suggests that regulatory changes have resulted in repo trading becoming increasingly expensive in terms of balance sheet cost. There are signs of declining liquidity emerging in the gilt repo market, including an impact on pricing and reduced willingness to trade in the repo market.

Market participants cite the cumulative impact of financial regulation as causing episodes of poorer liquidity in bond and repo markets. Increased capital requirements are particularly impacting on banks’ capacities to intermediate and support effective market functioning including in the sovereign debt market. The leverage ratio, which requires a minimum amount of capital to be held against all exposures regardless of relative risk profiles, may restrict the use of banks’ balance sheets as intermediaries to provide market liquidity especially in low-risk, low-return businesses
A number of European banks are strategically reviewing their business models, citing reduced risk capital and balance sheet capacity as constraints on their capacity to intermediate as market makers for bonds and fixed income derivatives.

EU rules have specified firm-level leverage disclosure requirements since 1 January 2015. Although the leverage ratio is currently non-binding, market participants have communicated that the disclosure requirement itself has resulted in the above mentioned impacts on the market, particularly in the repo markets. As part of its review into the leverage ratio the EU should consider in particular the secondary effects on market liquidity which are now becoming more apparent.

**Solution:** As the EU seeks to implement the next stages of the Basel recommendations, the wider liquidity impacts on market participants (market makers, debt issuers and national debt managers) should be explicitly taken into account. A specific Commission-led review on the impact on market liquidity would certainly be welcome, in parallel to the Financial Stability Board and Basel Committee’s longer term work in this area.
3 Investor and consumer Protection

Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence

3.1 – Timing of changes in deposit guarantee levels

**Directive(s) and/or Regulation(s):** Deposit Guarantee Scheme Directive (DGSD) (on timing: Articles 6(5), 6(6) and 6(7)).

**Summary:** The requirements for revising the deposit protection limit in the DGSD have the potential to negatively affect consumer confidence in the European system of deposit guarantees.

**Evidence:** DGSD strengthens the single market by providing a harmonised level of depositor protection across the EEA. The directive has, in general, enhanced depositor protection and contains several elements that will enhance depositor confidence in the system of deposit protection, including the protection for temporary high balances and requirements to ensure that deposit guarantee schemes pay out promptly to depositors.

However, there are particular challenges for Member States who use the option to convert the coverage level into their national currency which could impact consumer confidence and impose costs on firms. The DGSD harmonises the protection limit at €100,000. Member States may convert this amount into their national currency and may round the resulting conversion by up to €5,000 in either direction. The coverage level must be kept under review and adjusted in response to unforeseen circumstances such as currency fluctuations.

Transposition of the recast DGSD required the UK to reduce its deposit protection level from £85,000 to £75,000 in order to take account of changes in the EUR/GBP exchange rate since the UK increased its coverage limit in 2010, to what was then equivalent to €100,000.

UK authorities were able to take steps to manage this reduction (and the Commission was supportive in achieving this). This included maintaining the coverage level at £85,000 until 31 December 2015, to provide a transitional period for depositors to respect the EU law principle of legal certainty and to enable an orderly transition to the new coverage level.

Nevertheless, the adjustment to the coverage level had a negative effect on consumer confidence in the UK deposit guarantee system, with firms seeing evidence of consumers rearranging their finances in response to the changes. Furthermore the knowledge that further adjustments may be
necessary in the future damages the scheme’s credibility and consumer confidence in being able to make long term financial plans based around the coverage limit. The requirements of Article 6(5)-(7) could result in several UK coverage level adjustments in quick succession.

The challenge of ensuring consumer confidence in the stability of deposit guarantees will be to ensure that depositors are not exposed to regular adjustments to the coverage level and that any future adjustments in the coverage level are handled in a way that makes sufficient transitional provisions for depositors. The transitional provisions in the DGSD seemed designed to support Member States who were transitioning from a historically higher coverage level, but not to take account of the impact of reductions in the coverage level caused by currency conversion.

**Suggested solution:** Reviews of the coverage level should be aligned with consumer confidence in the system of depositor protection. For example, enabling Member States who state their coverage level in national currencies to delay conducting their currency conversion until the Commission has completed its inflation adjustments and revisions of the coverage level in line with Articles 6(6) and 6(7).

As a minimum, the requirement on Member States to review their coverage level in order to take account of any changes in the exchange rate should occur following the Commission’s review of whether the coverage level, as a whole, remains appropriate. The Member State review should avoid the need for adjustment as a result of short-term fluctuations and only require changes as a result of genuine, very large and lasting changes in the long-term exchange rate. This could potentially be achieved by using a wider rounding margin and/or a long-term average rather than a spot rate. Appropriate transitional arrangements should be permitted in order to protect depositors who may be adversely affected by an adjustment in the coverage level. One possibility may be to lock the coverage rate for accounts denominated in national currencies.

### 3.2 – Timing of Solvency II reviews

**Directive(s) and/or Regulation(s):** DIRECTIVE 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

**Summary:** The implementation of Solvency II will greatly improve and modernise the current EU framework for the prudential regulation of insurers. The regime introduces a comprehensive set of requirements with the ambition of providing an enhanced and more consistent level of protection for policyholders throughout Europe.

While Solvency II rules have only come into effect from 1 January 2016, the UK can see the case for giving the planned review of Solvency II in 2018 a broader scope and possibly bringing it forward to an earlier timetable. The UK regulators have submitted separate responses focusing on
the prudential issues related to the framework. The additional, broader priorities for the UK government are for the review to focus on the impact of the framework on long-term investment and competitiveness.

**Evidence:** As the Solvency II rules came into effect on 1 January 2016, the UK has had a limited time to see the regime working in practice and so does not yet have concrete evidence on the overall impact of the new regime. The UK will gather more evidence during the first half of 2016. However, our experience of implementing Solvency II to date is already raising issues around the impact of the framework on long-term investment and competitiveness of the European insurance industry.

**Suggested solution:** The UK has work underway to explore the issues raised by the implementation of Solvency II and therefore it is premature to propose specific solutions. However, as part of the planned review of Solvency II there needs to be a close examination of its impact on:

a) Long-term investment: how does Solvency II affect EEA insurers’ ability to invest in a way that contributes to stable, long-term growth in the European economy?

b) Competitiveness: how does Solvency II affect EEA insurers competing internationally, both against foreign competitors operating within the EEA, and when themselves operating in foreign markets outside the EEA?

Previous impact assessments will need to be updated and refinements to framework may be needed to ensure Europe remains a world leading centre for insurance business. It is important to conduct monitoring and peer review exercises to ensure that Solvency II is uniformly implemented across Europe; and identify if further rules or guidance are needed to ensure harmonisation. An inconsistent application will undermine the principle of the European single market. Finally, the impact of Solvency II on the EEA’s international competitiveness in the continuing absence of a global standard for insurance regulation should be considered.

### 3.3 – Changes to existing payment account switching service

**Directive(s) and/or Regulation(s):** Payment Account Directive (PAD).

**Summary:** PAD Chapter 3 requires the UK to provide a switching service for payment accounts and Articles 16, 17, 18, 19 and 20 of Chapter 4 requires the provision of payment accounts with basic features (also known as basic bank accounts). The UK already has domestic non-legislative measures in place on switching and basic bank accounts. The need to legislate to ensure sufficient legal certainty for the transposition of PAD has added an unnecessary layer of administrative and regulatory burden, with no clear benefit to consumers in the UK.
Evidence: The Current Account Switch Service (CASS) is already offered to over 99 per cent of the UK’s current account market and delivers effective switching for consumers. Although PAD allows Member States to maintain an alternative switching service under certain conditions, the UK has had to legislate to ensure the provision of switching services at the margins of the market and expand the responsibilities of regulators with regards to switching. This has placed additional burdens on the CASS, firms and regulators.

Suggested solution: The Commission should routinely give rigorous consideration to and assess the impact of changing existing domestic regimes that are working well before creating an explicit or implied requirement to legislate.

3.4 – Mortgage market diversity

Directive(s) and/or Regulation(s): Mortgage Credit Directive (MCD).

Summary: Lack of harmonised regulation is not the main barrier to an EU wide market for mortgages; firm understanding of foreign markets and consumer preferences are more important. Harmonisation of conduct regulation for the mortgage market in the MCD has increased burdens for firms and in some areas has undermined the ability for firms to provide cross-border services.

Evidence: The primary obstacles to an EU wide market for mortgages includes the relative difficulty for lenders in understanding credit risk in unfamiliar markets and the complexity in enforcing loans under foreign legal systems (as distinct from regulatory frameworks). For borrowers, the scale and nature of a mortgage commitment drives a preference for dealing with well established, or local, brands. The MCD provides for some flexibility in recognition of the diverse mortgage market across the EU. However, where it has not offered scope for Member States to maintain consumer protections which have proved effective, for example around disclosure documentation (the European Standardised Information Sheet), burdens on firms have been unnecessarily increased. Some provisions may also directly undermine cross-border mortgage lending, such as regulatory requirements on providers of foreign currency loans – lenders could withdraw from this market, which in turn could make it more expensive for consumers and reduce choice.

Suggested solution: The Commission’s mortgage policy should focus on addressing the primary obstacles around lenders and borrowers knowledge and risk appetite, while ensuring that conduct regulation provides scope for Members States to maintain consumer protections that have proved effective.

3.5 – Mortgage creditworthiness checks
**Directive(s) and/or Regulation(s):** Mortgage Credit Directive (MCD).

**Summary:** The UK is supportive of the MCD’s objective of making the mortgage market safer for both lenders and borrowers. However, the creditworthiness requirements in the MCD can force lenders to deny borrowers cheaper deals that would be beneficial to both consumers and financial institutions. This is because some existing mortgage holders and will be unable to pass the MCD’s creditworthiness test even if they are not increasing the size of their mortgage.

**Evidence:** The rigidity of the creditworthiness requirements in the MCD means that consumers who have been previously granted a mortgage and are looking to re-mortgage must pass a creditworthiness assessment. Those mortgage holders who cannot pass a creditworthiness assessment will not be able to re-mortgage, even if their mortgage payments would fall. This creates situations where mortgage lenders are required to tell borrowers they cannot afford cheaper deals.

**Solution:** To replicate the exemptions the FCA have already built into the UK’s Mortgage Market Review in the MCD. The FCA’s exemptions allow lenders to waive the ‘creditworthiness test’ for existing mortgage holders, that are not increasing their debt, whether they are staying with their existing lender or switching lender.
Are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?

4.1 – Liquidity of Sukuk

**Directive(s) and/or Regulation(s):** Liquidity Coverage Ratio (LCR), Capital Requirements Regulation (CRR).

**Summary:** Fully Shari’ah compliant banks do not hold assets which attract interest. However, the CRR limits the amount of non-interest bearing assets that can be included in these firms’ liquid buffers.

**Evidence:** In Islamic finance, the religious requirements of Shari’ah law prohibit the payment of interest. The vast majority of instruments that the EU LCR permits to be held in the liquidity buffer pay some form of interest to the owner.

Fully Shari’ah compliant EU banks are permitted to hold Shari’ah compliant bonds (known as ‘sukuk’), which do not pay interest. However, in the EU it is difficult for these firms to include these assets as part of their liquidity requirements.

Basel III, and the EBA’s impact assessment for the LCR, recognised the challenges the LCR poses for fully Shari’ah compliant banks. Both proposed supervisory discretion from the LCR’s liquid asset requirements to address this issue.

Whereas sukuk have much lower issuance levels than non-Islamic assets; issuance is concentrated in sovereigns and tend not to be denominated in currencies such as EUR and GBP (this means there could be concerns around their liquidity). Supervisors are able to impose tough operational restrictions on sukuk bonds included in the liquidity buffer.

Although recognition of sukuk was secured in the EU’s definition of the liquidity ratio, it is restrictive. If left unaddressed, this restriction will create disproportionate additional costs for fully
Shari’ah compliant banks in meeting the LCR requirements as compared with other EU credit institutions.

**Solution:** There is currently discretion for supervisors to permit these institutions to hold a limited amount of assets to meet their liquidity requirements. The UK believes that this discretion should be extended to permit more sukuk bonds to meet the liquidity requirements. This work could be initiated via the review on Islamic Finance, mandated by the CRD, although there is currently no deadline as to when this review must be done.

### 4.2 – Disproportionate application of international accounting standards

**Directive(s) and/or Regulation(s):** International Accounting Standards Regulation 1606/2002 (Article 6).

**Summary:** International accounting standards can pose disproportionate burdens on small and medium size enterprises.

**Evidence:** The International Accounting Standards Regulation requires listed companies to prepare their consolidated financial statements using international accounting standards (IAS). The IAS regime is designed for large multinational conglomerates and the burden of compliance does not scale down to smaller firms. Full International Financial Reporting Standards (IFRS) accounting can be disproportionately onerous for smaller listed firms. Standards such as IFRS 7 (Financial Instruments Disclosures for non-financial companies), IFRS 2 (Share-based payment) and IFRS 8 (Operating segments) are complex and the associated disclosure requirements often require a level of specialist skill not readily available within smaller firms.

The Green Paper, Building a Capital Markets Union, already identifies that the complexity of the financial reporting requirements required of those accessing capital markets may act as a deterrent to small firms seeking finance and considers how information requirements might be simplified, especially for SMEs.

**Suggested solution:** The Commission should work with IASB, EFRAG, supervisors and other stakeholders to consider the necessity and proportionality of requiring smaller listed firms to comply with full international reporting standards, or whether more flexibility (such as reduced disclosure – an “IFRS minus” basis) could be permitted without leading to a reduction in the quality of reporting or requiring SME growth markets to accept weaker accounting standards for member firms. The Commission might explore if compliance with the IFRS for SMEs for smaller listed firms would be sufficient to meet the needs of investors and prudential regulators. This would help ensure that the compliance burden on smaller listed firms is proportionate while ensuring that firms listed on the EU’s regulated markets continue to report under international standards.
4.3 – Non-financial firms and MiFID II

**Directive(s) and/or Regulation(s):** Markets in Financial Instruments Directive (MiFID) II.

**Summary:** Disproportionate burdens on non-financial firms.

**Evidence:** MiFID II introduces a number of reporting requirements on non-financial firms that participate in financial markets which are not tailored to the size of activity they undertake. As a result, they place disproportionate burdens on small and medium sized firms. For example, the transaction reporting provisions require all clients of investment firms that are legal entities to be identified by a Legal Entity Identifier (LEI). This is expected to require a very significant number of non-financial firms that do not currently have a LEI to apply for a LEI and pay an annual cost, irrespective of the number of transactions they enter into. A further example is the requirement for all non-financial firms which rely on the ancillary activities exemption to notify annually the competent authority of this. Finally, the requirement for position reporting to apply to the level of the end-client in all cases, irrespective of the sizes of those positions.

**Solution:** A de minimis approach should be adopted in relation to all reporting requirements.

4.4 – Proportionate prudential regulation of less complex banks

**Directive(s) and/or Regulation(s):** Capital Requirements Regulation (CRR).

**Summary:** There are two key reviews which will look into the appropriate treatment of prudential requirements for firms in the EU: the impact of CRR on lending and whether rules could be simplified and the appropriate prudential rules for investment firms. Both are helpful in trying to determine whether regulation may be disproportionate for certain types of firms, including mutual building societies and smaller banks.

**Evidence:** The Basel regulatory framework was and is intended to address the risk to financial stability posed by large internationally active banks. Following the financial crisis, the Basel framework has become increasingly complex and demanding to ensure compliance. While this complexity may be appropriate for larger, systemically important banks, it has made it harder for smaller and less complex institutions to compete.

The overall complexity of the current framework has some potentially serious and undesirable effects that we believe warrant a thorough discussion with a view to coming up with appropriate policy responses in the EU.

Different kinds of banks and business models contribute to the resilience of the financial system and thereby financial stability. A regulatory framework that allows for diversity is more supportive
of competition and innovation, helping consumers to get better products and the economy to be more productive.

Complexity also means that managers of less complex banks have less time to focus on serving the economy, as they increasingly concern themselves with ensuring regulatory compliance.

Larger firms have a competitive advantage relative to smaller firms — they can spread the fixed costs of expertise required to understand and take advantage of this complex set of rules across a much larger cost base than smaller firms. A clear example of this is in terms of reporting requirements which make very little allowance for the differing burden they place on different sized firms.

Although the principle of proportionality is supposed to apply, in practice this has not been given any clear meaning. Since supervisors are predisposed to err on the side of caution, there is a risk that this results in regulatory requirements imposed on small, less complex banks which are not in proportion to the risk that they pose to financial stability and the economy. This may have a negative impact on competition, lending (including to SMEs) and growth, thereby preventing the EU economy from reaching its full potential. Indeed, this may have an adverse impact on the EU’s global competitiveness as, for example, the US does not apply the Basel framework to local and state banks, which means these banks are better able to lend to the local economy and contribute to growth in the US economy and creating a competitive advantage over the EU.

**Solution:** The Commission should consider developing proposals designed to achieve a more proportionate and fit-for-purpose prudential framework for smaller / less complex banks and credit institutions. Any such regime would need to offer an equivalent level of protection, although we believe we should be open to consider whether there are different ways of arriving at that level of protection. The Commission’s consultation on the impact of CRR on lending, launched over the summer, is an important input for this work. Similarly, we welcome the work being undertaken by the ESAs looking into what an appropriate prudential regime could look like for investment firms and encourage the Commission to develop proposals for a prudential regime tailored to the risks posed by these investment firms.

**4.5 – Capital requirements on OTC derivative transactions**

**Directives and/or regulation(s):** European Market Infrastructure Regulation (EMIR), Capital Requirements Directive (CRD) IV/CRR.

**Summary:** EMIR and CRDIV/CRR penalise bilateral trading and may go too far.
Evidence: OTC derivatives transactions which are not subject to EMIR’s clearing obligation will, for certain market participants, be subject to new regulatory technical standards governing collateralisation (margining) and will incur much higher capital charges than cleared transactions.

While it was consistent with the intention of policymakers, following the financial crisis, to establish incentives to promote central clearing, there are some economically useful instruments for which electronic trading or clearing may never be appropriate. A significantly higher cost of entering into bilateral OTC derivatives may deter market participants from entering into economically useful trades.

This heightened cost potentially disproportionately impacts buy-side firms, such as asset managers and corporate end users, which are major users of bespoke OTC hedging instruments to suit their business needs.

Suggested solution: We recommend that the Commission – in reviewing EMIR and in future work on capital requirements – assess whether the overall economic incentives in place through EU legislation to encourage a move away from bilateral OTC derivatives trading and towards clearing are proportionate.
Excessive compliance costs and complexity

In response to some of the practices seen in the run-up to the crisis, EU rules have necessarily become more prescriptive. This will help to ensure that firms are held to account, but it can also increase costs and complexity, and weaken a sense of individual responsibility. Please identify and justify such burdens that, in your view, do not meet the objectives set out above efficiently and effectively. Please provide quantitative estimates to support your assessment and distinguish between direct and indirect impacts, and between one-off and recurring costs. Please identify areas where they could be simplified, to achieve more efficiently the intended regulatory objective.

5.1 – Non-core investment fund practices

**Directive(s) and/or Regulation(s):** Alternative Investment Fund Managers Directive (AIFMD), Article 6 (4); Undertakings for Collective Investment in Transferable Securities (UCITS) Article 6(3).

**Summary:** Articles 6(3) of UCITS and 6(4) of AIFMD show an inconsistency in the ability to perform non-core practices, resulting in practical complexities with regard to fund management operations.

**Evidence:** Broadly speaking, Article 6 of AIFMD and UCITS are similar, except Article 6(3) does not permit UCITS management companies to perform non-core service of transmitting and receiving orders of financial instruments. AIFMD Article 6(4), however, does permit this practice. This inconsistency is a burden to firms that undertake both UCITS and Alternative Investment Fund management.

**Suggested solution:** This could be corrected by aligning the permitted activities under UCITS to those under AIFMD. Extending the UCITS permissions would decrease the burden on firms that undertake both UCITS and AIF management.

5.2 – Simplifications made by TDAD

**Directive(s) and/or Regulation(s):** Transparency Directive Amending Directive (TDAD)

**Summary:** The TDAD has simplified the reporting procedure for industry and consumers and offers an example of a constructive approach to Financial Services legislation.
Evidence: The TDAD reduced burdens on industry by removing the requirement for issuers to produce quarterly reports. Reducing the overall requirement to produce financial reports from quarterly to half yearly significantly lowered the burdens on businesses, especially SMEs, and simplified reporting for customers. The TDAD also extended the deadlines that firms had to produce their semi-annual reports, to make it easier for firms to meet these requirements.

Suggested solution: Continue to adopt a proactive approach to reduce the cost of regulation and reporting on industry without negatively impacting on consumers across EU legislative files.

5.3 – Short position reporting

Directive(s) and/or Regulation(s): Markets in Financial Instruments Regulation (MiFIR) Article 26.

Summary: The requirement under the transaction reporting system in Article 26 of MiFIR for MiFID II firms to flag short sales in each transaction report where applicable is unduly burdensome.

Evidence: MiFIR introduces an additional administrative burden on MiFID II firms to flag short sales in each transaction report. This will require firms to further develop their IT systems to gather this information. Furthermore, the information may not be reliable given that the client may not disclose the correct information and/or it would be difficult for the firm to collect the information without this conflicting with other existing requirements.

Suggested solution: Require data collection on short positions via the Short Selling Regime rather than MiFIR.

5.4 – Implementation timelines for legislation

Directive(s) and/or Regulation(s): Found across multiple pieces of legislation, particularly the Bank Resolution and Recovery Directive (BRRD), Markets in Financial Instruments Directive / Regulation (MiFID 2 / MiFIR), Payment Services Directive (PSD 2), Payment Accounts Directive (PAD), and Solvency 2.

Summary: Implementation deadlines and sequences for legislation are set without appropriate regard for the challenges of implementation for firms or authorities.

Evidence: The implementation of legislation, including transposition, the setting of regulatory and implanting standards and the changes necessary in firms is a costly and lengthy process (the implementation of Solvency II was estimated to cost UK insurers ~£1.8bn in single incidence costs and took more than 7 years).

Some of the costs of implementing new legislation for supervisors and firms are fixed, others are dependent on the length of time available to make a change. Where related pieces of legislation,
such as the PSD and PAD, come into force at different times this results in higher fixed costs and unnecessary work where changes are made in an inefficient sequence. Where legislation is concluded but the secondary measures necessary for implementation by firms and supervisors are slow or delayed, as happened with Solvency II, this raises the costs of implementation and increases the chance of error as implementation is rushed to meet statutory deadlines. In some cases, such as MiFID II, it has been impossible for necessary preliminary measures, such as ESMA’s IT system, to be put into place in time for the scheduled application of legislation. This has necessitated new primary legislation delaying the implementation in order for firms and authorities not to be in breach of an impossible requirement.

**Suggested solution:** In the future, when related pieces of legislation are being worked on and require implementation by similar firms, they should be scheduled for implementation together. Additionally the Commission should reconsider the framing of timetables for implementation in its legislative proposals to allow them to be more flexible to the Level 2 legislative process and more easily altered if necessary.
Reporting and disclosure obligations

The EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors.

Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals.

Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value.

6.1 – Multiple and varying reporting requirements

**Directive(s) and/or Regulation(s):** European Market Infrastructure Regulation (EMIR) Article 9; Markets in Financial Instruments Regulation (MiFIR) Articles 24 – 27; Markets in Financial Instruments Directive MiFID) II Article 18; Securities Financing Transaction Regulation (SFTR); Short Selling Regulation (SSR) Article 7; Alternative Investment Fund Managers Directive (AIFMD) Article 3 and Article 24.

**Summary:** Multiple and varying reporting requirements cause unnecessary burdens for firms.

**Evidence:** A commodity derivative transaction, for example, could be subject to overlapping or duplicative reporting requirements under EMIR, MiFID and the Regulation on wholesale energy market integrity and transparency (REMIT) legislation. One example of an area where reporting requirements could, depending on the particular circumstances, be duplicative concerns exchange-traded derivatives (ETD) transactions, which must be reported to trade repositories under EMIR but are also, to some extent, covered under the MiFID transaction reporting regime. The transaction will also need to be reported under the position reporting regime in MiFID II.
Suggested solution: While each reporting regime has different objectives, the Commission should identify where the data reported under requirements across separate Financial Services files overlap and create needless compliance burden for firms, while providing little additional benefit to EU authorities. The Commission should also promote consistent reporting requirements across common elements, such as the details of the financial instrument transacted, that must be reported under separate dossiers, ensuring that – wherever possible – the same data is reported in an identical way across regimes, reducing unnecessary complexity and cost for market participants. Naturally, in simplifying and/or removing any reporting requirements, the Commission should bear in mind (i) the operational costs to firms of adapting to any changes and strike an appropriate balance between adjusting reporting regimes to reduce duplicative requirements and recognising the investments firms have already made to comply with current rules, and (ii) the respective purposes of the specific reporting regimes. The Commission may also want to conduct an impact assessment on the issues surrounding reporting requirement inconsistencies across regimes.

6.2 – Consistent disclosure for retail investors

Directive(s) and/or Regulation(s): Packaged Retail Investment and Insurance-based Investment Products (PRIIPS); Insurance Distribution Directive (IDD); Prospectus Directive (PD); Solvency II; Markets in Financial Instruments Directive (MiFID); Institutions for Occupational Retirement Provision (IORP); Undertakings for Collective Investment in Transferable Securities (UCITS).

Summary: Across the legislative framework there is no consistency in the disclosure requirements for retail investors. Regulation relies on the rationality of consumers to understand the information.

Evidence: An illustrative example is the duplication of pre-contractual information between the PRIIPS Regulation which covers packaged retail investment and insurance-based investment products, and the sectoral regulation for investment services and activities and insurance. These include MiFID II, Solvency II and IDDII. As a result, for similar products, consumers can receive different or multiple disclosures. Although there have been attempts at both Level 1 and Level 2 to give thought to how these requirements interact, the differing timelines and separate processes have made this difficult. If the information is not aligned, this risks confusing and further alienating consumers. Most EU legislation in the retail space includes some requirement for firms to disclose information to consumers. As legislation is reviewed, disclosure is added rather than removed so a consumer will receive several different disclosures generated by EU legislation throughout the purchasing process and lifecycle of their products. Behavioural economics highlights that the more information consumers receive, the less able they are to engage and use the information to make
effective decisions. Increased disclosure requirements make disclosure and pre-existing disclosure less effective in empowering consumers to make effective decisions.

**Suggested solution:** Consider reporting and disclosures from a customer's viewpoint to ensure that economically-equivalent products are subject to similar rules. The Commission should use opportunities offered by statutory review to consider rationalising the requirements in existing legislation where necessary and, when legislating in the future, consider disclosure in light of technological changes and new understanding of consumer behaviour.

### 6.3 – Country-by-country reporting of financial firms taxation

**Directive(s) and/or Regulation(s):** Article 89 of Capital Requirements Directive (CRD) IV (country by country reporting requirements).

**Summary:** Article 89 of CRD IV requires banks and investment firms to annually report turnover, profit and tax paid for each EU country in which they operate, with the aim of providing stakeholders with a better understanding of where taxes are paid and how this aligns with business activity/profit. It is the UK's view that the simplistic definition of tax paid used in the report risks undermining its objectives.

**Evidence:** The largest investment banking groups recently published country by country reports which revealed the low amount of UK corporation tax to have been paid in 2014.

For many banks the report provided an accurate representation of their UK tax paid, with low tax payments explained by a lack of UK profit and/or the availability of relief for losses previously incurred.

For other banks however, the report did not provide an accurate representation of their UK tax paid.

That is because: (a) the report fails to pick up tax payments made by UK branches of non-EU companies, including those made on behalf of wider UK operations; and (b) the report does not take account of the fact that a bank's tax payments in 2014 may be reduced to reflect overpayments in a previous period.

**Suggested Solution:** The definition of tax paid should be amended so that it covers tax payments made by a UK branch of a non-EU company on behalf of other UK companies within scope of the CRD IV report.
Standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.

7.1 – Article 55 BRRD

Directive(s) and/or Regulation(s): Bank Recovery and Resolution Directive (BRRD), Article 55.

Summary: The BRRD introduced a common recovery and resolution framework for banks and investment firms in the EU. Article 55 requires Member States to ensure firms include a clause in any contract governed by third country law that creates a liability, acknowledging that the contract is subject to resolution in an EU Member State, and binds the holder to accept a reduction of the principal, conversion or cancellation. While there are significant benefits, primarily for liabilities that are intended to be loss absorbing – for example subordinated debt and long-term senior unsecured debt – it has the unintended consequence of reducing EU banks’ ability to offer trade finance, which supports investment in the EU, and requires contracts to be renegotiated in order to comply.

Evidence: The provision was drafted very broadly and requires contractual recognition language to be included in a wide range of contracts, including those that create a contingent liability, such as trade finance. Banks offer trade finance products to support and fund trade transactions, rather than using them to fund the bank. The liabilities are either contingent or will at some point be fulfilled. It is therefore questionable whether bailing them in would contribute to the recapitalisation of the bank. Attempting to bail-in trade finance liabilities is therefore unlikely to have a significant positive impact on recapitalising a firm and would damage the provision of trade finance.
A requirement to include contractual clauses of the type required by Article 55 could lead to a fall in the number of trade finance transactions that can be undertaken by EU banks, as it is not possible to add contractual bail-in terms to certain trade finance liabilities. The scope extends to a number of products typically governed by uniform international industry rules and procedures set by the International Chamber of Commerce and other industry organisations. The use of international standard documentation and rules, the practice of having no express choice of governing law of contracts, the legal nature of certain finance liabilities and the inability to impose unilateral changes to a contract because of the dominant bargaining position of non-customers makes it practically impossible for banks to add contractual bail-in terms to some types of trade finance liabilities. This may affect the ability of EU banks to offer trade finance to clients, or the attractiveness of that trade finance to investors, and therefore reduce the number of transactions. The impact on SMEs is likely to be disproportionate as they are less likely to be in a position to access trade finance solutions from non UK/EU banks or other market participants. Compliance with the contractual documentation will also require banks to renegotiate tens of thousands of contracts with little corresponding financial stability benefit.

While the current approach taken by the UK (requiring firms to include the clause in all contracts except where impracticable to do so) addresses some of the immediate issues, it is burdensome for both firms (who must make real efforts to include such language in contracts, in order to be able to demonstrate that it is impracticable) and regulators (who must determine whether something is impracticable). The UK therefore does not consider this to be an optimal long-term solution and believes this is already having an effect on trade finance.

**Suggested solution:** The scope of Article 55 could be narrowed to capture a smaller range of liabilities while meeting the original policy aim. For example, it could be confirmed that the exclusion from bail-in for commercial and trade creditors under Article 44(2) (g) (ii) of the BRRD can be read to include trade finance as provided by EU banks. Alternatively, the forthcoming delegated act specifying the circumstances in which resolution authorities can exercise discretion to exclude an eligible class of liabilities from the scope of bail-in could specifically refer to trade finance as a possible candidate for exemption. However, this would not be nearly as effective as a change to the Level 1 text itself, since the delegated act only deals with how resolution authorities exercise their discretion, and cannot provide legal certainty.

**7.2 – Cost of prospectus documentation updates**

**Directive(s) and/or Regulation(s):** Prospectus Directive (Directive 2010/73/EU).
Summary: The changes to the Prospectus Directive (PD) made by PD II (Directive 2010/73/EU) resulted in additional costs to businesses to prepare prospectuses without any material benefit to investors.

Evidence: PD II made a number of reforms which required businesses to produce prospectuses which were different from those previously required under the original PD. In particular, PD II required the use of a different, more prescriptive structure for the summary section. This shift imposed costs on businesses who had to pay lawyers to amend the documentation they had been using before then (for example, the previous year’s bond prospectus). Even in the most straightforward case of a plain vanilla bond, the costs of compliance with the PD II requirements on summaries have been privately estimated at £10,000 to £15,000 per prospectus. The costs were even higher (estimated at £18,000 to £25,000 per product) for retail structured products. Responses to the PD review consultation in 2015 suggested that PD II changes regarding summaries have not been helpful to investors and so have had no benefits which would justify the costs.

Suggested solution: The problems caused by PD II indicate that as a general rule the costs of transition must be considered very carefully when changing the rules relating to documentation. This lesson is relevant both to the upcoming PD review (where we hope this specific issue will be addressed) and other legislation which affects the legal documentation used in the market. In future, when the Commission is considering any proposal where an impact on legal documentation is reasonably foreseeable, it should:

1. specifically estimate the costs of transitioning from existing precedent documentation to documentation which complies with the proposed new requirements; and,

2. take these costs into account in determining whether to propose any legislative or regulatory changes.
Rules outdated due to technological change

Please specify where the effectiveness of rules could be enhanced to respond to increasingly online-based services and the development of financial technology solutions for the financial services sector

8.1 – Emerging platforms and distance marketing

**Directive(s) and/or Regulation(s):** Distance Marketing Directive

**Summary:** Legislation is out of date and should be reviewed to ensure suitability for emerging platforms and technology.

**Evidence:** Firms are increasing their use of mobile devices as a platform to engage with customers. However, firms find it difficult to comply with disclosure requirements when communicating with customers using mobile devices, for example when customers use the devices to access pre-contractual information. Legislation makes specific mention to outdated technology, such as fax machines and floppy disks, but makes no allowance for the needs of new platforms. The length of time taken to implement legislation exacerbates differences between original legislation and changes in technology.

**Suggested solution:** Financial services regulations covering communication with customers should be reviewed to make sure that they are fit for purpose given the increasing use and development of technology in consumers' purchasing habits at the domestic level. More widely, the Commission should seek to future proof new legislation by default as far as possible by using technology neutral language across the entire acquis. The Commission should avoid being too prescriptive in the language, for example specifying the number of sheets of A4 paper a consumer should receive, and instead use terms that can be adapted to fit changes in technology in order to allow innovative companies to take a more flexible approach to communicating with customers.

8.2 – Encouraging emerging financial services technologies

**Directive(s) and/or Regulation(s):** Encouraging emerging Financial Services Technology

**Summary:** The UK welcomed the Commission’s proposal to ‘report on national regimes and best practice and monitor the evolution of the Crowdfunding sector’ and look forward to contributing in a way that supports the conclusions of the Capital Markets Union Action Plan. The action plan
itself acknowledged that ‘premature regulation could hamper, not foster, the growth of this fast-growing and innovative funding channel’ and so Member States are best placed to decide their own Crowdfunding regulations. This remains the UK view.

We also will continue to share best practice so other Member States can learn from the UK approach and allow their own Crowdfunding industries to thrive.

**Evidence:** The UK approach has been highly successful where our proportionate and flexible attitude has helped to yield a strong growth rate. In 2014 investment Crowdfunding experienced annual growth of 188 per cent, raising £88m; while peer to peer grew by 177 per cent to £1.3bn. This has translated into clear economic and social benefits for the UK – 70 per cent of businesses raising money through equity Crowdfunding have increased turnover and 60 per cent have increased employment.

**Suggested solution:** The Commission builds on the conclusions of the Capital Markets Union Action Plan, continuing to avoid premature regulation that could hamper, not foster, growth. The Commission still has an important role to play in showcasing the different regulatory approaches and helping to share best practice across Member States. The Commission should continue to work with Member States to gather evidence on the performance of Crowdfunding, and consider what lessons can be learned and applied to help foster growth of Crowdfunding across the EU. The UK Government welcomes the opportunity to explain how it has helped to support the growth of the Crowdfunding industry in the UK and looks forward to working with the Commission and other Member States on this.

### 8.3 – Anti-money laundering regulation and digital currency exchanges

**Directive(s) and/or Regulation(s):** Anti-money laundering directive

**Summary:** Digital currencies firms could bring significant benefits for EU consumers, businesses, and the economy. At present, many of these benefits cannot be realised because digital currency firms cannot access the banking services they need to establish themselves in the EU. Since the negotiations of the fourth anti-money laundering Directive, the UK has undertaken a wide-reaching evidence gathering exercise on the potential risks and benefits of digital currencies. In light of this evidence, the UK Government intends to bring anti-money laundering (AML) regulation to digital-to-fiat currency exchange firms, to help the industry demonstrate its credibility and legitimacy – and to create a hostile environment for illicit actors. The UK has chosen to focus regulation on digital-to-fiat currency exchanges in particular because it is this type of business that carries the highest money-laundering risk in a digital currency network. The UK does not intend to extend AML regulation to digital-to-digital exchanges, or non-exchange firms, as
these businesses carry a low money-laundering risk, and doing so would stifle much of the legitimate digital currencies sector.

**Evidence:** The UK published a call for evidence in August 2014 on the benefits and risks of digital currencies. A summary of responses was published in March 2015. Responses noted there are potential benefits offered by digital currencies as a payment method, noting positive impacts for consumers, retailers, charities, the government and the wider economy. In particular, respondents commented on the potential for cheaper and faster payments. Respondents described how decentralised digital currencies can provide a more efficient infrastructure for the transfer of money, by removing the need for traditional intermediaries (such as banks or payment scheme companies) to oversee the process and verify that the transaction is genuine. These benefits could be realised at an EU-wide level, promoting trade and competition in the interests of consumers, and contributing to the single market.

Furthermore, the National Crime Agency in the UK has found little evidence to indicate that digital currencies are used by established money laundering specialists or that they play a role in terrorist financing. This strongly suggests that the overall level of money-laundering and terrorist-financing conducted through digital currency networks is low. Nevertheless, while the ML/TF risk is low across the whole digital currencies sector, respondents to the UK’s call for evidence pointed out that the point of exchange between digital and fiat currencies could carry an ML/TF risk as it is the point at which users “cash in” and “cash out” of the digital currency network. For this reason, the UK Government intends to target AML regulation at these digital-to-fiat exchanges.

A number of industry respondents to the call for evidence also highlighted that the lack of a stable regulatory regime is a key blocker that prevents legitimate digital currency firms from being able to access UK banking services. They called for the introduction of a proportionate regulatory framework to help address this issue.

**Suggested solution:** The UK Government intends to bring digital-to-fiat currency exchange firms into domestic AML regulation. This is a proportionate approach, as widening the regulatory perimeter (for example, to include wallet providers) would be excessively burdensome on regulated firms and would be disproportionate to the risk posed by this wider group of providers. The Commission should similarly explore how AML regulations could be applied to digital-to-fiat currency exchanges at an EU level while ensuring legitimate actors can continue to operate, innovate and deliver benefits to consumers, businesses and the wider economy.
Barriers to entry

Please document barriers to market entry arising from regulation that the EU should help address. Have the new rules given rise to any new barriers to entry for new market players to challenge incumbents or address hitherto unmet customer needs?

9.1 – Unintended impacts in the IFR

**Directive(s) and/or Regulation(s):** Multilateral interchange fee regulation (IFR).

**Summary:** There have been instances where firms have inadvertently been caught by regulation because a thorough impact assessment has not been undertaken. This can restrict the ability of new and emerging players to compete, given the requirement for them to comply with regulation which has not been designed with their specific business model in mind.

**Evidence:** Under the IFR, some cards schemes were inadvertently caught without an assessment of the impact on their ability to operate. This is because the nuances to the business models of smaller card schemes were not fully considered.

Whereas the IFR makes a clear distinction between four party schemes (which are caught by the regulation) and three party schemes (which are exempted), it fails to consider all the various three party schemes which licence with other payment service providers. As a result, there are some small cards schemes which will be caught by the regulation without a sufficient assessment of the impact. Therefore, the IFR could act as a barrier to the growth of some small schemes and to new entrants.

**Suggested solution:** All legislative proposals should be preceded by a full and comprehensive impact assessment. Where this assessment fails to address the impact on firms, or where they are inadvertently caught, a further assessment should be undertaken before the rules come into place.

9.2 – Requirement for external valuation in AIFMD

**Directive(s) and/or Regulation(s):** Alternative Investment Fund Managers Directive (AIFMD) Article 6(19).

**Summary:** The requirement for an AIFM to either choose to appoint an external valuer or check their valuation with an external valuer (Art 19(9)) is costly and adds little value.

**Evidence:** Article 19 of AIFMD requires the Alternative Investment Fund manager to appoint an external valuer to either value – or verify the valuation – of the assets of the AIF under
management. The AIF manager is responsible for the valuation but, crucially, the external valuer is liable for the valuation of the asset(s), for example, property in property AIFs. In practice, it is difficult and costly for AIFMs to secure external valuers, as there is no limit to the liability threshold with regard to an external valuer being held liable for negligence or intentional failure on their part. This ultimately inhibits the market in an unnecessary way.

**Suggested solution:** The Commission should review this requirement under the AIFMD review.

9.3 – Prohibition of naked short selling

**Directive(s) and/or Regulation(s):** Short Selling Regulation (SSR) Chapter 3.

**Summary:** The introduction of a blanket prohibition on naked short selling contributes to both excessive compliance costs and can pose a barrier to entry.

**Evidence:** SSR introduced a prohibition on naked short selling in order to address the risk of settlement failures brought about by the belief of naked short seller’s inability to source stock to fulfil his delivery obligations to the buyer. However, this type of prohibition limits the speed and extent to which a short selling strategy can be executed since firms have to spend time and resources locating and borrowing stock before carrying out a short sale. Associated administrative burdens and costs may pose a barrier to entry.

**Suggested solution:** The Central Securities Depositories Regulation (CSDR) tightens the settlement discipline regime set out in the SSR thus removing the need for the prohibition of naked short selling.

9.4 – Additional national requirements beyond those in UCITS

**Directive(s) and/or Regulation(s):** Undertakings for Collective Investment in Transferable Securities (UCITS).

**Summary:** National regulators have imposed further requirements on top of the requirements existing in the Level 1 directive (fees, requirement for paying agents etc.). This increases legal uncertainty for managers as well as costs.

**Evidence:** The excessive complexities and costs may discourage funds from marketing in other jurisdictions, resulting in less competition in the market. For example, investment funds authorised under UCITS are currently subject to a number of barriers to their being efficiently passported and marketed into different jurisdictions. Chapter 11 of UCITS sets out the rules and processes on the cross border distribution of investment funds. Article 92 requires such funds to appoint a paying agent in each jurisdiction where the fund is to be marketed. This, along with other restrictions
introduced at national levels, has proven costly and reduced the likelihood that funds will be distributed into certain jurisdictions, limiting the funds’ ability to attract investment. The UK therefore believes that, in line with the Alternative Investment Fund Managers Directive, the requirement to appoint a paying agent or meet other national restrictions prior to being passported or marketed in that jurisdiction should be removed.

**Suggested solution:** Ensuring that national regulators respect the spirit of the Directive and adopt a consistent approach would ensure that fund managers do not incur extra complexities and unplanned costs. The Commission should consider this issue in the review of cross-border barriers under Capital Markets Union.
Links between individual rules and overall cumulative impact

Given the interconnections within the financial sector, it is important to understand whether the rules on banking, insurance, asset management and other areas are interacting as intended. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-sectoral rules (for example with regard to financial conglomerates). Please explain in what way and provide concrete examples.

10.1 – Inconsistent provisions relating to cross border supervision


Summary: Inconsistent provisions relating to cross border supervision.

Evidence: Various key terms relating to cross border activity are defined differently in different pieces of legislation. The division of supervisory responsibility to regulate such cross border activity is also, by both design and implementation, different across regimes. In many cases the rules under individual directives apply to the same firms but put in place different regimes and differing responsibilities for home and host state competent authorities depending on the market sector.

Examples include inconsistencies on whether the home or host state are responsible for conduct supervision. Conduct of business supervision of Markets in Financial Instruments Directive firms is the responsibility of the host state (though the home state is responsible for conduct supervision in relation to cross-border services from branches). Under the E-Commerce Directive the majority of conduct supervision is the responsibility of the home state (though the host state can impose marketing rules).
For example, there are differences in the time limit provided to prepare for supervision following branch notification. This is two months under the Markets in Financial Instruments Directive, Solvency II, Mortgage Credit Directive and the Undertakings in Collective Transferable Securities regime but immediately under the Alternative Investment Fund Managers Directive.

These inconsistencies between sectors and jurisdictions add to the cost of regulation, administration and serve to reduce the efficiency of the Single Market. By placing artificial barriers between the markets of European Member States these issues hinder the fundamental economic freedoms for citizens and firms, many of whom will engage in multiple activities with different supervisory divisions, leading to confusion and sub-optimal outcomes.

**Suggested solution:** Future legislation and reviews, such as the AIFMD review in 2017, should take a more consistent approach to these definitions and the division of responsibilities across borders. Consistency of definitions across files where appropriate would ease the interpretation of legislative measures. Better use of recitals, guidelines and the fostering of supervisory cooperation will help to smooth practical administrative barriers to the freedom of the Single Market.

### 10.2 – Further improvements to passporting

**Directive(s) and/or Regulation(s):** Found across a range of piece of legislation including: Markets in Financial Instruments Directive (MiFID) / Undertakings in Collective Transferable Securities Regime (UCITS) / Prospectus Directive (PD) / Insurance Distribution Directive (IDD) / Payment Services Directive (PSD).

**Summary:** Passporting regimes are important for financial services and are fundamental to the Single Market. However, there are areas where better consistency and clarity across jurisdictions and regimes would be beneficial and help further lower barriers to the free movement of capital and services.

**Evidence:** The requirements for passporting regimes necessarily vary across different pieces of legislation. However, individuals and firms can be left facing multiple and varying requirements for connected services, related products and the same clients. These inconsistencies and duplications, both within and between regimes, are not necessary and create uncertainty for firms, raise the cost of cross border activity and establish regulatory barriers to market entry across the Single Market. For example, under PSD II, a firm providing payment services across the EU will be required to set up a point of contact in each of the Member States in which it operates. Firms which aim to grow their customer base across the EU will have to invest in setting up such a compliance function, the cost of which could outweigh the benefits of entering the market, especially for start-ups and SMEs. This limits innovation, growth and customer access to services
across the EU. The UK supports a single point of contact in the Member State in which the firm is registered.

Different jurisdictions within the Single Market also implement passporting regimes differently, creating deliberate or accidental gold-plating requirements for firms seeking to passport their services and products across the Single Market. Additional costs and barriers to passporting prevent the efficient allocation of capital and fair competition across the Union.

**Suggested solution:** The UK believes that future reviews and legislation can take an improved approach to these definitions and the implementation of cross border passporting regimes to ensure that they consider the cumulative burdens placed for single firms and products across multiple pieces of legislation and are designed to minimise these. Better enforcement of national implementation, guidelines and the fostering of supervisory cooperation will help prevent duplication and inconsistency of implementation across the Single Market and smooth practical administrative barriers to the freedom of the Single Market.

**10.3 – Duplication of disclosure rules**

**Directive(s) and/or Regulation(s):** Accounting Directive (Article 19.2(e) (i)).

**Summary:** Duplication of disclosure rules for companies preparing accounts under International Financial Reporting Standards (IFRS).

**Evidence:** In addition to sectoral reporting requirements firms may be subject to the same cross sectoral accounting requirements as a result of the application of both EU law and IFRS. Duplication between IFRS and EU reporting requirements creates potentially significant compliance burdens for firms without adding supervisory information and with the risk of confusion should EU law fall out of synchronisation with international standards. An example of this is where the EU’s accounting framework requires disclosure, in certain circumstances, of a company’s financial risk management objectives and policies; information which is required to be disclosed within the financial statements of companies reporting under IFRS 7.

**Suggested solution:** Where European law is applied to all companies, not just those compelled to report under international financial reporting standards, EU law should avoid imposing obligations in such a way that those reporting under IFRS are required to duplicate disclosures in order to comply with both levels of reporting obligation. This could be addressed in the next review of the Accounting Directive.

**10.4 – Impacts of the clearing obligation**
**Directive/Regulation:** European Market Infrastructure Regulation (EMIR) Article 4 (the clearing obligation) and Capital Requirements Regulation (CRR) Article 429.

**Summary:** All financial firms will be subject to mandatory clearing under EMIR, with the first clearing obligation entering into force for certain interest rate swaps from mid-2016. At the time EMIR was being negotiated, it was envisaged that there would be a ready provision of client clearing services by clearing members. However, in anticipation of mandatory clearing, many smaller financial firms are reporting difficulties in finding clearing members willing to offer them these services.

For some smaller firms, the difficulties they are facing accessing clearing have the potential to result in serious unintended consequences for their businesses, disproportionate to any financial stability risk reduction achieved by requiring these firms to clear their hedging contracts.

The constriction of the client clearing market may also have wider consequences. For example, having fewer clearing banks in the market implies there are fewer options for the porting of client positions in the event of a clearing member default.

Overall the UK is concerned there is a risk that the treatment of client clearing under the leverage ratio, as currently calculated, stands to exacerbate the adverse potential consequences for small financial firms of the clearing obligation, as well as having a negative effect on clearing overall.

**Evidence:** Evidence suggests that a significant factor depressing the supply of client clearing is the Basel III leverage ratio. Under its current definition, the leverage ratio does not recognise the risk mitigating impact of initial margin in calculating banks’ risk exposures. As a result, significant levels of capital may be required to capitalise clearing members’ exposures arising from their clearing clients. Evidence from numerous market participants indicates that this has created a key disincentive to offering client clearing services, contributing to the withdrawal of several large clearing members from the market. Smaller clients are disproportionately affected by the reduction in the market, with evidence suggesting that those banks which continue to offer clearing services are focussing on larger clients with whom they have wider business relationships.

One example of an unintended consequence of the interaction between EMIR’s clearing obligation and the leverage ratio concerns smaller mortgage lenders in the UK, whose use of derivatives to hedge the interest rate risk arising from their fixed interest rate mortgage lending is critical to their business models. Without access to clearing there is a risk that these firms will be unable to transact interest rate hedges and will be forced to withdraw, partially or fully, from the fixed rate mortgage market, to the detriment of competition, and, ultimately, consumers. Small building societies (mutual banks) in the UK, many of whom have less than €500m in total assets, have found a very limited number of clearing banks in the market willing to offer them clearing services.
These firms do not trade swaps in large volume, with some firms transacting fewer than 10 contracts annually.

It is worth noting that other jurisdictions exempt smaller financial firms from clearing. For example, under Dodd-Frank, the US exempts firms with total assets of $10bn or less. Other jurisdictions including Australia and Canada all either have similar exemptions in place or plans to introduce them.

**Solution:** The Commission should consider the impact on smaller financial firms and other EMIR objectives of the insufficient provision of client clearing and possible measures to alleviate the problem. These should include both: 1) An amendment to the calculation of the leverage ratio (CRR, Article 429) to reduce the impact of the leverage ratio on client clearing by appropriately reflecting the risk mitigating impact of initial margin; and 2) a suitable exemption from EMIR’s clearing obligation for small financial firms.
Different pieces of financial services legislation contain similar definitions, but the definitions sometimes vary (for example, the definition of SMEs). Please indicate specific areas of financial services legislation where further clarification and/or consistency of definitions would be beneficial.

11.1 – Definition of payment accounts

**Directive(s) and/or Regulation(s):** Payment Accounts Directive (PAD), Article 2 and Payment Services Directive (PSD), Article 4.

**Summary:** The definition of ‘payment account’ in PAD Article 2 is only slightly different to that in PSD Article 4. Given the very different aims of PAD and PSD, it would be more appropriate if the Directives did not both refer to ‘payment account’ as this has led to confusion in the UK over the scope of the Directives. This should be taken into account for future Directives.

**Evidence:** The payment accounts discussed in PAD are those required for essential day-to-day banking transactions such as receiving a salary, pension or allowance and for the payment of utility bills. However, PAD’s definition of payment accounts potentially captures many accounts for which PAD was not expressly intended, including e-money accounts such as e-commerce purchases, gift cards, money transfer etc. Industry views indicate that these products often have a very specific payment proposition, are almost invariably used as secondary accounts, are often used for a limited period of time and store very low values (around €35). It is incongruous for them to fall under the scope of this Directive, which is intended to address concerns about access, transparency and competition, in accounts used for day-to-day banking transactions.

**Suggested solution:** The scope of the Directive should be considered when it is reviewed to assess its proportionality. More broadly, the most appropriate term should be used for each directive based on the limited aims of that directive. The same term should not be used in multiple directives if those directives have different aims, in order to avoid confusion over scope.

11.2 – Third country CCPs in BRRD

**Directive(s) and/or Regulation(s):** Bank Recovery and Resolution Directive (BRRD).

**Summary:** BRRD uses a definition of payment system that is based on designation under the Settlement Finality Directive (98/26/EC), although there seems to be no policy rationale for limiting the definition to EU entities. This is particularly important for non-EU central counterparties (CCPs). Firstly, in contrast to EU CCPs, non-EU CCPs cannot have confidence that, in the event of an EU
clearing member failing, its liabilities to the CCP will not be bailed in. This may make it less attractive for a non-EU CCP to admit an EU bank as a clearing member and may incentivise a non-EU CCP to declare an EU clearing member in default, where possible, if it considers that the clearing member is failing or likely to fail. Secondly, EU banks are required (by Article 55) to seek to amend their contracts with non-EU CCPs to include a clause acknowledging that the contract may be subject to bail-in. As it is very likely that liabilities to a non-EU CCP would be subject to a discretionary exclusion by the resolution authority, this has limited benefit and comes with considerable costs to the European bank. It may also cause non-EU CCPs to examine more closely the risks that they are exposed to in the case of bank failure and reassess their appetite for accepting European banks as clearing members.

Evidence: Article 44 of BRRD requires Member States to ensure that resolution authorities have the power to bail-in creditors of failing banks. Article 44(2) defines a number of exclusions from the bail-in power – i.e. contracts that should not be subject to bail-in. These include “liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated according to Directive 98/26/EC, the Settlement Finality Directive (SFD), or their participants arising from the participation in such a system”. EU CCPs are designated settlement systems under the SFD. However, non-EU CCPs are not designated as settlement systems under that Directive and therefore liabilities of EU banks to non-EU CCPs are not excluded liabilities under the BRRD. This seems contrary to the rationale for the exclusion, as explained in Recital 70 of the BRRD: “To reduce the risk of systemic contagion, the bail-in tool should not apply to liabilities arising from participation in payment systems which have a remaining maturity of less than seven days […].” This rationale is as true for non-EU CCPs as EU CCPs, since clearing is a global business, with many EU firms clearing through non-EU CCPs and vice versa.

It is also difficult to align with Title VI of the BRRD which aims to ensure effective cooperation between EU and non-EU jurisdictions to ensure the effective resolution of firms and the safeguarding of global financial stability. Taking a different approach to EU and non-EU CCPs runs contrary to that aim.

A third country (non-EU) CCP needs to be recognised by ESMA to offer clearing services to EU customers, fulfilling certain requirements. When the UK first introduced bail-in powers it excluded all liabilities to CCPs. It was necessary to amend this to transpose the BRRD, limiting the exclusion. When the government consulted on these changes a number of respondents raised concerns with this change arguing that all centrally cleared contracts should be excluded from bail-in, regardless of where the CCP was headquartered.

The EBA technical advice on discretionary exclusions from bail-in identifies CCPs as a key source of the financial contagion that these exclusions are designed to avoid, making no distinction between
EU and non-EU CCPs. The EBA noted that several respondents had raised concerns about their ability to comply with Article 55 of the Directive in relation to non-EU market infrastructure.

**Suggested solution:** Article 48 of the BRRD should be amended to exclude liabilities to all settlement systems and central counterparties, without distinction between EU and non-EU CCPs. In order to define these CCPs, it is possible to use the definition of a CCP in Article 2(1) of EMIR, or recognition by ESMA (which does capture recognised third country CCPs).

The UK proposes the following addition to Article 44(2): “(fa) liabilities with a remaining maturity of less than seven days, owed [by or] to a central counterparty recognised by ESMA under Article 25 of Regulation (EU) 648/2012 and arising from the participation in a system of clearing provided by the central counterparty.”
Overlaps, duplications and inconsistencies

Please indicate specific areas of financial services legislation where there are overlapping, duplicative or inconsistent requirements

12.1 – Duplication in the PSD and EMD

**Directive(s) and/or Regulation(s):** Payment Services Directive (PSD) II and E-Money Directive (EMD).

**Summary:** There are examples of duplicate legislation which could have been merged into a single Directive for greater ease and clarity.

**Evidence:** The Commission had an aspiration to merge the revised Electronic Money Directive (EMD) and PSDII, however this never materialised. As a result e-money institutions are regulated under a separate piece of legislation. It makes more sense for these to be classified as payment service providers and regulated as part of PSDII to allow for consistent regulatory treatment across industry.

**Suggested solution:** EMDII and PSDII should be completely aligned in the first instance, with a view to merging them at the next feasible opportunity. For example, the conduct rules for e-money issuers should be completely aligned with those for payments services providers in PSDII.

12.2 – Clarity over the role of ESMA

**Directive(s) and/or Regulation(s):** European Market Infrastructure Regulation (EMIR) Article 49.

**Summary:** Lack of clarity over the role of ESMA in validating significant changes to central counterparties (CCP) risk models under Article 49, potentially leading to uncertainty for industry in the procedure for adopting model changes, as well as duplication of processes.

**Evidence:** CCPs’ risk models are at the core of their risk management and should be subject to robust review and challenge. The adoption of significant model changes could also have commercial implications for CCPs and the process for the review and validation of the models should be conducted within reasonable timeframes. However, the respective roles of the national competent authority (NCA), the college and ESMA in validating and approving such changes under Article 49 of EMIR are not fully clear, are potentially inconsistent with the rest of the college process and have led to differences of interpretation between college members. This has led to uncertainty for industry in the procedure for adopting model changes, as well as duplication of
processes and, ultimately, could lead to unnecessary delays for market participants in bringing innovative models to market.

**Suggested solution:** The UK’s view is that the intention of EMIR is that ESMA’s role in assessing CCP risk model changes is limited to a technical review of the model change which informs the NCA and the college in their consideration of the change, but that the responsibility for approving such changes rests solely with the NCA, taking into account the opinion of the college. The UK believes there would be benefit in clarifying this in EMIR.
While the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether they are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.

13.1 – Insurance guarantee scheme

**Directive(s) and/or Regulation(s):** Insurance Guarantee Scheme

**Summary:** Insurance enables economic activity, helping individuals and firms manage risk. Inconsistent insurance policyholder protection across the EEA, in the form of widely varying insurance compensation schemes, could act as a barrier for businesses and consumers trying to obtain insurance products for cross-border activity. Inconsistencies in life insurance arrangements create frictions for labour mobility, while varying standards in the protection of general insurance (such as buildings or liability cover) complicate business activity. The EU – through a legislative vehicle or through the Capital Markets Union – should ensure there are appropriate standards across the EEA to remove this barrier to investment, as well as helping protect consumers and manage fiscal risks.

**Evidence:** Of the 30 EEA countries, only 12 operate an Insurance Guarantee Scheme (Bulgaria, Denmark, France, Germany, Ireland, Latvia, Malta, Norway, Poland, Romania, Spain and the United Kingdom). Broken down further, of these 12, three (Bulgaria, Germany and Poland) have a scheme which covers life insurance only, three (Denmark, Ireland and Norway) have a scheme which covers non-life insurance only and six (Spain, France, Latvia, Malta, Romania and the UK) countries that have a scheme which covers both. This disparity has two main consequences:

1) Under existing insurance Directives, EEA insurers are permitted to undertake business anywhere in the EEA by establishing a branch or on a freedom of services basis (passporting). Whenpassporting, the home state supervisor remains the lead prudential supervisor and controls the authorisations relevant to the firm. However, with inconsistencies in the Member States’ Insurance Guarantee Schemes, it can be extremely unclear for policyholders what protection, if any, they will benefit from. In addition, those Member States with an Insurance Guarantee Scheme could be asked to foot the bill for the failure of EEA firms operating in their jurisdiction.

2) Measured in terms of gross written premiums, it means that one third of the EEA insurance market is not covered by an Insurance Guarantee Scheme in the event of an insurance company
going bankrupt. This means there is no level playing field across the EAA for business and labour market activity reliant on insurance.

**Suggested solution** A prospective Insurance Guarantee Scheme Directive which:

1) Provides for harmonising insurance guarantee standards (which include compensation, continuity of protection and payment of liabilities to a high level) to be adopted by all Member States, so that policyholders would be adequately protected regardless of the home state of the insurer.

2) Includes the home country principle i.e. an Insurance Guarantee Scheme covers all an insurer’s business including business written on a branch or services basis.

3) Covers life and non-life insurance policies.

4) Provides for establishment of individual schemes at national level and not a single pan-EU guarantee scheme with a mutual borrowing facility.

5) Risk-based ex-post funding on the basis of contributions from insurers.

6) Coverage levels that are set in a way that avoids any currency volatility.

### 13.2 – Loophole in the CSDR

**Directive(s) and/or Regulation(s):** Central Securities Depositories Regulation (CSDR) Article 7 (settlement discipline regime).

**Summary:** Inconsistencies in the application of the CSDR settlement discipline regime lead to legal loophole.

**Evidence:** CSDR makes no distinction between Continuous Net Settlement (CNS) systems and Trade Date Netting (TDN) systems. The CNS methodology extinguishes all failed transactions at the end of the processing day and nets them against the next day’s settlement. This avoids the securities settlement discipline regime as settlement fails are not carried over multiple days.

**Suggested solution:** Legislate for an anti-avoidance clause in the securities settlement discipline regime.

### 13.3 – UCITS master-feeder structures

**Directive(s) and/or Regulation(s):** Undertakings for Collective Investment in Transferable Securities (UCITS) Article 58.

**Summary:** UCITS Directive Article 58 hinders the take-up of master-feeder structures.
**Evidence:** Under UCITS Article 58, a UCITS (employing the investment powers under Article 55) is prevented from being the master UCITS in a master-feeder structure. This ultimately hinders the uptake of master-feeder structures. Restricting the uptake of master-feeder structures is problematic because the fund of funds model is a popular vehicle.

**Suggested solution:** In the UCITS VI review, the Commission should review Article 58 to allow UCITS fund of funds to operate as master funds in the master-feeder structure.
EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.

14.1 – Increasing risk concentration

**Directive(s) and/or Regulation(s):** European Market Infrastructure Regulation (EMIR); Markets in Financial Instruments Directive (MiFID 2); Markets in Financial Instruments Regulation (MiFIR); Capital Requirements Regulation (CRR); and Capital Requirements Directive (CRD 4).

**Summary:** Obligations and incentives for financial market participants to use central counterparties (CCPs) have increased the level of risk concentrated in CCPs.

**Evidence:** The clearing and trading obligations in EMIR and MiFID, implementing G20-agreed financial reforms, alongside the beneficial capital treatment of exposures to CCPs have led to greatly increased usage of CCPs and a concentration of risk in these venues. Although CCPs perform an important market function, in that they are inherently risk reducing for their participants, the overall level of risk in CCPs has increased significantly. Given the incoming requirements for market participants to use their services, this has made the financial system increasingly vulnerable to the failure of a CCP. We therefore strongly support the Commission’s commitment to bring a legislative proposal on CCP recovery and resolution, in order that the EU has a robust framework to address CCP failure. We also support the Commission’s participation in developing international standards for CCP resolution in the FSB before bringing its proposal. A unilateral European approach to the recovery and resolution of CCPs would run a significant risk of being misaligned with global standards and the standards of other significant jurisdictions. This could lead to regulatory arbitrage, limiting the ability of EU and national competent authorities to protect EU financial stability, and disadvantage the competitiveness of the EU financial system.

**Suggested solution:** With obligations and incentives for financial market participants to use central counterparties (CCPs) increasing the level of risk concentrated in CCPs, it is vital for the EU to implement an internationally agreed framework for CCP recovery and resolution.

14.2 – Securitisation
Directive(s) and/or Regulation(s): Securitisation proposals.

Summary: A diverse financial sector supports jobs, growth and stability while reducing volatility.

Evidence: The financial system should not shy away from higher risk higher yield products in order to lead to a more diversified financial sector and provide more choice. A well-functioning financial system that allows for risk and treats it appropriately will better support jobs, growth and absorb risk with reduced overall volatility.

There is a parallel to be drawn between covered bonds and securitisation. The prudential treatment of covered bonds is more favourable despite their risk profile often being materially identical to that of securitisation. This means that financial institutions will often favour covered bonds over securitisation. This is problematic because the on-balance sheet nature of covered bonds may prevent risk from being appropriately distributed (as, unlike securitisation, they cannot be sold on to third party investors), and limit the level of liquidity that can be brought to the market. Not having a level playing field between securitisation and covered bonds could unhelpfully disincentivise higher risk and higher yield securitisation products which would increase the diversification of risk and improve liquidity. Though we acknowledge entirely that there needs to be a sufficiently robust regulatory framework to ensure that risks are appropriate so as not to endanger financial stability.

In developing the regulatory framework, there needs to be a holistic and cross-sectoral approach to ensure that risk is not overly supressed. Doing otherwise can impact liquidity and may push risk into other areas where there is not a sufficient level of regulatory oversight. However, a robust, liquid and transparent securitisation market where participants understand the risks will enable investors to diversify portfolios and share risk across the financial sector. This approach ties together growth with market resilience and long term economic stability.

Suggested solution: The UK welcomes securitisation work to date, particularly on levelling the playing field between securitisation and covered bonds, and also on the cross-sectoral approach to the work. The principles behind the approach taken in this case should apply elsewhere when developing the regulatory framework. The importance of transparent, managed risk in a dynamic financial market should be at the forefront of the Commission’s thinking when it is developing legislation, so that markets can function effectively in order to support the real world economy.

14.3 – Movement of risk within the financial system

Directive(s) and/or Regulation(s): European Market Infrastructure Regulation (EMIR); Alternative Investment Fund Managers Directive (AIFMD); Solvency II; Capital Requirements Directive (CRD4); Capital Requirements Regulation (CRR); and Markets in Financial Instruments Directive (MiFID II).
**Summary:** Regulation aimed at increasing the financial stability of sectors of the financial services industry could have shifted risk throughout the wider financial system. Further analysis is required to ascertain the extent of this risk beyond the regulatory perimeter and whether this presents a systemic risk. Before considering any further action on non-banks it is also worth considering the impact of current and future regulation that could be constraining the vital functions undertaken by non-banks.

**Evidence:** Analysis by the European Central Bank and other institutions shows that since the global financial crisis the European banking and insurance sectors have remained roughly constant in size but have seen significant increases in their capital levels. Non-banking as a sector has however increased significantly in size and scope, taking on functions which were previously conducted by banks. Neither the level of risk in the non-bank sector, nor the extent to which non-bank risk may be systemic is well understood. Measures have been put in place to manage bank exposure to non-banks, which limits the potential for contagion, but any concentration of risk could lead to adverse market conditions, such as market illiquidity, that will have a wider impact.

The ability of non-banks to play a vital role in markets vacated by banks also needs careful consideration, current and future regulation could constrain the ability of participants to effectively fulfil necessary functions such as market making, which could adversely impact on repo markets that underpin the fixed income market. Before considering any further action to tackle risk in the non-bank sector Member States and the Commission should establish a strong evidence base to understand the effects on the financial system and wider economy of attempting to reduce that risk, particularly on market liquidity.

**Suggested solution:** The Commission, the Eurosystem of Central Banks and Member States should conduct a broad analytical exercise looking at the impact of bank regulation on risk concentration beyond the banking sector, and the ability of markets to operate effectively as banks exit from undertaking a number of traditional functions in tandem with an increase in non-bank regulation. Key to this will be taking a holistic and balanced look at the level and systemic nature of risk in the non-bank sector while considering the knock on effects to both the financial system and the wider economy of changes to the regulation of this sector.
15 **Procyclicality**

*EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how*

15.1 – Anti pro-cyclical tools

**Directive(s) and/or Regulation(s):** Capital Requirements Regulation / Directive (CRR / CRD IV) & Solvency II.

**Summary:** The UK supports capital requirements on banks, investment firms and insurers under CRR / CRD IV and Solvency II. As these may be inherently pro-cyclical, and the efficacy of the tools to counter procyclicality has not yet been tested in practice, the UK believes that they must be carefully monitored and evaluated to ensure that they are effective and have no unintended consequences.

**Evidence:** Capital requirements on firms, as imposed under CRR / CRD IV and Solvency II, can have a pro-cyclical effect as declining economic conditions raise risk and capital levels at a time when firms should be injecting capital into the economy. The UK supports the capital requirements regime implemented in the European Union and the tools it includes to mitigate the problems raised by its pro-cyclical elements. The UK is aware, however, that these tools have not been effectively tested in practice. The UK believes that they must be carefully monitored and evaluated to ensure that they are effective and have no unintended consequences.

**Suggested solution:** The UK would like to see the Commission work with national authorities to monitor and analyse the effectiveness and unintended consequences of counter-cyclical tools and make adjustments where necessary to address pro-cyclciality risks and ensure the effectiveness of financial stability tools.
HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000
Email: public.enquiries@hmtreasury.gsi.gov.uk