HOUSE OF LORDS

Select Committee on the European Union

EU Financial Affairs Sub-Committee

Oral evidence: Financial Regulation and Supervision following Brexit

Monday 11 December 2017

4.30 pm

Watch the meeting

Members present: Baroness Falkner of Margravine (The Chairman); Lord Bruce of Bennachie; Lord De Mauley; Lord Desai; Lord Fraser of Corriegarth; Baroness Liddell of Coatdyke; Earl of Lindsay; Lord Skidelsky; Lord Woolmer of Leeds.

Evidence Session No. 9 Heard in Public Questions 125 - 134

Witness

I: Mr Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies.

Examination of witness

Mr Karel Lannoo.

Q125 **The Chairman:** Welcome, Mr Karel Lannoo, to our inquiry on financial regulation and supervision following Brexit. I have to do some formal administrative things before we start the questions. You have a list of interests that have been declared by members of the Committee. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the public record in printed form and will be on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise any minor errors. The session is on the record. It is being webcast live and will be accessible subsequently via the parliamentary website. Would you like to make any brief opening remarks?

Mr Karel Lannoo: Members, Chair, it is a pleasure to be here before the Committee and to speak on an issue that I have been following for a very long time; I do not mean Brexit but financial regulation. It is one of my core areas of expertise. As soon as I heard about the possibility that this would happen, I remembered that I was here in London as part of a committee at the London School of Economics, which warned exactly two years ago that Brexit would have a big impact on the City. I remember some members of that group, academics and others, who said, "You're exaggerating. We don't know yet".

A lot of the debates on the importance of single-market freedoms started only after the Brexit decision, not before. Basically, and this is the debate that we see in the newspapers today, there was no proper impact assessment of how this would affect the UK and the City in particular. The whole debate about one of your key questions today, equivalence, started only in September or October last year, and not before. There was no appreciation of how important the single-market freedoms were for the City of London.

One key thing that I said two years ago and which I still strongly believe is that there was almost a direct correlation between the growth of the single market—the single-market freedoms—and the growth of the City. I came to London at the end of the 1980s. Today, the City has entirely transformed, also thanks to the fact that it has become a capital for financial services and services more broadly in the EU. For example, 30 years ago there were some banks in the area, but the whole area of Canary Wharf did not exist. The City has become enormous. That is what I mean: there is a direct correlation with the achievement of more single-market freedoms in all the areas of financial services, from banking to investment services to insurance to asset management, hedge funds and rating agencies.

I have brought you some copies of papers produced on this issue. We have seen the achievement of the single market in financial services and all the aspects of financial services and the growth of the City as the leading financial centre in the EU—to the detriment of some other centres. Today, we are seeing some of these other centres trying to get some business back. They think, "Perhaps we could get it back from London and we should get it back from London".

The Chairman: You said "get it back from London". Do you believe that there was a shift? I do not want to go into the history too much, but do you think that London "took" it from others, or was it because London had an ecosystem, a conducive environment to the development? Big Bang and the liberalisation of our financial services, and the growth of the single market as you correctly describe, made it all happen at around the same time. Therefore I would argue that there is no bringing back. Or is there?

Mr Karel Lannoo: I think the business migrated naturally to London, because London had the environment that was most conducive to financial services and to services in general. That is why I described this geographical transformation of the City, which all of us have marked over the past 30 years, which basically coincides with the achievement of the single market—1992 until today. Every person can see it. Compared with another city, the one that is probably most often mentioned in this regard—Paris—and the real estate transformation or non-transformation of Paris, London is much more modern and much more adapted to that environment than Paris.

Of course, many other elements play a role in that, such as labour markets. Labour market reform is extremely important. By the way, this is not part of the EU's agenda; this is what was done here during the Thatcher years. This is something that France and other member states of the EU have not managed to do over past years. France is doing it only now, under Macron, with a delay of 30 years. To have an attractive services environment—I speak of services in general—you need to have fairly flexible hiring and firing laws; again, this is not part of the EU's agenda.

Why is a financial services centre a centre? It is because it manages to attract a critical mass of all kinds of services. The more it manages to attract this mass of services, the more services will come. It is almost like the network effect that we know from economics. The more you attract the services, the more will come to the centre, and the more you can pay high salaries to people working in that business because you attract competence, which many other places do not have.

In addition, I would argue that we needed a conglomeration process in a European financial centre because we have far too many financial centres in Europe today, and every financial centre is basically related to every country or every capital of a country. Compared with Asia, North America, Latin America and other places around the globe, there are far fewer financial centres in every other region than there are in Europe. So we had the natural process of a concentration of financial centres in Europe, which was ongoing and will now be a bit disrupted because of Brexit.

Mr Karel Lannoo: We will see the process of fragmentation. That is for sure. It will be fragmentation to other centres. That process has already started, as in the decision two or three weeks ago on the European agencies, the EMA and the EBA. We see it among operators that are active in the City—American and Japanese banks, et cetera—and are deciding, according to circumstances and their own preferences, whether they will go to the Netherlands, Germany, France or another jurisdiction.

Q126 **The Chairman:** Can we turn to the EU's priorities after the transition? What do you think the EU's priorities will be after the transition to phase 2?

Mr Karel Lannoo: The good thing about this meeting taking place today is that we know what happened on Friday; your planning was excellent. I read the conclusions on the train yesterday evening as I came over. I think they are very important. At least we now have an agreement and business can start to plan. We know that, most likely, there will be no hard Brexit and that there will be a transition. I do not fully understand what the exact legal form of that transition will be, but I think it will be a prolongation of the exit. There will have to be unanimity in the Council of the 27 member states on the fact that the UK will continue to have access to the single financial market and the single market in general for another two or three years, but in return it will contribute to the EU budget and will be part of the EU construct in the sense that the European Court of Justice will be the highest appeal body if there is a disagreement among member states. That is what I expect.

What does that mean specifically for financial services? It means that the single-market freedoms will continue as they are today, with the big exception that the UK will no longer be part of the European Parliament, the European Council or the Council of Ministers: the decision-making on financial services and all the structures below that, such as the agencies, the special committees, et cetera. The question is how a lot of the expertise in the City, the Treasury and all the related supervisory bodies will be translated into the decision-making in Brussels once we reach March 2019. Will it be a Norway-like situation in which Norway is informally part of these committees, or will it be different? I do not know yet. It is too early to say.

Lord Desai: Does financial regulation generally work in a more global way? The Financial Stability Board has certain norms that it wants to lay down and the UK has been as much part of the global scene as it has the EU. Even when the EU is on its own, there will be some effective convergence because you cannot have financial markets following different routes. How do you think that will be handled?

Mr Karel Lannoo: You mean the interaction between the international framework and the European framework.

Lord Desai: Exactly.

Mr Karel Lannoo: The big difference is that the international framework is purely voluntary—it is codes and guidelines—whereas the EU framework is laws. Basel III is a clear example. On Friday, we agreed specific rules on the use of internal models—basically guidelines. What does the US do? It applies Basel to its big banks, not to its small banks. What does the EU do? It applies it to everybody—all banks, even a bank across the street that employs 20 people. The very big banks—Deutsche Bank, BNP Paribas—have to apply these rules, too. That is a constraint on the EU situation, in the sense that you wonder whether these rules are really made for smaller banks. You can say that some of them are, but we apply everything to everybody. We have the single rule book, with the same rules for every member state and every bank operating everywhere in the EU.

The Chairman: Staying with regulation, we come to Lord Skidelsky.

Q127 **Lord Skidelsky:** Could you enlighten us a bit on how things are going on the European side? A little time back, I read an essay by Professor Paul De Grauwe, in which he said that the EMU either has to go forward towards political unity or it breaks up. What do you think is happening at the moment? There are proposals for a European monetary fund and a separate budget for the EMU, but there is little detail and one thinks that Germany will be opposed to both those things. Do you think that there is a strong forward political momentum, or is it going into reverse, which would also be important for our view of our future relations with this entity?

Mr Karel Lannoo: From my perspective, it is clear that monetary union is going forward. We have survived the crisis. The most difficult moment was at the end of December 2011, when there was a big question over it and it was not a matter of if but when it would break down. It continued to exist, however, and there is now strong agreement among the 19 member states, certainly the bigger ones, that it cannot go backwards and that there would be a bigger cost than a benefit to start again. We can look back to the situation in 1992-93, when states such as Italy carried out competitive devaluations, and ask whether that helped those countries at the time. Clearly, it did not; it always put them in a worse situation. Monetary union has been a big step forward.

The problem is that, over the last years, the ECB has been asked to do much more than it was designed for. It was not only a monetary policy actor but a fiscal actor, giving warnings to member states and saying that they needed to do this or that, even though it was not designed to do that. Basically, the ECB did what other entities such as the European Council could not do or did not want to do, but that is what the Commission now wants to do. The proposals made on Wednesday last week will strengthen the structure that we started to create during the financial crisis: the European monetary fund, or what is called today the European stability mechanism, and other elements.

Looking at the proposals in more detail, there are things that I have sympathy with, although whether they will fly is another issue. There are other elements that I think will create dangerous expectations among citizens all over Europe, such as having a European Finance Minister without giving that person the powers to do what a Finance Minister is supposed to do. A European Finance Minister, at least for the time being, will not be capable of raising taxes, but that is what a Finance Minister does. If you call him a Finance Minister, that is a misnomer. The name should be "the ultimate budget authority", to make it clear to all member states that the Commission can tell them that they need to correct this or that and that it is not for the ECB to do that. The member states should react to that prudently and should not go too quickly in this domain.

Lord Skidelsky: So there is not going to be another European banking crisis.

Mr Karel Lannoo: That is another matter, but we are certainly working on it. We had four banking cases in June involving three Italian banks and one Spanish bank. The case of the Spanish bank was resolved according to the rules. With regard to the three Italian banks, one was kept alive with a lot of state aid and the others were resolved with state aid and sold to another bank. The banking rules that we have had since the financial crisis are applied in a different way in the EU, but at least today we have much stronger capital framework, which you also have in the UK, by the way. The definition of capital has become much tighter. We are still working on creating much more solid deposit guarantee schemes in the member states and we have a framework for resolving banks that did not exist before.

By the way, the bank recovery and resolution directive was strongly inspired by the UK's Banking Act 2009. The fact that we have rules on this allows any person to go to court and say, "The rules have not been applied. I don't want to bail out that bank. The rules have to be applied". That means bailing for so much and then using the resolution fund, which already exists, to stop taxpayers' money being used to bail out the bank.

Basically, this resolution fund should have about €60 billion at the end; it already has €20 billion. Colleagues of mine have calculated how good that framework would have been in 2009 if we had had it then. We have concluded that it could have faced a big crisis. If the combination of bail-in and using elements of the resolution fund could have prevented the use of taxpayers' money—and, by the way, this resolution fund could have become a shareholder of banks and could have sold its stakes in the banks in the meantime—it would probably have become richer over time if it had used the proceeds of those shares.

Two of my colleagues, Daniel Gros and Willem Pieter De Groen, did the calculations for a report for the European Parliament, and they were very well done. We looked at all the big cases from 2008-19—Royal Bank of Scotland, Lloyds Bank, ING, Fortis Bank, the German banks, et cetera—and calculated how much would still have been needed from the resolution fund if the quantity of money that was put in was applied to rules under the new framework; if we had applied bail-in to 8% of total assets.

Lord Skidelsky: Could we get a copy of that report?

The Chairman: Yes. Would you care to send us a copy of the report, presumably electronically?

Mr Karel Lannoo: No problem. My colleagues will be more than happy to do that.

The Chairman: Thank you very much. Lord Desai, do you want to pick up harmonisation?

Q128 **Lord Desai:** The EU takes global regulation but applies it in its own way to many more banks, and so on. On the one hand, there is a push towards harmonisation but, on the other hand, there might be the idea that national differences ought to be accommodated. There is a conflict in the further march of the EU towards integration, is there not? How do you think that will be resolved?

Mr Karel Lannoo: This is a conflict that we have seen for the past 10 years, even before that. It has always been there. I remember very well that when Draghi was still head of the Basel Committee, before he became head of the ECB in 2008 or 2009, he said that Basel II was the cause of the problems that we have today, because Basel II left far too many loopholes. Since then we have tried to close the loopholes, have tried to have a much tighter definition of capital, and all the other things, and we have now enshrined this in European law. Basically, we left member states the option, for example, to include minority interests and capital, which should have been included for 30% or the interest that they had. There are plenty of examples like that. We were comparing apples and pears in the sense that we were comparing the capital ratios of banks that were not comparable because the standards were not sufficiently unified. That was the result of every member state asking for its own compromises.

We still have this to some degree today, but the rules have become much tighter. The Basel Committee has been given many more powers by the Financial Stability Board and the G20, such as to name and shame and to assess how these frameworks have been implemented. By the way, the Basel Committee has formally said on several occasions something the Commission did not like to hear: "Look, you are not in line with what we have agreed". The Commission has tried to calm it down, but it has said the same to the United States and to China on certain occasions.

Danièle Nouy, the head of the SSM—the Single Supervisory Mechanism—at the ECB says there are still far too many options for national discretion. There are something like 120 different ways in which member states can interpret the current rules. But we are already much further ahead today than we were 10 years ago. For example, if we look at the agreement made on Friday by the Basel Committee, we immediately see that Denmark has a special way of funding the housing market through covered bonds: that is, the rules should be applied differently to Denmark than to other countries. There it is up to the EU to find a balance between the interests of certain specific systems—because we are still integrating systems in the EU—and having a harmonised approach for everybody.

I would argue, and I think this was one of the Committee's questions, that we have probably gone a bit too much towards the single rulebook. We have taken diversity into account because we have 28 different countries, with different financial systems, and we have to try to take those into account, but of course this should not hinder the free provision of services across borders or lead to a bank saying, "I have no access to this other market just because it says that my rules are not equivalent to the rules that are in place in that other state". So the reciprocity or mutual recognition that has been in place in the single market since it was created should be forced to function more by the European Commission.

Q129 **Lord De Mauley:** My question is in three parts. In your view, which parts of the financial services industry across the EU are likely to be most affected by Brexit? How will the impact of the cessation of passporting be felt on each side of the channel? Which sectors will be most heavily and least heavily impacted?

Mr Karel Lannoo: Thank you very much. The first part of your question is probably related to the third part. The parts that will be most affected are those where the single provision of services on a cross-border basis is most developed. That is on the wholesale side, because on the retail side there are many impediments. Consumer protection rules are still a national competence. You can say that about retail banking, probably a bit less about asset management or wealth management; there we are somewhere in between. Insurance is still by and large a national business. The more that certain services are concentrated in the City, the more some of these services may be affected by the loss of the passport and the breaking away of the UK from the EU.

Lord De Mauley: Sorry, which ones?

Mr Karel Lannoo: The more services are concentrated in the City—a process, as I described at the beginning, that we have seen over the past 25 years—the more some of those services will be affected. But I would not overdo this, because, again, banks are now trying to find ways around that, and they see that the critical mass of expertise, infrastructure and people is in this city. American banks, as well as other non-EU banks, kept a base somewhere within the EU 27. Now they are trying to step up their services in these places to try to continue to do the business they do today from London through a subsidiary in the EU 27.

The degree to which, for example, they will have to relocate people from the UK to other places depends on how the rules will be interpreted in the future. One of the papers I distributed looks at the rules that are applicable today. In an area such as asset management, where a lot is concentrated in the City, no distinction is made in the rules between delegation to a third country and delegation to another EU country. I also think about the UCITS rules for unit trusts. If you do delegate asset management from the registration in one place to the management of the assets in another place, you can do it as well in Hong Kong as in London and there is no distinction in the rules. The EU is now trying to make a distinction in the rules in the ESA review that is on the table, which was proposed in September but the document has still not been adopted. It will be a long time before that is adopted, because member states want to maintain the flexibility of delegation. ESMA would like a common interpretation of what can be delegated, but there is certainly no consensus among member states to have this in place.

So, overall, the parts that will be most affected are, for example, everything that is wholesale. Asset management, syndicated loans, helping large corporations to raise equity, derivative transactions, et cetera, may be affected, but it will depend on the degree to which the rules that we have today are still in place.

In addition, looking at the EU rules as they are today, there is a large diversity in the third-country rules and in how strict they are. There are certain areas where there are no third-country rules whatever—I am thinking about payment services and wiring services. The payment services directive, which is important for FinTech firms, for example, makes no reference whatever to third-country rules. So if you are a FinTech in London today, you do not know what will happen tomorrow.

Then there are certain areas in between, such as asset management, which I mentioned, and reuse, where there are some third-country rules but they are not very clear. Then you have some regulations where the third-country rules are extremely detailed—for example, what I call the hedge funds directive; its former name was the alternative investment fund managers' directive—where there are very extensive third-country rules, because hedge funds are often, or mostly, domiciled in third countries but do business within the EU. These rules were drafted in 2009-10.

So there is a diversity of rules that describe what will be possible after March 2019 or after the transition period, depending on which of the current rules apply. It depends on the sector, but the question is how broadly they can be interpreted or how strict they will be. Some people have argued for a generalised interpretation or a general change of all these rules in order to have a form of equivalence for the UK, but that will be on the table to be discussed in the months to come during the transition, and there will be a new regime afterwards. That, I think, has answered most of your questions on how passporting will be affected and on which sectors will be most affected.

Another sector that I did not mention but which will probably be affected a lot is wealth management: private asset management by the City for private clients. Again, that depends on the interpretation of the rules and whether the person on the other side is seen to be a well-informed customer and knows how the local authority interprets the rules. Sometimes you can say, "Look, I'm not a consumer but I am a well-informed investor. I do not need the protection of my home country. I am allowed to take advice from a host country, even within the EU”.

I would add to your question something that is often not sufficiently part of the debate. Many EU 27 banks have very important activities in the City and they may also be affected. I am thinking about large French and German banks that have come to the City for the same reasons that others have come. If their Governments interpret the rules very tightly, their businesses may be less affected because they may have thousands of people in the City, along with UK and other third-country foreign banks active in the City. There was a column about this in the *Financial Times* today. This is very important, because if these operators are strong on the wholesale side, the City—not only their home country—is the place to be.

Q130 **Baroness Liddell of Coatdyke:** I take it from what you said that you do not particularly welcome the direction of travel of the review of the European Supervisory Authorities. Am I interpreting that correctly, given in particular what you said about the weaknesses of having a single rule book and the need to get some diversity due to the strengths and weaknesses in different parts of markets? Is that a fair interpretation of your view of how the review is going forward?

Mr Karel Lannoo: No. I do not see this as a criticism of the way the authorities function today. I think the authorities have done a lot of very good work, but of course they have limited means to do what they are supposed to do. When they started in 2010, they had not only regulatory but supervisory tasks. So far, they have mainly exercised regulatory tasks and very few supervisory tasks, although they want to do more. Today, for example, the ESAs review for ESMA recommends more supervisory tasks. However, so far they have acted like every agency in the EU construct—as a kind of executive body for the EU Commission, helping the EU, at level 2 or level 3, to enact legislation or giving advice to the EU Commission on what legislation to implement. In certain cases, you could probably say that they have gone too far in their interpretation, but basically they have been helping member states with the interpretation of EU rules.

Baroness Liddell of Coatdyke: You do not see that as weakening the national competent authorities?

Mr Karel Lannoo: Basically, they have always worked in a very intergovernmental way with all the member states on board.

Baroness Liddell of Coatdyke: And you see that continuing?

Mr Karel Lannoo: The Commission wants to give the executive body of these authorities more powers, but so far, or until the new rules are adopted, it is a case of 27 or 28 member states agreeing with the executive or the governing board of these authorities what the rules are. I think these agencies have done very good work in a “grey area” with questions and answers on the interpretation of certain directives. Today, we have a system where they help member states, which ask what the interpretation is of this or that article in a certain directive or a certain regulation.

Baroness Liddell of Coatdyke: So you see the direction of travel continuing in that way. You talked about delegation and asset management. We have had a lot of evidence from representatives of the asset management industry, who voiced their concerns about delegation. What do you think the simplest answer would be in a post-Brexit world?

Mr Karel Lannoo: I think their concerns are justified. There could be more stringent rules on delegation, as proposed in the ESA review, but the question is whether they will be adopted. This is basically related to the diversity of the financial centre that we have in the EU and the diversity of interests. Whether we will come to a common interpretation of the rules on, for example, delegation remains to be seen. There is still a long way to go before we can have that, but I would not be too pessimistic about it.

In response to the question from your colleague, the EU 27 will, certainly for the foreseeable future, be interested in a lot of business being done in the City, because it will have no alternative. To take a totally different sector, I was in the Netherlands, where the pension fund industry is extremely big. For its specialised services, such as derivatives, the pension fund industry there does not find a market in the Netherlands; it comes to London. That will not be resolved in two years' time. So it will be in the interests of the member states of the EU 27 to have a mutually beneficial process.

As a think tank, we have done a study for the European Parliament showing that if there is a hard Brexit, there will be a cost for all of us. The cost declines the further you are from the UK, but all the countries that are close trading partners with the UK will have costs. They all know that, and they will no doubt say that they need to continue to have this interaction in as flexible a way as possible. They do not want a cliff-edge effect.

Q131 **The Earl of Lindsay:** I want to ask you about supervisory co-operation post Brexit. How do you think it will work? Do you see it as being fairly ad hoc or more structured and being given some sort of framework? Do you see there being barriers to it working well in terms of being able to provide oversight of cross-border activity? Finally, do you anticipate that post Brexit the supervisory co-operation will be sufficient to address the problems arising from a crisis?

Mr Karel Lannoo: That is a very pertinent question. I take it that you are talking about supervisory, not regulatory, co-operation, or are you talking about both? Co-operation on rule making or only on supervision are a bit different.

The Earl of Lindsay: Can we start with supervision?

Mr Karel Lannoo: It is a crucial issue. Of course, everything will depend on what we do in the coming two or three years to adapt to the circumstances. If you look at what we have done recently with the European Economic Area—Norway, Liechtenstein and Iceland, but essentially the first two—we have managed to come up with a deal and we have incorporated them in the European Supervisory Authorities, the ESAs. Today, that deals more with regulation, but in the future it will also be supervision. Of course, it is difficult to say how it will be, but I imagine that in the future we will come to a solution in order to continue to have the UK involved in the ongoing supervisory setting.

One very clear example is CCPs. We know that there is a proposal on the table in Brussels to have very strict control of CCPs that are outside the EU 27. This is basically politics. I cannot imagine this structure moving to the EU overnight, or in 16 months, so we will need to have a deal with the UK where there is mutual satisfaction that the supervision that is happening here on these structures is in the interests of the EU 27, and I would say vice versa for some other business that is done in the EU 27 for the UK.

The most difficult thing will be the period in between. Until we have the new structure in place, how will it happen? There is a danger that there could be a grey period in between where there is no clarity about which rules and structures apply. However, since this is supervision, unlike regulation, the structures that we have in place today, and had even before the crisis, of supervisory colleges for banks, insurance companies and even infrastructure should continue to be in place. Also, at that level, if it is supervision, there will be an acceptance that you basically follow those with the most expertise in that given case, rather than strictly applying the rules. I think that in the end a modus operandi will be found that will be driven by the necessity of circumstances, rather than saying strictly, "Now they are out, we will not apply these rules any more", as basically happens on an international level with all the countries in the world.

The Earl of Lindsay: Can I go back to the distinction that you offered between supervision and regulation? If you are fairly optimistic that on a supervisory level a way will be found for the United Kingdom to remain involved, as has been for found some other third countries, and if, as you also said, that where there is expertise, solutions tend to be engineered, do you think that will allow the United Kingdom post Brexit to become more involved in the regulatory space as well? After all, supervision and regulation are merged into each other, with supervision as the least political part of that axis. If Britain is sitting comfortably and is invited in at the technical, supervisory end, it would be perhaps less difficult for us then to quietly play a role in the development of EU regulation thereafter.

Mr Karel Lannoo: That is precisely why I asked you to make that distinction, because I see, certainly in the short term, much more of a problem with regulation than with supervision, where, because of circumstances, authorities will see that they need to be realistic.

However, on regulation, I see a big problem. We do not know exactly what the situation will be after March 2019. Will the UK be excluded from all the different committees—from the committees in the Council that discuss proposals on the table to export committees, on all different levels? That is the strength of European intervention, that it is not only heads of state and Ministers who meet, it is all the levels below. There are thousands of committees that meet on a daily basis in Brussels and in the member states but—and this depends on the strict interpretation of the rules—suddenly in March 2019 it is finished.

We have seen such problems in the past with the EEA countries. I hope there will be some modus operandi on this. For example, another country that we forget to mention from time to time—Switzerland—is fully involved in the justice and home affairs committees because it is part of Schengen, but nobody speaks about this. The Swiss ambassador is called to join a meeting in Brussels. If the Justice and Home Affairs Council is discussing issues that affect Schengen, he is called into the meeting and it is extremely flexible. I hope that politics, or certain sensitivities, will not prevent that happening. It will probably not happen at all the levels at which it happens today, but in the end I think that pragmatic solutions may prevail.

Again, that is why I think the agreement made on Friday is extremely important—as well as the document, which is not a formal legally binding document in the common understanding—as a stepping stone towards realising this. As I said, I hope that common sense will prevail and that narrow-minded thinking on the part of certain member states does not prevent it happening. There were certainly some fights in the corridors, let us say, but overall I think—I hope—that common sense will prevail.

Q132 **Lord Bruce of Bennachie:** On that note, given your insight, you have made fairly clear what you think about what is happening and the potential loss of the benefits that we have had, but you have also said that you hope for a pragmatic, common-sense outcome. What is actually possible? We have been told, "Well, you can talk about Norway or Canada or Switzerland or some permutation", but people are talking about equivalence, which does not really cover it; it is mutual recognition and enhanced equivalence.

What is possible with regard to those achievements from the EU 27 point of view, bearing in mind that there are also people on the UK negotiating side who would regard any of the things that you are talking about as surrendering to continuing subordination to EU rule-making? What kind of practical outcome do you think can be achieved and would be acceptable to the EU 27?

Mr Karel Lannoo: I know that there are also problems on the UK side with certain groups that want a clear break and that certainly do not want any jurisdiction by the European Court of Justice, for example. However, we also have the agreement on Friday, which says that for free movement of people there will certainly be jurisprudence by the European Court of Justice for a longer period of time. I assume that, as in other areas, if you want one you will have the other. We know now that there will be a transition period after March 2019. How long it will last we do not know, although we know that it means access to the single market but at the same time acceptance of the jurisprudence of the European Court of Justice. It is extremely difficult to say how that will evolve after that period.

There are also many things that are accepted now which this country did not find acceptable a year ago. I was surprised that there was not more reaction in this country against what was agreed on Friday, such as the budgetary issues, certainly from the hard groups within the Tories. That is why I think that a lot is still possible in the future, also on the financial services side. It is clear, certainly for the time being, that the interpretation of the single passport will be as it is under the current rules after the transition period, unless there is a change to all those rules.

However, it will be extremely difficult to have an overall change to those rules, because, as I said, equivalence is different in all the different domains of financial services. You would have to have an omnibus directive or omnibus regulation to change it all, or you would have to have a decision of the European Council to say that there is mutual recognition or an overall mutual equivalence between the EU and the UK. That will be very difficult, because for that to happen there will be lot of demands from the EU side, saying, "EU equivalence means this and that for us", but the UK will say, "But for us equivalence does not mean this and that. We think you are going too far. Because we are no longer in the EU, we want to benefit from a more flexible environment", which some groups are arguing for. Hence it will be very difficult to have an overall equivalence agreement. I think we will continue to have the pillarised equivalence approach according to the sector of the financial services.

Q133 **Lord Bruce of Bennachie:** That brings me to my next question. Again, the talk is of a free trade agreement including services, which, given that they account for 90% of the UK economy, is important. However, that is not what other countries have. Then the argument will be, "Ah, but the UK is not another country. It's the only country that has ever left the EU and we know each other. Therefore, we should get an agreement that covers services and enables us to carry on as you suggest". However, our witnesses are saying that a transitional agreement is helpful because it postpones the day, but unless we know what we are transitioning to, it still leaves us with some difficulties regarding how these issues will be resolved. You are implying that the problems are just as acute for the EU 27 as they are for the UK, but do you really think that is the case?

Mr Karel Lannoo: From a purely political point of view, everyone will look at it from their own perspective. Before coming to a generalised equivalence agreement or a generalised Commission agreement with the UK, many different interests in the EU 27 will have to be reconciled, such as asset management, insurance, simple banking services, hedge funds or alternative investment management. It is almost impossible to imagine reconciling all those interests at once; rather, they will be dealt with one by one.

Lord Bruce of Bennachie: That is just the financial services sector. There is also food, agriculture, cars, space and so on.

Mr Karel Lannoo: Exactly. It is only one of the many sectors.

Lord Bruce of Bennachie: So we could be talking 10 years.

Mr Karel Lannoo: A headline in the *Financial Times* today says that the chemicals and pharmaceutical industry is asking the Government to stick to EU standards. We will be seeing more of this in the months to come. But we know, for example, that the asset management industry, and certainly the hedge fund industry, in this town is rather reluctant to do that and wants to keep flexibility. It thinks that the EU rules are too constraining.

We should also think about the bonus rules. At the beginning I mentioned on purpose that the financial centre can pay higher salaries if it manages to have a conglomeration of services. On that issue, again, we know that not only government but many others in this town would prefer not to have the EU rules. Another sector is FinTech, with crowdfunding and so on. The UK approach is clearly that of the regulatory sandbox, which means in effect a very flexible regulatory regime, letting the industry emerge, but other EU member states take other approaches. The EU is now working on a regulatory approach to FinTech. Is it needed? I do not know. It is a very limited industry size-wise. I assume that it does not cause any systemic risk at the moment, so let member states experiment with this sector rather than have harmonised rules from the beginning.

The Chairman: Mr Lannoo, you mentioned briefly—this is slightly out of context, but I mention it as you raised it—that you were surprised at the reaction to the budget. I was not entirely clear what you meant by that.

Mr Karel Lannoo: I am sorry. Surprised by?

The Chairman: By the reaction on Friday to the agreement on the financial settlement, the budget. Could you elaborate on that for a moment? Did the UK do better than you expected? As you know, we spoke about the fact that this Committee published a report in that regard. Did the UK do better or worse than you had expected?

Mr Karel Lannoo: My main surprise was that there was an agreement. Of course, it has been in the newspapers for a long time, but it happened rapidly. I did not expect there to be a deal and certainly not on the amount of money that was mentioned. By the way, one of our researchers had more or less predicted that it would be €50 billion or €55 billion, which is simply a calculation. But this was accepted. Of course, they knew that they had to accept this to move to the next phase, as the EU Commissioner said very clearly.

Q134 **Lord Fraser of Corriegarth:** As you might imagine, the last question is about the cliff-edge possibilities. In your view, will it be possible for a solution to problems of contractual continuity to be reached relatively easily outside the main scope of the negotiations? What will a transition period need to provide from the perspective of the EU 27, and how could it be agreed?

Mr Karel Lannoo: Thank you. That is another important issue. Basically, you are asking about the grandfathering of rules that are applicable today and how they will be applicable in the future. When I read through the document agreed on Friday, I saw that there was a whole section on the EIB, the European Investment Bank, and the loans that it is undertaking. I do not remember exactly what was in there, but there is already an agreement that, as long as a certain loan is in operation, the EU rules will continue to apply. Basically we have it in one direction, and I assume that it will also go in the other direction.

So, the basis is already there to say that although there will be a form of grandfathering, which will apply in both directions, it will be the same for every contract on the table from now until March 2019. A contract will fall under the EU rules and that will continue for the life of that contract. That is what I would expect. I am not a lawyer, but I think that is what international law would say. Of course, there will certainly be uncertainties, but that, again, is why it was so important that at least we had that deal on Friday. With a clear perspective on the transition, business will be able to continue to operate with some certainty.

The Chairman: So in terms of grandfathering and contracts that will be engaged in until March 2019, if there is a two-year transition period and it is a standstill period—in other words, we continue as now for a further two years—in your opinion will grandfathering still apply to the contracts agreed in that transition period?

Mr Karel Lannoo: We will have to wait and see, but I presume so. Even if the UK is no longer part of the decision-making construct, it will certainly still be part of the single market, so I would assume that the same rules would apply to contracts agreed in that period. However, that will have to be clarified in the coming nine months.

Lord Fraser of Corriegarth: And presumably, after that, everything will continue, as has been set out, unless the rules are specifically changed. The only parallel that I can think of is Hong Kong, where one or two rules have changed since we left, but broadly the frameworks remain the same, and unless there have been specific alternations the same system has continued.

Mr Karel Lannoo: Yes, I had not thought about Hong Kong—

Lord Fraser of Corriegarth: It is a complete change of regime, clearly.

Mr Karel Lannoo: Yes, it was a complete change of regime, but we can see how business has continued to function in the meantime. In the Hong Kong example, basically common sense prevails. In 2000, there was an expectation that China would have a much stricter approach.

Lord Fraser of Corriegarth: Mind you, there is a 50-year transition period there.

Mr Karel Lannoo: We will have to see what happens in 30 years' time.

Lord Desai: All will become clear in the fullness of time.

Lord Fraser of Corriegarth: This is like the question posed by Zhou Enlai: "Was the French Revolution a success? I don't know. It's too soon to tell".

Lord Woolmer of Leeds: Do we have time in the public session?

The Chairman: I think we do.

Lord Woolmer of Leeds: You touched on CCPs, EMIR and so on. Do you think the Commission's approach will change post March 2019 or 2021? You said that there were different views within the EU 27 about the impact of changes, particularly in relation to location policy. How do you see the Commission's approach developing in the next two to three years? Do you think that Brexit will make any difference to it, or do you think that the implications for the users and the counterparties are likely to mean that London, with its advantages, will continue to be a key centre for the EU, as well as globally?

Mr Karel Lannoo: Thank you for that question, which is a very difficult one. CCPs are probably one of the most controversial areas in this domain. On the one hand, it is a very complex business that requires a high concentration of financial services business. You can only really develop if you have big business behind you, which means the big balance sheets of big banks, and if you are a big financial centre. On the other hand, many member states, notably France, have asked why they cannot have big business. That is what I said in my paper. Why did Hollande say, the day after the Brexit vote, "Ah, this business can come to France"? What did Hollande know about CCPs? Probably nothing specific, but somebody told him that this is an important business. If there are billions going around in that business, of course the member states might think, "It wouldn't be bad if I had that business in my territory for my country's balance sheet"—meaning the liquidity management of the country overall.

That is why it is a controversial business, and why we have this proposal—the third EMIR amendment, which was proposed in June this year—with very strict rules, if you are outside the EU area and fall into another jurisdiction, about what you can and cannot do, with the eventual possibility of requiring businesses to be relocated. The ECB has additional concerns and fears that that may affect its financial stability control and that it needs to have the CCPs under its jurisdiction, which this country knows very well; there was a court case about this. It is an area that I will watch extremely carefully in the coming months and years.

I have spoken to parliamentarians to try to sound out their views. The views are widely divergent. Some say, "We agree with the Commission proposal", and others say, "We will amend it strongly". Others say even, "This is only a political proposal. It was part of the build-up to the discussions". If they see the discussions going in the direction of it having less priority or being watered down or there being a consensus between supervisors, there should not be too much concern and there will be agreement that the supervision that is carried out in the UK post Brexit will satisfy supervisors from the EU.

Of course, there is a legal issue, which you mentioned, about continuity for contracts. Certainly, collateral is a big issue that will have to be solved. If business continues to be carried out here for banks in the EU, of which the UK will no longer be a part, what legal certainty will they continue to have for transactions that are happening in the City on the basis of collateral which they pledge over here? Is there continuity for their business? That remains to be seen. Certainly the way it is going in Brussels today, there is an attempt by two countries to get some more business in the CCP field.

Lord Woolmer of Leeds: Is time likely to be a healer on some of these things? If London, as a major clearing centre, is an important part of the EU economy, can you think through ways in which the issues of supervision, even of regulation, could be developed to enable the EU—the Commission but also the member states, the counterparties—to feel that it makes a lot of sense for London to remain a very substantial centre? That does not stop Paris or Frankfurt having a go, but do you think there are ways of overcoming the fears, because part of the pressure is fear, is it not—"This is outside. We cannot control this thing. It is very big"? Are there ways of overcoming fears over time?

Mr Karel Lannoo: By the way, in the paper that I distributed among you I argue that in its impact assessment on the third proposal of changes to EMIR, but also of all three levels, the Commission has not analysed sufficiently risk management within CCPs. It has said just that there is a fear of interconnectedness and all the big banks are doing business through these CCPs, and if one of these CCPs were to fail we will have a new financial crisis, but it has not analysed how the risk management is done today in these different CCPs. I have no balance-sheet data, for example, of what a CCP looks like, meaning that the risk analysis has not been done. I hear from CCPs themselves and from large banks—since this is a mutual structure, meaning that the banks have as much interest in controlling the CCP as the CCP has to do its risk management well—that the incentives are very strong to continue to have this business extremely well managed. Of course, it could disrupt the financial system, but the incentives on all members of the CCPs are so big that in principle they should do the business well.

In addition, I think member states will realise that you cannot move this business rapidly to another state. As I said, this depends on large banks with large balance sheets with a lot of capital. We know also that there is another proposal, which is included in your questions, in the banking reform package to have sub-holding companies set up in the EU. But again, it is a cost for banks. If a large American bank has £40 billion or

£50 billion capital here to have a part in another EU member state, to split it up is costly, because £10 billion plus £40 billion is not the same as having £50 billion in a certain jurisdiction, because you cannot do as much with £10 billion plus £40 billion as you can with £50 billion.

There is also the whole infrastructure of having the CCPs, which you can probably move. But, again, if you look at the two principal CCPs in this town, you cannot move that business so rapidly. There is the legal environment, the common law versus civil law. There is the wiring of the entire environment. All these infrastructures are interconnected with the banks, and so on. You cannot move this business in 16 months, not even in three or four years. That is why, again, due to the conglomerate effects of a financial centre, there are some aspects that will be affected by the passport but others will not be at all.

The critical mass that London has today will be affected by the fact that the UK breaks out of the EU, but other elements will not be affected or will be affected only to a limited degree. Of course, there are the modalities of the degree to which member states will be tough in trying to get this business into the EU 27 compared with what it is, but they may realise after some time that it is a complex business and that they will never be able to manage what is in London today. This business has grown in London over a very long period, at least 40 or 50 years, and is not moveable in a matter of two or three years.

The Chairman: Thank you, Mr Lannoo. I think we would like to conclude the public evidence session. The Committee will now meet in private, but we invite you to stay on.