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FILE TITLE:

FINANCE

SERIES

EUROPEAN POLICY

PART

5

PART BEGINS

19 OCT 2002

PART ENDS

20 DECEMBER 2002

CAB ONE

Labour Administration

PART
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Series : **EUROPEAN POLICY**

File Title : **FINANCE**

Part : **5**

Date	From	To	Subject	Class	Secret
21/10/2002	Cab Off		EU/Switzerland & Savings Tax Meeting	C	
23/10/2002	PPS	HMT	Stability & Growth Pact	C	
23/10/2002	Cab Off	Cab Off	Stability Pact : Commission Discussion	R	
08/11/2002	EU/PS	PM	Stability & Growth Pact	C	
14/11/2002	Brussels/UKREP	PPS	EU Finance Services	R	
19/11/2002			European Economic Reform Progress Report	R	
27/11/2002	PPS	HMT	Europe: Economic Reform	U	
03/12/2002	HMT	PPS	EU Financial Services	R	
09/12/2002	EU/PS		To Digby Jones, CBI: Economic Reform in Europe	U	
13/12/2002	PD(DS)	PM	EU Financial Services	C	
13/12/2002	Cab Off	EU/PS	EU Financial Services: Treasury paper	C	
20/12/2002	FA/APS	PM	Economic reform: Swedes and Finns	C	
20/12/2002	PPS	HMT	EU Financial Services	C	
20/12/2002	EU/PS	PM	EU Financial Services: Treasury paper	C	

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LONDON SW1A 2AA

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From the Principal Private Secretary

20 December 2002

Dear Mark,

EU FINANCIAL SERVICES

Thank you for your letter of 3 December replying to mine of 17 October. I was also grateful for Sir Nigel Sheinwald's letter of 14 November.

The Prime Minister agrees with what you are doing and your strategy for the future. He welcomes the close liaison between the Treasury and City representatives that led to acceptable outcomes at Ecofin on both Prospectuses and Pensions. But his overall conclusion is that both we and the City need to raise our game. In particular he believes that:

- (i) protecting the interests of the City as a strategic UK national interest should be given a high priority by ministers and officials. We must prevent others regulating away our comparative advantage in this area to benefit their own providers. We also need to articulate clearly our own vision of what an integrated single market in financial services should look like;
- (ii) the necessary official resources should be devoted to this objective both in London and in UKRep Brussels. In particular, the Prime Minister thinks that the Treasury should consider establishing a monitoring unit, staffed by a mixture of civil servants and City secondees, to work with the industry in identifying and highlighting barriers to trade, discrimination and other examples of non-implementation of EC obligations. Our contacts suggest that the City would be happy to find good quality people;
- (iii) we should do what we can to ensure that the City are geared up to identify their interests well in advance and play their part, with us, in advancing them in Brussels. This may involve pressing them to do more, in London and in Brussels, to identify UK interests in a coherent, professional manner and early enough to influence the Brussels debate.

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- 2 -

- (iv) the Commission should put greater stress on enforcement, preferably by establishing an enforcement unit in the Internal Market Directorate. They would need to work closely with DG Comp. Such a unit would complement a Treasury monitoring unit and could be tasked to investigate all complaints arising from stakeholders in the member states and take the lead on infraction action where that proves necessary.

The Prime Minister believes we should also look at what leverage we have over other member states in terms of both deals and pressures. In other words, where we have really important interests we need to think outside the framework of the immediate negotiation to maximise the chances of success.

The Prime Minister would be grateful for a further report by early March on progress. This issue will also no doubt be discussed at the meeting we are planning on economic reform in January.

I am copying this letter to Sir Nigel Sheinwald.

To: Jm

JEREMY HEYWOOD

Mark Bowman
HMT

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Cop

From: Roger Liddle
Date: 20 December 2002

PRIME MINISTER

cc: Stephen Wall
Jeremy Heywood
Arnab Banerji
Andrew Adonis
Geoffrey Norris
Steven Morris
Matthew Rycroft
Francis Campbell
Martin Donnelly

ECONOMIC REFORM: SWEDES AND FINNS

I had Spring Council discussions on my trip to Sweden and Finland this week. In Stockholm, I met Anders Norstromm, Persson's key adviser on European economic reform. In Helsinki, I had an hour with Finance Minister Ninisto. These discussions were characterised by:

- **Deep gloom** about the German economy (Ninisto's firm view was that we have not yet seen the worst).
- **Despair about the Stability Pact.** Ninisto thought that the recent Commission paper was pretty sensible, but that the French and Germans were not prepared to change their policies to abide by the terms of even a revised Pact. So there should be no revision of the Pact and the early warning procedures should be initiated in January and February against the French and Germans.
- **Concern about the preparation for the Spring Summit:** both the likely tone of the Commission Synthesis Report and the way the Council would be prepared. No enthusiasm for putting it in the hands of a Foreign Ministers'

GAERC. The Swedes hope that the Greeks will initiate some informal "sherpa" meetings.

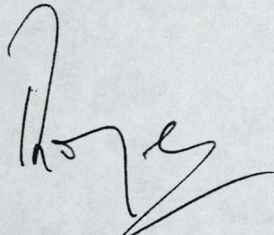
In terms of outcomes for the Spring Council, not many new ideas. **The Swedes handed me a copy of their November paper** which contains some ideas we should look at:

- Establishment of an independent Research Council to try to move EU research cooperation onto a more objective basis and reduce the potential for pork-barrel politics.
- Reinforcing the employment targets with a tougher 'sub-target' for the percentage of unemployed subject to active labour market measures and a child care indicator.
- A Commission report on ways to better integrate non-EU nationals in labour markets.
- Reform of EU health and safety legislation in an effort to reduce the rising cost of sickness and disability.
- Ambitious targets for environmental technology.

As for the liberalisation agenda, the Swedes support a new Commission drive on non-financial services. Public procurement is an important step. Mutual recognition of qualifications obviously matters. But the Swedes don't have a strategy for taking this forward.

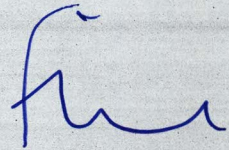
I put to both the Swedes and Finns **our ideas for a Wise Person's Group to identify the top two or three specific measures each Member State should take to meet the Lisbon employment targets.** Both Nordstrom and Ninisto

responded enthusiastically to our proposed Harz Commission for Europe, and it resulted in a lively discussion. **So we have an open door there to make a joint proposal, if we wish to pursue it.** The Dutch would I am confident join in as well, once their election is out of the way.

A handwritten signature in black ink, appearing to be 'Roger Liddle', written in a cursive style.

ROGER LIDDLE

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From: Stephen Wall
Date: 20 December 2002

PRIME MINISTER

cc: Jeremy Heywood
Martin Donnelly
Derek Scott
Arnab Banerji
Roger Liddle

EU FINANCIAL SERVICES: TREASURY PAPER

Following a spate of complaints from senior City of London figures about the direction that the EU's financial services agenda is developing we asked Treasury to provide an assessment of the **costs/benefits** of recent EU legislation and a **strategy** for taking our agenda forward.

/ The resulting paper is attached. You have already had some comments on it from Derek Scott.

HMT's views

The paper is short on any real **quantitative assessment** of the impact on the economy of the recent raft of regulatory measures and is rather patchy on detailed recommendations. The latter in part reflects the fact that Treasury is still engaged in an internal debate and ongoing dialogue with stakeholders on the best way forward.

But it concludes that:

- on balance, there is a "**small net benefit**" to the **UK economy** from the eight measures prioritised (including new rules on **accounting treatment**, cross-border **pensions** and the streamlining of procedures for companies raising capital on a pan-EU basis) at Barcelona, now largely agreed;
- but points out that without a great deal of **heavy lifting** by UK during the negotiation process the outcome would have been much worse.

The paper goes on to note that there remain several important legislative measures in the pipeline, notably on **Investment Services** and **capital adequacy** for banks ("Basle II"). But looking forward, Treasury place a new emphasis on

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delivery, rather than further legislation, as the way forward. **Enforcement, monitoring and implementation** are highlighted as areas where the Commission should focus its energies, rather than drawing up a new action plan crammed full of new legislative proposals. They note that they are giving further thought to **retail financial services**.

The assessment and the suggested strategy sounds broadly right to us. It chimes well with the thinking of the more sophisticated end of **City opinion**. This has crystallised in a paper (also attached) that has recently been prepared by several leading City figures, including Nigel Wicks, Malcolm Levitt, David Walker and Judith Mayhew, in an unprecedented show of unity.

Common features of both papers' assessment of the current situation include:

- the creation of an **integrated, open single market** in financial services remains a valid objective;
- on the right terms this could produce significant **economic benefits** for the UK and the rest of the EU in terms of a **lower cost of capital** for business and greater **choice** for consumers. A recent LSE study suggesting benefits of the order of 1.1% EU GDP is cited with approval;
- but there remains much to do to **deliver** this vision. National rules and practices, many motivated by **protectionist** instincts, continue to fragment the EU market, **restrict competition** and add to costs;
- the City paper also notes continuing widespread discrimination including in national tax systems;
- **mutual recognition** of regulatory rules applying in a companies' **home state**, supplemented by **harmonisation** in limited "core" areas such as solvency requirements should form the basic model for EU financial services;
- while recognising that the **retail market** will need tighter consumer protection regulation it notes that there is currently no mechanism to ensure such regulation is **proportionate** and does not simply protect domestic suppliers under the guise of consumer protection;

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- 3 -

- **enforcement** has generally been weak, with the Commission slow to investigate without formal complaints from companies, who are themselves frequently reluctant to go public in this way;

The City paper

The City paper proposes eight guiding principles to guide the further development of the single market in financial services:

- markets are created and developed by **market participants** not by rules and regulations;
- policy instruments other than **legislation** should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address a clear market failure;
- **consultation** with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input;
- regulation must be **risk-based**, taking account of the different nature of the risks facing different types of firms, customers and investors;
- **surveillance, implementation and enforcement** must be effective at both the **national level** and by the **Commission** (it suggest the latter should set up a dedicated Enforcement Unit);
- regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their **innovation** and development;
- representatives of market practitioners should provide **regular reports** to all the EU institutions on progress towards creating a fully functioning single market;
- a **European Financial Market Forum** should be established to help develop a coherent approach and philosophy for the creation of the single market.

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Comment and next steps

The City paper is a good piece of work. The very fact that it was produced at all (under City of London Corporation auspices) and with such wide buy-in is a step forward in getting the City to present a clear and coherent view on EU issues. Experienced Euro hands such as Nigel Wicks and Judith Mayhew have helped to ensure that the prescription for the way forward is **realistic**, recognising that we cannot simply walk away from the single market as some in the City have sometimes appeared to advocate.

The recommendations in the paper are closely in line with what HMT are arguing for. In general it provides a **realistic** vision of what we want out of the FSAP process.

The one area where the paper's recommendations will be particularly difficult to pursue relates to the extent of **harmonisation** of consumer protection rules. The idea of market-led standards being developed is a concept that most other Member States have genuine difficulties with. They believe this exposes the consumer to unacceptable risk. This aspect of the paper has already been criticised in the FT by the (German) head of the committee of the European Parliament committee that scrutinises financial services legislation. Judith Mayhew's has responded robustly, pointing out that the paper was not calling for a *purely* market driven approach.

We should avoid as far as possible arguing against consumer protection harmonisation measures on principle, simply because they represent a change to existing **UK practice**. Such arguments are unlikely to prevail. Creating a unified EU capital market invariably means change of some sort for everybody.

We should also remember that the City and HMG do not always agree on the **domestic regulatory agenda**, where there has been a case by case assessment of extension of formal regulation in response to specific concerns in areas ranging from pension mis-selling to regulation of mortgage advice.

Encouragingly, whatever the day to day tensions over the detail of specific dossiers, the debate in Brussels is showing some signs of going in a direction broadly consistent with the City/HMT view. The Commission's most recent progress report on FSAP, presented to Ecofin last week, highlighted the importance of **enforcement and implementation** as recently agreed legislative measures come into force. And Alex Schaub, new Director-General of DG

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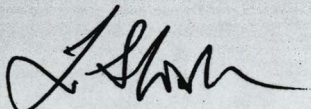
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Markt, was positive about the need to assess specific pieces of legislation against whether they deliver the high level objectives of **reduced costs, increased efficiency and greater choice** when he saw us at No 10 recently.

But however sympathetic the Commission and others may be to this vision in principle, there remains a big challenge ahead to realise it. Securing appropriate **conclusions language** at the **spring European Council** will be a key staging post.

/ You should be aware that the City is feeling a little sore at the relative lack of engagement at the political level from HMT. The draft reply therefore flags the importance of developing a more pro-active approach to the City and HMT working together. It also picks up the points in Derek's minute to you.



STEPHEN WALL

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**DRAFT LETTER FROM JEREMY HEYWOOD TO MARK
BOWMAN, PS CHANCELLOR**

EU FINANCIAL SERVICES

Thank you for your letter of 3 December replying to mine of 17 October.
I was also grateful for Sir Nigel Sheinwald's letter of 14 November.

The Prime Minister agrees with what you are doing and your strategy for the future. He welcomes the close liaison between HM Treasury and City representatives that led to acceptable outcomes at Ecofin on both Prospectuses and Pensions. But his overall conclusion is that both we and the City need to raise our game.

He finds it extraordinary that it has taken the arrival on the scene of Nigel Wicks to produce a coherent City view. So he believes we need to do what we can to ensure:

- (i) that protecting the interests of the City as a major national interest continues to be given a high priority by ministers and officials. We must prevent others regulating away our comparative advantage in this area to benefit their own suppliers. We also need to articulate clearly our vision of what an integrated single market in financial services looks like;
- (ii) that the necessary official resources are devoted to it both in London and in UKRep Brussels by the Treasury and the FSA. In particular, the Prime Minister thinks that HM Treasury should establish a monitoring unit, staffed by a mixture of civil servants and City

secondees, to work with the industry in identifying and highlighting barriers to trade, discrimination and other examples of non-implementation of EC obligations. Our contacts suggest that the City would be happy find good quality people;

- (iii) that the City are geared up to identify their interests well in advance and play their part, with us, in advancing them in Brussels. This may involve you in pressing them to do more, in London and in Brussels, to identify the interests in a coherent, professional manner and early enough to influence the Brussels debate.
- (iv) That the Commission put greater stress on enforcement, preferably by establishing an enforcement unit in the Internal Market Directorate. They would need to work closely with DG Comp. Such a unit would complement the proposed HMT monitoring unit and could be tasked to investigate all complaints arising from stakeholders in the Member States and take the lead on infraction action where that proves necessary.

The Prime Minister states we should also look at what leverage we have over other member states in terms of both deals and pressures. In other words, where we have really important interests we need to think outside the framework of the immediate negotiation to maximise the chances of success.

The Prime Minister would be grateful for a further report by early March on progress.

I am copying this letter to Sir Nigel Sheinwald.

4. DEC. 2002 10:20

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Call you have first shot at it?
that's right

HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

3 December 2002

Jeremy Heywood
Principal Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

cc: 50. - t.p.

cc: 50/DS/AS

*Work putty to - to TB with
- good cover note.*
Jez

New Jersey,

EU FINANCIAL SERVICES

Thank you for your letter of 17 October requesting an assessment of the Financial Services Action Plan (FSAP) and a view of the prospects for next Spring's European Council. I attach a Treasury paper which covers these issues.

I am copying this letter and the paper to Sir Stephen Wall and Sir Nigel Sheinwald.

h
Mark
MARK BOWMAN
Principal Private Secretary

RESTRICTED**EU FINANCIAL SERVICES****Development of the FSAP**

1. Integration of financial services across the EU is an important component of European economic reform. An effective integrated EU financial services market should:

- allow broader and deeper capital markets, reducing the cost of capital and increasing the efficiency of capital allocation across the EU, which in turn should make a major contribution to raising Europe's growth, employment and productivity;
- allow consumers and investors to benefit from a greater choice of more competitive and innovative financial services and products; and
- benefit UK-based financial services firms which have the expertise to take advantage of the new opportunities that a single EU financial services market would bring, and so further strengthen the City's position as an international financial centre.

2. While judging the potential benefits is very difficult, a very recent report ordered by the Commission from London Economics suggests that full integration of EU markets would result in a 0.5 per cent reduction in the cost of capital for EU business and a one-off increase in GDP over ten years of

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about 1.1 per cent for the EU as a whole. (The figures for individual countries vary from 0.3 to 2.0 per cent.)

3. It is for these reasons that the UK supported the concept of an FSAP, as part of the agreement by Heads of Government at the Cardiff Summit in 1998, and has offered broad support for completing an FSAP of 42 measures by the end of 2005. At the same time, we have also argued that legislative action by the EU should be properly prioritised and targeted at barriers to the operation of the single market. And we have argued that proper implementation is as important as new legislation. These potential benefits and the UK's approach to financial services in Europe have most recently been set out in the European Economic Reform White Paper in February 2002.

4. We have always been aware of the risks, particularly of a fast-tracking new legislation to tight deadlines, especially when the legislation seeks to re-write and centralise the acquis rather than tackle specific barriers. This is particularly true where the Commission has the sole right of initiative, and legislation is subject to QMV and co-decision with the European Parliament. The Barcelona European Council agreed to adopt eight priority measures by the end of 2002. We have argued that the content of these measures is at least as important as the timescale to which they are adopted. They must be linked to economic and other policy goals.

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5. The Commission's latest Communication lists 30 of the FSAP's measures as complete. From a box-ticking perspective, the EU has shown that it can deliver financial services legislation to a tight timetable: it looks likely that all eight of the Barcelona priorities will be "agreed" by the end of 2002 in some form or another, albeit in some cases yet to reach formal adoption or to clear the European Parliament.
6. But an assessment of the content of these measures is more mixed. On balance, we judge on a qualitative basis that the eight measures prioritised at Barcelona might produce a small net benefit when compared with the previous status quo. What is clearer is that without UK involvement in the process (and the process would have continued with or without our involvement), they would undeniably have led to materially worse results – for economic reform and for the City in particular.
7. Annex A sets out a brief assessment of the eight Barcelona priorities.
8. The Prospectus Directive is a useful example, largely because the City has seen it as a litmus test of the EU's commitment to financial services reform. We endorsed the underlying objective of the Directive – to make it easier for firms to raise capital in different markets using a single prospectus document, thus reducing legal, regulatory and translation costs. The initial text of the Directive was unhelpful, rewriting swaths of related Community law and

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Introducing new regulatory requirements where we considered them unnecessary. Through the negotiation process, working closely with the City, and in particular selecting our priorities on the basis of continuous consultation, we succeeded in:

- opposing new burdens for small firms (eg removing requirements to file annually updated prospectuses);
- recognising important differences between institutional and private investors (avoiding excessive regulation of prospectuses intended for the former); and
- ensuring the survival of the EU's 2.3 trillion euro bond market (eg ensuring that all wholesale bond issues in a market such as London can continue to be supervised by a single regulator rather than on the basis of where the Issuer is incorporated, which would have led to market fragmentation).

9. The Prospectus Directive remains a compromise, and includes elements that we would prefer to have excluded. But we believe its final net impact should be mildly positive.

10. The Prospectus Directive has also been instructive in terms of alliances and opposition to our views. Throughout the process, France, Italy and many other Southern European countries have opposed many of our demands. We have

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consistently worked closely with countries such as Germany, Austria, Netherlands, Luxembourg, Denmark, Sweden and Finland - and as the debate shifted from technical supervisors (who dominate the process in many Member States' delegations at working level) to finance ministers, we were able to pick up a more broad-based support that allowed the Chancellor and Finance Minister Eichel to speak jointly at ECOFIN.

Working arrangements

11. As the Prospectus Directive demonstrates, we are working closely with the financial sector in this field. Our European Financial Services team had dealings with over 85 organisations on these issues during September and October this year, including about 30 individual financial institutions, 30 trade associations and 15 exchanges or other infrastructure providers.

12. We are taking a more formalised, tiered approach to work with the sector on EU issues:

- first, increasing awareness and visibility among senior executives through, for example, ministerial breakfast events;
- second, we have regular strategy discussions among very senior representatives from the sector - both wholesale and retail;

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- third, we are increasing information flow to business by instituting a regular stocktake event for the 30-40 trade associations active in this field, and increasing the material available through our website. Treasury officials as well as ministers regularly speak at trade association conferences and attend discussions that trade associations hold with their members on EU issues;
- fourth, it is now our standard practice to set up consultation groups with industry on each directive, as we have done on the Supplementary Pensions and Prospectus Directives. These involve 30 or more representatives from businesses and trade bodies – and then work closely with selected “drafting groups” of experts when we negotiate texts. We also use smaller, ad hoc groups where necessary to assess strategy on particular issues.

13. The Treasury has increased the resources it devotes to these issues, to about 10 policy advisers, to allow us to deal more effectively with the FSAP. UKREP resources in this field have also been increased over the past 12 months. The Treasury leads joint project teams, involving the FSA and UKREP as well as other departments as necessary, on all key new directives. A further benefit of this approach is to ensure that officials responsible for implementation are involved throughout the process.

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14. We believe that the combination of these internal and external working arrangements provides for a sound approach to negotiating directives and to setting the strategic agenda, while strong relations with other finance ministries (especially Germany) are key to success, especially in the end-game of negotiations. The close working relationship with the City (through these sorts of contacts) certainly helps our approach: but we must also be careful not to be perceived, including by the Commission and other Member States, as acting solely in the commercial interests of the UK financial sector, otherwise our position will be compromised.

15. We also need to improve the understanding of financial services issues in the EU institutions. We have taken up a proposal (made initially by the London Investment Banking Association) that the Commission itself make use of more secondees from the financial services sector when preparing draft legislation. This point was made most recently when the new head of DG Markt (Alex Schaub) met the Financial Secretary during a visit to London earlier in November. Other steps include working with the UK financial services sector to improve the understanding of MEPs as well as the Commission, through presentations and seminars in Brussels and visits to the City of London. Recent work within the City to prepare an agreed "vision" for the future of financial services in Europe (led by Sir Nigel Wicks under the auspices of the City Corporation, published just over a week ago) has helped the sometimes rather fragmented financial community

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present their arguments more coherently, again contributing to better understanding of the issues.

Future approach

16. The UK's approach to financial services in the EU was set out in a Treasury paper published in July 2000 and repeated in the February 2002 White Paper. The approach was one of mutual recognition of home-state regulation, underpinned by core common standards. This remains our preferred model, especially for capital market integration, and will inform our general approach to many of the remaining FSAP dossiers.

17. There are, however, three areas where we have been or are developing thinking:

- first, the Chancellor has been leading steps in the EU to change decision-making processes on financial legislation. The new Lamfalussy arrangements for securities legislation ought to lead to principle-based framework directives, more easily adapted comitology-based rules, greater flexibility for national regulators and a commitment to better consultation. ECOFIN has recently agreed to a joint proposal from the Chancellor and Hans Eichel to extend this framework to banking and insurance, and to set up a more effective senior official "Financial Policy Committee" to ensure that political demands are

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translated into working-level results. The UK financial sector is broadly supportive, especially of moves to improve consultation;

- second, we are mid-way through the FSAP and we are giving thought to what follows it. What is clear is that there is little appetite in the UK sector for lots more legislation. Instead, we are likely to want to put "delivery", rather than legislation at the heart of this debate. Delivery means putting enforcement, monitoring and implementation higher on the agenda, as we have continuously tried to do, including most recently by the Financial Secretary in her meeting with Alex Schaub. Schaub seems to speak the right language on these issues. The Commission has made further reference to enforcement and implementation in its latest Communication, including plans to work more closely with Member States during the implementation process. Meanwhile, implementation and enforcement are issues that we raise regularly, both with the Commission and UK financial institutions. In some cases we have been able to provide support (as with some complaints over Spanish tax law and mutual funds). In others, UK-based firms are unwilling to complain, but we are encouraging them to set out their concerns. Our focus must be to make the Commission take its Treaty responsibilities more seriously in this respect;

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and help businesses resolve difficulties when they encounter them as appropriate;

- third, perhaps as part of a follow-up to the FSAP, we are considering retail financial services. This is an area where the Government has been very active in the UK. It is also the case that different factors apply to the integration of retail rather than wholesale markets. We need to understand and be responsive to different business models in the sector. One possibility is that we will want to push for select, targeted interventions aimed at particular products and markets. But we need to discuss this more with the industry.

Prospects for the Spring European Council

18. The analysis above suggests that, while we can talk up specific successes, we should not over-emphasise the delivery of the package of legislation to deadline. To do so simply encourages box-ticking at the expense of proportionate, objectives-based regulation.

19. We should be extremely wary about endorsing any "FSAP2" based heavily on a legislative approach to creating an integrated market. If we judge the timing to be right, we should instead press for alternative policy instruments – for the Commission to put in place more effective enforcement

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and monitoring procedures, and to use its competition policy powers more effectively in this field, for example.

20. One possible important next step in this process may well be the establishment of the Member State-led "Financial Policy Committee" in the early New Year. It could be tasked by ECOFIN to propose further objectives in this field. Treasury officials are discussing options around this with their German counterparts.

HM Treasury

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ANNEX A

Barcelona Priorities

- The Collateral Directive will increase the range of financing approaches available to European companies. It makes some fairly modest changes to UK law, but brings much more significant improvements in the law of many other Member States. While we would have preferred a wider scope allowing more non-financial companies to benefit from the Directive, the text still marks a useful step forward towards the single market in financial services. The Directive has now been adopted.
What?
- The Market Abuse Directive will create a regime to tackle market manipulation in the EU and update the existing EU insider dealing legislation. An effective market abuse regime will tackle financial crime and improve market integrity, although we have concerns about the impact of more detailed rules on the ability of the UK to implement in a light touch manner. It will be formally adopted very shortly.
What?
- The Insurance Intermediation Directive is intended to create a single market in insurance via a "passport" for EU retail insurance intermediaries. An effective single market should increase competition and innovation and bring significant consumer benefits. In

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return for the "passport", Member States are required to set certain minimum standards for insurance mediation. In the UK, this will require the FSA to take over regulation of intermediaries previously covered by the General Insurance Standards Council, with a consequent increase on the regulatory burden affecting this sector. The Directive was adopted in September.

- The Distance Marketing of Financial Services Directive establishes a set of EU-wide rules on the information that must be supplied to consumers when financial services are sold at a distance, which arguably some benefits for the operation of an integrated market. It was adopted in June.
 - The Financial Conglomerates Directive will introduce legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-sectoral activities (eg bancassurance) to foster systemic stability. The main objectives of the Directive – to ensure that financial conglomerates are adequately capitalised, preventing the same capital being counted twice over, and to introduce methods for calculating a conglomerate's overall solvency position – are sensible. It will be adopted very shortly, probably before the end of December 2002.
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- The Prospectus Directive sets out to create a single EU "prospectus" for issuers of securities (shares and bonds). It has been seen as a litmus test by many in the City as to whether the FSAP is meeting its original objectives or not. Political agreement was reached at ECOFIN in November in a compromise that secured our main objectives, both in protecting smaller firms from burdensome reporting requirements and allowing the international bond markets in the City to continue to function. We now judge it creates a net benefit for market integration, but this depends in part on the outcome of its consideration by the European Parliament and the approach taken under the secondary EU comitology legislation. We expect formal adoption in early 2003.
- The Occupational Pensions Directive is intended to put in place a prudential framework that removes barriers to developing occupational pension schemes. The Council Common Position was a finely balanced compromise that allowed the UK to meet its main negotiating objectives. The European Parliament is currently starting its second reading of the proposal, and we would expect final adoption in early-mid 2003.
- The objective of the International Accounting Standards Regulation (on which DTI leads) is to increase transparency of EU accounts (and therefore

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the attractiveness and comparability of EU markets) through harmonising EU financial reporting on the basis of globally agreed accounting standards, developed by the International Accounting Standards Board. The Regulation will require all companies listed on regulated markets to prepare their consolidated accounts on the basis of International Financial Reporting Standards (previously known as International Accounting Standards – IAS) from 2005.



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Dame Judith Mayhew DBE
Chairman of the Policy and
Resources Committee

Frits Bolkestein
Commissioner
European Commission
Rue de la Loi 200
B-1000 Brussels

22 November 2002

Dear Commissioner

Creating a Single European Market for Financial Services

From our previous discussions I am sure we are agreed that the completion of the Single Market in financial services is one of the most important challenges faced by the European Union in the next few years. As the most comprehensive international financial centre in Europe, the City is keen to ensure a fully functioning and effective Single Market. The Corporation of London, as the administrative authority for the City, facilitates a continuing dialogue between all those interested in maximising the competitiveness and utility of these financial services throughout the world.

We support fully the aims of the Financial Services Action Plan together with the Lamfalussy principles as well as the need for the markets to work within a framework of corporate governance and agreed international accounting standards. We are determined that a Single European Financial Market should work for the good of the customer, the European economy and our ability to compete effectively around the world.

As you may be aware, a group of City people has been working on a discussion paper about the creation of the Single European Financial Market with practitioners and trade associations representing a wide range of European and international companies present in the City.

I hope you will find the resulting paper (enclosed) a worthwhile contribution to the ongoing debate about how best to complete a fully functioning market. Please treat it as work in progress on which we would be most interested to have your comments.

The text sets out eight Principles and Practices to underpin policy, legislation, consultation, regulation, implementation, enforcement, governance and external review needed to achieve the objective of a competitive, innovative functioning single market. I hope you will find this paper timely in view of the economic evidence you have published this week that integration would increase European Union growth by 1.1% over the next decade or so. What we are seeking is an open, transparent, equitable and competitive market place as a result of this integration. Otherwise the economic benefits of integration will not be achieved as envisaged by the Lisbon European Council.

I am writing in similar terms to a number of your colleagues in the Commission and we will also be circulating the paper to Ecofin Ministers, emphasising that it is intended for discussion.

Judith Mayhew

CREATING A SINGLE EUROPEAN MARKET FOR FINANCIAL SERVICES

- A DISCUSSION PAPER

**Produced by a working group in the City of London drawn from a broad
range of international financial services interests**

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Summary of contents

Executive Summary

- I Introduction**
- II The Benefits of a Single European Market for Financial Services**
- III What would a Single Market look like?**
- IV An Ethical and Stable Financial Market**
- V Different approaches to Financial Services Regulation**
- VI How do we create a fully functioning integrated single market?**
- VII Why is there no Single Market?**
- VIII The Champion for the Single Market**
- IX Eight Principles and Practices for the Single Market**
- X What needs to be done?**

CREATING THE SINGLE EUROPEAN MARKET FOR FINANCIAL SERVICES

This note:

- **Recalls the Lisbon Council Conclusions calling for the completion of the single market in financial services, which is one where buyers and sellers of financial services and products may deal with one another throughout the EU, wherever they, their systems or infrastructures may be located;**
- **Emphasises the benefits, in terms of greater choice and better value for customers, prosperity, jobs and growth, which a single financial services market can bring;**
- **Describes what the single financial market should look like, including the need to be responsive to users;**
- **Reminds that financial markets usually work with "other people's money" and that investors expect markets to operate in a stable, responsible and ethical manner and to be subject to high standards of governance and accountability;**
- **Explains why such a market does not yet exist;**
- **Sets out eight Principles and Practices to underpin policy, legislation, consultation, regulation, surveillance, implementation, enforcement, corporate governance and external review which are needed to achieve the objective of a competitive, innovative fully functioning single market.**

On the basis of the reasoning in this paper, it is suggested for discussion that the following Principles and Practices should be formally enshrined in the most authoritative manner in Community law and practice:-

(2)

1. Markets are created and developed by market participants not by rules and regulations (paragraph 34)
2. Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure (paragraphs 35-36)
3. Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input (paragraphs 37-39)
4. Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties (paragraphs 40-41)
5. Surveillance, implementation and enforcement must be effective both at the national level and by the Commission (paragraphs 42-43)
6. Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development (paragraph 44)
7. Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market (paragraph 45)
8. A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single Market (paragraphs 46-49)

+ brackets.
to be sure that the EF will respect
the revised ceilings during 1992 annual budgetary
rounds the IIA will need to be amended to
reflect as to the EF.

I INTRODUCTION

“Efficient and transparent financial markets foster growth and employment by better allocation of capital and reducing its cost. They therefore play an essential role in fuelling new ideas, supporting entrepreneurial culture and promoting access to and use of new technologies. It is essential to exploit the potential of the euro to push forward the integration of EU financial markets. Furthermore, efficient risk capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs.”

- 1. This was the agreement of the Heads of State or Government at the Lisbon European Council in March 2000. In effect this acknowledged the progress made since the launch of the single market vision in the 1985 Internal Market White Paper but recognised that more remains to be done. Since 2000 further progress has been made towards the Lisbon goal of integrated EU financial markets. For example,**
 - Passage of the legislation in the Financial Services Action Plan (FSAP) is well under way. The latest report from the Commission (2 October 2002) notes that 30 measures have been completed and that progress is being made on 15;**
 - The creation of a Monitoring Group to review progress in implementing the Lamfalussy process, which will report in Spring 2003;**

- The Community's legislative institutions have agreed on the procedures that were recommended in the Lamfalussy report to speed up and make more efficient the legislative process to improve co-operation among regulators;
- The enhancement of the policy role of the Financial Services Policy Group;
- The extension of the multi-level Lamfalussy process to banking and insurance.

2. Despite the adoption or proposal of legislation since Lisbon and progress at the institutional level most market participants would agree that a great deal of work is still needed to create a functioning Single European Market for Financial Services (hereafter referred to as the "Single Market"). The procedural and institutional improvements described above, though necessary, do not of themselves deliver the integrated market which requires market-driven changes by the participants, including new entrants. It is therefore timely to reflect on what further needs to be done to accomplish the goal set out at the Lisbon Council. Of course, such reflection should not impede any constructive work now in hand. It is in this spirit that this note has been written. It should be treated as a draft and as representing "work in progress", on which comments would be warmly welcomed.

II THE BENEFITS OF A SINGLE MARKET

3. The benefits of a Single Market should accrue to all the users of the market as well as to the European economy at large. They were clearly set out in the Interim Report from the group of "Wise Men" chaired by Alexandre Lamfalussy in November 2000, in particular:

- (• Improved allocation of capital, through, for example
 - ♦ More efficient, deeper and broader security markets enabling savings to flow more efficiently to investment;**
 - ♦ Lower transaction costs and improved market liquidity;**
 - ♦ More diversified and innovative financial systems;**
 - ♦ More opportunities to pool risk;****
- More efficient intermediation between savers and investors, through
 - ♦ Intensified competition among financial intermediaries across Europe, leading to fewer inefficiencies;**
 - ♦ Giving users greater freedom of choice;**
 - ♦ The opportunity to reap economies of scale and scope across a larger market;****
- A stronger, faster growing European economy resulting from the above.**

| In short, the benefit is improved customer value and choice together with greater economic prosperity and efficiency.

4. Of all the elements in the process of economic reform set out at the Lisbon European Council, the achievement of the single European financial market is perhaps the most crucial one in creating

“the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” (Lisbon Council Conclusions, March 2000)

This is because the financial market is the mechanism for allocating the savings of the Community's citizens to their most productive uses – to creating growth, prosperity and jobs. Such a market can only be created by responding to the needs of users – savers, borrowers, issuers, intermediaries, traders, infrastructure and information suppliers - and by innovation and competition among participants. Europe faces global competition for capital and the world will not wait for Europe.

5. There has been a number of useful studies that have attempted to quantify the benefits, in terms of potential higher returns to savers, lower transaction costs or higher GDP. But none of these studies has had the public impact of the Cecchini Report, which publicised the benefits of the 1992 Single Market programme. But an important study for the Commission by independent consultants (November 2002) has just quantified some of the potential economic benefits of financial market integration. On the other hand there have been studies, such as the Gyllenhammer report (2001), which demonstrate how much more needs to be done to remove obstacles to an open, competitive single market.
6. The creation of a single market will allow the wider European market to compete on an equal basis with international rivals that are already

free of the constraints under which Europe labours. Finance is a global industry, and global players will seek to meet their financial needs in the marketplaces that offer them the greatest advantages in terms of cost, flexibility and liquidity. Beyond the potentially huge advantage offered to European retail investors by a single European market, there is another, potentially even greater prize to be won by ensuring that Europe is the wholesale financial marketplace of first choice for global investors.

III. WHAT WOULD A SINGLE MARKET LOOK LIKE?

7. The objective is to achieve an integrated, fully functioning market where buyers and sellers of financial assets and services can deal with one another throughout the EU, wherever they, their systems or infrastructures may be located.
8. Today, although there are some parts of the capital market which function well on a pan-EU basis, the systems of market participants, the processes of financial intermediation, the functions offered and the range of products available still largely reflect the old national markets. There is still some way to go to create the competitive, innovative, fully functioning, single financial market across the EU that is envisaged in the Lisbon Presidency conclusions.

Such a market would involve:

- The freedom of market participants – intermediaries and end users – to invest and raise funds in all Member States;
- Financial institutions authorised by their home state authorities to be able to compete whether by a branch or on a cross-border

service basis within all national systems, with access to all essential infrastructures, on a remote basis if necessary;

- Intermediaries able to offer whatever functions, products, services and instruments they are licensed to provide by their home state authority across the EU;
- Infrastructure providers to be free to offer services across the EU;
- Market structures, intermediation processes, products/services/instruments, and infrastructures to evolve in response to market forces, competition and innovation;
- An EU wide market for corporate ownership within a framework of sound corporate governance which safeguards shareholders interests;

// Simply to list such characteristics of an integrated market is sufficient to demonstrate how much still needs to be done.

IV AN ETHICAL AND STABLE FINANCIAL MARKET

9. Money and securities are the materials which financial markets handle. The sums involved account for a very large part of the wealth of the personal sector in the Member States. The relevant markets intermediate, reallocate and mitigate most of the biggest risks faced by private households and businesses, particularly (though not only) through insurance and pension provision. No other part of the economy apart from government itself has so much of people's wealth, welfare and wellbeing in its hands. So whenever financial service businesses or their employees fail to observe proper standards, they have it in their power to do great damage to

individuals as well as to society at large. It is therefore natural that government authority should intervene through a variety of laws and regulations, to a greater degree than elsewhere in the economy, to protect people and institutions from such potential behaviour. In this regard we acknowledge the aims of the Competitiveness Council concerning corporate governance, the need for rigorous accounting standards, and of the Commission's concern for fair treatment of consumers.

10. It is also natural that the authorities should take a keen interest in maintaining the stability and continuity of financial markets and business, and their services and products. The economic and social costs of failure can be very serious. Hence the authorities' very proper interest in maintaining defences against the domino-effects of systemic failure. So, clearly regulators have a duty to act to promote and safeguard ethical and stable markets. But it is important too to recognise that inappropriate regulation can stunt innovation and product development and reduce customer choice. Misguided or heavy handed official action can damage or even destroy markets, as the initial development of the eurobond market in Belgium and Luxembourg following the adoption of measures by the USA illustrates.

V DIFFERENT APPROACHES TO POLICY TOWARDS FINANCIAL SERVICES REGULATION

- 11. There are different approaches to policy towards financial services, reflecting the legal and political history and culture of different Member States and, in many cases, the nature of their financial markets. Whichever approach is followed, effective regulation requires the authorities to work with market participants to avoid mere lip service compliance with rules. One approach is characterised by detailed, highly prescriptive, hard-edged rules, as in the case of much of American securities regulation, but experience demonstrates the need to focus on substance rather than form. Another legislative approach is based more on overarching principles, trusting competition among firms and markets to deliver financial services efficiently and discourage non-compliance by a minority of participants.**
- 12. Moreover there can be a role for non-legislative solutions to single market problems as the first answer to difficulties, with legislation only used as a fall back. In many cases self-regulation by industry bodies, reinforced by the need of participants to avoid damage to their reputation, may provide the best results, particularly in sectors which are rapidly changing; legislation and regulation will be hard pressed to keep up with important new developments. Ombudsmen too may provide non-judicial redress, but this does not rule out judicial redress should the aggrieved individual wish to take the matter further. Ombudsmen are, however, invariably quicker than the judicial process.**
- 13. There is a place too for private sector and market driven solutions and of joint working between governmental and private sector**

bodies. But it should be emphasised that such non-legislative solutions can only play a role if they enjoy the confidence of the public and there is a high degree of assurance that they will deliver outcomes in a more effective way than legislation.

14. It can be difficult to lay down hard and fast rules to determine which of the different approaches to regulation is preferable for a particular market, product or industry and the judgement should be made on a case by case basis. It is a mistake to think that one approach is always the better one and the legislative framework should contain sufficient flexibility to accommodate a range of options, some being more appropriate for particular markets, participants or risks than others.
15. However, while healthy and productive financial markets will need intervention by the authorities, the well being of markets depends to an unusual degree on other factors. The intimate and intricate web of relationships in healthy markets is permeated and promoted to a remarkable degree by values, conventions, confidence, trust, incentives and expectations. The values these promote embrace honesty, openness, putting the customer first, avoiding conflicts, maintaining confidentiality, behaving in a professional way and with social as well as commercial responsibility. Where this value framework flourishes, financial markets generally flourish too; and where it is weak (for whatever reason), however good the laws and regulations may be themselves, the economy will perform less well, and citizens and consumers will suffer - all too often very directly.
16. Creating and maintaining these values is, primarily, a matter of self-regulation, active social responsibility, training and education in promoting good standards in corporate governance, the ethics of the professions and the proficiency levels of market operators in other

areas. However, marking and policing the frontier between official regulation, private sector self-regulation and social responsibility of many other kinds which one encounters requires a subtle, active and considered partnership between all parties involved.

VI HOW DO WE CREATE A FULLY FUNCTIONING INTEGRATED SINGLE MARKET?

17. Most, if not all, developed markets require some sort of "rules of the game", if only to define the responsibilities of the various market participants and the means to enforce those responsibilities. Such rules can be informal but normally have the force of law. What should be the "rules of the game" for the single European financial market described above? What should be the legislative/ supervisory/ regulatory framework?
18. In broad conceptual terms, two approaches have been suggested for providing the framework for the creation of the Single Market.
19. The first approach is the complete harmonisation of legislative/ supervisory/regulatory objectives, instruments and structures; "harmonisation" in this context often being taken to mean complete uniformity of detailed rules rather than a harmony of outcomes. Thus, since the law in each Member State is the same any institution, process, product or financial instrument permitted in one Member State is permitted in all. Conversely, any process, product etc disallowed in one Member State is disallowed in all. Such an approach has the benefit of eliminating conflicting or overlapping national rules.
20. The complete harmonisation approach was rejected by the European Community for the reasons set out in the 1985 White Paper on the

Internal Market. It would take years to achieve, even if it could ever be achieved. In the meantime innovation would be delayed. Furthermore, as experience has unfortunately shown, national authorities would be effectively lobbied, for legitimate commercial reasons, by domestic firms to oppose the harmonisation measures which threaten to expose them to greater competition.

21. The second broad approach is mutual recognition. This "new" approach was incorporated, in theory at least, in the 1985 White Paper for the "1992" programme for the single market.

22. This approach involves in broad terms:

- Minimum harmonisation of essential prudential rules incorporated in Directives concerning e.g. solvency, own funds, accounts;
- Home country supervision on the basis of such harmonised rules;
- Mutual recognition of each national competent authority of the others;
- Thereby enabling an institution authorised in one Member state to operate in all, offering whatever products it was authorised to supply at home in all without the need for complete harmonisation.

23. The two approaches summarised above are not mutually exclusive. Some standardisation is essential in some areas for an efficiently functioning Single Market, for example accounting standards. Furthermore, participants value standardisation of market practices where it has been market driven and designed by the market itself to meet business needs. An important advantage of market driven standardisation is that it can include participants world wide and

provide an important step to harmonisation at the global level. There are important examples:

- ISDA¹ and ISMA² conventions represent industry forms of contractual netting, although the risk that such contracts might not be recognised in some jurisdictions created a need for the collateral directive to underpin them;
- ISO 15022 message standards introduced and implemented by most share and settlement companies have, for the first time, begun to provide their customers with the opportunity of using standard interfaces and standard message protocols to communicate with their chosen settlement service provider.

24. Yet despite market practitioners' recognition that harmonisation has a role in creating the framework of the European single financial market, most practitioners have favoured mutual recognition of conduct of business and any product regulation as the normal basis for cross border transactions between professionals. This is to enable transactions to be based on one set of regulations without needing to wait for standardisation across Member States, given that professionals can be expected to understand and have confidence in such an approach.

25. In the case of retail customers, who have both less market power and less familiarity with the regulatory framework within which a supplier in another Member state operates, greater harmonisation or host state regulation is often favoured by authorities on grounds of consumer protection rather than mutual recognition; however there is no mechanism to test whether or not restrictions on the ability of

¹ International Securities and Derivatives Association

² International Securities Market Association

non-domestic suppliers to offer products or services is proportionate to the problem and consistent with EU competition law or is simply protecting domestic suppliers under the guise of consumer protection.

VII WHY IS THERE NO SINGLE MARKET?

26. The hopes expressed in the 1985 White Paper have not been borne out in practice. There are a number of reasons for this disappointing state of affairs.
27. Some are associated with the fact that market practices, structures, cultures and ways of doing business differ across Member States. This can make penetration by foreign newcomers difficult and costly, whatever their preferred business model. Other reasons are that domestic suppliers and perhaps the authorities arrange matters so as to impede competition and innovation.
28. Then there are issues associated with the EU legislative process and outcomes or which raise matters of competition policy :
 - Clauses in Directives concerning the general good, monetary policy and consumer protection have enabled Member States to introduce national rules which have created barriers to foreign competition, whether by a local branch or cross-border. Examples include clauses in passporting directives concerning banking, insurance, UCITS and distance marketing; clauses in the original ISD which allow different national definitions of professional investors, or which require retail business to be concentrated on regulated markets, or which enable restrictions to be imposed or maintained on cross-border access to trading

systems such as a stock exchange, on provision of trading facilities and on access to clearing and settlement services;

- Such rules have been introduced into EU law without testing whether such national measures are proportionate to the problem that it is asserted they need to address and without checking that they are compatible with competition law;
- There have been flaws in implementation, sometimes arising from ambiguities in Directives which are themselves the result of compromises reached in the Council of Ministers and the difficulty of effectively enforcing these imperfect texts;
- National tax regimes can have the effect of discriminating in favour of domestic products/institutions, such as investment funds; of course non-discrimination between domestic and non-domestic products is compatible with differences between different national tax structures.

29. Moreover:

- Treaty and ECJ requirements concerning non-discrimination against foreign EU suppliers have been used by Member States without legal challenge to ban products offered by foreign institutions on the grounds that the ban also applies to national institutions – which may be unwilling or unable to provide such products. Whatever the legal complexities, the effect is certainly discriminatory and also reduces choice, competition and innovation;
- Enforcement measures against discrimination are usually not initiated without a formal complaint; but some financial institutions are often unwilling to lodge one, for understandable reasons. In

these circumstances there is a case for the Commission taking a more proactive role. If this requires more resources the Commission should have them.

30. The practical result of these various factors is that:

- Products authorised in one Member state cannot always be sold in another, such as interest bearing current accounts;
- Even where funds are so authorised (e.g. UCITS) the cost of local registration and compliance with marketing requirements is prohibitive;
- The tax system may discriminate against non-domestic products, such as mutual funds;
- Authorisation for innovative products authorised elsewhere in the EU may be delayed until local firms can compete;
- Cross border transactions between professional counterparties can be subject to overlapping or contradictory rules;
- Transactions between professionals may be subject to regulation more appropriate to transactions with retail customers and small savers;
- Access to essential national infrastructures may be denied or the use of non-domestic infrastructures for transactions involving a domestic counterparty may be impossible;

These examples, taken together with many others throughout the European Union present users with higher costs and restricted choice, and make the financial sector less competitive and innovative than it could be. Capital is allocated inefficiently and the end result is that the European economy is worse off.

It is not surprising that the thicket of obstacles described above have frustrated the creation of a fully functioning single financial market in Europe. Brave words and good intentions pronounced by the European Council have not been followed through in the detail of legislation or in national implementation or enforcement. The new "Lamfalussy process" will help, but it is clear therefore that there needs to be a high profile political push if a Single Market is to be completed and fully implemented.

VIII THE CHAMPION FOR THE SINGLE MARKET

32. One key element in the completion of the Single Market should be a visible, ongoing commitment by the most senior political body in the Union.
33. It is the Conclusions of the European Council which have set out the ambitious programme for creating a more efficient and productive European economy. It is right that this body, which comprises not only the elected Heads of State or Government of the Member States of the European Union but also the President of the European Commission, should champion the completion of the Single Market. The European Council needs to equip itself to monitor and to promote the implementation of its Conclusions.
34. But the European Council cannot itself supervise the detailed work which is required. This must rest with the Commission, with ECOFIN Council, and with the European Parliament. And to carry out these responsibilities, those bodies must be properly supported by a strong yet supple advisory and decision-making process.

IX EIGHT PRINCIPLES AND PRACTICES FOR THE SINGLE MARKET

35. Agreement on structures to take the work forward is not sufficient. There also needs to be agreement on the fundamental principles that should underlie their creation, regulation and operation of such structures. Eight Principles and Practices are suggested below. They need to be formally embedded in the most authoritative manner in Community legislation and practice so that they underpin the action necessary.

i Markets are created and developed by market participants not by rules and regulations

36. However well legislation is drafted and however speedily and accurately it is transposed into national legislation, it cannot of itself guarantee a thriving single market. This, in the end, rests with "economic agents", the investors and issuers of capital and the myriad of market intermediaries which link them together using the facilities provided by the operators of the market infrastructure. In short, the development of the Single Market needs to take full account of the legitimate needs of market participants, who in the end create and develop the market, provided that the obstacles are removed.

ii Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure

- 37. Non-legislative solutions to single market problems should be seen as the first answer to difficulties, with legislation used as a last resort. Legislation can, and sometimes does, hinder the development of markets or can drive them abroad. Legislation is often not the solution to dismantling barriers in the way of the creation of the Single Market. Private sector and market driven solutions and joint working between governmental and private sector bodies should always be considered before resorting to legislation. Sometimes implementing and enforcing existing legislation or using competition policy more vigorously would provide a better route forward.**
- 38. If legislation has to be proposed, its emphasis must be on the creation of a genuine competitive and innovative Single Market, which avoids creating new obstacles or legitimising obstacles created by national legislation. It is important to avoid legislation which imposes burdens on market participants which are disproportionate to the problem it is said to address. Likewise, legislation needs to take account of the variety of participants and products, so that as well as being proportionate it needs to be differentiated; in this context it should also be borne in mind that some participants, particularly in the retail sector, have no cross-border business ambitions and are sufficiently regulated under their home country national law. All proposed legislation should be judged by the following tests-**

- Does it provide for authorised service providers in one Member State to have the right to offer services licenced by their national competent authority throughout the EU?
- Does it give authorised service providers right of access, on a remote basis if they have no local establishment, to all necessary infrastructures?
- Is it proportionate to the problem that it claims to address?
- Is it cost-effective?
- Does it address a clear market failure and have a significant probability of producing benefits that demonstrably exceed the cost?
- Are the terms sufficiently clear so as not to create ambiguities of interpretation which could hinder the single market?

iii Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input

39. Legislative and other initiatives agreed at the level of the Community are increasingly affecting all aspects of commercial and economic life in the Community. It is therefore becoming even more important for legislation to reflect the most thorough consultation with those whom it will affect.
40. Such an obligation to consult at all stages of the legislative process should be laid upon the Commission by a suitable amendment to the Treaty. Indeed, this principle of consultation is emphasised in the Conclusions of the European Convention's Working Group 1 on the

Principle of Subsidiarity. The Conclusion states³ "It is for the Commission to consult, as soon as possible, all the players (particularly the Member States, economic operators, local and regional authorities and social partners) who may be affected directly or indirectly by the legislative act being planned or drafted."

41. Such an obligation to consult should encapsulate principles of good consultation, such as requirements for

- **Timely consultation before proposals are formally adopted as well as during the principal stages of the legislative process which allows sufficient time for those affected to make submissions to the Commission;**
- **Reasoned responses by the Commission to submissions, including reasons for acceptance and non- or partial acceptance;**

iv Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties

42. There is one general principle that should shape regulation to protect the interests of customers and savers in the Single Market. Regulation should be risk based. It should take account of the different nature of risks facing different types of participants. This principle of risk based regulation should underpin all legislation dealing with conduct of business rules, permissible products and transactions with differing categories of customer.

43. The principle of risk based regulation provides a rationale for regulation to distinguish between

³ WD19 REV1 - WG1 page 5

professional clients/counterparties, such as financial institutions, corporate treasuries, and SMEs/individuals that provide financial services; and

• retail clients, such as personal customers and SMEs (except those that provide financial services)

It can reflect the different experience and expertise of those concerned so that the more experienced and expert ("transactions between equals") are subject to lighter regulation than the retail customer. Moreover, where demonstrable risks are minimal legislation is not needed.

v *Surveillance, implementation and enforcement must be effective both at the national level and by the Commission*

44. The Commission is the guardian of the Community treaties and of the legislation made under them. That role requires the Commission to ensure

- Proper implementation of Community legislation at the national level;
- The implementation and enforcement of legislation by Member States, taking into account the specific legislation itself and the Treaty more widely;
- The vigorous pursuit of competition policy in the financial services area, to avoid anti-competitive behaviour by market participants;
- The systematic evaluation, in a transparent manner, of national laws and regulations. Measures alleged to be justified on

grounds of the general good, monetary or consumer policy, should be tested to ensure that they are proportionate, non-discriminatory in their economic effect and consistent with competition policy;

- The instigation of proactive, annual monitoring of how national financial markets are evolving and the extent to which impediments to competition of any type persist, along the lines of the reviews of Unfair Tax Competition by Member States, or the multilateral surveillance of economic/fiscal developments.

45. This is a massive task that will increase significantly as the Single Market deepens and the Community enlarges. Moreover, the Commission needs to take every opportunity to move its role as Treaty guardian to a more proactive level, actively pushing forward the three tasks referred to above and without waiting for complaints to be put before it. Indeed, such a proactive obligation of the Commission should be considered for explicit inclusion in the Treaty, to reinforce Article 226. For such a role, the Commission will undoubtedly require more resources and staff, perhaps grouped within a new Enforcement Unit. It also requires that market participants should ensure that the Commission is supplied with information on anti-competitive behaviour, on a confidential basis if they prefer.

vi *Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development*

- 46. Earlier in this note it was pointed out that financial markets deal with “other people’s money”. Market participants, whether traders, managers or company directors, exercise therefore a sort of “trustee relationship” in their management of those savings. The regulation and behaviour of market participants, both firms and people, needs to reflect that fact. But this objective needs to be brought about in a way which does not frustrate or stultify the development of the Single Market in a manner which prevents it becoming the facilitator of growth by the methods envisaged in the Lisbon Conclusions.**

vii *Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market*

- 47. It has been emphasised in this note that market participants carrying out their everyday business transactions and initiatives create and develop financial markets. It therefore seems appropriate for a group of representative market participants to provide the European Council, ECOFIN, the European Parliament and the Commission with independent, regular reports of progress towards the creation of a fully functioning Single Market. Such reports, which could be accompanied by ECOFIN/Commission assessments, could be provided for the Spring European Councils. These reports would assess the extent to which obstacles to the completion of the single market remain and advise on the extent to which legislation is compatible with the eight Principles and Practices set out above.**

viii A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single European Financial Market

48. Both market participants and regulators in the financial markets of the Member States face different challenges and different market structures and practices and to some extent they still operate in different cultures.
49. It is not therefore surprising that there is some lack of a coherent approach and philosophy (which will be exacerbated by the impending enlargement of the Community) among market participants and the authorities involved in the creation of the Single European Financial Market. Without some common understandings on these matters, there is a real risk that its creation may well be inhibited.
50. This risk could be mitigated by the establishment of a European Financial Markets Forum. It might be composed of officials from the national authorities concerned, market participants and their associations having appropriate market share, and academic experts. Its role might be to debate the issues and to develop sound principles and practices, including approaches to global standards, able to command support from the authorities and markets.

X WHAT NEEDS TO BE DONE?

51. On the basis of the reasoning in this paper, it is suggested for discussion that the following Principles and Practices should be formally enshrined in the most authoritative manner in Community law and practice:-

- 1. Markets are created and developed by market participants not by rules and regulations (paragraph 34)**
- 2. Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure (paragraphs 35-36)**
- 3. Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input (paragraphs 37-39)**
- 4. Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties (paragraphs 40-41)**
- 5. Surveillance, implementation and enforcement must be effective both at the national level and by the Commission (paragraphs 42-43)**
- 6. Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development (paragraph 44)**
- 7. Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market (paragraph 45)**
- 8. A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single Market (paragraphs 46-49)**

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10 DOWNING STREET
LONDON SW1A 2AA

17 October 2002

From the Principal Private Secretary

EU FINANCIAL SERVICES

A number of leading City figures seem to be of the view that the Financial Services Action Plan (FSAP) is not in practice fulfilling our expectations and may be setting policy on a course that will fail to bring any benefits to the UK financial services industry (and may indeed be counterproductive).

As you know, the Prime Minister has always regarded opening up the EU's financial services and capital markets as an integral part of the Lisbon strategy for delivering economic reform in the EU, benefiting UK companies and consumers as well as the UK financial services industry.

Although the City is clearly not the only constituency that stands to benefit from reform, the Prime Minister is nevertheless concerned about their growing hostility to the FSAP.

He would therefore be grateful for the Chancellor's assessment of where things stand with the FSAP, the prospects for the run up to next spring's European Council and whether we need to modify our strategy on EU financial services. It would be useful if this assessment could address the following issues:

- whether the directives and legislation so far agreed under the FSAP have or are likely to bring net gains to the UK financial services industry and the wider economy;
- whether on present trends the likely outcome of the complete dossier of eight directives prioritised at the Barcelona European Council for agreement this year will bring positive benefits to the UK financial services industry and the wider economy;
- if there are clear gains, what are they and can they be clearly identified and quantified?

- if there are no clear net gains, what changes are required to the planned directives and what are the chances of gaining enough support from other member states for the necessary changes.

The Prime Minister feels we need a comprehensive and rigorous assessment of these issues, including the views of the participants in the various financial markets and other stakeholders in reform.

In the light of this assessment the Prime Minister would also be grateful for the Chancellor's recommendations for taking forward the Government's policy on EU financial services in ways that ensure that potential benefits of an EU-wide single market in financial services are realised and brings clear gains to the UK's financial services industry and to the wider economy. He would particularly welcome the Chancellor's thoughts on two issues:

- whether we should step up the pressure on the Commission to enforce more effectively the existing stock of single market – and underpinning tax – legislation. To facilitate this should we for example set up a dedicated unit in the Treasury, staffed by a combination of civil servants and City practitioners to identify current enforcement weaknesses or discriminatory tax/regulatory rules in individual member states which might be inhibiting the development of a fully competitive single market?;
- what more we can do to improve the Commission's understanding of the financial markets?

I would be grateful if the Prime Minister could have this assessment by 7 November. In the meantime I am copying this note to Sir Stephen Wall and Sir Nigel Sheinwald

JEREMY HEYWOOD

Mark Bowman

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The Permanent Representative
Sir Nigel Sheinwald KCMG

14 November 2002

Jeremy Heywood
No 10

Dear Jeremy
EU FINANCIAL SERVICES

United Kingdom
Permanent Representation
To the European Union

Avenue d'Auderghem 10
1040 Brussels
Telephone: (0032)(2) 287 8211
Facsimile: (0032)(2) 287 8383
Direct Line: (0032)(2) 287 8271
E-mail: nigel.sheinwald@fco.gov.uk

1. Thank you for copying me your 17 October letter to Mark Bowman requesting an assessment of the UK's strategy on the Financial Services Action Plan (FSAP). I thought it might be useful to feed in views from UKREP.
2. Your letter raised a number of issues – the link between the FSAP and economic reform, whether the legislative output is of net benefit to the UK, growing City scepticism, and whether we need a change of strategy.
3. I continue to see the FSAP as a central plank of economic reform. The results of the London Economics survey, released on Tuesday by the Commission, provide firm evidence: a 1.1 per cent increase in GDP, a 0.5 per cent increase in employment and a 6 per cent increase in business investment projected to flow from financial market integration. Further work, soon to be published by the Commission, is expected to suggest that integrated financial markets would lead to a permanent boost in growth in manufacturing industry.
4. The key question is whether or not the individual legislative measures will deliver these integrated markets. The jury is still out. But I believe the outcome of the eight directives prioritised at Barcelona will be of net gain to the UK, and to the City in particular. And we should bear in mind that without the political vehicle of the FSAP, securing successful negotiating outcomes for the UK would have been much harder on the basis of ad-hoc Commission proposals, as previously planned. It is true that the directives most central to reforming capital markets – prospectuses, collateral and pensions – have not been as liberalising as the UK would have wished. But the messages I receive from contacts with the industry lead me to believe that they represent a gain.
5. The situation is less clear on the retail legislative programme. Here our goal (and that of the FSAP) is to increase choice and competition to benefit consumers. But the Distance Marketing and Insurance Mediation directives are unlikely to deliver this in the absence of a coherent overall retail strategy. While the Commission has carried out work on such a strategy, it has no political visibility. The danger we need to guard against is a stream of ad-hoc measures on the retail side, piggy-backing on the FSAP, that raise compliance costs for a largely domestically

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focused industry with no accompanying benefit for the consumer. Such measures may also cut across the considerable number of domestic reforms under way in this area.

6. You mention the growing doubts about the FSAP in the City. I too have picked this up. But I believe and hope the tide may turn. Underlying the City's concern was the lack of consultation by the Commission – a bad thing in itself, but compounded by a lack of knowledge about markets amongst Commission staff. City frustration found a particular focus in the proposed prospectus directive.
7. The Commission appears to have turned a corner, stressing that their rigorous consultation on the proposal for an Investment Services Directive will now be the model. And the message from industry visitors to UKREP on the outcome for the prospectus directive has been cautiously positive. I wouldn't want to overplay this. Much important legislation remains in the pipeline and the HMG/City relationship will need careful management. The recent and more formalised contacts that the Treasury has established will help, both on individual proposals and in influencing the Commission's longer term agenda. James Sassoon, who paid a useful first visit to Brussels last week, seems keen to promote and expand this dialogue.
8. Finally, I do not believe our strategy is, or should be, static. We should continue to position the FSAP as central to the economic reform agenda, but the levers to deliver our objectives need frequent review. In the immediate term, there will be no let up in the flow of legislative measures stemming from the FSAP. The "rapid reaction" drafting groups that HMT has used in the case of the Pensions and Prospectuses seem to have delivered in terms of process and results. We should continue to use them. And we need to work closely with the European Parliament, co-legislators in this area, to establish common ground.
9. But we must also look ahead. An emerging theme is the need for a period of consolidation following the FSAP. We need to evaluate whether or not the individual legislative proposals are achieving their objectives and draw the relevant conclusions. The reconfigured Financial Services Policy Group should play an important role in carrying out this analysis and proposing any next steps. We also need to focus on ensuring proper enforcement of the legislation once adopted. I have been encouraged in my early contacts with Alex Schaub that he shares these views.

Yours Nigel

Nigel Sheinwald

cc: Mark Bowman, PPS/Chancellor
Sir Stephen Wall KCMG LVO, No 10
Michael Arthur, Economic Director, FCO
James Sassoon, HMT
Jon Cunliffe, HMT
Melanies Dawes, HMT

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Martin Donnelly, Cabinet Office

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FROM: RICHARD CRABTREE

European Secretariat

DATE: 13 December 2002

STEPHEN WALL

cc: Jeremy Heywood

Martin Donnelly

Derek Scott

Arnab Banerji

Roger Liddle

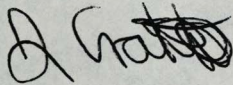
Rachel Green

Mark Sweeney/Mayerling

Patel/Christina Scott / Rod McGrade .

EU FINANCIAL SERVICES: TREASURY PAPER

I attach a draft minute to the PM on the Treasury's reply to Jeremy's letter and the recent Mayhew/Wicks paper (both attached). The note incorporates a further draft letter for Jeremy to send to PPS/Chancellor containing some specific action points.



RICHARD CRABTREE

DRAFT MINUTE TO PM

EU FINANCIAL SERVICES: TREASURY PAPER

Following a spate of complaints from senior City of London figures about the direction that the EU's financial services agenda is developing we asked Treasury to provide an assessment of the **costs/benefits** of recent EU legislation and a **strategy** for taking our agenda forward.

2. The resulting paper is attached.

HMT's views

3. It is unfortunately rather sort on any real **quantitative assessment** of the impact on the economy of the recent raft of regulatory measures and is rather patchy on detailed recommendations. The latter in part reflects the fact that Treasury is still engaged in an internal debate and ongoing dialogue with stakeholders on the best way forward.

4. But it concludes that:

- on balance, there is a "**small net benefit**" to the **UK economy** from the eight measures prioritised (including new rules on **accounting treatment**, cross-border **pensions** and the streamlining of procedures for companies raising capital on a pan-EU basis) at Barcelona, now largely agreed;
- but points out that without a great deal of **heavy lifting** by UK during the negotiation process the outcome would have been much worse.

5. The paper goes on to note that there remain several important legislative measures in the pipeline, notably on **Investment Services** and **capital adequacy** for banks ("Basle II"). But looking forward, Treasury place a new emphasis on **delivery**, rather than further legislation, as the way forward. **Enforcement, monitoring and implementation** are highlighted as areas where the Commission should focus its energies, rather than drawing up a new action plan crammed full of new legislative proposals. They note that they are giving further thought to **retail financial services**.

6. The assessment and the suggested strategy sounds broadly right to us. It chimes well with the thinking of the more sophisticated end of **City opinion**.

This has crystallised in a paper (also attached) that has recently been prepared by several leading City figures, including Nigel Wicks, Malcolm Levitt, David Walker and Judith Mayhew, in an unprecedented show of unity.

7. Common features of both papers' assessment of the current situation include:

- the creation of an **integrated, open single market** in financial services remains a valid objective;
- on the right terms this could produce significant **economic benefits** for the UK and the rest of the EU in terms of a **lower cost of capital** for business and greater **choice** for consumers. A recent LSE study suggesting benefits of the order of 1.1 % EU GDP is cited with approval;
- but there remains much to do to **deliver** this vision. National rules and practices, many motivated by **protectionist** instincts, continue to fragment the EU market, **restrict competition** and add to costs;
- The City paper also notes widespread discrimination in national **tax** systems;
- **mutual recognition** of regulatory rules applying in a companies' **home state**, supplemented by **harmonisation** in limited "core" areas such as solvency requirements should form the basic model for EU financial services;
- while recognising that the **retail market** will need tighter consumer protection regulation it notes that there is currently no mechanism to ensure such regulation is **proportionate** and does not simply protect domestic suppliers under the guise of consumer protection;
- **enforcement** has generally been weak, with the Commission slow to investigate without formal complaints from companies, who are themselves frequently reluctant to go public in this way;

[The City paper

8. The City paper proposes eight guiding principles to guide the further development of the single market in financial services:

- markets are created and developed by **market participants** not by rules and regulations;
- policy instruments other than **legislation** should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address a clear market failure;
- **consultation** with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input;
- regulation must be **risk-based**, taking account of the different nature of the risks facing different types of firms, customers and investors;
- **surveillance, implementation and enforcement** must be effective at both the **national level** and by the **Commission** (it suggest the latter should set up a dedicated Enforcement Unit);
- regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their **innovation** and development;
- representatives of market practitioners should provide **regular reports** to all the EU institutions on progress towards creating a fully functioning single market;
- a **European Financial Market Forum** should be established to help develop a coherent approach and philosophy for the creation of the single market.

Comment and next steps

9. The City paper is a good piece of work. The very fact that it was produced at all (under City of London Corporation auspices) and with such wide buy-in is a step forward in getting the City to present a clear and coherent view on EU issues. Experienced Euro hands such as Nigel Wicks have helped to ensure that the prescription for the way forward is **realistic**, recognising that we cannot simply walk away from the single market as some in the City have sometimes appeared to advocate.

10. The recommendations in the paper are closely in line with what HMT are arguing for. In general it provides a **realistic** vision of what we want out of the FSAP process.

11. The one area where the paper's recommendations will be particularly difficult to pursue relates to the extent of **harmonisation** of consumer protection rules. The idea of market-led standards being developed is a concept that most other Member States have genuine difficulties with. This aspect of the paper has already been criticised in the FT by the (German) head of the committee of the European Parliament committee that scrutinises financial services legislation. Though Judith Mayhew's has responded robustly, pointing out that the paper was not calling for a *purely* market driven approach.

12. Inevitably, in a world of **QMV**, we will need to accept **compromises** that involve rather more harmonisation than the City would like. The challenge will be to ensure that consumer protection rules that are harmonised are:

- **differentiated** to provide different levels of protection for retail and wholesale investors;
- are **proportionate** and;
- **non-discriminatory**.

13. We should avoid as far as possible arguing against consumer protection harmonisation measures on principle, simply because they represent a change to existing **UK practice**. Such arguments are unlikely to prevail. Creating a unified EU capital market invariably means change of some sort for everybody.

14. We should also remember that the City and HMG do not always agree on the **domestic regulatory agenda**, where there has been a case by case assessment of extension of formal regulation in response to specific concerns in areas ranging from **pension mis-selling** to **regulation of mortgage advice**.

15. Encouragingly, whatever the day to day tensions over the detail of specific dossiers, the debate in Brussels is showing some signs of going in a direction broadly consistent with the City/HMT view. The Commission's most recent progress report on FSAP, presented to Ecofin last week, highlighted the importance of **enforcement** and **implementation** as recently agreed legislative measures come into force. And Alex Schaub, new Director-General of DG Markt, was positive about the need to assess specific pieces of legislation against whether they deliver the high level objectives of **reduced costs**, **increased efficiency** and **greater choice** when he saw us at No 10 recently.

16. But however sympathetic the Commission and others may be to this vision in principle, there remains a big challenge ahead to realise it. Securing

appropriate **conclusions** language at the **spring European Council** will be a key staging post.

17. The attached draft reply for Jeremy to send to HMT picks up some specific areas of action for the next few months. It invites further comments from HMT. We will hold a Whitehall meeting to discuss all this on this in late January.

18. You should be aware that the City is feeling a little sore at the relative lack of engagement at the political level from HMT. The draft reply therefore flags in appropriately nuanced terms the importance of developing a more proactive approach to the City and HMT working together.

RICHARD CRABTREE

**DRAFT LETTER FROM JEREMY HEYWOOD TO MARK
BOWMAN, PS/CHANCELLOR**

EU FINANCIAL SERVICES

Thank you for your letter of 3 December replying to mine of 17 October. I was also grateful for Sir Nigel Sheinwald's letter of 14 November.

In the light of the Treasury's assessment of progress with FSAP the Prime Minister believes that there are a number of actions/objectives that we should pursue in the coming months.

- Aim for **conclusions** language at the **Spring European Council** that stresses the importance of effective **enforcement, implementation and monitoring** of financial services legislation. We should ensure that the single market develops on terms that the City of London can exploit its comparative advantage as well as producing benefits for consumers and businesses. Unjustified **discrimination** and **protectionist** approaches to regulation should be highlighted and tackled.
- Consider the establishment of an **Enforcement Unit** in DG Markt, who would have a remit for taking this work forward and reporting regularly on progress to Ecofin and the European Parliament.
- Continue to work with the industry to improve the **effectiveness of City lobbying** in Brussels, Strasbourg and EU capitals. The establishment of **full time City representation in Brussels** may be an attractive way to promote this agenda. The effectiveness of such a unit would depend critically on the individual chosen to head such an office being widely respected and trusted across the City so that they could speak on behalf of the whole of the City, resolving differences of view where necessary. If Treasury Ministers agree this is something that might be explored further with leading City figures.
- The Prime Minister welcomes the extensive **contact** between HM Treasury officials and the financial services sector at all levels in the organisation during the intensive, and frequently difficult, legislative process over recent months. Would it be possible to build on this by

identifying a **single figure** charged with articulating City views on EU issues across Government? This should help to improve the **clarity** with which the City puts its message across and facilitate even closer working between all parts of HMG and the City.

- The Prime Minister believes that ensuring that the UK's comparative advantage in financial services is not unnecessarily eroded by regulation that is **protectionist**, adds unreasonably to **compliance costs** or is **disproportionate** to its objective, is an important goal. We should make clear to audiences at home and abroad that an important part of HMG's objectives in EU financial services discussions is to support the interests of the UK financial services sector, alongside **reducing the cost of capital for business** and **increasing choice and value for money for consumers**. We should also make clear that the main beneficiaries of an over-zealous approach to regulation will be non-EU financial centres.
- It would be helpful in presenting our case to EU audiences if we were able to use more firm **quantitative** data and other tangible evidence to support judgements on relative priorities within FSAP and our stance on particular dossiers. Is this something that the City Corporation or FSA might be able to help with?

Officials will need to discuss these points further in the course of the usual Cabinet Office meetings preparing for the spring European Council. I would however welcome any immediate observations on these specific points that Treasury Ministers have.

Finally, I would be grateful if you could keep us in touch with developing Treasury thinking on the **retail strategy**.

I am copying this letter, as before, to Sir Stephen Wall and Sir Nigel Sheinwald.

[JH]

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HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

3 December 2002

Jeremy Heywood
Principal Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

"SW. - t.p.o"

cc: MB/DS/MS

*Worth putting to the TB with
on good cover note. Jaz*

Dear Jeremy,

EU FINANCIAL SERVICES

Thank you for your letter of 17 October requesting an assessment of the Financial Services Action Plan (FSAP) and a view of the prospects for next Spring's European Council. I attach a Treasury paper which covers these issues.

I am copying this letter and the paper to Sir Stephen Wall and Sir Nigel Sheinwald.

*h
M*

MARK BOWMAN
Principal Private Secretary

RESTRICTED**EU FINANCIAL SERVICES****Development of the FSAP**

1. Integration of financial services across the EU is an important component of European economic reform. An effective integrated EU financial services market should:

- allow broader and deeper capital markets, reducing the cost of capital and increasing the efficiency of capital allocation across the EU, which in turn should make a major contribution to raising Europe's growth, employment and productivity;
- allow consumers and investors to benefit from a greater choice of more competitive and innovative financial services and products; and
- benefit UK-based financial services firms which have the expertise to take advantage of the new opportunities that a single EU financial services market would bring, and so further strengthen the City's position as an international financial centre.

2. While judging the potential benefits is very difficult, a very recent report ordered by the Commission from London Economics suggests that full integration of EU markets would result in a 0.5 per cent reduction in the cost of capital for EU business and a one-off increase in GDP over ten years of

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about 1.1 per cent for the EU as a whole. (The figures for individual countries vary from 0.3 to 2.0 per cent.)

3. It is for these reasons that the UK supported the concept of an FSAP, as part of the agreement by Heads of Government at the Cardiff Summit in 1998, and has offered broad support for completing an FSAP of 42 measures by the end of 2005. At the same time, we have also argued that legislative action by the EU should be properly prioritised and targeted at barriers to the operation of the single market. And we have argued that proper implementation is as important as new legislation. These potential benefits and the UK's approach to financial services in Europe have most recently been set out in the European Economic Reform White Paper in February 2002.

4. We have always been aware of the risks, particularly of a fast-tracking new legislation to tight deadlines, especially when the legislation seeks to re-write and centralise the acquis rather than tackle specific barriers. This is particularly true where the Commission has the sole right of initiative, and legislation is subject to QMV and co-decision with the European Parliament. The Barcelona European Council agreed to adopt eight priority measures by the end of 2002. We have argued that the content of these measures is at least as important as the timescale to which they are adopted. They must be linked to economic and other policy goals.

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5. The Commission's latest Communication lists 30 of the FSAP's measures as complete. From a box-ticking perspective, the EU has shown that it can deliver financial services legislation to a tight timetable: it looks likely that all eight of the Barcelona priorities will be "agreed" by the end of 2002 in some form or another, albeit in some cases yet to reach formal adoption or to clear the European Parliament.

6. But an assessment of the content of these measures is more mixed. On balance, we judge on a qualitative basis that the eight measures prioritised at Barcelona might produce a small net benefit when compared with the previous status quo. What is clearer is that without UK involvement in the process (and the process would have continued with or without our involvement), they would undeniably have led to materially worse results – for economic reform and for the City in particular.

7. Annex A sets out a brief assessment of the eight Barcelona priorities.

8. The Prospectus Directive is a useful example, largely because the City has seen it as a litmus test of the EU's commitment to financial services reform. We endorsed the underlying objective of the Directive – to make it easier for firms to raise capital in different markets using a single prospectus document, thus reducing legal, regulatory and translation costs. The initial text of the Directive was unhelpful, rewriting swaths of related Community law and

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Introducing new regulatory requirements where we considered them unnecessary. Through the negotiation process, working closely with the City, and in particular selecting our priorities on the basis of continuous consultation, we succeeded in:

- opposing new burdens for small firms (eg removing requirements to file annually updated prospectuses);
- recognising important differences between institutional and private investors (avoiding excessive regulation of prospectuses intended for the former); and
- ensuring the survival of the EU's 2.3 trillion euro bond market (eg ensuring that all wholesale bond issues in a market such as London can continue to be supervised by a single regulator rather than on the basis of where the Issuer is incorporated, which would have led to market fragmentation).

9. The Prospectus Directive remains a compromise, and includes elements that we would prefer to have excluded. But we believe its final-net impact should be mildly positive.

10. The Prospectus Directive has also been instructive in terms of alliances and opposition to our views. Throughout the process, France, Italy and many other Southern European countries have opposed many of our demands. We have

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consistently worked closely with countries such as Germany, Austria, Netherlands, Luxembourg, Denmark, Sweden and Finland - and as the debate shifted from technical supervisors (who dominate the process in many Member States' delegations at working level) to finance ministers, we were able to pick up a more broad-based support that allowed the Chancellor and Finance Minister Eichel to speak jointly at ECOFIN.

Working arrangements

11. As the Prospectus Directive demonstrates, we are working closely with the financial sector in this field. Our European Financial Services team had dealings with over 85 organisations on these issues during September and October this year, including about 30 individual financial institutions, 30 trade associations and 15 exchanges or other infrastructure providers.

12. We are taking a more formalised, tiered approach to work with the sector on EU issues:

- first, increasing awareness and visibility among senior executives through, for example, ministerial breakfast events;
- second, we have regular strategy discussions among very senior representatives from the sector - both wholesale and retail;

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- third, we are increasing information flow to business by instituting a regular stocktake event for the 30-40 trade associations active in this field, and increasing the material available through our website. Treasury officials as well as ministers regularly speak at trade association conferences and attend discussions that trade associations hold with their members on EU issues;
- fourth, it is now our standard practice to set up consultation groups with industry on each directive, as we have done on the Supplementary Pensions and Prospectus Directives. These involve 30 or more representatives from businesses and trade bodies – and then work closely with selected “drafting groups” of experts when we negotiate texts. We also use smaller, ad hoc groups where necessary to assess strategy on particular issues.

13. The Treasury has increased the resources it devotes to these issues, to about 10 policy advisers, to allow us to deal more effectively with the FSAP. UKREP resources in this field have also been increased over the past 12 months. The Treasury leads joint project teams, involving the FSA and UKREP as well as other departments as necessary, on all key new directives. A further benefit of this approach is to ensure that officials responsible for implementation are involved throughout the process.

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14. We believe that the combination of these internal and external working arrangements provides for a sound approach to negotiating directives and to setting the strategic agenda, while strong relations with other finance ministries (especially Germany) are key to success, especially in the end-game of negotiations. The close working relationship with the City (through these sorts of contacts) certainly helps our approach: but we must also be careful not to be perceived, including by the Commission and other Member States, as acting solely in the commercial interests of the UK financial sector, otherwise our position will be compromised.

15. We also need to improve the understanding of financial services issues in the EU institutions. We have taken up a proposal (made initially by the London Investment Banking Association) that the Commission itself make use of more secondees from the financial services sector when preparing draft legislation. This point was made most recently when the new head of DG Markt (Alex Schaub) met the Financial Secretary during a visit to London earlier in November. Other steps include working with the UK financial services sector to improve the understanding of MEPs as well as the Commission, through presentations and seminars in Brussels and visits to the City of London. Recent work within the City to prepare an agreed "vision" for the future of financial services in Europe (led by Sir Nigel Wicks under the auspices of the City Corporation, published just over a week ago) has helped the sometimes rather fragmented financial community

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present their arguments more coherently, again contributing to better understanding of the issues.

Future approach

16. The UK's approach to financial services in the EU was set out in a Treasury paper published in July 2000 and repeated in the February 2002 White Paper. The approach was one of mutual recognition of home-state regulation, underpinned by core common standards. This remains our preferred model, especially for capital market integration, and will inform our general approach to many of the remaining FSAP dossiers.

17. There are, however, three areas where we have been or are developing thinking:

- first, the Chancellor has been leading steps in the EU to change decision-making processes on financial legislation. The new Lamfalussy arrangements for securities legislation ought to lead to principle-based framework directives, more easily adapted comitology-based rules, greater flexibility for national regulators and a commitment to better consultation. ECOFIN has recently agreed to a joint proposal from the Chancellor and Hans Eichel to extend this framework to banking and insurance, and to set up a more effective senior official "Financial Policy Committee" to ensure that political demands are

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translated into working-level results. The UK financial sector is broadly supportive, especially of moves to improve consultation;

- second, we are mid-way through the FSAP and we are giving thought to what follows it. What is clear is that there is little appetite in the UK sector for lots more legislation. Instead, we are likely to want to put "delivery", rather than legislation at the heart of this debate. Delivery means putting enforcement, monitoring and implementation higher on the agenda, as we have continuously tried to do, including most recently by the Financial Secretary in her meeting with Alex Schaub. Schaub seems to speak the right language on these issues. The Commission has made further reference to enforcement and implementation in its latest Communication, including plans to work more closely with Member States during the implementation process. Meanwhile, implementation and enforcement are issues that we raise regularly, both with the Commission and UK financial institutions. In some cases we have been able to provide support (as with some complaints over Spanish tax law and mutual funds). In others, UK-based firms are unwilling to complain, but we are encouraging them to set out their concerns. Our focus must be to make the Commission take its Treaty responsibilities more seriously in this respect;

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and help businesses resolve difficulties when they encounter them as appropriate;

- third, perhaps as part of a follow-up to the FSAP, we are considering retail financial services. This is an area where the Government has been very active in the UK. It is also the case that different factors apply to the integration of retail rather than wholesale markets. We need to understand and be responsive to different business models in the sector. One possibility is that we will want to push for select, targeted interventions aimed at particular products and markets. But we need to discuss this more with the industry.

yes!

Prospects for the Spring European Council

18. The analysis above suggests that, while we can talk up specific successes, we should not over-emphasise the delivery of the package of legislation to deadline. To do so simply encourages box-ticking at the expense of proportionate, objectives-based regulation.

19. We should be extremely wary about endorsing any "FSAP2" based heavily on a legislative approach to creating an integrated market. If we judge the timing to be right, we should instead press for alternative policy instruments – for the Commission to put in place more effective enforcement

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and monitoring procedures, and to use its competition policy powers more effectively in this field, for example.

20. One possible important next step in this process may well be the establishment of the Member State-led "Financial Policy Committee" in the early New Year. It could be tasked by ECOFIN to propose further objectives in this field. Treasury officials are discussing options around this with their German counterparts.

HM Treasury

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ANNEX A

Barcelona Priorities

- The Collateral Directive will increase the range of financing approaches available to European companies. It makes some fairly modest changes to UK law, but brings much more significant improvements in the law of many other Member States. While we would have preferred a wider scope allowing more non-financial companies to benefit from the Directive, the text still marks a useful step forward towards the single market in financial services. The Directive has now been adopted.
vlt?
- The Market Abuse Directive will create a regime to tackle market manipulation in the EU and update the existing EU insider dealing legislation. An effective market abuse regime will tackle financial crime and improve market integrity, although we have concerns about the impact of more detailed rules on the ability of the UK to implement in a light touch manner. It will be formally adopted very shortly.
vlt?
- The Insurance Intermediation Directive is intended to create a single market in insurance via a "passport" for EU retail insurance intermediaries. An effective single market should increase competition and innovation and bring significant consumer benefits. In

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return for the "passport", Member States are required to set certain minimum standards for insurance mediation. In the UK, this will require the FSA to take over regulation of intermediaries previously covered by the General Insurance Standards Council, with a consequent increase on the regulatory burden affecting this sector. The Directive was adopted in September.

- The Distance Marketing of Financial Services Directive establishes a set of EU-wide rules on the information that must be supplied to consumers when financial services are sold at a distance, which arguably some benefits for the operation of an integrated market. It was adopted in June.
 - The Financial Conglomerates Directive will introduce legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-sectoral activities (eg bancassurance) to foster systemic stability. The main objectives of the Directive – to ensure that financial conglomerates are adequately capitalised, preventing the same capital being counted twice over, and to introduce methods for calculating a conglomerate's overall solvency position – are sensible. It will be adopted very shortly, probably before the end of December 2002.
- effect on
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- The Prospectus Directive sets out to create a single EU "prospectus" for issuers of securities (shares and bonds). It has been seen as a litmus test by many in the City as to whether the FSAP is meeting its original objectives or not. Political agreement was reached at ECOFIN in November in a compromise that secured our main objectives, both in protecting smaller firms from burdensome reporting requirements and allowing the international bond markets in the City to continue to function. We now judge it creates a net benefit for market integration, but this depends in part on the outcome of its consideration by the European Parliament and the approach taken under the secondary EU comitology legislation. We expect formal adoption in early 2003.
- The Occupational Pensions Directive is intended to put in place a prudential framework that removes barriers to developing occupational pension schemes. The Council Common Position was a finely balanced compromise that allowed the UK to meet its main negotiating objectives. The European Parliament is currently starting its second reading of the proposal, and we would expect final adoption in early-mid 2003.
- The objective of the International Accounting Standards Regulation (on which DTI leads) is to increase transparency of EU accounts (and therefore

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the attractiveness and comparability of EU markets) through harmonising EU financial reporting on the basis of globally agreed accounting standards, developed by the International Accounting Standards Board. The Regulation will require all companies listed on regulated markets to prepare their consolidated accounts on the basis of International Financial Reporting Standards (previously known as International Accounting Standards – IAS) from 2005.



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Dame Judith Mayhew DBE
Chairman of the Policy and
Resources Committee

Frits Bolkestein
Commissioner
European Commission
Rue de la Loi 200
B-1000 Brussels

22 November 2002

Dear Commissioner

Creating a Single European Market for Financial Services

From our previous discussions I am sure we are agreed that the completion of the Single Market in financial services is one of the most important challenges faced by the European Union in the next few years. As the most comprehensive international financial centre in Europe, the City is keen to ensure a fully functioning and effective Single Market. The Corporation of London, as the administrative authority for the City, facilitates a continuing dialogue between all those interested in maximising the competitiveness and utility of these financial services throughout the world.

We support fully the aims of the Financial Services Action Plan together with the Lamfalussy principles as well as the need for the markets to work within a framework of corporate governance and agreed international accounting standards. We are determined that a Single European Financial Market should work for the good of the customer, the European economy and our ability to compete effectively around the world.

As you may be aware, a group of City people has been working on a discussion paper about the creation of the Single European Financial Market with practitioners and trade associations representing a wide range of European and international companies present in the City.

I hope you will find the resulting paper (enclosed) a worthwhile contribution to the ongoing debate about how best to complete a fully functioning market. Please treat it as work in progress on which we would be most interested to have your comments.

The text sets out eight Principles and Practices to underpin policy, legislation, consultation, regulation, implementation, enforcement, governance and external review needed to achieve the objective of a competitive, innovative functioning single market. I hope you will find this paper timely in view of the economic evidence you have published this week that integration would increase European Union growth by 1.1% over the next decade or so. What we are seeking is an open, transparent, equitable and competitive market place as a result of this integration. Otherwise the economic benefits of integration will not be achieved as envisaged by the Lisbon European Council.

I am writing in similar terms to a number of your colleagues in the Commission and we will also be circulating the paper to Ecofin Ministers, emphasising that it is intended for discussion.

Judith Mayhew

CREATING A SINGLE EUROPEAN MARKET FOR FINANCIAL SERVICES

- A DISCUSSION PAPER

**Produced by a working group in the City of London drawn from a broad
range of international financial services interests**

www.cityoflondon.gov.uk

Summary of contents

Executive Summary

- I Introduction**
- II The Benefits of a Single European Market for Financial Services**
- III What would a Single Market look like?**
- IV An Ethical and Stable Financial Market**
- V Different approaches to Financial Services Regulation**
- VI How do we create a fully functioning integrated single market?**
- VII Why is there no Single Market?**
- VIII The Champion for the Single Market**
- IX Eight Principles and Practices for the Single Market**
- X What needs to be done?**

EXECUTIVE SUMMARY

CREATING THE SINGLE EUROPEAN MARKET FOR FINANCIAL SERVICES

This note:

- Recalls the Lisbon Council Conclusions calling for the completion of the single market in financial services, which is one where buyers and sellers of financial services and products may deal with one another throughout the EU, wherever they, their systems or infrastructures may be located;
- Emphasises the benefits, in terms of greater choice and better value for customers, prosperity, jobs and growth, which a single financial services market can bring;
- Describes what the single financial market should look like, including the need to be responsive to users;
- Reminds that financial markets usually work with “other people’s money” and that investors expect markets to operate in a stable, responsible and ethical manner and to be subject to high standards of governance and accountability;
- Explains why such a market does not yet exist;
- Sets out eight Principles and Practices to underpin policy, legislation, consultation, regulation, surveillance, implementation, enforcement, corporate governance and external review which are needed to achieve the objective of a competitive, innovative fully functioning single market.

On the basis of the reasoning in this paper, it is suggested for discussion that the following Principles and Practices should be formally enshrined in the most authoritative manner in Community law and practice:-

- 2
1. Markets are created and developed by market participants not by rules and regulations (paragraph 34)
 2. Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure (paragraphs 35-36)
 3. Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input (paragraphs 37-39)
 4. Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties (paragraphs 40-41)
 5. Surveillance, implementation and enforcement must be effective both at the national level and by the Commission (paragraphs 42-43)
 6. Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development (paragraph 44)
 7. Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market (paragraph 45)
 8. A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single Market (paragraphs 46-49)

+ brackets.
to be sure that the EF will respect
the revised ceilings during ECU annual budgetary
rounds the IIA will need to be amended to
reflect as to the EF.

I INTRODUCTION

"Efficient and transparent financial markets foster growth and employment by better allocation of capital and reducing its cost. They therefore play an essential role in fuelling new ideas, supporting entrepreneurial culture and promoting access to and use of new technologies. It is essential to exploit the potential of the euro to push forward the integration of EU financial markets. Furthermore, efficient risk capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs."

1. This was the agreement of the Heads of State or Government at the Lisbon European Council in March 2000. In effect this acknowledged the progress made since the launch of the single market vision in the 1985 Internal Market White Paper but recognised that more remains to be done. Since 2000 further progress has been made towards the Lisbon goal of integrated EU financial markets. For example,
 - Passage of the legislation in the Financial Services Action Plan (FSAP) is well under way. The latest report from the Commission (2 October 2002) notes that 30 measures have been completed and that progress is being made on 15;
 - The creation of a Monitoring Group to review progress in implementing the Lamfalussy process, which will report in Spring 2003;

- The Community's legislative institutions have agreed on the procedures that were recommended in the Lamfalussy report to speed up and make more efficient the legislative process to improve co-operation among regulators;
 - The enhancement of the policy role of the Financial Services Policy Group;
 - The extension of the multi-level Lamfalussy process to banking and insurance.
2. Despite the adoption or proposal of legislation since Lisbon and progress at the institutional level most market participants would agree that a great deal of work is still needed to create a functioning Single European Market for Financial Services (hereafter referred to as the "Single Market"). The procedural and institutional improvements described above, though necessary, do not of themselves deliver the integrated market which requires market-driven changes by the participants, including new entrants. It is therefore timely to reflect on what further needs to be done to accomplish the goal set out at the Lisbon Council. Of course, such reflection should not impede any constructive work now in hand. It is in this spirit that this note has been written. It should be treated as a draft and as representing "work in progress", on which comments would be warmly welcomed.

II THE BENEFITS OF A SINGLE MARKET

3. The benefits of a Single Market should accrue to all the users of the market as well as to the European economy at large. They were clearly set out in the Interim Report from the group of "Wise Men" chaired by Alexandre Lamfalussy in November 2000, in particular:

- Improved allocation of capital, through, for example
 - ♦ More efficient, deeper and broader security markets enabling savings to flow more efficiently to investment;
 - ♦ Lower transaction costs and improved market liquidity;
 - ♦ More diversified and innovative financial systems;
 - ♦ More opportunities to pool risk;
- More efficient intermediation between savers and investors, through
 - ♦ Intensified competition among financial intermediaries across Europe, leading to fewer inefficiencies;
 - ♦ Giving users greater freedom of choice;
 - ♦ The opportunity to reap economies of scale and scope across a larger market;
- A stronger, faster growing European economy resulting from the above.

In short, the benefit is improved customer value and choice together with greater economic prosperity and efficiency.

4. Of all the elements in the process of economic reform set out at the Lisbon European Council, the achievement of the single European financial market is perhaps the most crucial one in creating

“the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” (Lisbon Council Conclusions, March 2000)

This is because the financial market is the mechanism for allocating the savings of the Community's citizens to their most productive uses – to creating growth, prosperity and jobs. Such a market can only be created by responding to the needs of users – savers, borrowers, issuers, intermediaries, traders, infrastructure and information suppliers - and by innovation and competition among participants. Europe faces global competition for capital and the world will not wait for Europe.

5. There has been a number of useful studies that have attempted to quantify the benefits, in terms of potential higher returns to savers, lower transaction costs or higher GDP. But none of these studies has had the public impact of the Cecchini Report, which publicised the benefits of the 1992 Single Market programme. But an important study for the Commission by independent consultants (November 2002) has just quantified some of the potential economic benefits of financial market integration. On the other hand there have been studies, such as the Gyllenhammer report (2001), which demonstrate how much more needs to be done to remove obstacles to an open, competitive single market.
6. The creation of a single market will allow the wider European market to compete on an equal basis with international rivals that are already

free of the constraints under which Europe labours. Finance is a global industry, and global players will seek to meet their financial needs in the marketplaces that offer them the greatest advantages in terms of cost, flexibility and liquidity. Beyond the potentially huge advantage offered to European retail investors by a single European market, there is another, potentially even greater prize to be won by ensuring that Europe is the wholesale financial marketplace of first choice for global investors.

III WHAT WOULD A SINGLE MARKET LOOK LIKE?

7. The objective is to achieve an integrated, fully functioning market where buyers and sellers of financial assets and services can deal with one another throughout the EU, wherever they, their systems or infrastructures may be located.
8. Today, although there are some parts of the capital market which function well on a pan-EU basis, the systems of market participants, the processes of financial intermediation, the functions offered and the range of products available still largely reflect the old national markets. There is still some way to go to create the competitive, innovative, fully functioning, single financial market across the EU that is envisaged in the Lisbon Presidency conclusions.

Such a market would involve:

- The freedom of market participants – intermediaries and end users – to invest and raise funds in all Member States;
- Financial institutions authorised by their home state authorities to be able to compete whether by a branch or on a cross-border

service basis within all national systems, with access to all essential infrastructures, on a remote basis if necessary;

- Intermediaries able to offer whatever functions, products, services and instruments they are licensed to provide by their home state authority across the EU;
- Infrastructure providers to be free to offer services across the EU;
- Market structures, intermediation processes, products/services/instruments, and infrastructures to evolve in response to market forces, competition and innovation;
- An EU wide market for corporate ownership within a framework of sound corporate governance which safeguards shareholders interests;

Simply to list such characteristics of an integrated market is sufficient to demonstrate how much still needs to be done.

IV AN ETHICAL AND STABLE FINANCIAL MARKET

9. Money and securities are the materials which financial markets handle. The sums involved account for a very large part of the wealth of the personal sector in the Member States. The relevant markets intermediate, reallocate and mitigate most of the biggest risks faced by private households and businesses, particularly (though not only) through insurance and pension provision. No other part of the economy apart from government itself has so much of people's wealth, welfare and wellbeing in its hands. So whenever financial service businesses or their employees fail to observe proper standards, they have it in their power to do great damage to

● individuals as well as to society at large. It is therefore natural that government authority should intervene through a variety of laws and regulations, to a greater degree than elsewhere in the economy, to protect people and institutions from such potential behaviour. In this regard we acknowledge the aims of the Competitiveness Council concerning corporate governance, the need for rigorous accounting standards, and of the Commission's concern for fair treatment of consumers.

10. It is also natural that the authorities should take a keen interest in maintaining the stability and continuity of financial markets and business, and their services and products. The economic and social costs of failure can be very serious. Hence the authorities' very proper interest in maintaining defences against the domino-effects of systemic failure. So, clearly regulators have a duty to act to promote and safeguard ethical and stable markets. But it is important too to recognise that inappropriate regulation can stunt innovation and product development and reduce customer choice. Misguided or heavy handed official action can damage or even destroy markets, as the initial development of the eurobond market in Belgium and Luxembourg following the adoption of measures by the USA illustrates.

V DIFFERENT APPROACHES TO POLICY TOWARDS FINANCIAL SERVICES REGULATION

11. There are different approaches to policy towards financial services, reflecting the legal and political history and culture of different Member States and, in many cases, the nature of their financial markets. Whichever approach is followed, effective regulation requires the authorities to work with market participants to avoid mere lip service compliance with rules. One approach is characterised by detailed, highly prescriptive, hard-edged rules, as in the case of much of American securities regulation, but experience demonstrates the need to focus on substance rather than form. Another legislative approach is based more on overarching principles, trusting competition among firms and markets to deliver financial services efficiently and discourage non-compliance by a minority of participants.
12. Moreover there can be a role for non-legislative solutions to single market problems as the first answer to difficulties, with legislation only used as a fall back. In many cases self-regulation by industry bodies, reinforced by the need of participants to avoid damage to their reputation, may provide the best results, particularly in sectors which are rapidly changing; legislation and regulation will be hard pressed to keep up with important new developments. Ombudsmen too may provide non-judicial redress, but this does not rule out judicial redress should the aggrieved individual wish to take the matter further. Ombudsmen are, however, invariably quicker than the judicial process.
13. There is a place too for private sector and market driven solutions and of joint working between governmental and private sector

bodies. But it should be emphasised that such non-legislative solutions can only play a role if they enjoy the confidence of the public and there is a high degree of assurance that they will deliver outcomes in a more effective way than legislation.

14. It can be difficult to lay down hard and fast rules to determine which of the different approaches to regulation is preferable for a particular market, product or industry and the judgement should be made on a case by case basis. It is a mistake to think that one approach is always the better one and the legislative framework should contain sufficient flexibility to accommodate a range of options, some being more appropriate for particular markets, participants or risks than others.
15. However, while healthy and productive financial markets will need intervention by the authorities, the well being of markets depends to an unusual degree on other factors. The intimate and intricate web of relationships in healthy markets is permeated and promoted to a remarkable degree by values, conventions, confidence, trust, incentives and expectations. The values these promote embrace honesty, openness, putting the customer first, avoiding conflicts, maintaining confidentiality, behaving in a professional way and with social as well as commercial responsibility. Where this value framework flourishes, financial markets generally flourish too; and where it is weak (for whatever reason), however good the laws and regulations may be themselves, the economy will perform less well, and citizens and consumers will suffer - all too often very directly.
16. Creating and maintaining these values is, primarily, a matter of self-regulation, active social responsibility, training and education in promoting good standards in corporate governance, the ethics of the professions and the proficiency levels of market operators in other

areas. However, marking and policing the frontier between official regulation, private sector self-regulation and social responsibility of many other kinds which one encounters requires a subtle, active and considered partnership between all parties involved.

VI HOW DO WE CREATE A FULLY FUNCTIONING INTEGRATED SINGLE MARKET?

17. Most, if not all, developed markets require some sort of "rules of the game", if only to define the responsibilities of the various market participants and the means to enforce those responsibilities. Such rules can be informal but normally have the force of law. What should be the "rules of the game" for the single European financial market described above? What should be the legislative/ supervisory/ regulatory framework?
18. In broad conceptual terms, two approaches have been suggested for providing the framework for the creation of the Single Market.
19. The first approach is the complete harmonisation of legislative/ supervisory/regulatory objectives, instruments and structures; "harmonisation" in this context often being taken to mean complete uniformity of detailed rules rather than a harmony of outcomes. Thus, since the law in each Member State is the same any institution, process, product or financial instrument permitted in one Member State is permitted in all. Conversely, any process, product etc disallowed in one Member State is disallowed in all. Such an approach has the benefit of eliminating conflicting or overlapping national rules.
20. The complete harmonisation approach was rejected by the European Community for the reasons set out in the 1985 White Paper on the

Internal Market. It would take years to achieve, even if it could ever be achieved. In the meantime innovation would be delayed. Furthermore, as experience has unfortunately shown, national authorities would be effectively lobbied, for legitimate commercial reasons, by domestic firms to oppose the harmonisation measures which threaten to expose them to greater competition.

21. The second broad approach is mutual recognition. This "new" approach was incorporated, in theory at least, in the 1985 White Paper for the "1992" programme for the single market.

22. This approach involves in broad terms:

- Minimum harmonisation of essential prudential rules incorporated in Directives concerning e.g. solvency, own funds, accounts;
- Home country supervision on the basis of such harmonised rules;
- Mutual recognition of each national competent authority of the others;
- Thereby enabling an institution authorised in one Member state to operate in all, offering whatever products it was authorised to supply at home in all without the need for complete harmonisation.

23. The two approaches summarised above are not mutually exclusive. Some standardisation is essential in some areas for an efficiently functioning Single Market, for example accounting standards. Furthermore, participants value standardisation of market practices where it has been market driven and designed by the market itself to meet business needs. An important advantage of market driven standardisation is that it can include participants world wide and

provide an important step to harmonisation at the global level. There are important examples:

- ISDA¹ and ISMA² conventions represent industry forms of contractual netting, although the risk that such contracts might not be recognised in some jurisdictions created a need for the collateral directive to underpin them;
- ISO 15022 message standards introduced and implemented by most share and settlement companies have, for the first time, begun to provide their customers with the opportunity of using standard interfaces and standard message protocols to communicate with their chosen settlement service provider.

24. Yet despite market practitioners' recognition that harmonisation has a role in creating the framework of the European single financial market, most practitioners have favoured mutual recognition of conduct of business and any product regulation as the normal basis for cross border transactions between professionals. This is to enable transactions to be based on one set of regulations without needing to wait for standardisation across Member States, given that professionals can be expected to understand and have confidence in such an approach.

25. In the case of retail customers, who have both less market power and less familiarity with the regulatory framework within which a supplier in another Member state operates, greater harmonisation or host state regulation is often favoured by authorities on grounds of consumer protection rather than mutual recognition; however there is no mechanism to test whether or not restrictions on the ability of

¹ International Securities and Derivatives Association

² International Securities Market Association

non-domestic suppliers to offer products or services is proportionate to the problem and consistent with EU competition law or is simply protecting domestic suppliers under the guise of consumer protection.

VII WHY IS THERE NO SINGLE MARKET?

26. The hopes expressed in the 1985 White Paper have not been borne out in practice. There are a number of reasons for this disappointing state of affairs.
27. Some are associated with the fact that market practices, structures, cultures and ways of doing business differ across Member States. This can make penetration by foreign newcomers difficult and costly, whatever their preferred business model. Other reasons are that domestic suppliers and perhaps the authorities arrange matters so as to impede competition and innovation.
28. Then there are issues associated with the EU legislative process and outcomes or which raise matters of competition policy :
 - Clauses in Directives concerning the general good, monetary policy and consumer protection have enabled Member States to introduce national rules which have created barriers to foreign competition, whether by a local branch or cross-border. Examples include clauses in passporting directives concerning banking, insurance, UCITS and distance marketing; clauses in the original ISD which allow different national definitions of professional investors, or which require retail business to be concentrated on regulated markets, or which enable restrictions to be imposed or maintained on cross-border access to trading

systems such as a stock exchange, on provision of trading facilities and on access to clearing and settlement services;

- Such rules have been introduced into EU law without testing whether such national measures are proportionate to the problem that it is asserted they need to address and without checking that they are compatible with competition law;
- There have been flaws in implementation, sometimes arising from ambiguities in Directives which are themselves the result of compromises reached in the Council of Ministers and the difficulty of effectively enforcing these imperfect texts;
- National tax regimes can have the effect of discriminating in favour of domestic products/institutions, such as investment funds; of course non-discrimination between domestic and non-domestic products is compatible with differences between different national tax structures.

29. Moreover:

- Treaty and ECJ requirements concerning non-discrimination against foreign EU suppliers have been used by Member States without legal challenge to ban products offered by foreign institutions on the grounds that the ban also applies to national institutions – which may be unwilling or unable to provide such products. Whatever the legal complexities, the effect is certainly discriminatory and also reduces choice, competition and innovation;
- Enforcement measures against discrimination are usually not initiated without a formal complaint; but some financial institutions are often unwilling to lodge one, for understandable reasons. In

these circumstances there is a case for the Commission taking a more proactive role. If this requires more resources the Commission should have them.

30. The practical result of these various factors is that:

- Products authorised in one Member state cannot always be sold in another, such as interest bearing current accounts;
- Even where funds are so authorised (e.g. UCITS) the cost of local registration and compliance with marketing requirements is prohibitive;
- The tax system may discriminate against non-domestic products, such as mutual funds;
- Authorisation for innovative products authorised elsewhere in the EU may be delayed until local firms can compete;
- Cross border transactions between professional counterparties can be subject to overlapping or contradictory rules;
- Transactions between professionals may be subject to regulation more appropriate to transactions with retail customers and small savers;
- Access to essential national infrastructures may be denied or the use of non-domestic infrastructures for transactions involving a domestic counterparty may be impossible;

These examples, taken together with many others throughout the European Union present users with higher costs and restricted choice, and make the financial sector less competitive and innovative than it could be. Capital is allocated inefficiently and the end result is that the European economy is worse off.

3. It is not surprising that the thicket of obstacles described above have frustrated the creation of a fully functioning single financial market in Europe. Brave words and good intentions pronounced by the European Council have not been followed through in the detail of legislation or in national implementation or enforcement. The new "Lamfalussy process" will help, but it is clear therefore that there needs to be a high profile political push if a Single Market is to be completed and fully implemented.

VIII THE CHAMPION FOR THE SINGLE MARKET

32. One key element in the completion of the Single Market should be a visible, ongoing commitment by the most senior political body in the Union.
33. It is the Conclusions of the European Council which have set out the ambitious programme for creating a more efficient and productive European economy. It is right that this body, which comprises not only the elected Heads of State or Government of the Member States of the European Union but also the President of the European Commission, should champion the completion of the Single Market. The European Council needs to equip itself to monitor and to promote the implementation of its Conclusions.
34. But the European Council cannot itself supervise the detailed work which is required. This must rest with the Commission, with ECOFIN Council, and with the European Parliament. And to carry out these responsibilities, those bodies must be properly supported by a strong yet supple advisory and decision-making process.

IX EIGHT PRINCIPLES AND PRACTICES FOR THE SINGLE MARKET

35. Agreement on structures to take the work forward is not sufficient. There also needs to be agreement on the fundamental principles that should underlie their creation, regulation and operation of such structures. Eight Principles and Practices are suggested below. They need to be formally embedded in the most authoritative manner in Community legislation and practice so that they underpin the action necessary.

i Markets are created and developed by market participants not by rules and regulations

36. However well legislation is drafted and however speedily and accurately it is transposed into national legislation, it cannot of itself guarantee a thriving single market. This, in the end, rests with "economic agents", the investors and issuers of capital and the myriad of market intermediaries which link them together using the facilities provided by the operators of the market infrastructure. In short, the development of the Single Market needs to take full account of the legitimate needs of market participants, who in the end create and develop the market, provided that the obstacles are removed.

ii Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure

37. Non-legislative solutions to single market problems should be seen as the first answer to difficulties, with legislation used as a last resort. Legislation can, and sometimes does, hinder the development of markets or can drive them abroad. Legislation is often not the solution to dismantling barriers in the way of the creation of the Single Market. Private sector and market driven solutions and joint working between governmental and private sector bodies should always be considered before resorting to legislation. Sometimes implementing and enforcing existing legislation or using competition policy more vigorously would provide a better route forward.
38. If legislation has to be proposed, its emphasis must be on the creation of a genuine competitive and innovative Single Market, which avoids creating new obstacles or legitimising obstacles created by national legislation. It is important to avoid legislation which imposes burdens on market participants which are disproportionate to the problem it is said to address. Likewise, legislation needs to take account of the variety of participants and products, so that as well as being proportionate it needs to be differentiated; in this context it should also be borne in mind that some participants, particularly in the retail sector, have no cross-border business ambitions and are sufficiently regulated under their home country national law. All proposed legislation should be judged by the following tests-

- Does it provide for authorised service providers in one Member State to have the right to offer services licenced by their national competent authority throughout the EU?
- Does it give authorised service providers right of access, on a remote basis if they have no local establishment, to all necessary infrastructures?
- Is it proportionate to the problem that it claims to address?
- Is it cost-effective?
- Does it address a clear market failure and have a significant probability of producing benefits that demonstrably exceed the cost?
- Are the terms sufficiently clear so as not to create ambiguities of interpretation which could hinder the single market?

iii Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input

39. Legislative and other initiatives agreed at the level of the Community are increasingly affecting all aspects of commercial and economic life in the Community. It is therefore becoming even more important for legislation to reflect the most thorough consultation with those whom it will affect.
40. Such an obligation to consult at all stages of the legislative process should be laid upon the Commission by a suitable amendment to the Treaty. Indeed, this principle of consultation is emphasised in the Conclusions of the European Convention's Working Group 1 on the

● Principle of Subsidiarity. The Conclusion states³ "It is for the Commission to consult, as soon as possible, all the players (particularly the Member States, economic operators, local and regional authorities and social partners) who may be affected directly or indirectly by the legislative act being planned or drafted."

41. Such an obligation to consult should encapsulate principles of good consultation, such as requirements for

- Timely consultation before proposals are formally adopted as well as during the principal stages of the legislative process which allows sufficient time for those affected to make submissions to the Commission;
- Reasoned responses by the Commission to submissions, including reasons for acceptance and non- or partial acceptance;

iv Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties

42. There is one general principle that should shape regulation to protect the interests of customers and savers in the Single Market. Regulation should be risk based. It should take account of the different nature of risks facing different types of participants. This principle of risk based regulation should underpin all legislation dealing with conduct of business rules, permissible products and transactions with differing categories of customer.

43. The principle of risk based regulation provides a rationale for regulation to distinguish between

³ WD19 REV1 - WG1 page 5

professional clients/counterparties, such as financial institutions, corporate treasuries, and SMEs/individuals that provide financial services; and

retail clients, such as personal customers and SMEs (except those that provide financial services)

It can reflect the different experience and expertise of those concerned so that the more experienced and expert ("transactions between equals") are subject to lighter regulation than the retail customer. Moreover, where demonstrable risks are minimal legislation is not needed.

v Surveillance, implementation and enforcement must be effective both at the national level and by the Commission

44. The Commission is the guardian of the Community treaties and of the legislation made under them. That role requires the Commission to ensure

- Proper implementation of Community legislation at the national level;
- The implementation and enforcement of legislation by Member States, taking into account the specific legislation itself and the Treaty more widely;
- The vigorous pursuit of competition policy in the financial services area, to avoid anti-competitive behaviour by market participants;
- The systematic evaluation, in a transparent manner, of national laws and regulations. Measures alleged to be justified on

grounds of the general good, monetary or consumer policy, should be tested to ensure that they are proportionate, non-discriminatory in their economic effect and consistent with competition policy;

- The instigation of proactive, annual monitoring of how national financial markets are evolving and the extent to which impediments to competition of any type persist, along the lines of the reviews of Unfair Tax Competition by Member States, or the multilateral surveillance of economic/fiscal developments.

45. This is a massive task that will increase significantly as the Single Market deepens and the Community enlarges. Moreover, the Commission needs to take every opportunity to move its role as Treaty guardian to a more proactive level, actively pushing forward the three tasks referred to above and without waiting for complaints to be put before it. Indeed, such a proactive obligation of the Commission should be considered for explicit inclusion in the Treaty, to reinforce Article 226. For such a role, the Commission will undoubtedly require more resources and staff, perhaps grouped within a new Enforcement Unit. It also requires that market participants should ensure that the Commission is supplied with information on anti-competitive behaviour, on a confidential basis if they prefer.

vi Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development

46. Earlier in this note it was pointed out that financial markets deal with "other people's money". Market participants, whether traders, managers or company directors, exercise therefore a sort of "trustee relationship" in their management of those savings. The regulation and behaviour of market participants, both firms and people, needs to reflect that fact. But this objective needs to be brought about in a way which does not frustrate or stultify the development of the Single Market in a manner which prevents it becoming the facilitator of growth by the methods envisaged in the Lisbon Conclusions.

vii Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market

47. It has been emphasised in this note that market participants carrying out their everyday business transactions and initiatives create and develop financial markets. It therefore seems appropriate for a group of representative market participants to provide the European Council, ECOFIN, the European Parliament and the Commission with independent, regular reports of progress towards the creation of a fully functioning Single Market. Such reports, which could be accompanied by ECOFIN/Commission assessments, could be provided for the Spring European Councils. These reports would assess the extent to which obstacles to the completion of the single market remain and advise on the extent to which legislation is compatible with the eight Principles and Practices set out above.

viii A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single European Financial Market

48. Both market participants and regulators in the financial markets of the Member States face different challenges and different market structures and practices and to some extent they still operate in different cultures.
49. It is not therefore surprising that there is some lack of a coherent approach and philosophy (which will be exacerbated by the impending enlargement of the Community) among market participants and the authorities involved in the creation of the Single European Financial Market. Without some common understandings on these matters, there is a real risk that its creation may well be inhibited.
50. This risk could be mitigated by the establishment of a European Financial Markets Forum. It might be composed of officials from the national authorities concerned, market participants and their associations having appropriate market share, and academic experts. Its role might be to debate the issues and to develop sound principles and practices, including approaches to global standards, able to command support from the authorities and markets.

X WHAT NEEDS TO BE DONE?

51. On the basis of the reasoning in this paper, it is suggested for discussion that the following Principles and Practices should be formally enshrined in the most authoritative manner in Community law and practice:-

- 1. Markets are created and developed by market participants not by rules and regulations (paragraph 34)**
- 2. Policy instruments other than legislation should always be considered in preference to the legislative route. If legislation is necessary it should be proportionate, cost effective and address clear market failure (paragraphs 35-36)**
- 3. Consultation with participants is required at all stages, and in a timely manner, and with a reasoned response to practitioner input (paragraphs 37-39)**
- 4. Regulation must be risk based, taking account of the different nature of the risks facing the different types of firms, customers, investors and counterparties (paragraphs 40-41)**
- 5. Surveillance, implementation and enforcement must be effective both at the national level and by the Commission (paragraphs 42-43)**
- 6. Regulation and behaviour of market participants must help build fair and honest markets, while not frustrating or stultifying their innovation and development (paragraph 44)**
- 7. Representatives of market practitioners should provide regular reports to the European Council, ECOFIN, Parliament and Commission on progress towards creating a fully functioning single market (paragraph 45)**
- 8. A European Financial Market Forum should be established to help develop a coherent approach and philosophy for the creation of the Single Market (paragraphs 46-49)**

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to see pm's count

From: Derek Scott
Date: 13 December 2002

PRIME MINISTER

cc: Jeremy Heywood
Andrew Adonis
Arnab Banerji
Jonathan Powell

EU financial services.

In the middle of October we asked for the Treasury's assessment of the gains, if any, from the FSAP. In part this was prompted by the perception on the City that the FSAP was bringing few practical benefits to the UK. The Treasury's response is attached and is expressed in diplomatic ("leak-proof") prose, but the conclusion is pretty depressing.

On balance the Treasury conclude that, "the eight measures prioritised at Barcelona might produce a small net benefit". Of course things would have been very much worse if the British (government and City) had not worked their socks off, but as with much else in the EU British effort has to go into stopping stupid things happening rather than delivering clear and gains. This is inevitable since the pass has already been sold on QMV and the dominant attitude to markets on the continent is essentially hostile to practices that underpin successful financial markets in particular and liberal capitalism in general; but it is very depressing.

Looking ahead, the Treasury is getting its relations with the City on a more structured basis and beefing up resources in the financial services area. Nonetheless, despite the recent arrival of James Sasoon from Warburg (good news I think) a few more people seconded from the City would help. The

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- 2 -

Treasury are aware of this but it is quite difficult to get the right people particularly in the current environment when anyone in the City offered a secondment to Whitehall interprets this a way for existing employers to ease them out.

The Treasury rightly emphasises the dangers of any "FSAP2" based on a legislative approach and detects a shift of mood in Brussels. I hope this is right. The Treasury is surely correct in warning against an over-emphasis on deadlines since this often encourages bad legislation. And more generally the implications of the Treasury's assessment suggests that we should be very wary of overselling the likely gains on this front however desirable it may be thought to capture a day's headlines.

What more can be done? I keep coming back to the point that if Europe's biggest financial services industry were located in France or Germany, neither would allow others to muck it about in the way we are, QMV or no QMV. We need a unit - inside the Treasury but largely staffed by others perhaps - charged with not only ensuring that damaging measures are eliminated, but also being more proactive in enforcing and exposing breeches of directives and even the Treaty of Rome that are preventing markets working properly. We also need to look at areas outside financial services and capital markets where we can really hurt those member states that are causing us most trouble. This would of course ruffle more than feathers and might conflict with your wider objectives.

Derek Scott

DEREK SCOTT

*I agree with you.
but it's being
why done*

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10 DOWNING STREET

LONDON SW1A 2AA

020 7930 4433

9 December 2002

Dear Diego,

ECONOMIC REFORM IN EUROPE

I wanted to write to update you on recent progress on the European economic reform agenda.

Over the last few months we have taken some substantial steps forward in meeting the objectives set by Heads of Government at Barcelona in March. The single sky package agreed this week should significantly improve the management of Europe's airspace. We have made solid progress on the eight financial services measures identified as priorities by the Council. And the Commission is beginning to deliver on its commitments to better regulation.

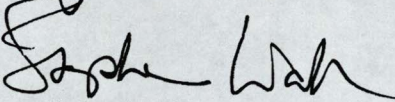
Most significantly, member states have now concluded a clear and far-reaching deal to open up the EU's energy markets to competition. The non-domestic market in all member states will be open by the end of 2004 and full market opening will be completed by 2007. Equally importantly, we achieved agreement on unbundling of transmission and distribution from production and services. So incumbents will not be able to use a dominant position in one of these sectors to stifle competition in another.

As you know, the energy sector in Europe is worth 4% of GDP. More efficient and competitive energy production will give a boost to Europe's companies and lower prices to consumers. By increasing competition, it will help Europe create jobs. As the same time it will ensure that, as Britain moves to being a net importer of gas in a few years' time, we should have cost effective access to new energy supplies from abroad.

There is, of course, a great deal still to be done to implement fully the Lisbon agenda. And there are areas – such as the Community Patent – where progress has been disappointing. However, we are encouraged by the recent

progress. We are in close contact with the Greek Government, and we are optimistic that under their Presidency next Spring we will be able to build on this momentum, and to focus the agenda more firmly than ever on measures to boost innovation, growth and employment.

We hope we can continue to work closely with the CBI to ensure that we can take the views of business fully into account as we prepare for the Spring European Council. I would welcome the chance to have a discussion with you in the New Year.

Yours ever,

J S WALL

Mr Digby Jones
Confederation of British Industry

Rec 4/12



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

3 December 2002 - Rec'd - 3/12
by fax

Jeremy Heywood
Principal Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Jeremy,

EU FINANCIAL SERVICES

Thank you for your letter of 17 October requesting an assessment of the Financial Services Action Plan (FSAP) and a view of the prospects for next Spring's European Council. I attach a Treasury paper which covers these issues.

I am copying this letter and the paper to Sir Stephen Wall and Sir Nigel Sheinwald.

*Yours
Mark*

MARK BOWMAN
Principal Private Secretary

EU FINANCIAL SERVICES

Development of the FSAP

1. Integration of financial services across the EU is an important component of European economic reform. An effective integrated EU financial services market should:

- **allow broader and deeper capital markets, reducing the cost of capital and increasing the efficiency of capital allocation across the EU, which in turn should make a major contribution to raising Europe's growth, employment and productivity;**
- **allow consumers and investors to benefit from a greater choice of more competitive and innovative financial services and products; and**
- **benefit UK-based financial services firms which have the expertise to take advantage of the new opportunities that a single EU financial services market would bring, and so further strengthen the City's position as an international financial centre.**

2. While judging the potential benefits is very difficult, a very recent report ordered by the Commission from London Economics suggests that full integration of EU markets would result in a 0.5 per cent reduction in the cost of capital for EU business and a one-off increase in GDP over ten years of

about 1.1 per cent for the EU as a whole. (The figures for individual countries vary from 0.3 to 2.0 per cent.)

3. It is for these reasons that the UK supported the concept of an FSAP, as part of the agreement by Heads of Government at the Cardiff Summit in 1998, and has offered broad support for completing an FSAP of 42 measures by the end of 2005. At the same time, we have also argued that legislative action by the EU should be properly prioritised and targeted at barriers to the operation of the single market. And we have argued that proper implementation is as important as new legislation. These potential benefits and the UK's approach to financial services in Europe have most recently been set out in the European Economic Reform White Paper in February 2002.

4. We have always been aware of the risks, particularly of a fast-tracking new legislation to tight deadlines, especially when the legislation seeks to re-write and centralise the acquis rather than tackle specific barriers. This is particularly true where the Commission has the sole right of initiative, and legislation is subject to QMV and co-decision with the European Parliament. The Barcelona European Council agreed to adopt eight priority measures by the end of 2002. We have argued that the content of these measures is at least as important as the timescale to which they are adopted. They must be linked to economic and other policy goals.

5. The Commission's latest Communication lists 30 of the FSAP's measures as complete. From a box-ticking perspective, the EU has shown that it can deliver financial services legislation to a tight timetable: it looks likely that all eight of the Barcelona priorities will be "agreed" by the end of 2002 in some form or another, albeit in some cases yet to reach formal adoption or to clear the European Parliament.

6. But an assessment of the content of these measures is more mixed. On balance, we judge on a qualitative basis that the eight measures prioritised at Barcelona might produce a small net benefit when compared with the previous status quo. What is clearer is that without UK involvement in the process (and the process would have continued with or without our involvement), they would undeniably have led to materially worse results – for economic reform and for the City in particular.

7. Annex A sets out a brief assessment of the eight Barcelona priorities.

8. The Prospectus Directive is a useful example, largely because the City has seen it as a litmus test of the EU's commitment to financial services reform. We endorsed the underlying objective of the Directive – to make it easier for firms to raise capital in different markets using a single prospectus document, thus reducing legal, regulatory and translation costs. The initial text of the Directive was unhelpful, rewriting swaths of related Community law and

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introducing new regulatory requirements where we considered them unnecessary. Through the negotiation process, working closely with the City, and in particular selecting our priorities on the basis of continuous consultation, we succeeded in:

- opposing new burdens for small firms (eg removing requirements to file annually updated prospectuses);
- recognising important differences between institutional and private investors (avoiding excessive regulation of prospectuses intended for the former); and
- ensuring the survival of the EU's 2.3 trillion euro bond market (eg ensuring that all wholesale bond issues in a market such as London can continue to be supervised by a single regulator rather than on the basis of where the issuer is incorporated, which would have led to market fragmentation).

9. The Prospectus Directive remains a compromise, and includes elements that we would prefer to have excluded. But we believe its final net impact should be mildly positive.

10. The Prospectus Directive has also been instructive in terms of alliances and opposition to our views. Throughout the process, France, Italy and many other Southern European countries have opposed many of our demands. We have

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consistently worked closely with countries such as Germany, Austria, Netherlands, Luxembourg, Denmark, Sweden and Finland – and as the debate shifted from technical supervisors (who dominate the process in many Member States' delegations at working level) to finance ministers, we were able to pick up a more broad-based support that allowed the Chancellor and Finance Minister Eichel to speak jointly at ECOFIN.

Working arrangements

11. As the Prospectus Directive demonstrates, we are working closely with the financial sector in this field. Our European Financial Services team had dealings with over 85 organisations on these issues during September and October this year, including about 30 individual financial institutions, 30 trade associations and 15 exchanges or other infrastructure providers.

12. We are taking a more formalised, tiered approach to work with the sector on EU issues:

- first, increasing awareness and visibility among senior executives through, for example, ministerial breakfast events;
- second, we have regular strategy discussions among very senior representatives from the sector – both wholesale and retail;

14. We believe that the combination of these internal and external working arrangements provides for a sound approach to negotiating directives and to setting the strategic agenda, while strong relations with other finance ministries (especially Germany) are key to success, especially in the end-game of negotiations. The close working relationship with the City (through these sorts of contacts) certainly helps our approach: but we must also be careful not to be perceived, including by the Commission and other Member States, as acting solely in the commercial interests of the UK financial sector, otherwise our position will be compromised.

15. We also need to improve the understanding of financial services issues in the EU institutions. We have taken up a proposal (made initially by the London Investment Banking Association) that the Commission itself make use of more secondees from the financial services sector when preparing draft legislation. This point was made most recently when the new head of DG Markt (Alex Schaub) met the Financial Secretary during a visit to London earlier in November. Other steps include working with the UK financial services sector to improve the understanding of MEPs as well as the Commission, through presentations and seminars in Brussels and visits to the City of London. Recent work within the City to prepare an agreed "vision" for the future of financial services in Europe (led by Sir Nigel Wicks under the auspices of the City Corporation, published just over a week ago) has helped the sometimes rather fragmented financial community

- third, we are increasing information flow to business by instituting a regular stocktake event for the 30-40 trade associations active in this field, and increasing the material available through our website. Treasury officials as well as ministers regularly speak at trade association conferences and attend discussions that trade association hold with their members on EU issues;
- fourth, it is now our standard practise to set up consultation groups with industry on each directive, as we have done on the Supplementary Pensions and Prospectus Directives. These involve 30 or more representatives from businesses and trade bodies – and then work closely with selected “drafting groups” of experts when we negotiate texts. We also use smaller, ad hoc groups where necessary to assess strategy on particular issues.

13. The Treasury has increased the resources it devotes to these issues, to about 10 policy advisers, to allow us to deal more effectively with the FSAP. UKREP resources in this field have also been increased over the past 12 months. The Treasury leads joint project teams, involving the FSA and UKREP as well as other departments as necessary, on all key new directives. A further benefit of this approach is to ensure that officials responsible for implementation are involved throughout the process.

present their arguments more coherently, again contributing to better understanding of the issues.

Future approach

16. The UK's approach to financial services in the EU was set out in a Treasury paper published in July 2000 and repeated in the February 2002 White Paper. The approach was one of mutual recognition of home-state regulation, underpinned by core common standards. This remains our preferred model, especially for capital market integration, and will inform our general approach to many of the remaining FSAP dossiers.

17. There are, however, three areas where we have been or are developing thinking:

- first, the Chancellor has been leading steps in the EU to change decision-making processes on financial legislation. The new Lamfalussy arrangements for securities legislation ought to lead to principle-based framework directives, more easily adapted comitology-based rules, greater flexibility for national regulators and a commitment to better consultation. ECOFIN has recently agreed to a joint proposal from the Chancellor and Hans Eichel to extend this framework to banking and insurance, and to set up a more effective senior official "Financial Policy Committee" to ensure that political demands are

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and help businesses resolve difficulties when they encounter them as appropriate;

- third, perhaps as part of a follow-up to the FSAP, we are considering retail financial services. This is an area where the Government has been very active in the UK. It is also the case that different factors apply to the integration of retail rather than wholesale markets. We need to understand and be responsive to different business models in the sector. One possibility is that we will want to push for select, targeted interventions aimed at particular products and markets. But we need to discuss this more with the industry.

Prospects for the Spring European Council

18. The analysis above suggests that, while we can talk up specific successes, we should not over-emphasise the delivery of the package of legislation to deadline. To do so simply encourages box-ticking at the expense of proportionate, objectives-based regulation.

19. We should be extremely wary about endorsing any "FSAP2" based heavily on a legislative approach to creating an integrated market. If we judge the timing to be right, we should instead press for alternative policy instruments – for the Commission to put in place more effective enforcement

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translated into working-level results. The UK financial sector is broadly supportive, especially of moves to improve consultation;

- second, we are mid-way through the FSAP and we are giving thought to what follows it. What is clear is that there is little appetite in the UK sector for lots more legislation. Instead, we are likely to want to put "delivery", rather than legislation at the heart of this debate. Delivery means putting enforcement, monitoring and implementation higher on the agenda, as we have continuously tried to do, including most recently by the Financial Secretary in her meeting with Alex Schaub. Schaub seems to speak the right language on these issues. The Commission has made further reference to enforcement and implementation in its latest Communication, including plans to work more closely with Member States during the implementation process. Meanwhile, implementation and enforcement are issues that we raise regularly, both with the Commission and UK financial institutions. In some cases we have been able to provide support (as with some complaints over Spanish tax law and mutual funds). In others, UK-based firms are unwilling to complain, but we are encouraging them to set out their concerns. Our focus must be to make the Commission take its Treaty responsibilities more seriously in this respect;

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and monitoring procedures, and to use its competition policy powers more effectively in this field, for example.

20. One possible important next step in this process may well be the establishment of the Member State-led "Financial Policy Committee" in the early New Year. It could be tasked by ECOFIN to propose further objectives in this field. Treasury officials are discussing options around this with their German counterparts.

HM Treasury

return for the "passport", Member States are required to set certain minimum standards for insurance mediation. In the UK, this will require the FSA to take over regulation of intermediaries previously covered by the General Insurance Standards Council, with a consequent increase on the regulatory burden affecting this sector. The Directive was adopted in September.

- The Distance Marketing of Financial Services Directive establishes a set of EU-wide rules on the information that must be supplied to consumers when financial services are sold at a distance, which arguably some benefits for the operation of an integrated market. It was adopted in June.
- The Financial Conglomerates Directive will introduce legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-sectoral activities (eg bancassurance) to foster systemic stability. The main objectives of the Directive –to ensure that financial conglomerates are adequately capitalised, preventing the same capital being counted twice over, and to introduce methods for calculating a conglomerate's overall solvency position – are sensible. It will be adopted very shortly, probably before the end of December 2002.

Barcelona Priorities

- The Collateral Directive will increase the range of financing approaches available to European companies. It makes some fairly modest changes to UK law, but brings much more significant improvements in the law of many other Member States. While we would have preferred a wider scope allowing more non-financial companies to benefit from the Directive, the text still marks a useful step forward towards the single market in financial services. The Directive has now been adopted.
- The Market Abuse Directive will create a regime to tackle market manipulation in the EU and update the existing EU insider dealing legislation. An effective market abuse regime will tackle financial crime and improve market integrity, although we have concerns about the impact of more detailed rules on the ability of the UK to implement in a light touch manner. It will be formally adopted very shortly.
- The Insurance Intermediation Directive is intended to create a single market in insurance via a "passport" for EU retail insurance intermediaries. An effective single market should increase competition and innovation and bring significant consumer benefits. In

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- The Prospectus Directive sets out to create a single EU “prospectus” for issuers of securities (shares and bonds). It has been seen as a litmus test by many in the City as to whether the FSAP is meeting its original objectives or not. Political agreement was reached at ECOFIN in November in a compromise that secured our main objectives, both in protecting smaller firms from burdensome reporting requirements and allowing the international bond markets in the City to continue to function. We now judge it creates a net benefit for market integration, but this depends in part on the outcome of its consideration by the European Parliament and the approach taken under the secondary EU comitology legislation. We expect formal adoption in early 2003.
- The Occupational Pensions Directive is intended to put in place a prudential framework that removes barriers to developing occupational pension schemes. The Council Common Position was a finely balanced compromise that allowed the UK to meet its main negotiating objectives. The European Parliament is currently starting its second reading of the proposal, and we would expect final adoption in early-mid 2003.
- The objective of the International Accounting Standards Regulation (on which DTI leads) is to increase transparency of EU accounts (and therefore

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the attractiveness and comparability of EU markets) through harmonising EU financial reporting on the basis of globally agreed accounting standards, developed by the International Accounting Standards Board. The Regulation will require all companies listed on regulated markets to prepare their consolidated accounts on the basis of International Financial Reporting Standards (previously known as International Accounting Standards – IAS) from 2005.



3/12/2002

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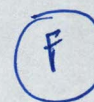
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020 7270 4580



cc EUPs



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

3 December 2002

Jeremy Heywood
Principal Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

cc. SW. - t.p.o.

cc: MD/DS/AB

Work put to the TB with
on grid cover note.

Dear Jeremy,

EU FINANCIAL SERVICES

Thank you for your letter of 17 October requesting an assessment of the Financial Services Action Plan (FSAP) and a view of the prospects for next Spring's European Council. I attach a Treasury paper which covers these issues.

I am copying this letter and the paper to Sir Stephen Wall and Sir Nigel Sheinwald.

MARK BOWMAN

Principal Private Secretary

SIP 31/12/02

RESTRICTED**EU FINANCIAL SERVICES****Development of the FSAP**

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- allow broader and deeper capital markets, reducing the cost of capital and increasing the efficiency of capital allocation across the EU, which in turn should make a major contribution to raising Europe's growth, employment and productivity;
- allow consumers and investors to benefit from a greater choice of more competitive and innovative financial services and products; and
- benefit UK-based financial services firms which have the expertise to take advantage of the new opportunities that a single EU financial services market would bring, and so further strengthen the City's position as an international financial centre.

2. While judging the potential benefits is very difficult, a very recent report ordered by the Commission from London Economics suggests that full integration of EU markets would result in a 0.5 per cent reduction in the cost of capital for EU business and a one-off increase in GDP over ten years of

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3. It is for these reasons that the UK supported the concept of an FSAP, as part of the agreement by Heads of Government at the Cardiff Summit in 1998, and has offered broad support for completing an FSAP of 42 measures by the end of 2005. At the same time, we have also argued that legislative action by the EU should be properly prioritised and targeted at barriers to the operation of the single market. And we have argued that proper implementation is as important as new legislation. These potential benefits and the UK's approach to financial services in Europe have most recently been set out in the European Economic Reform White Paper in February 2002.

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6. But an assessment of the content of these measures is more mixed. On balance, we judge on a qualitative basis that the eight measures prioritised at Barcelona might produce a small net benefit when compared with the previous status quo. What is clearer is that without UK involvement in the process (and the process would have continued with or without our involvement), they would undeniably have led to materially worse results – for economic reform and for the City in particular.

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consistently worked closely with countries such as Germany, Austria, Netherlands, Luxembourg, Denmark, Sweden and Finland – and as the debate shifted from technical supervisors (who dominate the process in many Member States' delegations at working level) to finance ministers, we were able to pick up a more broad-based support that allowed the Chancellor and Finance Minister Eichel to speak jointly at ECOFIN.

Working arrangements

11. As the Prospectus Directive demonstrates, we are working closely with the financial sector in this field. Our European Financial Services team had dealings with over 85 organisations on these issues during September and October this year, including about 30 individual financial institutions, 30 trade associations and 15 exchanges or other infrastructure providers.

12. We are taking a more formalised, tiered approach to work with the sector on EU issues:

- first, increasing awareness and visibility among senior executives through, for example, ministerial breakfast events;
- second, we have regular strategy discussions among very senior representatives from the sector – both wholesale and retail;

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- third, we are increasing information flow to business by instituting a regular stocktake event for the 30-40 trade associations active in this field, and increasing the material available through our website. Treasury officials as well as ministers regularly speak at trade association conferences and attend discussions that trade association hold with their members on EU issues;
- fourth, it is now our standard practise to set up consultation groups with industry on each directive, as we have done on the Supplementary Pensions and Prospectus Directives. These involve 30 or more representatives from businesses and trade bodies – and then work closely with selected “drafting groups” of experts when we negotiate texts. We also use smaller, ad hoc groups where necessary to assess strategy on particular issues.

13. The Treasury has increased the resources it devotes to these issues, to about 10 policy advisers, to allow us to deal more effectively with the FSAP. UKREP resources in this field have also been increased over the past 12 months. The Treasury leads joint project teams, involving the FSA and UKREP as well as other departments as necessary, on all key new directives. A further benefit of this approach is to ensure that officials responsible for implementation are involved throughout the process.

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14. We believe that the combination of these internal and external working arrangements provides for a sound approach to negotiating directives and to setting the strategic agenda, while strong relations with other finance ministries (especially Germany) are key to success, especially in the end-game of negotiations. The close working relationship with the City (through these sorts of contacts) certainly helps our approach: but we must also be careful not to be perceived, including by the Commission and other Member States, as acting solely in the commercial interests of the UK financial sector, otherwise our position will be compromised.

15. We also need to improve the understanding of financial services issues in the EU institutions. We have taken up a proposal (made initially by the London Investment Banking Association) that the Commission itself make use of more secondees from the financial services sector when preparing draft legislation. This point was made most recently when the new head of DG Markt (Alex Schaub) met the Financial Secretary during a visit to London earlier in November. Other steps include working with the UK financial services sector to improve the understanding of MEPs as well as the Commission, through presentations and seminars in Brussels and visits to the City of London. Recent work within the City to prepare an agreed "vision" for the future of financial services in Europe (led by Sir Nigel Wicks under the auspices of the City Corporation, published just over a week ago) has helped the sometimes rather fragmented financial community

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present their arguments more coherently, again contributing to better understanding of the issues.

Future approach

16. The UK's approach to financial services in the EU was set out in a Treasury paper published in July 2000 and repeated in the February 2002 White Paper. The approach was one of mutual recognition of home-state regulation, underpinned by core common standards. This remains our preferred model, especially for capital market integration, and will inform our general approach to many of the remaining FSAP dossiers.

17. There are, however, three areas where we have been or are developing thinking:

- first, the Chancellor has been leading steps in the EU to change decision-making processes on financial legislation. The new Lamfalussy arrangements for securities legislation ought to lead to principle-based framework directives, more easily adapted comitology-based rules, greater flexibility for national regulators and a commitment to better consultation. ECOFIN has recently agreed to a joint proposal from the Chancellor and Hans Eichel to extend this framework to banking and insurance, and to set up a more effective senior official "Financial Policy Committee" to ensure that political demands are

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translated into working-level results. The UK financial sector is broadly supportive, especially of moves to improve consultation;

- second, we are mid-way through the FSAP and we are giving thought to what follows it. What is clear is that there is little appetite in the UK sector for lots more legislation. Instead, we are likely to want to put "delivery", rather than legislation at the heart of this debate. Delivery means putting enforcement, monitoring and implementation higher on the agenda, as we have continuously tried to do, including most recently by the Financial Secretary in her meeting with Alex Schaub. Schaub seems to speak the right language on these issues. The Commission has made further reference to enforcement and implementation in its latest Communication, including plans to work more closely with Member States during the implementation process. Meanwhile, implementation and enforcement are issues that we raise regularly, both with the Commission and UK financial institutions. In some cases we have been able to provide support (as with some complaints over Spanish tax law and mutual funds). In others, UK-based firms are unwilling to complain, but we are encouraging them to set out their concerns. Our focus must be to make the Commission take its Treaty responsibilities more seriously in this respect;

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and help businesses resolve difficulties when they encounter them as appropriate;

- third, perhaps as part of a follow-up to the FSAP, we are considering retail financial services. This is an area where the Government has been very active in the UK. It is also the case that different factors apply to the integration of retail rather than wholesale markets. We need to understand and be responsive to different business models in the sector. One possibility is that we will want to push for select, targeted interventions aimed at particular products and markets. But we need to discuss this more with the industry.

Prospects for the Spring European Council

18. The analysis above suggests that, while we can talk up specific successes, we should not over-emphasise the delivery of the package of legislation to deadline. To do so simply encourages box-ticking at the expense of proportionate, objectives-based regulation.

19. We should be extremely wary about endorsing any "FSAP2" based heavily on a legislative approach to creating an integrated market. If we judge the timing to be right, we should instead press for alternative policy instruments – for the Commission to put in place more effective enforcement

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and monitoring procedures, and to use its competition policy powers more effectively in this field, for example.

20. One possible important next step in this process may well be the establishment of the Member State-led "Financial Policy Committee" in the early New Year. It could be tasked by ECOFIN to propose further objectives in this field. Treasury officials are discussing options around this with their German counterparts.

HM Treasury

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ANNEX A

Barcelona Priorities

- The Collateral Directive will increase the range of financing approaches available to European companies. It makes some fairly modest changes to UK law, but brings much more significant improvements in the law of many other Member States. While we would have preferred a wider scope allowing more non-financial companies to benefit from the Directive, the text still marks a useful step forward towards the single market in financial services. The Directive has now been adopted.
- The Market Abuse Directive will create a regime to tackle market manipulation in the EU and update the existing EU insider dealing legislation. An effective market abuse regime will tackle financial crime and improve market integrity, although we have concerns about the impact of more detailed rules on the ability of the UK to implement in a light touch manner. It will be formally adopted very shortly.
- The Insurance Intermediation Directive is intended to create a single market in insurance via a "passport" for EU retail insurance intermediaries. An effective single market should increase competition and innovation and bring significant consumer benefits. In

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return for the "passport", Member States are required to set certain minimum standards for insurance mediation. In the UK, this will require the FSA to take over regulation of intermediaries previously covered by the General Insurance Standards Council, with a consequent increase on the regulatory burden affecting this sector. The Directive was adopted in September.

- The Distance Marketing of Financial Services Directive establishes a set of EU-wide rules on the information that must be supplied to consumers when financial services are sold at a distance, which arguably some benefits for the operation of an integrated market. It was adopted in June.
- The Financial Conglomerates Directive will introduce legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-sectoral activities (eg bancassurance) to foster systemic stability. The main objectives of the Directive –to ensure that financial conglomerates are adequately capitalised, preventing the same capital being counted twice over, and to introduce methods for calculating a conglomerate's overall solvency position – are sensible. It will be adopted very shortly, probably before the end of December 2002.

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- The Prospectus Directive sets out to create a single EU "prospectus" for issuers of securities (shares and bonds). It has been seen as a litmus test by many in the City as to whether the FSAP is meeting its original objectives or not. Political agreement was reached at ECOFIN in November in a compromise that secured our main objectives, both in protecting smaller firms from burdensome reporting requirements and allowing the international bond markets in the City to continue to function. We now judge it creates a net benefit for market integration, but this depends in part on the outcome of its consideration by the European Parliament and the approach taken under the secondary EU comitology legislation. We expect formal adoption in early 2003.
- The Occupational Pensions Directive is intended to put in place a prudential framework that removes barriers to developing occupational pension schemes. The Council Common Position was a finely balanced compromise that allowed the UK to meet its main negotiating objectives. The European Parliament is currently starting its second reading of the proposal, and we would expect final adoption in early-mid 2003.
- The objective of the International Accounting Standards Regulation (on which DTI leads) is to increase transparency of EU accounts (and therefore

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the attractiveness and comparability of EU markets) through harmonising EU financial reporting on the basis of globally agreed accounting standards, developed by the International Accounting Standards Board. The Regulation will require all companies listed on regulated markets to prepare their consolidated accounts on the basis of International Financial Reporting Standards (previously known as International Accounting Standards – IAS) from 2005.



10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

27 November 2002

Dear Nick,

EUROPE: ECONOMIC REFORM

In February, the Government published its White Paper on European economic reform. The Prime Minister believes that this document helped to shape the economic reform debate both at and following the Barcelona Spring Council, and has proved a useful conduit for UK thinking in other EU capitals and EU institutions in general on taking forward the Lisbon agenda.

Building on the White Paper's success and in a context of changed economic circumstances and imminent EU enlargement, the Prime Minister believes it would be a good idea to publish, in January 2003, a "Progress Report" on European economic reform.

This shorter and more focused document would be well-timed – at the start of a calendar year and of the new Greek Presidency, and ahead of the Spring Council on economic reform – to serve four important purposes. It would:

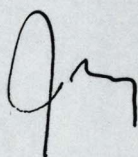
- reinforce and reinvigorate the European economic reform debate;
- underline the UK commitment to the Lisbon agenda;
- prioritise the reform debate, preventing key messages being crowded out by smaller and less pressing initiatives; and
- ensure that reform efforts are focused on results and delivery, not processes.

The new document should, as far as possible, complement the approach being taken by the Commission and the incoming Greek Presidency. However it should obviously highlight our key objectives such as employment creation; labour markets reform; and SMEs. It should also report on the successes we

have had (eg the recent agreement on energy liberalisation). We need to demonstrate that Lisbon is working, albeit not yet as well as we want.

In view of the Treasury's role in drawing up the original White Paper, it would be useful if you could circulate a draft of the Progress Report for consideration by Christmas. The Prime Minister will then hold a meeting in the new year to discuss the UK's priorities for the Spring Council, to be reflected in the document.

I am copying this letter to Chris Wormald (DFES), Andrew Campbell (DFT), Erica Zimmer (DTI), Simon McDonald (FCO), Neil Couling (DWP), Gavin Ross (DEFRA), David Prout (ODPM) and Christian D'Cunha, Nigel Sheinwald (UKRep) and Ian Fletcher (Cabinet Office).

Yours,


JEREMY HEYWOOD

Mark Bowman
HMT

European Economic Reform Progress Report

1. A European economic reform Progress Report would serve three key purposes. It would:
 - **reinforce and reinvigorate** the European reform debate – particularly important, in a context of imminent EU enlargement – and underline the **UK commitment** to the Lisbon agenda;
 - **shape the reform debate in an EU context** by highlighting priority areas and keeping the focus on results rather than on processes; and
 - **shape the reform debate in a Whitehall context**, ensuring that HMT retained its clear role as a driver of overall reform strategy, and preventing the overall message from being crowded out by a plethora of smaller initiatives.

Questions

2. The **publication date**; mid-January, or late December? The latter has the advantages of being post-EU Council, but ahead of the New Year and the Greek Presidency. Possible timelines for each are suggested at the end of this note.
3. Should this be presented as the **first of a series** of regular updates?
4. How far should the report set out **new** priorities or policies (rather than update existing ones)?
5. Is it correct to assume that this document will **not have White Paper status**?
6. Rather than attempting to cover the breadth of issues addressed in the White Paper, the outline presented here focuses on **key priorities**. Is this narrow approach agreeable?
7. Should the report be oriented towards the **Greek Presidency**?
8. The White Paper was accompanied by a separate annex covering the full set of **Structural Indicators**; this facilitated distribution of what proved a very popular and useful document. Alternatively, a shorter section could focus only on the headline indicators and be incorporated into the main document. Would this be preferable?

Draft Outline

Section 1: Introduction

9. The report as an accompaniment to (not replacement for) the 2002 White Paper. Intended to evaluate progress, assess changes in policy and context, and maintain momentum for reform. Reaffirmation of UK Government's commitment to Lisbon goals.

Section 2: Economic reform; a European priority

10. Why economic reform matters: ongoing EU underperformance relative to its own aspirations and its US counterpart. Tables and charts showing e.g. EU15 and MS productivity/employment; where possible and appropriate, CEC10 comparisons with EU15.

11. Reform mattered in early 2002; it matters equally, looking into early 2003. **Enlargement** is imminent; the background is one of greater global economic, financial and political **uncertainty**; some Member States have seen **changes of government**; **demographics** implies ageing populations and contracting workforces.

12. The need to maintain **credibility** becomes ever more important with each year of the Lisbon agenda. It is vital that reform does not/is not perceived to slow, let alone to slip into reverse. (CAP.)

13. Emphasise the need to focus on effective implementation – on delivery rather than on processes.

Section 3: The Lisbon agenda; goals and strategy

14. Much has been achieved since Lisbon; much more remains to be done. Where is progress evident, and where is there most scope for improvement?

Clear progress	Marking time	Ongoing challenge
Cars	Financial services	Community Patent
Energy	Takeovers	Agriculture
State aids	Services in general	
Regulation	Competition policy	
Telecoms	Entrepreneurship	
Employment	Aviation	

Section 4: Priority areas

15. **Competition:**

- create a genuinely single market in services;
- competition policy and state aids; and
- CAP

16. **Innovation:**

- produce a framework which delivers higher R&D with a strong private sector contribution and higher productivity; and
- promote entrepreneurship – the regulatory and financing environment for small businesses

17. **Investment and capital markets;**

- the FSAP and RCAP (due to be completed in 2003) – where next?); and
- developments in corporate governance.

18. Skills and employment;

- older workers - the employment target for older workers (50 per cent by 2010) will, on present trends, be missed; and
- policy focus on this area will to help underline the important link between employment rates and pensions sustainability.

19. Regional policy;

- tackle regional disadvantage by addressing specific market failures rather than geographical areas; and
- reform state aid and structural funds policy to produce a more coherent, flexible and better targeted framework centred on delivering outputs, not transfers.

Section 5: Economic reform as a global priority

20. In an increasingly interconnected and uncertain world, the need for a stronger, more resilient Europe is greater than ever.

21. Such a Europe would be a stronger transatlantic partner. The EU and US comprise the world's largest bilateral trading and investment relationship; a deeper and truly open transatlantic relationship can make an important contribution to global trade, prosperity and employment.

22. In the multilateral arena, also, it is important that the EU retain and redouble its commitment to openness, to free and fair trade, and to sustainable development (Doha, CAP).

Separate Annex: Structural Indicators

23. Charts/minimal text summarising EU15 progress vis-a-vis structural indicators.

**Alison Cottrell
EER**

Timeline for 20th December Publication of European Economic Reform Progress Report

WEEK OF:	EVENTS	REPORT
18-22 November		Draft outline
25-29 November	PBR (27 th)	Draft circulated at official level
2-6 December	ECOFIN (3 rd)	First draft to Ministers/ advisers
9-13 December	European Council (12 th -13 th)	Second draft to Ministers/ advisers Draft to printers (13 th)
16-20 December		Final sign-off (18 th) Printing (19 th) Copies available (20 th)
23 December-3 January	Holiday period	
6-10 January		
13-17 January	Commission's Spring Report (unspecified – early January)	

Timeline for 15th January publication of European Economic Reform Progress Report

WEEK OF:	EVENTS	REPORT
18-22 November		Outline draft (HMT)
25-29 November	PBR (27 th)	
2-6 December	ECOFIN (3 rd)	
9-13 December	European Council (12 th -13 th)	Report commissioned by No.10; draft circulated to officials
16-20 December		First draft circulated to Ministers/advisers (20 th)
23 December-3 January	Holiday period	
6-10 January		Second draft circulated to Ministers/ advisers (6 th) Draft to printers (10 th)
13-17 January	Commission's Spring Report (unspecified – early January)	Final sign-off (13 th) Printing (14 th) Copies available (15 th)
20-24 January	ECOFIN (21 st)	

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9.

The Permanent Representative
Sir Nigel Sheinwald KCMG

14 November 2002

Jeremy Heywood
No 10

Dear Jeremy
EU FINANCIAL SERVICES

United Kingdom
Permanent Representation
To the European Union

Avenue d'Auderghem 10
1040 Brussels
Telephone: (0032)(2) 287 8211
Facsimile: (0032)(2) 287 8383
Direct Line: (0032)(2) 287 8271
E-mail: nigel.sheinwald@fco.gov.uk

- X ✓ 1. Thank you for copying me your 17 October letter to Mark Bowman requesting an assessment of the UK's strategy on the Financial Services Action Plan (FSAP). I thought it might be useful to feed in views from UKREP.
2. Your letter raised a number of issues – the link between the FSAP and economic reform, whether the legislative output is of net benefit to the UK, growing City scepticism, and whether we need a change of strategy.
3. I continue to see the FSAP as a central plank of economic reform. The results of the London Economics survey, released on Tuesday by the Commission, provide firm evidence: a 1.1 per cent increase in GDP, a 0.5 per cent increase in employment and a 6 per cent increase in business investment projected to flow from financial market integration. Further work, soon to be published by the Commission, is expected to suggest that integrated financial markets would lead to a permanent boost in growth in manufacturing industry.
4. The key question is whether or not the **individual legislative measures** will deliver these integrated markets. The jury is still out. But I believe the outcome of the eight directives prioritised at Barcelona will be of net gain to the UK, and to the City in particular. And we should bear in mind that without the political vehicle of the FSAP, securing successful negotiating outcomes for the UK would have been much harder on the basis of ad-hoc Commission proposals, as previously planned. It is true that the directives most central to reforming capital markets – prospectuses, collateral and pensions – have not been as liberalising as the UK would have wished. But the messages I receive from contacts with the industry lead me to believe that they represent a gain.
5. The situation is less clear on the **retail legislative programme**. Here our goal (and that of the FSAP) is to increase choice and competition to benefit consumers. But the Distance Marketing and Insurance Mediation directives are unlikely to deliver this in the absence of a coherent overall retail strategy. While the Commission has carried out work on such a strategy, it has no political visibility. The danger we need to guard against is a stream of ad-hoc measures on the retail side, piggy-backing on the FSAP, that raise compliance costs for a largely domestically

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focused industry with no accompanying benefit for the consumer. Such measures may also cut across the considerable number of domestic reforms under way in this area.

6. You mention the growing doubts about the FSAP in the **City**. I too have picked this up. But I believe and hope the tide may turn. Underlying the City's concern was the lack of consultation by the Commission – a bad thing in itself, but compounded by a lack of knowledge about markets amongst Commission staff. City frustration found a particular focus in the proposed prospectus directive.
7. The Commission appears to have turned a corner, stressing that their rigorous consultation on the proposal for an Investment Services Directive will now be the model. And the message from industry visitors to UKREP on the outcome for the prospectus directive has been cautiously positive. I wouldn't want to overplay this. Much important legislation remains in the pipeline and the HMG/City relationship will need careful management. The recent and more formalised contacts that the Treasury has established will help, both on individual proposals and in influencing the Commission's longer term agenda. James Sassoon, who paid a useful first visit to Brussels last week, seems keen to promote and expand this dialogue.
8. Finally, I do not believe our strategy is, or should be, static. We should continue to position the FSAP as central to the economic reform agenda, but the levers to deliver our objectives need frequent review. In the immediate term, there will be no let up in the flow of legislative measures stemming from the FSAP. The "rapid reaction" drafting groups that HMT has used in the case of the Pensions and Prospectuses seem to have delivered in terms of process and results. We should continue to use them. And we need to work closely with the European Parliament, co-legislators in this area, to establish common ground.
9. But we must also look ahead. An emerging theme is the need for a period of **consolidation** following the FSAP. We need to evaluate whether or not the individual legislative proposals are achieving their objectives and draw the relevant conclusions. The reconfigured Financial Services Policy Group should play an important role in carrying out this analysis and proposing any next steps. We also need to focus on ensuring proper **enforcement** of the legislation once adopted. I have been encouraged in my early contacts with Alex Schaub that he shares these views.

Yours Nigel

Nigel Sheinwald

cc: Mark Bowman, PPS/Chancellor
Sir Stephen Wall KCMG LVO, No 10
Michael Arthur, Economic Director, FCO
James Sassoon, HMT
Jon Cunliffe, HMT
Melanies Dawes, HMT

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Martin Donnelly, Cabinet Office

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10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

17 October 2002

Dear Mark,

EU FINANCIAL SERVICES

A number of leading City figures seem to be of the view that the Financial Services Action Plan (FSAP) is not in practice fulfilling our expectations and may be setting policy on a course that will fail to bring any benefits to the UK financial services industry (and may indeed be counterproductive).

As you know, the Prime Minister has always regarded opening up the EU's financial services and capital markets as an integral part of the Lisbon strategy for delivering economic reform in the EU, benefiting UK companies and consumers as well as the UK financial services industry.

Although the City is clearly not the only constituency that stands to benefit from reform, the Prime Minister is nevertheless concerned about their growing hostility to the FSAP.

He would therefore be grateful for the Chancellor's assessment of where things stand with the FSAP, the prospects for the run up to next spring's European Council and whether we need to modify our strategy on EU financial services. It would be useful if this assessment could address the following issues:

- whether the directives and legislation so far agreed under the FSAP have or are likely to bring net gains to the UK financial services industry and the wider economy;
- whether on present trends the likely outcome of the complete dossier of eight directives prioritised at the Barcelona European Council for agreement this year will bring positive benefits to the UK financial services industry and the wider economy;
- if there are clear gains, what are they and can they be clearly identified and quantified?

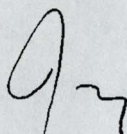
- if there are no clear net gains, what changes are required to the planned directives and what are the chances of gaining enough support from other member states for the necessary changes.

The Prime Minister feels we need a comprehensive and rigorous assessment of these issues, taking into account the views of the participants in the various financial markets and other stakeholders in reform, including the FSA.

In the light of this assessment the Prime Minister would also be grateful for the Chancellor's recommendations for taking forward the Government's policy on EU financial services in ways that ensure that potential benefits of an EU-wide single market in financial services are realised and brings clear gains to the UK's financial services industry and to the wider economy. He would particularly welcome the Chancellor's thoughts on two issues:

- whether we should step up the pressure on the Commission to enforce more effectively the existing stock of single market – and underpinning tax – legislation. To facilitate this should we for example set up a dedicated unit in the Treasury, staffed by a combination of civil servants and City practitioners to identify current enforcement weaknesses or discriminatory tax/regulatory rules in individual member states which might be inhibiting the development of a fully competitive single market?;
- what more we can do to improve the Commission's understanding of the financial markets?

I would be grateful if the Prime Minister could have this assessment by 7 November. In the meantime I am copying this note to Sir Stephen Wall and Sir Nigel Sheinwald

Yours,


JEREMY HEYWOOD

✓
From: Stephen Wall
Date: 8 November 2002

PRIME MINISTER

cc: Jonathan Powell
Alastair Campbell
Sally Morgan
Jeremy Heywood
Roger Liddle
Derek Scott
Sir Andrew Turnbull
Sir Nigel Sheinwald
Martin Donnelly

STABILITY AND GROWTH PACT

The Commission are planning a discussion next week on the Stability and Growth Pact which, potentially, could move things in our direction. Commissioner Solbes will bring forward a document which will, we understand, argue that there is no need to change the substantive content of the Stability and Growth Pact but that it needs to be interpreted better. One aspect of this may be to build up new criteria for judging what is the most appropriate medium term fiscal policy target for a member state, taking into account factors such as its debt level, its pension liabilities and its public investment needs.

On the basis of this paper and the discussion which follows, Solbes will try to secure agreement within the Commission for publishing a new communication on the Stability and Growth Pact.

This strikes me as quite a helpful development. It has the potential to prevent people like Prodi shooting from the hip. It also goes a long way to defuse the current poisonous atmosphere in the college resulting from a feeling that policy is

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being made without proper collective discussion. And, given that progress on changing the Stability and Growth Pact is effectively blocked at the moment, this delivers some potential movement in our direction.

The Treasury's initial reaction is less sanguine. They do not like the Commission being in the driving seat because they think that the Commission has competence ambitions over fiscal policy which are dangerous in the long term. They think that once the Germans have accepted their fiscal medicine (which they expect them to do) and once the French have accepted a warning letter (which they expect them to do next spring) then the climate for change, agreed by the member states, will be more favourable. They believe that there is quite a strong view among a majority of member states against allowing the Commission too big a say in the operation of the Stability and Growth Pact. This contrasts with the view Gordon Brown offered to you recently that substantial reform is unlikely in the short term.

This remains a very difficult call. But I suspect that the Treasury may be a bit optimistic in seeing the prospects of early change in the Stability and Growth Pact. The small member states are very dug in against change and they have the support of the Spanish. And opposition to Commission involvement seems to me to be bordering on the doctrinaire. The fact is that the Commission do have a role under the Treaties and they are the best impartial authority we have got. Maybe, over time, some alternative impartial authority could be invented but that could take a very long time indeed. The notion that the member states themselves can effectively police a Stability and Growth Pact is not borne out by recent events.

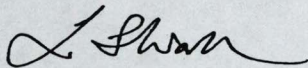
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- 3 -

So I have suggested to the Treasury that, even if we do not much like the messenger, we should not reject the message. A strong Stability and Growth Pact, but flexibly interpreted along the lines that the Commission are considering, would not be bad from our perspective. It is certainly better than a Stability and Growth Pact that becomes discredited because it is at the mercy of large member states.

It is also in our interest to encourage agreement on an improved Pact sooner rather than later. Continued high-profile tensions between Euro-Group members, the Commission and the ECB sap confidence in the Euro Zone economic management. We want a sensible macroeconomic framework, and continued progress on structural reform through the Lisbon agenda, in place by the March European Council, giving a positive framework for decisions on the Euro.



STEPHEN WALL

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Susan Claridge

From: Donnelly Martin - Secretariat D - [Martin.Donnelly@cabinet-office.x.gsi.gov.uk]
Sent: 23 October 2002 18:06
To: Crabtree Richard - European Secretariat -
Cc: Claridge Susan - No 10 -; Roberts Michael J - Secretariat D -; Green Rachel - European Secretariat -
Subject: For Info: FW: Stability Pact: Commission Discussion



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Letter from Peter Curwen to HMT on the above.

Debbie Chilcott
PA/Martin Donnelly
European Secretariat
020 7276 0447, 70W

DN → QJ
12.30 24th

-----Original Message-----

From: Joan.Nisbett@fco.gsi.gov.uk [mailto:Joan.Nisbett@fco.gsi.gov.uk]
Sent: 23 October 2002 16:03
To: 'dave.ramsden@hm-treasury.x.gsi.gov.uk'
Cc: 'Martin.Donnelly@cabinet-office.x.gsi.gov.uk'; Steve Cook; Peter Curwen * UKREP Brussels -REST
Subject: Stability Pact: Commission Discussion

Please find attached - letter from Peter Curwen to Dave Ramsden Esq, HMT

<<Ramsden-23oct.doc>>

The Cabinet Office's computer systems may be monitored and communications carried on them recorded, to secure the effective operation of the system and for other lawful purposes.

① Terry Hegwood
② Matta for all trace

24/10

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23 October 2002

Dave Ramsden Esq
HM Treasury

United Kingdom
Permanent Representation
To the European Union

Avenue d'Auderghem 10
1040 Brussels
Telephone: (0032)(2) 287 8211
Telex: 24312
Facsimile: (0032) (2) 287 8333
Direct Line: (0032)(2) 287 8264

Dear Dave,

STABILITY PACT: COMMISSION DISCUSSION

The College meeting in Strasbourg yesterday discussed recent developments on the Stability Pact. All but two Commissioners were directly critical of Prodi. It was apparently a session of high drama with Prodi's comments criticised as 'misjudged', 'unfortunate' and 'policy making on the hoof' to name but a few. I am surprised that none of the flavour of the discussion has (yet) reached the Press. I should be grateful if this letter could be handled with care – information obtained from the Pattens; please protect.

2. Solbes noted that the comments were badly timed and ill-judged; there were too many discordant voices; he was not prepared to stand behind any new decisions which were not workable. De Palacio said she had been in an EPP meeting when news broke. All Prime Ministers present had been in a 'state of shock'! Bolkestein noted that this had had a major negative impact in the Netherlands who felt that they had been 'tricked'; he gave 'full support and sympathy' for Solbes. Monti remarked that Solbes had been put in an impossible situation. There was much in similar vein from Liikanen, Diamantopoulou and Barnier, particularly on the process, lack of consultation and the impossible position for Solbes. Kinnock and Patten intervened similarly on the procedure but also emphasised the need to think through how best to achieve a system which was credible.

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3. Only Lamy and Neilson spoke in favour of Prodi. Lamy noting that 'hypocrisy' had been 'reigning'.
4. This discussion in the College was in many ways overdue. The College had been kept in the dark on the Solbes-Prodi re-interpretation of the Pact in September. The subsequent Prodi comments had thus compounded the feeling of a lack of consultation and collegiality on such a key issue.
5. A copy of this letter goes to Martin Donnelly (CO) and to Steve Cook (FCO).

Yours sincerely

Peter
PETER S CURWEN

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10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

23 October 2002

Dear Mark,

STABILITY AND GROWTH PACT

The Prime Minister met the Chancellor and the DPM yesterday to discuss the Stability and Growth Pact (SGP). Gus O'Donnell, Jon Cunliffe, Ed Balls, Jonathan Powell, Sir Stephen Wall and I were also present.

NO FURTHER COPIES SHOULD BE MADE of this letter and it should be made available ONLY to those WITH A STRICT NEED TO KNOW of its contents.

The Chancellor opened the meeting by running through the attached presentation. Ed Balls then noted the risks involved in any short term fix. For France, Italy, Germany and Portugal the immediate issue was whether the current 3% limit should be replaced by something that took greater account of the economic cycle. But this would not be sufficient for the UK. For us it was also very important to get a more sensible definition of medium and long-term sustainability. It made no sense for a country with a low debt stock and manageable future pension liabilities to aim for a balanced budget over the medium term. In addition it was important to improve the current co-ordination of fiscal and monetary policy – which would require changes to the ECB as well as the SGP. As the Chancellor had said it would also be unacceptable to turn the Commission into a sort of independent "EU Fiscal Authority" which seemed to be their aim.

The Prime Minister said that the Treasury's proposals for reforming the SGP were entirely sensible, though they were not – and should not be seen as – a new "sixth test". The main issue was how to ensure that the UK remained right at the heart of the current debate. This was a real moment of opportunity – the SGP was currently up for grabs and it was vital that we should be in there trying to seize the moment.

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The Chancellor confirmed that the UK was right at the heart of the debate. The issue of SGP reform was on the agenda of virtually every ECOFIN meeting and was constantly under discussion in bilaterals and other informal meetings. The UK's thinking was gaining ground – in many ways it was we who were setting the agenda. But it would be seriously counterproductive to launch a new high-profile UK initiative at this stage on the reform of the SGP. This would be seen as a wrecking tactic.

Nor was it clear, the Chancellor continued, that this was the moment of opportunity. As he had already noted, the sort of reform that France and Italy, for example, might want to see was not likely to be welcomed by the financial markets or the ECB. And the Germans – and many of the smalls – seemed very hostile to any reform. It was essential that any final reform package was seen by the markets as a credible and sensible toughening up of the rules rather than a short term fix designed to increase “flexibility” – otherwise the debate would move on to the future of the Euro itself.

The Prime Minister agreed that if reform was seen to be driven by indiscipline and weakness then this would be seriously counterproductive. But it was possible that France and Germany might come to see the UK's prospective entry into EMU as providing a credible opportunity for “disciplined” reform. It was certainly not sensible to assume that proper reform would inevitably have to wait for several years until growth was strong and deficits were clearly falling. For this reason it was vital that the UK should remain active and engaged in the debate. It was also absolutely clear that the UK only had any influence at all because countries assumed we would be joining the Euro fairly soon.

The Chancellor confirmed again that the UK was fully engaged in the current discussions. But we should not be prepared to sign up to a reform package that did not meet our essential requirements.

7.5.97
93

JEREMY HEYWOOD

Mark Bowman
HMT

Framework for thinking about SGP reform

- Where SGP came from
- Where SGP is now
- How SGP needs to develop
- UK in significantly different position

Where SGP came from

- Aimed at locking in sacrifices made to join EMU.
- Euro area sacrifices:
 - inflation down from 4.4% in 1990s to 2.1% now;
 - borrowing cut from 5.5% of GDP to 2.2% now.
- Important to have framework but SGP wrong framework for current and future challenges, eg world slowdown, ageing/pensions, accession.

But wide-ranging problems with SGP

- Focus on deficits not debts. Euro area debt forecast to remain stable at 70%, down only slightly from 75% in 1997 .
- Medium-term objective of close-to-balance not credible unless over the cycle.
- Poor transparency of data & assumptions hampers surveillance.
- Insufficient emphasis on caution, eg in UK audit output gap, oil, VAT etc; others don't.
- Coordination among fiscal authorities poor; coordination between fiscal and monetary authorities poorer still.
- Balance of competences wrong between C'ion & MS.

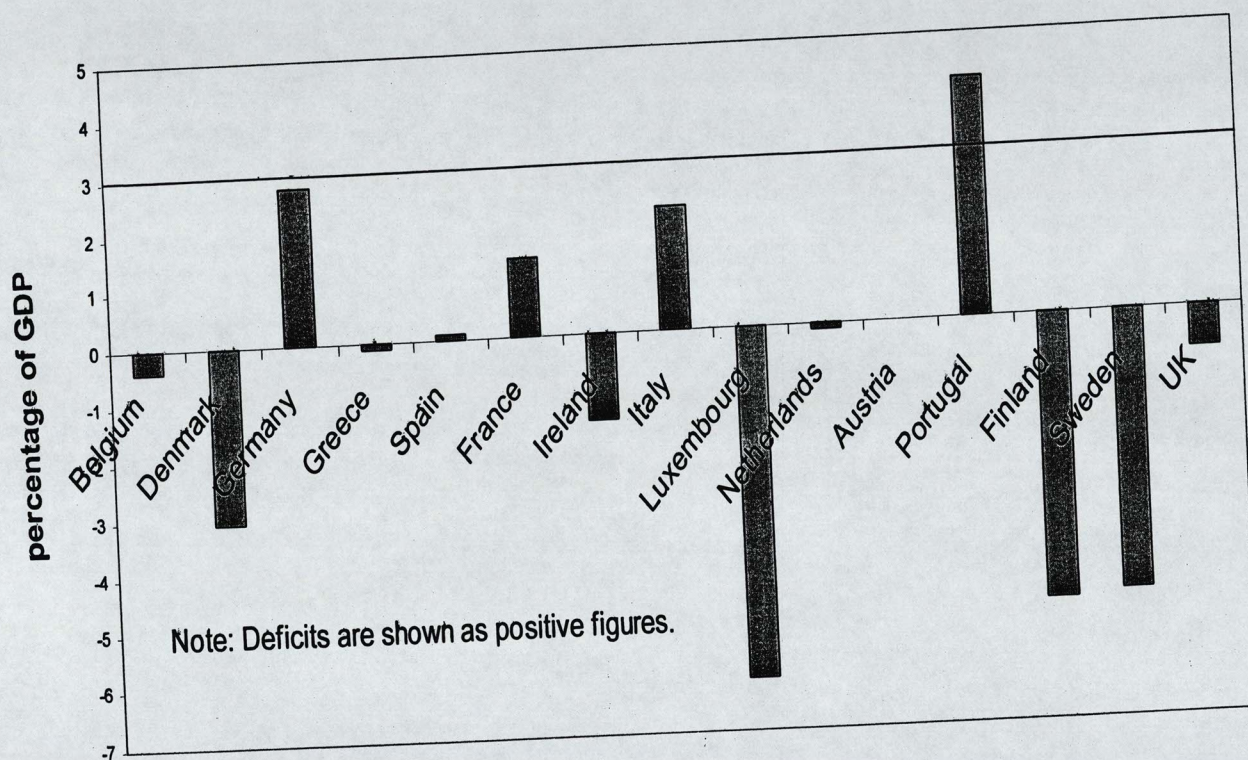
Where SGP is now

- Great deal of uncertainty in all EU countries about the outlook for growth and public finances.
- Figures based on C'ion forecasts – confidential. Due for release 13 Nov, but may change quite a bit before then.
- UK figures and forecasts are also C'ion, not ours. In no sense pre-empt PBR.

Actual deficits

- Wide range of deficits across MS in 2001.
- Portugal over 3%; Germany very near, but others (eg Finland, Sweden, UK) in surplus.

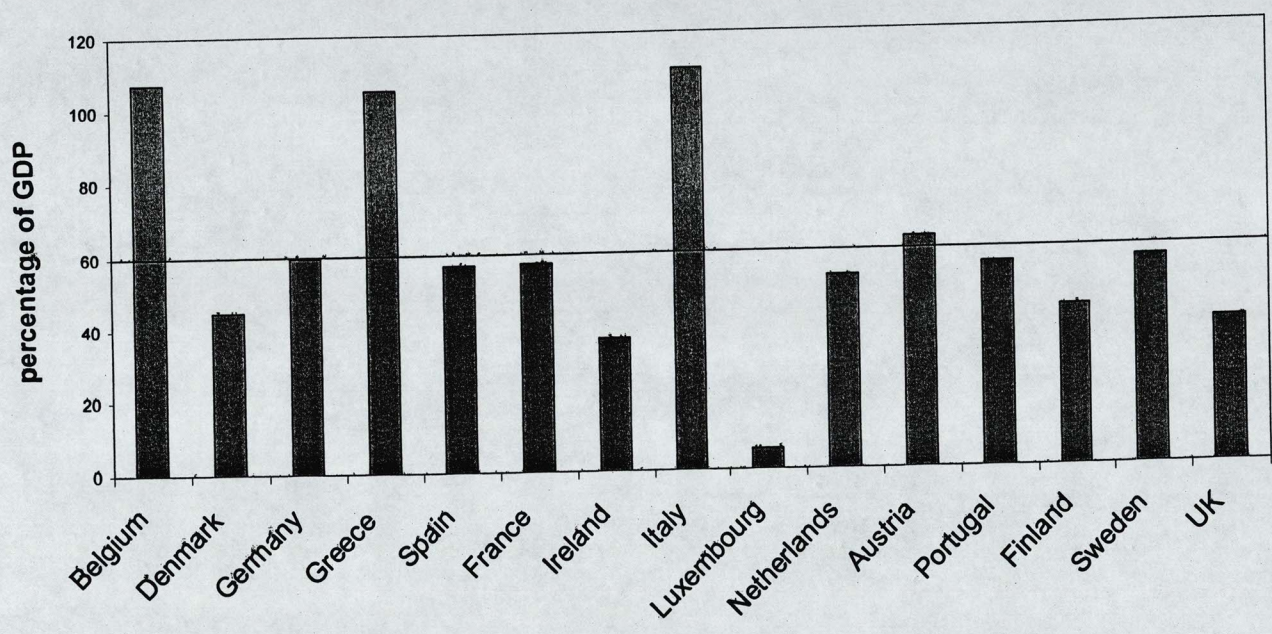
Actual deficit (2001)



Debt

- Wide range of debts across MS in 2001.
- Belgium, Greece & Italy continue to have particularly high debt levels.

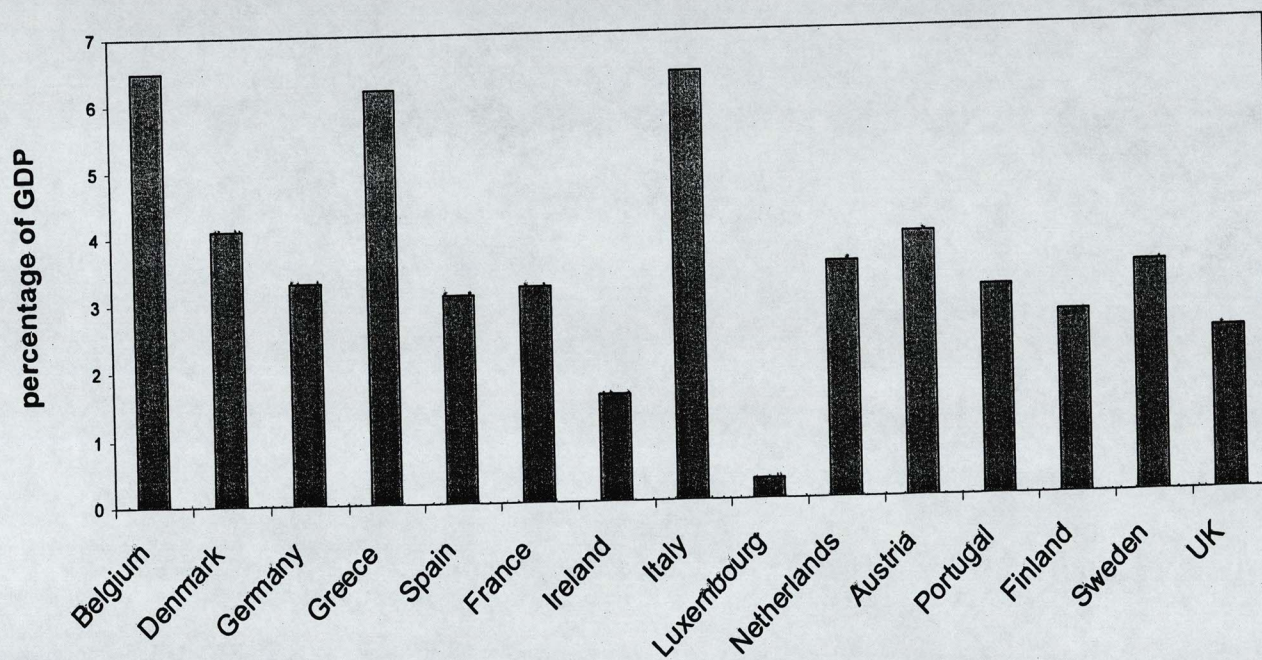
General government gross debt (2001)



Interest expenditure

- Debt repayments for 2001 – obviously highest in those MS with highest debt levels.
- Interest expenditure shows room for manoeuvre created by reducing debt levels.

General government interest expenditure (2001)



Crisis points for SGP

- Look at challenges faced by specific MS
- Portugal: a special case.
- Germany, France & Italy.
- UK significantly different.

Specific MS

- France, Germany, Italy & Portugal identified by C'ion since beginning of year as potential offenders on SGP.
- Economic & fiscal developments worsened since then.

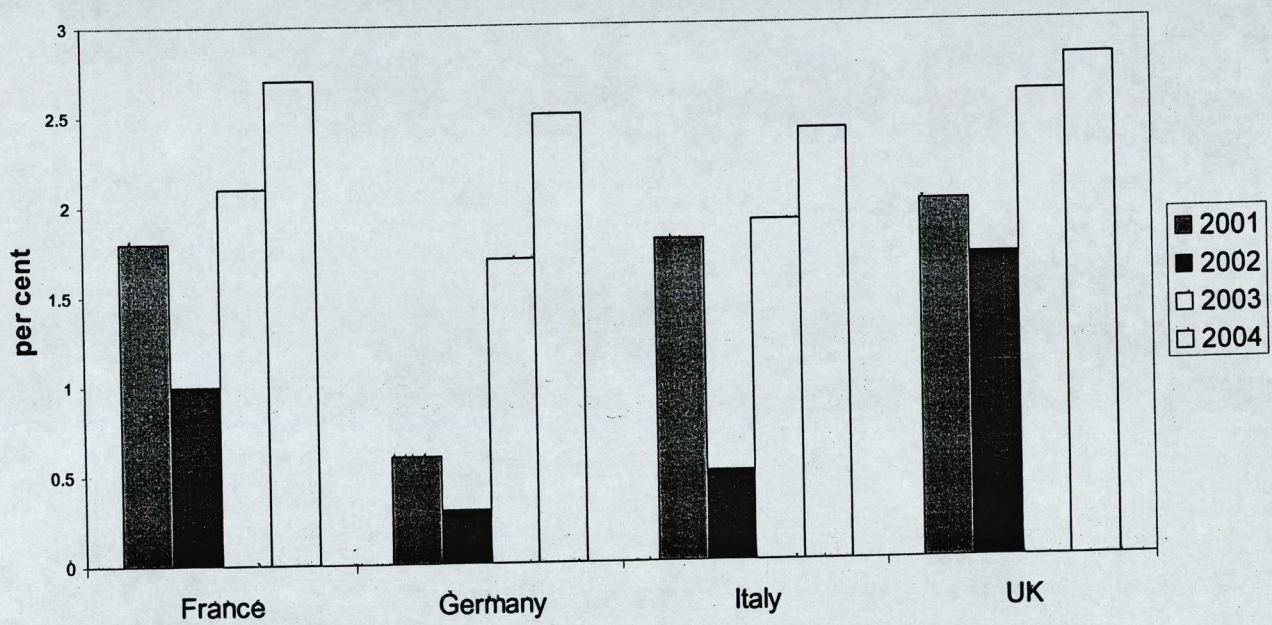
Portugal: a special case

- Main problem for 2001, when recorded a deficit of 4.1% of GDP.
- Excessive Deficit Procedure now under way against Portugal.
- For other 3 'offenders' most of problems are for 2002 and beyond

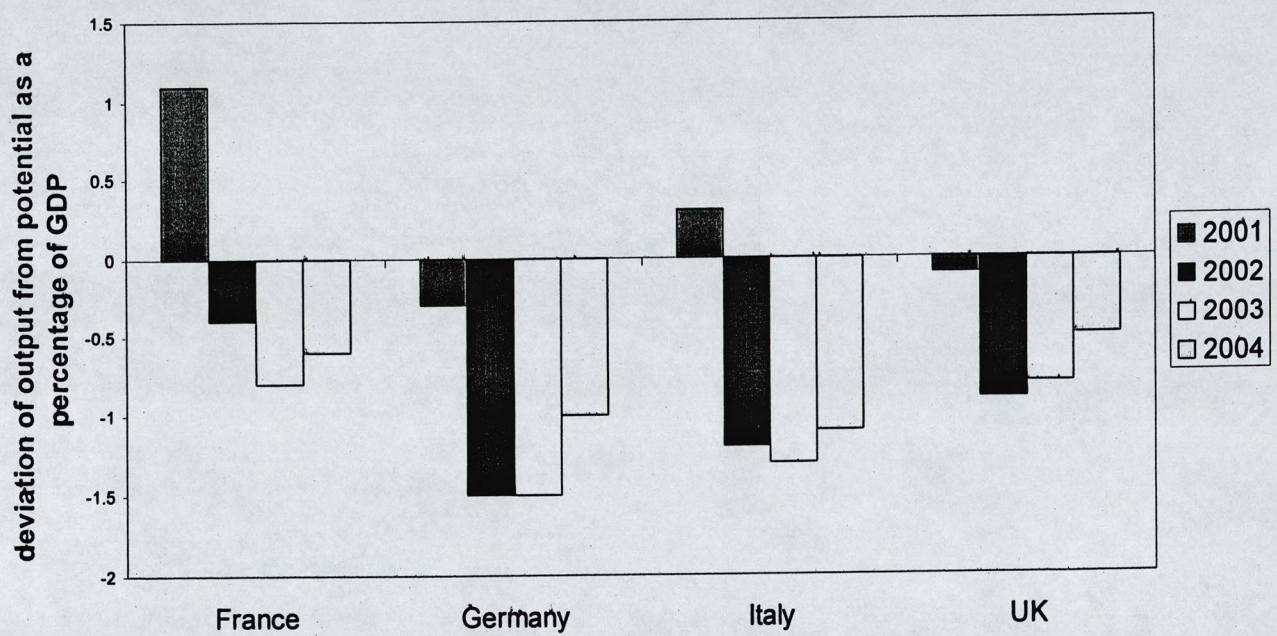
GDP growth & output gap

- Growth in Germany & Italy predicted to be worse than France, especially for 2002 & 2003.
- Negative output gaps in all three; significantly worse ones in Germany & Italy than UK.
- Key backdrop to discussions of structural adjustment path back to close to balance (C'ion/Eurogroup minus France have endorsed 0.5pp a year).
- UK slowdown not nearly as pronounced.

GDP growth



Output gap



Germany

- “Early warning” not proceeded with in Feb, after certain commitments, principally to avoid 3%.
- Govt now announced it will breach 3% in 2002; C’ion forecasting 3.7% for 2002, and 3.2% for 2003.
- Structural deficit also breaches 3% in 2002 (3.1%).

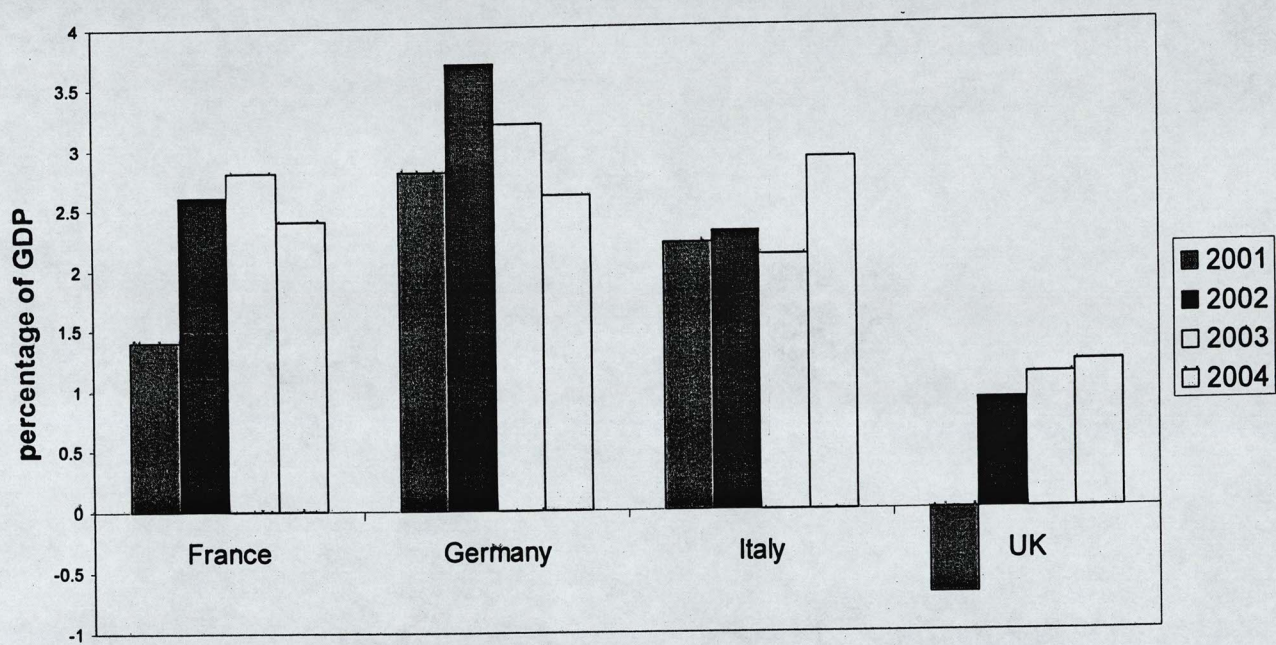
France

- French deficit also fairly high (C'ion forecast 2.6% for 2002, 2.8% for 2003).
- And problem sustained further out: increase in structural deficit in 2003, and deficit of 1.1% projected for 2006.
- May prompt “early warning” on failure to achieve ‘close-to-balance or in surplus’.

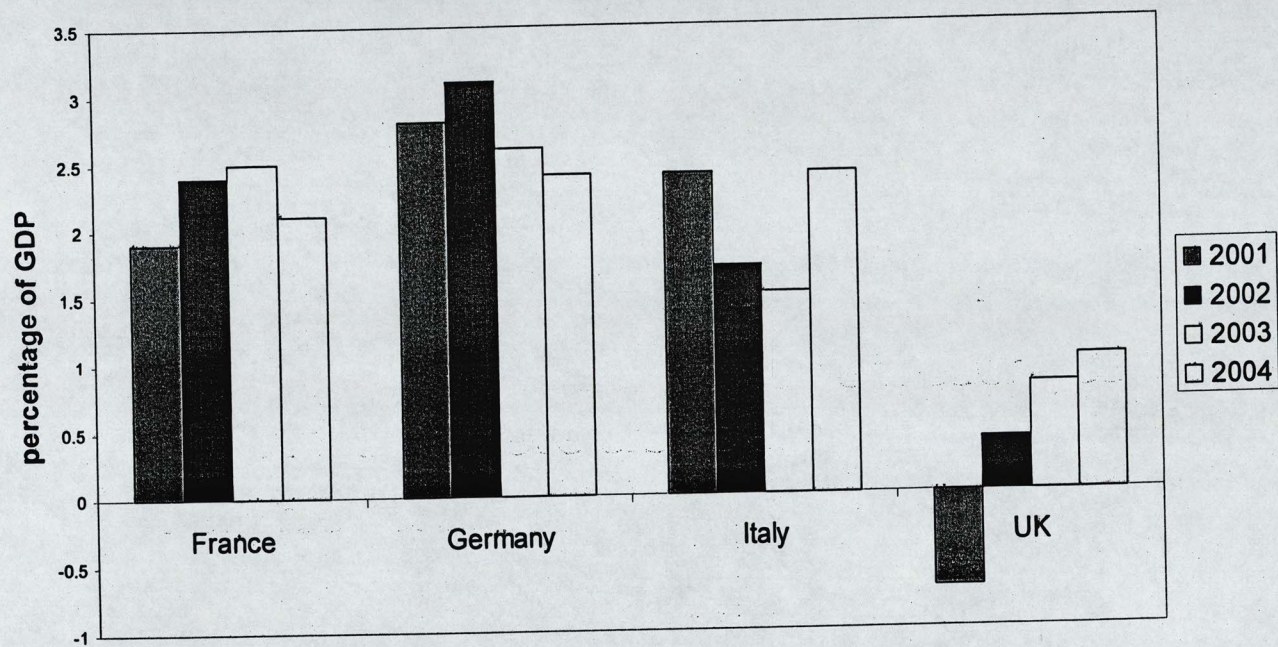
Italy

- Deficit looks relatively okay now (C'ion projecting 2.3% for 2002), but worsens over time (C'ion projecting 2.9% for 2004).
- Though authorities claim they will achieve significant structural improvement each year; few outside believe credible.
- Debt real issue.

Actual deficit



Structural deficit



Issues SGP reform must address

Must consider:

- The current cyclical position
- Need for credible rules over cycle

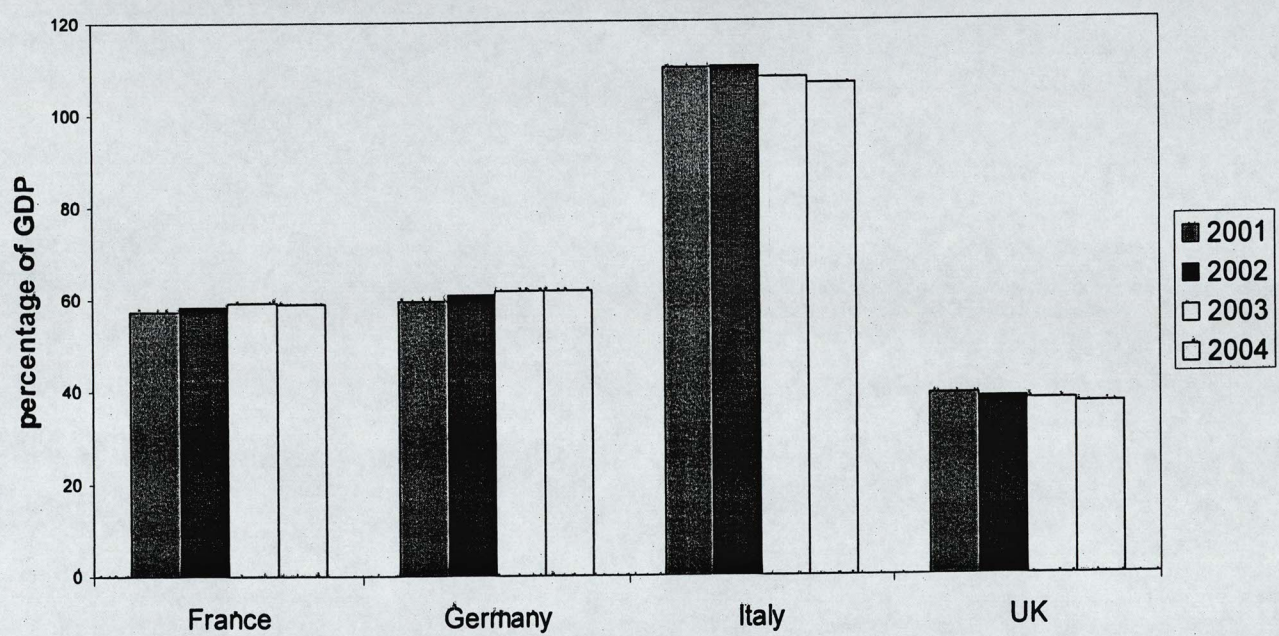
Must go wider to cover

- Importance of overall sustainability, not just current debt but future challenges from pensions & ageing
- Need for transparency in data & assumptions (more caution) and improved surveillance
- Coordination both between fiscal & monetary authorities
- Role of Commission relative to MS

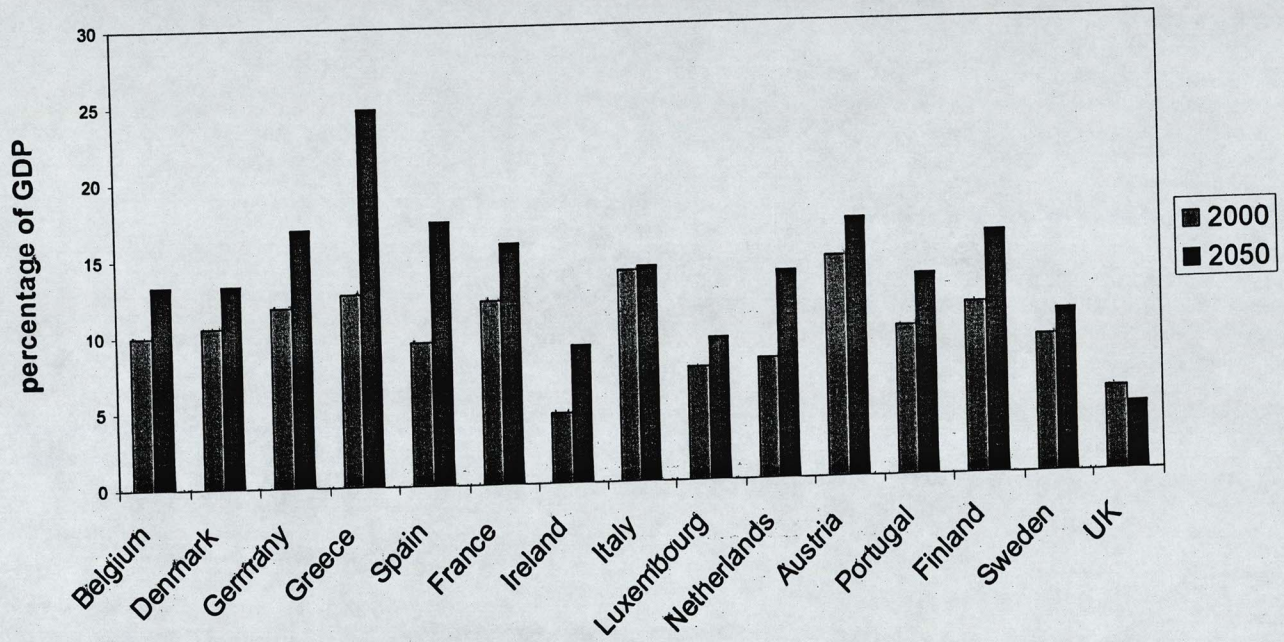
Sustainability/Debt

- Italy still very poor performer on debt. But Germany now shows debt rising slightly over time.
- UK much lower than majority of other MS.
- Ageing populations could push trend upwards if action not taken soon (see pension projections).

General government gross debt



Public pension expenditure



UK significantly different from Germany, France & Italy

- UK has a distinct rules-based fiscal framework, that takes account of the cycle, sustainability & public investment.
- UK has lower deficits in short run.
- UK has less of a cyclical slowdown.
- UK needs large increases in public investment in medium term to bring it up to EU level.
- UK has deficits rising and staying above 1½% into medium term, to finance investment for the long term.
- UK much better placed in terms of current debt position & long-term sustainability.

Progress in reforming the SGP

- July 2001: ECOFIN agreed a revised Code of Conduct with more emphasis on principles of cyclical adjustment, sustainability & public investment/quality.
- February 2002: ECOFIN conclusions on UK & Germany's fiscal programmes partially reflected sensible principles and move away from mechanistic targets.
- March 2002: Barcelona European Council conclusions emphasised achieving close-to-balance in 2004 (mechanistic) & C'ion secured remit for "common standards".
- October 2002: Solbes' proposals / Prodi statements a very mixed bag of sensible principles, mechanistic targets & greater rôle for C'ion.

Reform must be wide-ranging

- Necessary, but not sufficient, just to take account of current cyclical conditions.
- Necessary, but not sufficient, to just make medium-term rule credible.
- Necessary, but not sufficient, to just take more account of investment.
- Necessary, but not sufficient, to just distinguish between high & low debt.
- Necessary, but not sufficient, to improve surveillance, eg through surveillance agency.

SGP reform must:

- Be wide-ranging, to meet short-term, medium-term & long-term challenges.
- Be fundamental, to ensure long-term credibility and discipline.
- Ensure legitimacy, so must reflect MS' priorities, not those of the C'ion.
- Reflect UK's long-term fiscal objectives.

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FROM: RICHARD CRABTREE
European Secretariat
DATE: 21 October 2002

MARTIN DONNELLY
STEPHEN WALL



cc **Jeremy Heywood**

EU/SWITZERLAND AND SAVINGS TAX MEETING

Papers

- A Timeline of contacts and possible "bottom line" package from HMT submission on strategy to deal with Swiss [please protect with care]
- B Peter Curwen's letter of 21 November on Ecofin, 3 Dec
- C Letter from PS/ChX to PS/Foreign Sec of 8 November
- D PS/SoS FCO's reply
- E Ralph O' Neill's (BVI) letter of 5 September
- F Baroness Amos' reply of 31 October
- G Danish non-paper setting out possible compromise
- H Feira conclusions
- I Minutes of previous CO meeting
- J Lux telegram on Luxembourg position

Objectives

On EU/Switzerland:

- Update from HMT of the Chancellor's latest thinking on handling the end-game of the savings tax negotiation and consider whether further actions are necessary at this stage.
- Initial consideration of implications of a failure to get a deal in time for Copenhagen and UK response.

On other strands of savings tax/EoI discussions:

- To review position in negotiations with Americans and consider need for further actions to encourage them to come on board.
- To review handling of UK Caribbean OTs.

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Handling

A very restricted cast list: Nigel and Peter Curwen, Michael Arthur and Ivan Rogers only. Given the sensitivity of the issues under consideration we have not got Berne on an audio-link this time.

HMT, under direct instructions from ChX, have been keeping their cards close to their chest on handling the end-game. So this is primarily an opportunity for Ivan to brief us all on the ChX's latest thinking. David Richardson (head of International Tax at HMT) has however given me a brief oral update and I have extracted a key recent submission that went to the ChX (some of which has now been overtaken). I am circulating relevant extracts of that submission separately - please protect with care and do not reveal you have seen this. The rest of this brief reflects issues thrown up in these contacts.

I suggest you divide the discussion into four parts:

- handling the **EU/CH** negotiation: tactics, bottom lines and sticks
- latest **US** position on assurances they will adopt equivalent measures and potential need for lobbying on No 10 net.
- Ensuring the **Caribbean OTs** are fully signed up to same measures.
- What we do if we don't get a deal and handling of European Council.

Key dates

Thursday 21 st Nov (evening)	Bolkestein/Villager/Pederson trilateral
Monday 25 th Nov	ChX/(Paul) O'Neill bilateral
Friday 29 th Nov	possible Mer/Eichel/ChX/Pederson mtg
before Tuesday 3 rd Dec	further formal Cion/CH mtg
Tuesday 3 rd Dec	Ecofin discussion
[Tuesday 10 th Dec	Possible additional Ecofin]
Thurs 12 th /Friday 13 th	Copenhagen European Council. Possible Ecofin on preceding evening or in margins.
[Monday 16 th Dec	Possible additional Ecofin]
31 st Dec	Formal deadline for agreement on tax package.

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Issues

a) Switzerland

- Latest state of play with Commission/Switzerland negotiations. What are the Swiss now willing to offer? How far away is this from our bottom line and what Lux/Austria would accept as an equivalent measure? Time to get serious with the sticks?
- Prospects for a united UK/D/F/Dk line at 3 Dec Ecofin and through the end-game. Need to offer carrots to D and possibly F to bind them in?
- Likely response from Luxembourg and Austria to Presidency compromise package and ways of increasing the pressure on them to accept that such a package constitutes an equivalent measure.
- Anything more we (No 10/FCO/Posts) should be doing on our networks to help secure an acceptable deal?

Background

I understand that the ChX has *privately* accepted that the compromise package set out in the Danish non-paper should form the basis for a united UK/German/French/Presidency approach to the end-game.

Though he may well want to push for EoI on request in civil (evasion) cases from 2004 rather than, as the Danes, somewhat surprisingly, suggest, 2011 (ie the end of the transitional period for Austria, Luxembourg and Belgium to move to EoI). This is important because the Swiss definition of (criminal) tax fraud is very narrowly drawn – eg it would not apply to an individual who filled out a tax return incorrectly.

The idea behind the Danish non-paper is that a united front would be used to exert pressure at Ecofin on Bolkestein to take a tougher line with the Swiss than he is inclined to. Key extra element compared to Cion position is the need for the Swiss to make a proposal, subject to a referendum, on moving to full automatic EoI by 2011. However, the Chancellor remains determined not to *publicly* move away from insisting the Swiss move to full automatic EoI immediately – which, whilst understandable from a negotiating perspective, may complicate this approach.

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In negotiations earlier this week between the Commission and Switzerland I gather the former pushed for agreement to EoI on request in both civil and criminal cases ("the OECD standard"). The Swiss responded by bluntly refusing and arguing that the Commission had moved the goalposts for a deal (largely true – reflecting the weak willed approach taken by Bolkestein earlier on in the process).

The French appear pretty robust on the points in the Danish non-paper. But we should bear in mind the potential linkage to helping them out on delivering Chirac's manifesto commitment to **reducing VAT on restaurants** if they wobble. Perhaps tellingly, the French are trying to get the Presidency to add VAT on labour-intensive services to the Ecofin agenda for 3 Dec.

The Germans look a little less robust. They are the prime demandeurs for this dossier. The strategic judgement for them in approaching the end-game is essentially to consider the relative dangers of a veto being applied by:

- the UK, if a package is on the table that doesn't firmly rule out the return of the co-existence model for EU Member States (ie to accommodate Lux/Austria concerns);
- Luxembourg or Austria if a package is on the table that doesn't permit them to continue to withhold (ie not exchange information) after 2011 in circumstances where they argue the Swiss have not signed up to an equivalent measure.

If the Germans need an inducement I gather that the ChX is willing to concede on applying a **VAT co-operation measure** to insurance taxes, as the Germans have been pushing. They may also seek a linkage with removing a derogation for greenhouses from the draft **energy taxes** Directive – but this is more difficult for us as we apply special arrangements to this sector under our domestic climate change levy on business use of energy consumption. Both dossiers are due to be discussed at Ecofin on 3 December (see Peter's letter).

The Austrians and Luxembourgers have maintained their view, recorded in a footnote to the Feira conclusions, that an equivalent measure with the Swiss needs to include automatic EoI. It is unclear how far they will stick to this line if/when faced with a deal that the other 13 MS are prepared to accept. We should consider whether there are any carrots or sticks we can deploy with them. Beyond applying the diplomatic

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equivalent of thumb screws there are few obvious linkages – Ecopoints for Austria is the only obvious one, and given the state of enlargement negotiations that looks like a difficult one to pull off.

There has been much discussion of using various **sticks** on the Swiss to push them to offer up a better deal (linkage to other EU/CH negotiations; restrictions on capital movements between EU and CH; removing banking licenses from Swiss banks; applying an Italian style tax amnesty on capital repatriated from CH – on which Tremonti is due to present a paper to Ecofin). But none has really been threatened in a concerted way. The robust line taken by Villager with the PM and ChX in his recent visit suggest we may well need to push further to get an acceptable offer from them.

b) USA

Issues

- **Any movement from the US on what they are prepared to offer in public? Will this be enough?**
- **Should we consider contacts between No 10 and the White House?**

Dawn Primarolo saw the Deputy US Treasury Secretary earlier this week. My understanding is that the US remain privately willing to commit to something pretty close to automatic EoI. They will use new powers in draft IRS Regulations currently out to consultation to require banks to gather and pass on the necessary information to the IRS.

But the White House remains deeply ideologically sceptical about taking action which is seen as a way of exerting pressure on sovereign countries to alter their tax policies. The prospects of a public commitment in time for Copenhagen to full automatic EoI are therefore small. This could provide the Austrians and Luxembourgers with another excuse to say equivalent measures had not been agreed.

We considered at an earlier CO meeting whether we should use No 10 contacts with senior officials (including Meyer/Rice) in the White House to seek to get some movement on this. Implicitly a least drawing on the credit we may have over our handling of Iraq. The conclusion then was that such contacts may well be necessary in due course but not at that time.

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c) Caribbean Overseas Territories

Issues

- Prospects for all the OTs (inc Caymans) signing up to automatic EoI voluntarily?
- Timing and modalities for imposition by Westminster?

Failure to get the OTs signed up to same measures (the CDs have effectively already agreed) would de-rail the FERIA deal. Although they have not formally signed up, it seems that five of the six OTs will eventually sign up to automatic EoI. Correspondence between O'Neill (PM of BVI) and FCO Ministers on some sweeteners is ongoing. We hope that BVI and some/all of the other four sympathetic to EoI will announce publicly they are signed up after a Caribbean OTs meeting at the weekend.

The problem is the Cayman Islands, who seem highly unlikely to sign up of their own volition. The ChX and Foreign Secretary have agreed that EoI should be imposed on them in those circumstances. There is an outstanding question as to whether this should be done by a special Bill in the Westminster Parliament (less vulnerable to legal challenge) or order in Council (more straightforward, no Parliamentary handling complications).

You should be aware there has been considerable tension between FCO and HMT over the handling of the OTs and in particular respective responsibilities (HMT thought FCO should lead and vv). Discussion at our last meeting was full and frank and I gather it took a conversation between O'Donnell and Jay to (largely) resolve things.

Caymans have also asked the Commission for consultations on the impact of EoI on the Caribbean OTs under EU Decisions on Overseas Territories Co-operation. This appears to be going nowhere and HMT do not think it is a problem.

d) What happens if we don't get a deal?

- Presidency plans for further discussions after Ecofin on 3 December? Is a substantive discussion at European Council

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likely/help secure a deal? How does idea of an emergency Ecofin on 16 December (ie after Copenhagen) fit into this?

- What happens if we don't get a satisfactory deal at Copenhagen? Will the dossier slip into next year? Or are we likely to come under pressure to return to co-existence model?
- Will Chancellor veto any package that allowed co-existence to continue for Luxembourg, Austria and Belgium after end of transitional period? Consequences?

There may be limited appetite for – and utility in – crystal ball gazing at this point. But we need to know as soon as possible if it is likely that the issue will go to Heads to resolve at Copenhagen. Similarly whether if, despite attempts to keep France and Germany on board, long-term co-existence is likely to make a comeback if the Swiss continue to hold out against more extensive EoI than they have currently put on the table and the ChX will be forced to veto.

Juncker's dual role as PM and Finance Minister may be a factor in Presidency handling of the end-game. Their planning at present seems fairly vague for what happens after 3 December's Ecofin.

Possible conclusions

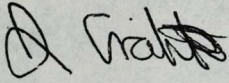
Will inevitably depend on the course of the discussion.

But elements might include:

- HMT to continue to work with France, Germany, Presidency and Commission to seek to secure a deal with Swiss on basis of Presidency non-paper.
- HMT will consider whether to offer concessions to Germany and France on other tax items at 3 Dec Ecofin in light of position then.
- HMT/FCO to review whether/how additional pressure could be put on Lux and Austria if they look like vetoing deal based on insufficient Swiss movement towards a genuinely "equivalent measure".
- We will keep under review, in consultation with HMT, whether to initiate No10/White House contact in light of ChX/O'Neill bilateral.

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- Must all keep n close touch as end game approaches.
Appreciate sensitivities but useful if HMT can ensure key
papers are copied to named officials in No 10/CO.



RICHARD CRABTREE

TIMELINE

NOTE A

FIXED DATES	POSSIBLE TIMETABLE FOR UK ACTIONS
<p>W/b 11 November</p> <p>11th/12th Pederson speaking to Bolkestein to propose joint Ped/Bolk meeting with Villiger before 20th. (Official level negotiations will be on 15th and 20th)</p> <p>12th James Sassoon seeing Bolkestein. (Briefing provided).</p> <p>13th Commission negotiations with US.</p> <p>13th PMG in Rome re Code.</p> <p>15th Commission negotiations with Switz.</p> <p>15th Deadline for OT's response to Baroness Amos.</p> <p>15th Regular meeting of OECD tax bureau (ie inner circle, including Gabs Makhlouf, Fr,D, and US. Opportunity in margins to prepare ground.)</p>	<p>W/b 11 November</p> <ul style="list-style-type: none"> • Arrange official meetings with Fr, D, [Dmk], [Switz], and joint Ministerial visit to Switz. • Agree in HMT joint UK, Fr, D memo to Swiss, and internal note on UK bottom line. • Pursue other options in Note B for keeping/increasing pressure on Switz (contacts with City etc). • Revenue note on amnesties. • Revenue check with US the suggestion from Commission that US need more from us on DTs. • Prepare other notes set out in para 3 of 11/11 submission (Austrian constitutional position; and further details of Swiss proposed 35% withholding tax). • CHX call to Pederson before Danish and Commission officials meet Swiss on 15th; or earlier if Pederson arranges bilateral with Villiger before then.
<p>W/b 18 November</p> <p>19th Code Group meets to agree</p>	<p>W/b 18 November</p> <ul style="list-style-type: none"> • Officials meet Fr, D, [Dmk]

<p>report to ECOFIN.</p> <p>20th Commission negotiations with Switz.</p> <p>21st/22nd Regular meeting of G6 officials, in Berlin (UK, D,Fr,NL,B,Lux).</p>	<p>to discuss joint memo and possible deal.</p> <ul style="list-style-type: none"> • CHX call to Eichel and Mer to finalise agreement of joint memo to Swiss and possible deal. • Possibly Fr, D, UK [Dmk] officials visit Switz ahead of joint Ministerial the following week. • Officials visit Swiss banks. • Consider OT's response with FCO, and provide advice/react as necessary. May need PMG visit to Caribbean. • Possible PMG/official visit to Ken Dam (US), to prepare way for O'Neill visit on 25th. • Possible PMG visit to/speech in Switz. • Continue to pursue other options in Note B.
<p>W/b 25 November</p> <p>25th Meeting of High Level Group on Tax Package.</p> <p>25th O'Neill visits London.</p>	<p>W/b 25 November</p> <ul style="list-style-type: none"> • [29th] CHX, Eichel, Mer, [Pederson] see Villiger. • CHX clarify US offer on EOI with O'Neill. • Issue joint statement with O'Neill on Switzerland. • Continue to pursue other options in Note B.

<p>W/b 2 December</p> <p>3rd ECOFIN</p> <p>5th US Internal Revenue Service public hearings on draft Regs for automatically <u>collecting</u> info from banks on non-residents.</p>	<p>W/b 2 December</p> <ul style="list-style-type: none"> • Bilateral contacts as necessary.
<p>W/b 9 December</p> <p>12th/13th Copenhagen European Council and possible ECOFIN.</p>	<p>W/b 9 December</p> <ul style="list-style-type: none"> • Bilateral contacts as necessary.

POSSIBLE BASIS OF DEAL WITH SWITZERLAND

Possible basis of deal	How it differs from present Swiss offer
1. Withholding tax. 15% rising to 20% in transitional period (ie as for A/L/B). <u>35% thereafter</u> . Scope equal to paying agent basis.	<ul style="list-style-type: none"> Swiss have offered 15% rising to 20% in transitional period (and in fact would apply 35% throughout the period if A/L/B did – but we shouldn't press this as exceeds Fiera). So OK. BUT Swiss have <u>not</u> offered a specific rate for <u>after</u> the transitional period. Instead they say the rate should be agreed after a review of the effectiveness of the EOI and withholding arrangements in the transitional period. We should say no review is needed: in 2011 when A/L/B move to automatic EOI, it would be equivalent for Switz to move to 35%. Some remaining issues over scope, which Commission are pursuing in their negotiations.
2. 75% revenue sharing of withholding tax (like A/L/B).	<ul style="list-style-type: none"> Some open points on Swiss offer, which Commission are pursuing.
3. Voluntary automatic EOI (like A/L/B).	<ul style="list-style-type: none"> Swiss have offered this.
4. Improved EOI on request.	<ul style="list-style-type: none"> Current offer limited to

<p>Ideally to OECD standard of on request in all (ie civil and criminal) cases, and without requirement of double incrimination. From end of transitional period, to match A/L/B move to automatic EOI (though OECD standard requires tax havens to move in 2004 on criminal and 2006 on civil).</p>	<p>criminal cases, and only where Swiss as well as requesting State definition of criminal met (so called "double incrimination"). Swiss definition of crime very restricted. OECD standard only requires requesting state definition to be met.</p>
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Notes

1. This is a bottom line. It does not preclude the possibility of securing a commitment on some further element of automatic EOI (eg for all new accounts, or an agreement that automatic EOI is the long term objective).
2. We should continue/increase pressure on the Swiss, including continuing to argue for automatic EOI, in order as a minimum to bring the Swiss up to the bottom line.
3. The deal must be subject to Germany and France agreeing not to allow A/L/B any different terms from Feira. We ought also to lock them into supporting the outcome of the Code Group (including the proposals for rollback by our DTs).
4. We have other negotiating capital on tax issues to use to help tie in the Germans and the French. The Germans want us to agree to include insurance tax in the Mutual Assistance Directive. And the French want us to support them on a reduced French VAT rate for restaurants and CDs.

RESTRICTED - POLICY



United Kingdom
Permanent Representation
To the European Union

20 November 2002

Melanie Dawes
HM Treasury

Avenue d'Auderghem 10
1040 Brussels
Telephone: (0032)(2) 287 8211
Telex: 24312
Facsimile: (0032)(2) 287 8333
Direct Line: (0032)(2) 287 8264

— Dear Melanie,

ECOFIN: 3 DECEMBER 2002

I promised a letter ahead of the 3 December ECOFIN setting out the current position, as seen from here. Obviously, this ECOFIN will be dominated by the Tax Package. But there are also important discussions on energy taxation and on the extension of the Lamfalussy procedures to Financial Supervision.

The Tax Package

2. This is clearly the most important and most difficult item for this ECOFIN. The Presidency has deliberately tabled tax as the last item on the agenda – to work late into the evening if necessary to try to secure agreement. However, we understand that in the event that agreement will not be reached at the first attempt, the Presidency are also now seriously considering an additional ECOFIN meeting – either on 10 December or (more likely) 16 December.

3. Procedurally, the Council is required:

- i) to assess, on the basis of a report, whether sufficient reassurances have been obtained from third countries (Switzerland, US, Monaco, Liechtenstein, San Marino and Andorra) that they will apply equivalent measures to that which apply in the draft Savings directive;
- ii) similarly to assess, on the basis of a report, whether sufficient reassurances have been obtained from dependent territories that they will apply the same measures;

RESTRICTED – POLICY

B





- iii) to assess a Report from the Code of Conduct Group on the results reached on the rollback of harmful business tax measures and the possible extension of benefits for some of these harmful measures beyond the end of 2005;
- iv) if agreement is reached on i), ii) and iii) then the Council, by unanimity, should:
 - a) adopt the Directive on taxation of Savings;
 - b) conclude agreements with third countries;
 - c) adopt the associated Directive on Interest and Royalties.

4. That then is the procedure. Our primary objective is:

- to secure adoption of a directive on taxation of savings consistent with the principles of the Feira deal. In particular, a directive that ensures that Luxembourg, Austria and Belgium operate automatic exchange of information (EOI) from the end of the seven year transitional period.

5. To achieve this we will need:

- i) to ensure that the Chancellor provides a report to the Council that gives complete reassurance that every one of our relevant dependent territories will adopt the same measures ie automatic EOI. That may mean that, at the Council, the Chancellor will need (as he hinted at the last ECOFIN) to signal that the UK will act through legislation to ensure that the Cayman Islands meet this obligation;
- ii) to ensure that the UK, France and Germany are, with the Presidency, speaking with one voice in arguing that the outcome of the negotiations with Switzerland and the US represent an equivalent measure for the purposes of the directive (assuming, of course, that what the Swiss eventually offer is acceptable!);
- iii) to ensure, again along with France and Germany, that the progress on the Code of Conduct on the rollback of harmful measures (including on the UK's dependent territories) has been more than enough (as part of the tax package) to allow agreement to the Savings directive. (At Feira, the draft Savings Directive and the



Code of Conduct were formally linked as a Package – agreement on the one is dependent on agreement on the other);

- iv) on this basis to ensure that the maximum pressure is placed squarely on Luxembourg, Austria and Belgium to accept that the offer from Switzerland is equivalent, and that they need to comply with the agreement they signed up to at Feira – to cease operating a withholding tax and move to automatic EOI at the end of the transition period.

6. The means by which we achieve this outcome is currently the subject of a huge amount of work.

Preparation for the Spring Council: streamlining and structural indicators

7. Both streamlining of economic policy processes and the report on structural indicators are in preparation for the Spring Economic Council. Both also overlap with the work of the Employment and Social Affairs Council (ESPHCA), and are on the agenda for ESPHCA on 3 December. With the main ECOFIN focus on tax it is unlikely that ECOFIN will discuss these two items at length, but we will need to co-ordinate carefully with colleagues on the ESPHCA side to avoid any ambushes.

8. Streamlining has already appeared twice on the ECOFIN agenda: once in October when there was no discussion at all, and again earlier this month, when it was agreed that EPC would work with the relevant ESPHCA preparatory committees to agree a Council position. It is still too soon to say if a joint report can be agreed.

9. The Commission communication on Structural Indicators came out on 16 October, and much work has been done by the EPC, and Joe Grice's subgroup. Seen from here the biggest issue is the shortlist of indicators, which the Commission is still refusing to recognise. This might provoke discussion in ECOFIN, as it did last year when the Chancellor spoke firmly in favour of the shortlist.

Financial supervision

10. The intention is to use this ECOFIN formally to endorse the extension of Lamfalussy to the financial services sector and proceed to the establishment of the various committees at level 1 (high 'political'), level 2 (advisory and comitology) and level 3 (regulatory). Some details remain to be finalised - how



the reconfigured FSPG (level 1) reports to Council and the provision of its secretariat. The final EFC report will also take into account the results of the consultation with industry. The industry responses were broadly positive but sought greater clarity about consultation mechanisms, particularly at level 2.

11. The main potential sticking point is the Parliament. The EP are discussing the extension of Lamfalussy this week at plenary. Randzio-Plath (chair of EMAC) has tabled a resolution calling for commitments from the Commission and Council to the reform of Article 202 of the Treaty to give the EP an enhanced role in the comitology process - essentially a right to veto any detailed implementing rules it considers to be outside the scope of the framework legislation. The Commission is likely to reaffirm its support for a Treaty change along these lines. The Council has taken the line that it is unable to commit Member States in advance of the 2004 IGC.

12. Depending on the outcome of the EP's deliberations, the Presidency may push for Council Conclusions that attempt to meet EP concerns but fall short of a commitment to Treaty change. If this does not do the trick, ECOFIN may have to discuss which parts of the Lamfalussy extension can proceed without the express endorsement of the EP, and move to implement these, postponing some of the other committee changes pending further discussions with the EP. The Presidency will consider how this might work, if necessary, following the EP's discussions in Strasbourg this week.

Corporate governance

13. The last ECOFIN saw a presentation of the report of the High Level Group of Experts on Company Law and Corporate Governance by the group's Chair, Jaap Winter. It is on ECOFIN's agenda again because Ministers requested that the Council should have a policy debate on the report once there had been more time for detailed analysis of its contents. The EFC has considered and asked the Commission to set out at ECOFIN the priorities on corporate governance which relate to financial services and markets. ECOFIN's discussion will feed into the Commission deliberations on the report, which will result in a Communication early next year setting out how the Commission plan to take the report's recommendations forward. This will then be followed by an Action Plan on company law and corporate governance towards the end of next year. We are seeking to ensure that the Commission do not rush into action and consult fully.



On the FSAP report and indicators

14. This item is purely procedural. It is the latest of the six-monthly reports produced by the Commission that are ticked through by the Council. The Council will also be asked to take note of the recent London Economics Study produced for the Commission. The study highlighted the potential gains for the EU economy that flow from integrated markets under the FSAP – a potential benefit at 1.1 per cent of EU GDP on €130 billion. Further work is now planned to develop indicators to measure progress toward integration. We will want to welcome the study and support further work on indicators. This work will be a priority for the reconfigured FSPG.

ECA's Annual Report

15. The European Court of Auditors' is required each November to provide the EP and Council with a report on the financial management by Commission and Member States of the EC Budget. The report also includes the Statement of Assurance concerning both the reliability of the Commission's accounts and the legality and regularity of the underlying transactions. This statement forms the beginning of the budgetary discharge procedure, under which the Commission is scrutinised for its management of the budget. For the seventh year running the ECA has not been able to give a positive Statement of Assurance for the EC budget. This is at least partly because Statement is based on a statistically small number of transactions from the EC budget, leading to a very wide margin of uncertainty.

Energy taxation

16. The Presidency will try (for the third time of asking) to reach political agreement on energy taxation. One more working group level meeting is planned for this Friday, followed next Tuesday (26th) by a high level group. The main problems remaining are French and German and our current assessment is that the two are unlikely to find agreement by (or at) ECOFIN.

17. The UK's exemption for domestic use of energy and our ability to introduce a lorry user charge appear to be secure. These have traditionally been our bottom lines throughout years of tortuous negotiation. In addition, Customs has submitted advice to the Chancellor that at Working and High Level Group we should press for an amendment that would allow Member States to set tax rates below the minimum rates for any business that has an energy efficient agreement. This is to cover a few small industries (paint spraying...) that would otherwise have a higher effective tax rate (because of a reduced discount) when



the directive comes into effect. I understand that final advice on whether to continue to push for this, at ECOFIN, will be offered after next Tuesday's High Level Group meeting.

VAT

18. Finally, there is the issue of VAT Administrative Cooperation. Germany want insurance taxes included. We want them excluded. We need to have resolved this well before the ECOFIN – we and Germany need to be as one for the hugely more important issue of the Tax Package.

19. A copy of this letter goes to Jon Cunliffe, Rebecca Lawrence and Patrick Guthrie. (I should be grateful if Patrick could circulate further in HMT.) Copies also go to Martin Donnelly (CO) and to Steve Cook (FCO).

Yours sincerely,

Peter

PETER S CURWEN



155493/02

HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

8 November 2002

Jonathan Sinclair
Private Secretary
to The Rt Hon Jack Straw MP
Secretary of State for Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
King Charles Street
LONDON
SW1A 2AH

• Head, EUD(1)

cc: PS/Baroness Amos
• EUDist

• Hd: Ecol; CNWED,

• OTD

Grateful for advice +

draft reply pto, in
co-ordination with OTD.

Jonathan

Dear Jonathan

The Chancellor has been considering how to deal with the issue of the Cayman Islands in relation to the Savings Tax Directive, and their letters of 21 October to the Council and the European Commission. As he has previously discussed and agreed with the Foreign Secretary it is vital that we are able to tell ECOFIN on 3 December that the Caymans and the other Caribbean Overseas Territories will adopt the same measures as in the draft Savings Directive.

The Chief Minister of the BVI has agreed to call a meeting of the Caribbean OTs, and Baroness Amos has asked for a response by 15 November. The Chancellor believes that, if the Caymans (or any other of the Caribbean OTs) do not give assurances within the next two weeks that they will adopt the necessary measures, they should be told that legislation, for example Orders in Council, will be adopted to ensure their compliance. Copies of this letter go to Sarah Albon PS/ Lord Irvine, Jeremy Heywood, Sir Stephen Wall and Sir Nigel Sheinwald.

Yours sincerely

WILLIAM PRICE
Private Secretary

C



RESTRICTED

14 November 2002

Mr. Crabtree
SSW
MD
MR
RB



cc Matrix

Foreign &
Commonwealth
Office

London SW1A 2AH

Dear Mark,

EU Taxation of Savings Directive: Caribbean Overseas Territories

Thank you for your letter of 8 November in which you raise the issue of ensuring that the Caribbean Overseas Territories (COTs) adopt the same measures as EU Member States to give effect to the draft Taxation of Savings Directive. You note the Chancellor's view that, should the COTs fail to do so by 22 November, they should be told that legislation would be adopted to ensure their compliance.

As you are aware, the Foreign Secretary has discussed this issue with the Chancellor and agreed the importance that, at the 3 December ECOFIN, the Chancellor can announce that the COTs will comply with the measures specified in the draft directive. Naturally, we hope that current negotiations with the COTs will result in a satisfactory and co-operative solution to this issue. Nevertheless, the Foreign Secretary has made clear to the Chancellor his willingness that legislative means should be used if the COTs fail to provide the necessary assurances that they will comply.

I note the Chancellor's desire to inform the Caymans (or other COTs) that we would proceed down a legislative route if they fail to provide sufficient reassurances on compliance by 22 November. I would strongly caution against such an action as it may precipitate the instigation of a judicial review by the Caymans, thus attracting the very attention we seek to avoid prior to the ECOFIN meeting. Therefore, if necessary, we believe any announcement of legislative action be saved for the ECOFIN discussions.

I am copying this letter go to Sarah Albon (LCO), Jeremy Heywood and Sir Stephen Wall (No 10) and Sir Nigel Sheinwald (Brussels).

Yours ever,

Jonathan

(Jonathan Sinclair)
Private Secretary

Mark Bowman Esq
PS/Chancellor of the Exchequer

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END 14/11/02

5



Ala Hunkle, OTD

Cont'd for advice and
draft reply by 13/9.

Tim Fisher
PS/Brs Amos
6/9



5th September, 2002

cc: PS/RUS

Dick W. Williams

Simon Featherstone, CVO(2)

Baroness Valerie Amos
Parliamentary Under Secretary of State
Foreign & Commonwealth Office
London SW1A 2AG

Dear Baroness Amos:

I am writing on behalf of the Chief Minister and Leader of Government Business of all the Caribbean Overseas Territories at this time to request your assistance in regard to matters of vital concern to our people.

The Partnership for Progress and Prosperity document (the "Partnership Report") heralded a new beginning for the relationship between the United Kingdom and its Overseas Territories. As you will recall Paragraphs 5.24 and 5.27 respectively provide as follows:

- 5.24 The EU is also considering a draft directive, which would require member states to operate a withholding tax on cross-border income from savings by individuals, or to provide information on savings income to other member states. It is proposed that member states should commit themselves within the framework of their constitutional arrangements to ensure equivalent measures are applied in dependent or associated territories.
- 5.27 Work in this area is at an early stage. There are still issues, including some of definition, to be resolved. Overseas Territory governments need, and are entitled to, clear guidance as to which aspects of their offshore financial industries are likely to continue to be able to flourish, and which may be subject to change. We will work closely with them as the initiatives unfold. These initiatives will require greater international cooperation through, for example, the exchange of information on tax matters and improved transparency. A study of the possible economic impact of the initiatives on some of the Overseas Territories will be undertaken to help us determine the best way forward. Our interest is to ensure that offshore financial industries in the Overseas Territories flourish, and do so on the basis of compliance with standards and practices consistent with internationally agreed norms.

(1)



Baroness Valerie Amos

Page 2

5th September, 2002

The Caribbean Overseas Territories were discouraged to learn that, shortly after the Partnership for Progress and Prosperity document was published, the United Kingdom agreed to the Feira Accord. The Feira Accord provided for substantive changes to the process outlined in the Partnership Report and increased the potential demands which would be put on the Overseas Territories, without any prior discussions with the Overseas Territories. The Feira Accord proceeded on the basis of the exemption of some Overseas Territories, with financial services sectors while including the Caribbean Overseas Territories, and failed to consider the implications for the Caribbean Overseas Territories of their inclusion while exempting many of their significant competitors in the Caribbean region and globally.

Subsequent correspondence with the Paymaster General has revealed that despite the assurances given in the Partnership Report that a thorough study of the implications of the various initiatives supported by the United Kingdom would be done, the United Kingdom has done no evaluation of the implications of these initiatives for the Overseas Territories either before or subsequent to giving support to these initiatives.

Despite the absence of the study outlined in the Partnership Report, in ongoing discussions with the Paymaster General, the Caribbean Overseas Territories have:

1. Affirmed both our willingness to participate in any truly representative global forum, which is endeavouring to establish standards for international cooperation in tax matters and our commitment to the adoption of uniform global standards for exchange of information and transparency, and the adoption of uniform implementation timetables.
2. Affirmed that our approach to the EU Tax Package is within the context of our constitutional relationship with Her Majesty's Government.
3. Affirmed that we will be guided at all times both by the need to safeguard our international competitiveness and by the need to maintain globally recognised international financial standards,
4. Affirmed that within this context, we have always indicated our willingness to participate in a constructive and inclusive international debate about the development of genuinely international standards.
5. Recognised the international commitments made by HMG, in the spirit of cooperation and partnership desire to be as cooperative as we can be without jeopardizing our current economies, opportunities for sustainable development or the latitude available for economic diversification, including within the financial services industry;

Baroness Valerie Amos

Page 3

5th September, 2002

6. Taking note of our mutual desire for a partnership for Progress and Prosperity, the EU Code of Conduct (Business Taxation) as agreed on 1 Dec 1997 and the Revised Proposal for a Directive on the Taxation of Savings as proposed by the European Commission on 18 July 2001 and further taking note of the response provided by the Paymaster General to the Chief Minister of the British Virgin Islands in the context of the Forty Questions asked in Tortola, British Virgin Islands on the occasion of the Ministerial meeting of October 2001, and further being cognizant of the potential adverse direct and indirect effects which may be occasioned by the announcement of, or implementation of, any agreement to implement the proposed measures; and
7. Confirmed that, in the event that the Conclusions of the Feira European Council and the November 2000 ECOFIN are fully implemented, and that the OTs would not be required to implement measures in advance of EU Member States and other designated jurisdictions which are materially in competition with the OTs, then the OTs are prepared to cooperate in the context of the Partnership for Progress and Prosperity with implementation of the EU Taxation of Savings Directive, this being subject to the implementation of an agreed public stance on the OTs position and the OTs being provided with alternative opportunities for the sustainable development of their economies.

The Caribbean Overseas Territories, being aware of the scope and content of the related negotiations which the European Commission intended to enter into with Switzerland and the other five independent countries named in the Feira Accord, were willing to make this confirmation relying on the United Kingdom to secure for the Caribbean Overseas Territories benefits which are the same as or equivalent to those which the United Kingdom has agreed that the European Commission could offer to non-EU jurisdictions in order to secure their implementation of the EU draft Directive on the Taxation of Savings Income. These benefits need not be secured in a manner which would undo the Feira Accord, but as in the case of negotiations with Switzerland, could be achieved by parallel negotiations assuming the United Kingdom is willing to undertake such negotiations.

We are not asking for "hand-outs". We wish to be able to build sustainable economies which are internationally competitive. We have undertaken broad consultation with our private sectors and have on that basis assessed the likely costs and damage to our economies which would result from implementation of the draft Directive. Based on this analysis, analysis published by the IMF in the context of EU Member States and published materials setting out the compensating benefits being offered by the EU to Switzerland and other independent countries, we have identified measures which will allow us to continue to survive. The range of potential compensating benefits includes:

Baroness Valerie Amos

Page 4

5th September, 2002

A) Access to UK and wider EU financial services markets, including without limitation;

1. Non-discriminatory designation of equivalence status in respect to FATF categorization and anti-money laundering mainstreaming,
2. Non-discriminatory eligibility for any financial services related designations available from the UK, eg. Recognition for the CSX,
3. Agreement from the UK to use its influence to have Caribbean OTs removed from EU States single country "Black lists",
4. Preferential protocols to rectify distortions to the trade in services which are occasioned by the non-inclusion of jurisdictions materially in competition with the OTs.

B) Institutional Capacity Building including without limitation:

1. Access to the UK regulatory database for purposes of due diligence on the same basis as the Crown Dependencies
2. Co-funding of a Brussels office for the Caribbean OTs
3. Funding for the establishment of a specialist commercial court for the OTs.

C) Training/Education and Infrastructure Enhancements to facilitate diversification, including without limitation:

1. Removal of the 3-year residence requirement in respect of domestic rates for tertiary education,
2. Funding for Professional Training programmes
3. Secondments for OT regulators and government officials

D) Comprehensive Taxation Agreements, including without limitation

1. Provisions for tax sharing/tax sparing
2. Access to the UK's Double Taxation Agreement regime

Baroness Valerie Amos

Page 5

5th September, 2002

- E) Trade Related Measures, including without limitation:**
1. Access to representation in the WTO trade negotiations
 2. Fisheries Resources Allocations and Development
- F) Funding for the Public Sector and Private Sector implementation of the requirements of the Savings Directive**
- G) Other**
1. Economic Stabilization Fund for the mitigation of socio-economic shocks to the OTs
 2. Renegotiations of European Development Fund formulation
 3. Full indexing of pensions paid from the UK to persons in the OTs
 4. Direct representation on all relevant international standard setting bodies
 5. Recognition of Data Protection equivalence for EU Data Protection Act purposes
 6. Support for E-Business development
 7. Funding for Telecommunication infrastructure development
 8. Assistance with promoting European tourism to the Caribbean Overseas Territories
 9. Commitment to reverse the process of political and economic marginalization of the Caribbean
 10. Increased role in participation in Commonwealth fora
 11. Funding of a major study of coral bleaching which is threatening the dive tourism markets in the Caribbean Overseas Territories
 12. Consultation on the appointments of governors and attorney's general
 13. Such other measures as the OTs or HMG may propose

21-NOV-2002 16:41 FROM
21-NOV-2002 17:40 FROM OTD
09/05/02 THU 19:04 FAX 1 809 49 43549

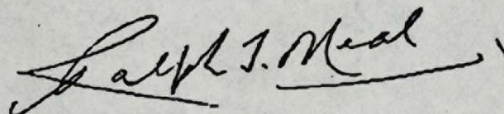
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CHIEF MINISTER & ATTORNEY

Baroness Valerie Amos
Page 6
5th September, 2002

The Caribbean Overseas Territories know that Her Majesty's Government is well aware that our economies are far less diversified than those of the six independent countries which the European Commission is currently negotiating with and that the impact of the draft Directive will be far greater on our economies than on any of the six independent countries. We are therefore confident that if the European Commission is able to secure the inclusion of the six named countries set out in the Feira Accord, you will be able to use your good offices to secure for the Caribbean Overseas Territories the benefits set out above to compensate our economies for any damage occasioned by the draft Directive on the Taxation of Savings Income. We would also be much obliged to learn of what efforts Her Majesty's Government is using to ensure that those Overseas Territories not included in the Feira Accord also support the proposed directive.

Thank you for your kind and ongoing assistance.

Yours sincerely



Ralph T. O'Neal
Chief Minister

pw: Savings
Tax.



Foreign &
Commonwealth
Office

London SW1A 2AH

From The Parliamentary Under Secretary of State

31 October 2002

Hon Ralph T O'Neal JP OBE
Chief Minister of the British Virgin Islands
Administration Complex
Road Town
Tortola
British Virgin Islands

For Steve Cook
(2320/3896)

Dear Chief Minister,

In my letter to you of 11 October I undertook to reply more fully to your letter of 5 September, in which you raised issues of concern to all the Caribbean Overseas Territories (COTs) over the implementation of the EU Taxation on Savings Directive. I regret the delay, but, as you will appreciate, your letter raised a number of issues dealt with by different UK Government Departments.

I am very grateful to you for being ready to see yesterday, and at such short notice, Treasury colleagues and the Governor. I welcome the willingness that you and your colleagues have shown to help HMG in meeting our international commitments, and I acknowledge your continuing concerns over the possible economic impact of the implementation of the Directive on your Territories.

However, as I made clear at the Overseas Territories Consultative Council (OTCC) at the end of September, we do not believe that any negative impacts would be either substantial or long-term. On the contrary, we believe that it will be a positive advantage to be able to market your financial services as some of the most transparent and best regulated in the world.

As my Ministerial colleagues and I have said on a number of previous occasions, the British Government fully recognises the importance of a level playing field. I understand that the Paymaster General underlined this when you met her in London on 27 May. Dawn Primarolo went on to say that the UK continues to push the case for automatic Exchange of Information within the G7 and the EU.

I agree that it would be unfair to expect the Overseas Territories to implement the same measures as required under the Directive in advance of EU Member States and other designated jurisdictions. I know that the Chief Secretary also made clear that he accepted this point when you saw him on 24 September in advance of the Commonwealth Finance Ministers Meeting (CFMM). But this is not what we are asking you to do.



I appreciate that you continue to be concerned about the potential economic impact of adopting the same measures as in the Directive and that you believe that implementation could have an adverse effect on the sustainability and the ability of your financial services sectors to compete internationally. With this in mind, I have reviewed your list of potential compensatory benefits. Although some of the items listed are not within the gift of the UK Government there are nevertheless a number of areas where we might be able to assist. The attachment to this letter provides further detail.

As you are aware, the UK Government attaches the utmost importance to the successful conclusion of the Tax Package by the end of 2002, in line with the timetable agreed at Feira. We need a commitment from the COTs to adopt the same measures as in the Savings Directive – namely, automatic exchange of information on the savings income of EU residents.

I was very glad to hear of your offer to gather together your Ministerial colleagues in the other Caribbean Territories. I think this will be very helpful. We do however need to have your reaction to this letter, and our comments on the compensatory measures, by 15 November. I am sorry this is a short deadline, but we need to ensure that the Chancellor of the Exchequer can confirm in early December that all relevant UK Overseas Territories will commit to the EU Tax Package by the end of the year.

Yours sincerely,

BARONESS AMOS

(Approved by the Minister and signed in her absence
by her Private Secretary, Tom Fletcher)

A) Access to UK and wider EU financial services markets, including without limitation:

- 1) Non-discriminatory designation of equivalence status in respect to FATF categorisation and anti-money laundering mainstreaming.**

Granting of equivalence status is currently dependent on whether a member country complies substantially with the FATF 40 + 8 recommendations. Whilst it is not possible to offer a general dispensation to equivalence status, the UK would be prepared to consider applications on a case-by-case basis which would take account of assessments by respected international institutions of individual territory's legislative and regulatory frameworks.

- 2) Non-discriminatory eligibility for any financial services related designations available from the UK, eg. Recognition for the CSX.**

We presume that this refers to the recognition of the exchange for the purposes of UK tax law. Consideration of this issue has been deferred.

- 3) Agreement from the UK to use its influence to have Caribbean OTs removed from the EU States single country "Black lists".**

HM Government will continue its policy of doing everything within its power, to ensure that the interests of the Caribbean OTs are taken into account when such lists are drawn-up.

- 4) Preferential protocol to rectify distortions to the trade in services which are occasioned by the non-inclusion of jurisdictions materially in competition with the OTs.**

We should welcome further clarification of this issue in order to consider it.

B) Institutional Capacity Building, including without limitation:

- 1) Access to the UK regulatory database for purposes of due diligence on the same basis as the Crown Dependencies.**

This issue was previously raised at the OT Regulators meeting in Miami on 2 November 2001. The FCO followed up with a letter in December 2001 asking Regulators to provide more details of their request. The letter also explained the need to establish what regulatory gateways were currently available in the OTs and asked for full details of OT data protection regulation. This is a requirement to ensure compliance with EU directives on data protection with respect to countries outside the European Economic Area (EEA). This issue was also raised by KPMG in the review of Financial Regulation in the Caribbean OTs and Bermuda.

It would be helpful if you could clarify the kind of information that you would like access to, in the event that existing regulator-to-regulator channels may already meet your requirements; for example the FSA Intelligence Team has already indicated that they are more than willing to provide assistance to the OTs.

Access may also be gained to the Overseas Territories Regional Crime Intelligence System (OTRCIS) to enable you to exchange information with other OT regulators.

2) Co-funding of a Brussels office for the Caribbean OTs.

HM Government is currently considering how best to strengthen support for Overseas Territories in their relations with the European Commission.

3) Funding for the establishment of a specialist commercial court for the OTs.

Before consideration can be given to the proposal more information is needed on the form of Commercial Court which the Territories have in mind. Resources and costs will vary significantly according to whether the Commercial Court would be a Circuit Court, using facilities already in existence in individual OTs, or a court specific to each OT. Alternatively, is it the intention to establish a specialist Commercial Court on one Territory that would hear commercial cases from all COTs? Or is HMG being asked only to carry out a study of possible options?

C) Training/Education and Infrastructure Enhancements to facilitate diversification, including without limitation:

1) Removal of the 3-year residence requirement in respect of domestic rates for tertiary education.

The FCO remains in touch with the Department for Education and Skills on this issue. As we made clear during the OTCC, the (three-year) residency requirement applies also to UK citizens returning after a period of living overseas. You will therefore understand the political difficulty of fulfilling a request, which would put British Citizens at a disadvantage. But we shall continue to look for imaginative ways of increasing access for British OT citizens to vocational and tertiary education.

2) Funding for Professional Training programmes.

The FCO's Good Government Fund and Economic Diversification Fund already provide financial assistance with professional training and this policy will continue.

3) Secondments for OT regulators and government officials.

Earlier this year the Overseas Territories Department, FCO was host to a BVI Government Economist on a three-month secondment, which was beneficial to both parties involved.

The FCO will continue to encourage and promote opportunities for further secondments, not only to the UK but also to Overseas Territories, within HM Government and other bodies.

D) Comprehensive Taxation Agreements, including without limitation:

- 1) Provisions for tax sharing/ tax sparing.**
- 2) Access to the UK's Double Taxation Agreement regime.**

As the Paymaster has previously commented, the UK would be willing to consider a request for a full treaty for any territories that have made commitments under the OECD's Harmful Tax Practices Initiative, and that otherwise meet the standards of fiscal transparency demanded by the UK.

Any request would be considered according to the UK's normal policy on tax treaties (outlined in paragraphs 22 and 23 of the UK's response to the 40 questions posed at Tortola).

Under present Government policy, tax sparing agreements are possible. They are considered in carefully selected cases that meet clearly defined development objectives. In recent years the policy has been that the relief is strictly time limited. Moreover, other policy objectives – that treaties should reflect a satisfactory overall balance – would apply.

It is debatable whether other States with which the UK has concluded tax treaties would be willing to extend the benefits that they give to UK residents on a bilateral basis also to residents of the Overseas Territories. OECD members might want to enter into treaties with Territories that have signed up to the OECD Harmful Tax Practices Initiative.

In relation to the specific treaty request made by Montserrat, the UK repeats its existing offer:- provided Montserrat is prepared to make the commitments requested in relation to the Savings Directive, the UK is prepared now to discuss the possibility of a new treaty.

E) Trade Related Measures, including without limitation:

- 1) Access to representation in the WTO trade negotiations.**

In order for the COTs to be represented in WTO trade negotiations the UK would need to extend its membership of the organisation to cover them. This would

require the COTs to accept that the rights and obligations flowing from the Marrakesh Agreement Establishing the World Trade Organisation should become binding on them. We suggest that the COTs consider carefully the balance of costs and benefits such action would entail. The Foreign Office and Department of Trade and Industry would be happy to provide further advice on the procedural requirements for extending the UK's WTO membership, should the COTs decide to proceed with this course of action.

2) Fisheries Resources Allocations and Development.

The FCO, working with the OTs, already provide assistance with negotiations for more quota from international fisheries bodies and this policy will continue.

We will use the resources available to us to encourage fisheries in the OTs (a strong fisheries industry is something we are keen to see in many OTs). We shall ensure that any action taken is complimentary to current DFID schemes and compliant with the various fisheries treaties to which the OTs are party (i.e., UN Fish Stock Agreement) and OT obligations under Regional Fisheries Organisations.

F) Funding for the Public Sector and Private Sector implementation of the requirements of the Savings Directive.

HMG will extend all possible assistance to the OT Governments to ensure that the Directive is introduced as painlessly and cost effectively as possible. We could also provide administrative assistance to both the Public and Private Sectors with regards to the establishment of the systems necessary for the exchange on information as per the Savings Directive.

G) Other:

1) Economic Stabilisation Fund for the mitigation of socio-economic shocks to the OTs.

This was raised at the OTCC in September 2001, shortly after the terrorist attacks of 11 September, and again at the OTCC in September 2002. The FCO and DFID jointly sponsored a study (by Oxford Analytica) into the effects of 11 September on OT economies but concluded that a Stabilisation Fund would not be appropriate.

2) Renegotiations of European Development Fund formulation.

Although HM Government has no control over the EU Commission we will explore the avenues available for the renegotiations of the European Development Fund and make recommendations to the Commission accordingly. We will in

particular ensure that the figures used for the calculation of EDF allocations for the COTs are up to date.

3) Full indexing of pensions paid from the UK to persons in the OTs.

Entitlement to indexed State Pensions is based on residence in the UK unless the UK national lives in a country with an historical reciprocal agreement on Social Security Benefits or in the European Economic Area.

We are currently defending a favourable judgement on indexing of pensions to UK pensioners living abroad in the Court of Appeal. In the circumstances it would be unwise for us to comment further.

4) Direct representation on all relevant international standard setting bodies.

Regretfully HM Government are not in a position to be able to meet this request. However, we can give an assurance that we will consult the OTs more regularly, in advance of any decisions being taken which will impact up on them.

5) Recognition of Data Protection equivalence for EU Data Protection Act purposes.

The EU Data Protection Act prohibits the transfer of personal data outside the EU to a third country unless the level of protection of personal data in that country is deemed "adequate".

If a Territory is able to demonstrate that it has data protection regimes of a similar standard to the EU's then we will try to influence the Commission to make progress in this area.

6) Support for E-Business development.

We see increased e-business development as flowing from the liberalisation of the telecommunications market which HMG is already committed to support (see 7 below).

7) Funding for Telecommunication infrastructure development.

The FCO has made available over £150,000 to support the telecommunications liberalisation process over the past 18 months and continues to provide support, most recently for the completion of tariff re-balancing studies in Anguilla and the recruitment of a telecoms regulator for the Anguillan Public Utilities Commission. British experts continue to provide ad hoc advice as required and to facilitate negotiations with Cable and Wireless on bringing to an end their monopoly on the provision of services.

8) Assistance with promoting European tourism to the Caribbean Overseas Territories.

HM Government is willing to consider specific requests for advice and assistance to the COTs on the marketing of their Territories and the best way to promote themselves to the European Tourism market.

9) Commitment to reverse the process of political and economic marginalization of the Caribbean.

HM Government remains committed to the sustainable political and economic development of the COTs and the Caribbean region as a whole. This is essentially a matter for the COTs and independent states, but we shall assist where we can, and when appropriate. Telecommunications liberalisation is an example of an area where HMG is able to support a sector which should benefit within a global economy.

10) Increased role in participation in Commonwealth fora.

We will encourage opportunities for the OTs, although not full members of the Commonwealth in their own right, to have their voices heard through inclusion in UK delegations and/or consultation in advance of major meetings and events. The most recent example of this been the CFMM preparatory meeting on 24 September, when OT representatives were able to put points of concern to the Chief Secretary, so that the UK delegation could raise them during interventions.”)

11) Funding of a major study of coral bleaching which is threatening the dive tourism markets in the Caribbean Overseas Territories.

HMG would be content to support a proposal for a study into the causes (and effects) of coral bleaching. This support might take the form of assistance with Terms of Reference for possible funding from the European Commission. At the Bonaire EU – OCT forum the Commission expressed willingness to consider environmental conservation projects, especially those that affected more than one OCT or ACP state.

12) Consultation on the appointments of governors and attorney's general.

As advised in the OTCC meeting, September 2002 HMG will consult Chief Ministers (and equivalents) approximately half way through a current Governor's tour to ascertain the particular skills and expertise that the new Governor should have. The appraisal system will be reinforced by annual visits by FCO reporting officers to each Territory. Chief Ministers (and equivalents) are free to comment on their Territory's Governors' performance, in the first instance, to the FCO Director General on the understanding of a transparency requirement.

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TO CABINET OFFICE P.10/10

13) Such other measures as the OTs or HMG may propose.

We are unable to comment on this in the absence of specific request, but the (mutual) rights and responsibilities of HMG's partnership approach to relations with the Overseas Territories are well known.

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P.10

5 November 2002

Non Paper

The Commission and the Presidency should work in close collaboration to aim for a satisfactory outcome of the coming negotiations with Switzerland. A package consisting of the following six elements could be considered to be proposed to the Swiss at a meeting between Commissioner Bolkestein, the President of the ECOFIN council and the Swiss President and Finance Minister:

- a) Withholding tax at a rate increasing to 35 per cent by 2011.
- b) Revenue sharing at a 75/25 per cent basis.
- c) Information upon request in civil cases taking effect from 2011.
- d) Grandfathering for capital, which was deposited in Swiss bank etc. on the 1 January 2003. Such capital is not subject to the obligation for exchange of information from 2011.
- e) Review clause, including a commitment from the Swiss Government to submit a proposal for automatic exchange of information with effect from 2011, subject to national democratic procedures (referendum).
- f) A commitment from the EU to engage in negotiations with Hong Kong and Singapore for equivalent measures. The adoption of the Directive, including the commitment of Switzerland to deliver information upon request in civil cases after 2010, will take place independently of these negotiations.

Various fall-back options could be considered as compromises:

- i) The grandfathering clause could take effect later than 1/1-2003, but no later than 1/1-2011.
- ii) As a supplement to the grandfathering could be considered a tax amnesty granted by the Member States.
- iii) Information upon request could be narrowed down to tax fraud cases subject to imprisonment of at least 6 months according to the laws of the requesting State, regardless of the laws of the requested State.

Period	2004-2010	From 2011
Proposal from the Commission	<ul style="list-style-type: none"> - Withholding tax - Revenue sharing - Voluntary exchange of information [fraud + evasion = OECD standard] - Review Clause 	<ul style="list-style-type: none"> - Withholding tax - Revenue sharing - Voluntary exchange of information [as before] - Exchange of information upon request
Swiss proposal	<ul style="list-style-type: none"> - Retention tax - Revenue sharing - Review clause - Exchange of information in tax fraud cases and the like - Swiss companies to be covered by the Parent Subsidiary Directive 	<ul style="list-style-type: none"> - Retention tax - Revenue sharing - Exchange of information in tax fraud cases and the like - Swiss companies to be covered by the Parent Subsidiary Directive



**COUNCIL OF
THE EUROPEAN UNION**

Santa Maria da Feira, 20 June 2000

9034/00

FISC 75

REPORT

from: Council (Ecofin)
to: European Council
Subject: Tax package

1. The Helsinki European Council on 10-11 December 1999 agreed that a High Level Working Group will provide a report to the Council with possible solutions on the issue of taxation of savings income and on the Code of Conduct and the Directive on Interest and Royalties as a package, and that the Council will report to the European Council in June 2000 at the latest.

This report is in response to that remit.

2. The Council agrees that the Directive on the taxation of savings, which will apply only to non-residents, shall be based on the following key elements:
 - a) With a view to implementing the principle, set out in the Helsinki European Council Conclusions, that all citizens resident in a Member State of the European Union should pay the tax due on all their savings income, exchange of information, on wide as basis as possible, shall be the ultimate objective of the EU in line with international developments.
 - b) Until then, Member States shall exchange information on savings income with other Member States or, subject to point d), operate a withholding tax. Member States which operate a withholding tax agree to transfer an appropriate share of their revenue to the investor's state of residence.

- c) In order to preserve the competitiveness of European financial markets, as soon as agreement has been reached by the Council on the substantial content of the Directive and before its adoption, the Presidency and the Commission shall enter into discussions immediately with the US and key third countries (Switzerland, Liechtenstein, Monaco, Andorra, San Marino) to promote the adoption of equivalent measures in those countries; at the same time the Member States concerned commit themselves to promote the adoption of the same measures in all relevant dependent or associated territories (the Channel Islands, Isle of Man, and the dependent or associated territories in the Caribbean). The Council shall be informed regularly on the progress of such discussions. Once sufficient reassurances with regard to the application of the same measures in dependent or associated territories and of equivalent measures in the named countries have been obtained, and on the basis of a report, the Council will decide on the adoption and implementation of the Directive no later than 31 December 2002, and do so by unanimity.
- d) The Commission shall report regularly on Member States' experience with the application of the systems referred to under point b) above, as well as on international developments concerning the access to bank information for tax purposes. When the Council decides on the adoption and implementation of the Directive on the basis of paragraph c), with the consequences that follow for dependent or associated territories, any Member State operating a withholding tax shall agree to implement exchange of information, as soon as conditions permit, and in any case, no later than seven years after the entry into force of the directive.
3. Work shall be pursued on this basis with a view to reaching agreement on the tax package as a whole, according to a parallel timetable for the key parts of the package (Taxation of savings, Code of Conduct (Business Taxation) and Interest and Royalties).
4. The Council further took note of the statements for the Council minutes as set out in the Annex.
-

Statements for the Council minutes

re. taxation of savings

- 1) All Member States expect a resolution to the outstanding issues below before the Council adopts the Directive.
- 2) The Representatives of the Governments of the Member States, meeting within the Council, agree that no derogation from the exchange of information requirement shall be granted in enlargement negotiations with accession countries.
- 3) The Council and the Commission commit themselves to seeking agreement on the substantial content of the Directive, including on the rate of the withholding tax, by the end of the year 2000.
- 4) The Council states that the reference to unanimity under point 2.c) is without prejudice to the outcome of the IGC.
- 5) The Council notes that Austria and Luxembourg may operate the withholding tax during the transition period. Belgium, Greece and Portugal will inform the Council of their position before the end of the year 2000.
- 6) Luxembourg considers that the "equivalent measures" as well as the "same measures" referred to in paragraph c) also include the implementation of exchange of information as foreseen in the last sentence of paragraph d).
- 7) Denmark, France, Finland, Germany, Ireland, Italy, the Netherlands, Spain, Sweden and the United Kingdom expect that the rate of the withholding tax will be at least 20-25 percent, and it is their view that exchange of information should be introduced within 5 years after the adoption of the directive.
- 8) The Austrian government accepts the OECD report "Improving Access to Bank Information for Tax Purposes" but cannot, at this stage, for constitutional reasons, accept a move to drop banking secrecy for non-residents.

As the Directive will apply only to non-residents, Austria can retain its final withholding tax for residents and its present banking legislation as far as domestic residents are concerned.

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CABINET OFFICE AD HOC MEETING, 27 SEPTEMBER 2002

EU/SWITZERLAND AND SAVINGS TAX/EXCHANGE OF INFORMATION

Present:

Martin Donnelly	CO (Chair)	Michael Richardson	FCO
David Richardson	HMT	Peter Curwen	UKREP
Clare Thorpe	HMT	Richard Crabtree	CO (Secretary)
Basil Eastwood	HMA Berne *		

The CHAIR explained that the purpose of the meeting was to consider the Government's strategy for persuading **Switzerland** to sign up to an acceptable "**equivalent measure**", and to review the latest position on parallel discussions with the US and the UK's Overseas Territories (OTs).

In discussion the following operational points were agreed:

- (i) Publicly, and with the Swiss, we should continue to stick to the line that only full automatic exchange of information (EoI) is an acceptable equivalent measure from Switzerland. However, privately, we should continue to develop our thinking on what were acceptable options for the end-game, taking account of the need for any package to be negotiable with the Swiss, including to pass their federal legislature and survive a possible referendum.
- (ii) We should stay in close touch with **EU allies**, in particular, the French, Germans and Danes (EU Presidency), as our ideas developed. Initial analysis by officials suggested that a combination of a high rate of **withholding tax** and **EoI on request** applying to both tax fraud and tax evasion could be an acceptable outcome. But the Chancellor of the Exchequer had not yet reached a definitive view.
- (iii) We should continue to pursue discussions with the Swiss **banks** in parallel with talking to the Swiss federal authorities. They may be able to agree to more detailed provisions for EoI in practice than the Swiss Government would be able to accept in a legally binding Treaty, especially if it was subject to a referendum before it could be passed into law. Since some form of agreement with

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the Swiss Government would be required, one option would be to keep this fairly broad-brush and use an implementation deal with the banks to sketch in the detail.

- (iv) **HMT** should continue to consider ways of increasing the pressure on Swiss banks with major operations in London. One option would be to invite senior representatives of the two leading Swiss banks for a meeting with a Treasury Minister. The **Bank of England**, with whom HMT were in touch separately, might also be able to play a role here.
- (v) On possible **counter-measures** it was unclear whether threatening a go slow on the other second wave EU/Switzerland negotiations would, in practice, bring the Swiss round on savings tax/EoI. The ideas on impending the free movement of capital between the EU and Switzerland that the Commission were working up would need to be scrutinised carefully. It was not clear how effective such a measure might be in practice, nor whether any advantages in increasing leverage on the Swiss would outweigh possible costs for the City. Therefore at Ecofin on 8 October it would be best to stick with serious but non-specific threats of the risks to the EU/Switzerland relationship if the latter did not co-operate on this dossier.
- (vi) We should also continue to keep up the pressure on the **French** and **Germans** to take a robust line in internal EU discussions and in their own bilateral contacts with the Swiss. **HMT** should raise this at senior official level in the margins of **Ecofin** on 8 October.
- (vii) Our aim in bilateral discussion with the **US** should be to clarify that they are prepared to make a clear **commitment** of their willingness to implement new IRS regulations, currently out to consultation, and to pass information collected under these regulations in the future to the twelve EU Member States who would be operating EoI without a transitional period. Given the differing signals emerging from UST and the White House it would be important to ensure such a commitment was on behalf of the whole Administration.
- (viii) We should continue to take all opportunities to register the high importance HMG attached to the Americans making a commitment along these lines. Since opposition to EoI was

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focussed in the White House we should ensure the message got through to them as well as UST.

- (ix) If and when the Americans made such a commitment in discussions with the UK, our **Permanent Representative to the EU** should convey this message immediately to Commissioner Bolkestein. In parallel **HMT** should advise other sympathetic Member States, notably the Germans, French and Danes (as EU Presidency). A deal of this sort with the US could be credibly presented to the Swiss as amounting to a US commitment to automatic EoI in practice, which would make their position more difficult.
- (x) If it looked as though there was a risk that the White House were prepared to block such a commitment we would need to lobby the Administration at senior level. This was best done by **HMA Washington** with Larry Lindsey (National Economic Council), Glenn Hubbard (Council of Economic Advisers) and, if possible, given the other pressures on her time currently, Condoleeza Rice (National Security Adviser). Jeremy Heywood, in his role as **UK G8 Sherpa**, could also usefully raise the point with Gary Edson (US G8 Sherpa). Treasury Special Advisers might also be able to use their contacts in the Administration.
- (xi) **HMT** should produce a one-page speaking note on a contingency basis for use on such occasions. This should be circulated as soon as possible and by **Friday 4 October** at latest, so that it was ready for immediate use if circumstances warranted it.
- (xii) Even if things went as well as could be expected with the Swiss and US we would still need to prevent **Luxembourg** and **Austria** from seeking to veto the deal on the basis that appropriate equivalent measures had not been agreed. The risk of an Austrian veto was probably greatest. **FCO** should ask B E Vienna to take all available opportunities to stress the robust UK position on the dossier.
- (xiii) Messages from the **OTs** were starting to cause concern. The Caymans in particular were seeking to apply unreasonable conditions to their previous offer to introduce the "same measures" as the EU. They were also seeking to expand the list of third countries with whom the EU had to enter into

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arrangements for "equivalent measures" before they themselves would introduce automatic EoI. This was a potential deal-breaker since it would allow Belgium, Luxembourg and Austria to seek to blame the UK for any failure to reach agreement on the dossier by the end of the year.

- (xiv) We needed to engage immediately with the OTs to make clear that this was not acceptable. FCO should invite Baroness Amos, as Minister responsible for the OTs, to write to the Paymaster General proposing the establishment of a joint FCO/HMT taskforce to consider the points raised by the OTs and to work up as a matter of urgency a strategy for getting them on board. The letter should also propose that an official from each of FCO and HMT, acting as special representatives of Baroness Amos, travel to the Caymans and possibly other OTs to explain HMG's thinking. This might need to be prepared by a call from Baroness Amos to the relevant island Prime Ministers.
- (xv) FCO should clear a draft of this letter with Ukrep and HMT and ensure it is copied to No 10 and Ukrep. It should issue as soon as possible.

**Cabinet Office
European Secretariat
October 2002**

Distribution:

Sir Stephen Wall	No 10
Jeremy Heywood	No 10
Michael Arthur	FCO
Ivan Rogers	HMT
David Richardson	HMT
Clare Thorpe	HMT
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SUBJECT: LUXEMBOURG: SAVINGS TAX

SUMMARY

1. Luxembourgers say they are ready to defend their position on savings tax. But they do not want to find themselves isolated at Copenhagen.

DETAIL

2. When I saw him on other business on 7 November, Gramegna (Economic Director, MFA) turned the conversation to savings tax. His impression from attending meetings between Juncker and other (unspecified) EU Heads of Government was that Luxembourg had never been as "ready to do battle" on any issue before. The government had gone as far as it could at Feira. Unless it was clear that the dependent territories and third countries (not only Switzerland, but also notably the US) were prepared to accept Exchange of Information (EOI) Luxembourg would argue that the "equivalent measures" condition had not been met. In that case, Juncker would echo the Chancellor of the Exchequer's line (in respect of the City) by arguing that he would not agree to anything which was against the interests of Luxembourg. Gramegna maintained that, just as the interests of the bond market in the City argued against a withholding tax, so the private banking and fund administration interests of Luxembourg argued against EOI.

3. Though he saw little prospect of this actually happening, Gramegna went on that Juncker did not want to find himself alone against 14 at Copenhagen. He would see it as particularly unreasonable if inordinate pressure was put on some countries simply because they were small. Juncker also felt strongly that, at Copenhagen, the EU should not create a precedent by putting one country's back firmly to the wall on an issue of critical importance to it.

4. In response, I said that, as the Luxembourg team would have noted at ECOFIN, the UK's commitment to EOI had not wavered. This commitment flowed from the Helsinki principle that people should pay all the tax due to the authority to which it was due, rather

PAGE 1

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than any distinction between the rival interests of bond and fund markets. It would be wrong to imagine that EOI was a particularly British hang-up. Successive ECOFINs recorded the strong views of others on the subject. I went on that we did not believe that the EU had pressed the Swiss hard enough; and that, though I was relatively unsighted on negotiations with the US, I did not have the impression that the Americans were as opposed to a substantial level of EOI as the Luxembourgers seemed to think. I added that, as the Chancellor had indicated at ECOFIN, the UK Dependent Territories would meet the Feira requirements.

5. Gramegna concluded that Luxembourg's objective would be to see the co-existence model restored and adopted as soon as possible. Unlike some members of his government, Juncker was persuaded that savings should be taxed. But he was now as convinced of the merits of a withholding tax as the Chancellor was of EOI.

COMMENT

6. Gramegna's account of the Luxembourg position is a mixture of defiance, nervousness and a plea for understanding in the run up to the Copenhagen Summit. It reinforces the view in my telno 133 that, however central the negotiations with Switzerland to the substance of Luxembourg's position (and we cannot rule out that Juncker will stand out against EOI at Copenhagen alone if necessary), his worst nightmare would be to find himself entirely isolated there. The positions adopted consistently by Austria and Belgium at ECOFIN (and no doubt in bilateral exchanges) have probably led the Luxembourgers to conclude that this scenario is unlikely. But they clearly hope that a wider group, who have supported exchange of information, but are not as fiercely opposed to a withholding tax as the UK, can be detached and won over to the coexistence camp - if only on the grounds that it offers the only real prospect of savings actually being taxed in the short term.

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