Will the City of London Accept EU Financial Supervision?

By Nicolas Veron

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The City of London, Europe's main financial hub, has benefited throughout most of the late 1990s and the 2000s from a peculiar combination of factors. It gained hugely from European financial integration, spurred by the European Union's efforts to create a single market for financial services and by a worldwide trend towards removing cross-border financial barriers. At the same time, the entire UK financial system, including the City, went largely unregulated under the "light-touch" oversight philosophy then adopted by the Financial Services Authority (FSA), the UK financial supervisor. Tax conditions were similarly lenient. The UK government and public opinion did not object, as they largely saw the City's prosperity as a boon for the entire country. And EU authorities in Brussels were generally happy to go along the deregulatory agenda to tear down national barriers within the Union.

This combination has been swept away by the financial crisis. The UK political consensus shifted sharply towards blaming bankers for the current economic hardship. The heads of the FSA and of the Bank of England have become leading voices in global calls to restrict the business models of financial firms, and the Independent Commission on Banking, set up by the Cameron government, may propose measures along such lines in its final report later this year. Meanwhile, a ruthless drive towards fiscal consolidation increases pressure to turn the tax screws on the City and all the wealthy individuals that surround it.

Simultaneously the UK is impacted by changes across the Channel. The EU has entered its own cycle of re-regulation. Three new European Supervisory Authorities (ESAs) have started operations on January 1, and are likely to affect London's regulatory environment more directly than anything coming from the Continent before the crisis – including the European Securities and Markets Authority (ESMA) in Paris and the European Banking Authority (EBA) in London. They are tasked with creating a "single rulebook" that would harmonize financial rules further than the existing European directives. They would also directly supervise some market participants, such as rating agencies in the case of ESMA.

Britain endorsed this reform at a crucial summit in June 2009, when memories of the Icelandic crisis were fresh and there was a pervasive fear of its being left isolated in the cold. But now many in London seem to have second thoughts. An interesting parallel may emerge. In the early 1990s, Germany agreed to delegate its monetary policy as the price for the creation of the euro and the corresponding strengthening of the EU single market. But the current crisis has forced the European Central Bank, despite its Frankfurt location, to cease acting as a Bundesbank writ large. The reactions in Germany, including the recent saga of Axel Weber's resignation, have illustrated how sensitive the loss of monetary sovereignty remains there. Similarly, the UK accepted the ESAs for the sake of EU financial integration, but may not be fully prepared for the consequences.

The City's worst fear is to see its gatekeeper position bypassed in what remains the world's most important transcontinental financial relationship, between the US and Europe. From this standpoint, a fight over the ESAs could prove a much bigger threat than, say, the merger between Deutsche Börse and NYSE Euronext. At this point the new agencies are small and fledgling. Their governance framework, which gives equal weight to all EU members, will probably lead to some dysfunction. The current stress-test process may dent the EBA's credibility early on. But the ESAs are almost sure to grow over time. Large US financial firms will back their efforts to fight financial protectionism on the continent. The inevitable frictions with London will mean much more than ordinary turf wars.

Of course, much larger challenges loom ahead for London's EU policy. In the euro crisis, the UK currently behaves – unlike, say, Sweden or Poland – as if it could remain unaffected by the consequences of new economic governance arrangements. This is implausible. For better or worse, the UK will not stay out of what is likely to become a major overhaul of the EU institutions in which the single currency is embedded. But the corresponding developments may take some time to unfold. For any British politician facing euroskeptical electors, hiding one's head in the sand is the easiest approach in the short term.

In the meantime, controversies over the ESAs' powers will remain a focal point of the UK's relationship with its European neighborhood. The pre-crisis conditions, in which the City developed pan-European activity in the absence of pan-European supervision, were unsustainable and cannot be expected to return. But many City players are still unwilling to recognize the new state of affairs. The near-total absence of debate about the EU in Britain these days should be a concern not only to Brussels, but to London as well.

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