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COVER NOTE

From:	Thomas Wieser, President of EFC
date of receipt:	27 April 2016
To:	Jeroen Dijsselbloem, President of the ECOFIN Council
Subject:	2015 EFC Report to the Commission and the Council on "The Movement of Capital and the Freedom of Payments's

Delegations will find attached 2015 EFC Report to the Commission and the Council on "The Movement of Capital and the Freedom of Payments".

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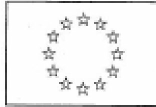

ECONOMIC AND FINANCIAL COMMITTEE

THE PRESIDENT

Brussels, 18 April 2016

Ares(2016)1831373

Mr Jeroen Dijsselbloem
President of the ECOFIN Council
Wetstraat 147
B - 1048 Brussel

Concerns: 2015 EFC Report to the Commission and the Council on "The Movement of Capital and the Freedom of Payments"

Dear Mr President,

Under Article 134 (2) of the EC Treaty, the Economic and Financial Committee (EFC) is mandated, amongst other things, to: "*examine, at least once a year, the situation regarding the movement of capital and the freedom of payments, as they result from the application of this Treaty and of measures adopted by the Council; the examination shall cover all measures relating to capital movements and payments; the Committee shall report to the Commission and to the Council on the outcome of this examination.*"

Accordingly, I hereby provide you with the annual EFC Report for 2015. As in the past, the Report reviews the state of affairs with respect to capital flows, the Commission's enforcement actions and new policy initiatives, as well as action taken in the fight against terrorist financing, money laundering and market abuse.

The Report highlights that the recovery of capital flows in the EU in the period 2014-15 has been weaker than in other world regions and, by looking at the overall level of cross-border capital flows, there is still less financial integration between EU countries than there was before the crisis. Also capital markets in most European countries are still relatively underdeveloped and fragmented when compared to the US. The free movement of capital, as a key principle of the single market, must be upheld and it is essential to ensure that this fundamental freedom is not unduly hampered and continue to support the work to that end. In this regard, we note that a

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number of restrictions remain in place in the EU, of which some but not all are linked to the crisis and are justified, proportionate and limited in time.

The Investment Plan and the Capital Markets Union aim to unlock the substantial savings held in the EU and help channel these towards productive investment. In January 2015, the EFC underscored the importance of the removing unjustified barriers to the free movement of capital, and welcomed the initiative of the Commission to set up an Expert group to address this issue alongside the Capital Markets Union. The EFC has also carried forward its work on the third pillar of the Investment plan with a review of several investment bottlenecks, in particular insolvency frameworks. First policy conclusions are planned for June 2016.

Whilst Member States continue to hold divergent legal views on the compatibility of intra-EU Bilateral Investment Treaties with EU law, and the number of investor-to-State arbitrations initiated against Member States on the basis of intra-EU BITs is growing, the EFC welcomes the efforts of the Commission towards an efficient and pragmatic solution for the settlement of disputes between investors and states, compatible with EU law.

As in previous years, the EFC is grateful for the high quality assessments prepared by the Commission services, which greatly benefited our annual examination. In view of the objectives of the Capital Markets Union, the EFC has invited the Commission to take a forceful approach in respect of unjustified barriers to the free movement of capital.

I have also written in similar terms to the President of the European Commission.

Yours sincerely,

Thomas Wieser
EFC Chairman

Attachment:

Annual Report to the Commission and the Council on the Movement of Capital and Freedom of Payments (8 April 2016, Ares(2016)1831029)

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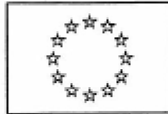

ECONOMIC AND FINANCIAL COMMITTEE

SECRETARIAT

8 April 2016

Ares(2016)1831029

Annual EFC Report to the Commission and the Council on the Movement of Capital and the Freedom of Payments

INTRODUCTION

Under Article 134(2) of the Treaty on the Functioning of the European Union (TFEU), the Economic and Financial Committee (EFC) is called upon *"to examine, at least once a year, the situation regarding the movement of capital and the freedom of payments, as they result from the application of this Treaty and of measures adopted by the Council; the examination shall cover all measures relating to capital movements and payments; the Committee shall report to the Commission and to the Council on the outcome of this examination."*

Based on the Commission's examination, the EFC in its 18th Report assesses key developments in global and EU capital markets in 2014-2015, including the implications of the crisis on cross-border capital flows and the free movement of capital. This note covers the assessment of enforcement actions and policy initiatives undertaken to enhance capital movements and underlines the role of international dialogues in promoting cooperation.

1. GENERAL DEVELOPMENTS

In 2014-15, global capital flows have considerably recovered. Yet, net capital flows remained lower in the EU than in non-European emerging and developing countries and, to a lesser extent, in some other advanced economies. Some improvement was nevertheless discernible in the first half of 2015 and in the first three quarters of 2015 taken cumulatively, the net financial account balance for the EU showed a 'net inflows' position.

By looking at the overall level of cross-border capital flows, there is still less financial integration between EU countries than was the case before the crisis, and therefore the allocation of available funds across Europe continues to be a major challenge. This

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economic context strengthens the need for prompt implementation of the Investment Plan for Europe, which should be based on effective free movement of capital and freedom of payments, underpinning a well-functioning single market for capital. Its success in mobilising investment finance without crowding out private investment will also depend on Europe's capacity to remove remaining barriers to investment.

A number of regulatory and non-regulatory barriers remain across all the major infrastructure sectors, including energy, information, communication technology, transport, and across the single market in services. The EFC in January 2015 underscored the importance of the removal of barriers and welcomed the initiative of the Commission to set up an Expert group on unjustified national barriers to free movement of capital alongside the Capital Markets Union. The EFC has also carried forward its work on the third pillar of the Investment plan with a review of several investment bottlenecks, in particular insolvency framework; first policy conclusions will follow in June 2016.

The EFC agrees that it is essential to ensure that the free movement of capital is not hampered and effectively underpins the objective of the capital markets union initiative to build truly integrated, open, competitive and efficient European financial markets.

2. RECENT TRENDS IN CAPITAL FLOWS

Against a backdrop of declining oil prices, accommodative monetary policy and a relative weakening of the euro against other international currencies, the economic recovery in 2015 has been resilient and widespread, albeit moderate in most Member States. As a consequence, the recovery in capital flows has been weaker in the EU than in other world regions.

Net capital outflows have gradually been reduced since early 2014, and the EU even became a net importer of capital in the first and second quarter of 2015 in a context where EMDEs experienced their first net outflows in nearly three decades. Euro area banks slowed the pace of their expansion of holdings and FDI abroad. At the same time, portfolio investment in the euro area became less attractive to foreign investors.

The deleveraging process seems to have stalled for euro area banks after a significant adjustment in 2008-2013. FDI and portfolio flows have in part been compensating for the decrease in cross-border banking flows which points to the importance of complementing the largely bank based nature of finance in Europe with a capital markets union. Cross-

border portfolio investment is still less important than before the crisis and market liquidity has been declining recently in several important market segments, especially corporate debt, despite the increase in portfolio flows in the EU and globally, creating a risk of sharp reversals if some downside risks materialise.

The downturn in EU FDI, for a third consecutive year, has been characterised by declining intra-EU FDI flows and extra-EU FDI inflows exceeding intra-EU FDI inflows in some quarters, mostly due to a subdued economic recovery and slow economic growth that weighs on international investment. For the moment there seem to be no signs that intra-EU FDI might start increasing again and overtaking extra-EU FDI inflows, as in the pre-crisis period.

In 2014 European companies increased their outward greenfield investment, with the core euro area recording the greatest rise. The average deal value for mergers and acquisitions increased sharply in 2015 to well above the 2007 peak of EUR 87 million, as the number of deals was declining or not increasing as fast as the value of deals. The volume of cross-border inbound deals grew faster than that of domestic deals in both 2014 and 2015.

Looking forward, the following factors are likely to impact capital flows, in addition to geopolitical tensions:

- Divergence between EU/Japan Quantitative Easing and US monetary policy normalisation are likely to continue influencing capital flow movements.
- Growth patterns and adjustments in emerging economies might be further accelerated by changing monetary policy conditions and in turn impact capital flows in and out of those regions.
- Sharp adjustments in commodity prices might trigger shifts in economic growth and trade patterns that could in turn affect cross-border lending and investment.
- Cross-border bank deleveraging is expected to continue weighing on international financial integration in Europe, despite some signs of its slowing down.
- Declining market liquidity in a number of market segments, especially corporate debt, increases the probability of a sharper adjustment if some of the downside risks materialise.

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3. LEGAL FRAMEWORK FOR THE FREE MOVEMENT OF CAPITAL AND PAYMENTS

The free movement of capital is fundamental to the single market. The TFEU allows capital movements to be restricted only under specific conditions, including national measures to prevent infringements of national laws, regulations on taxation and prudential supervision of financial institutions, and measures justified on grounds of public policy or public security (Article 65 1(b)). Measures may also be justified by other overriding reasons in the general interest, as recognised by the Court of Justice. All measures must be suitable and proportionate.

At national level, a growing number of Member States have also set up mechanisms to review investment in order to safeguard public security or public policy interests, and/or exercise special powers over companies operating in strategic sectors. Any measure affecting cross-border investment must fully comply with the rules on free movement of capital to avoid making the EU less attractive as an investment destination.

There is no secondary EU legislation harmonising the general rules on free movement of capital. The policy is therefore mainly enforced by monitoring developments in Member States and their application of the principles across the economy.

Whilst most unjustified barriers to capital movements are solved through dialogue, in some cases formal infringement proceedings are launched to safeguard the integrity of the single market for capital. During the reporting period, the Commission closed three infringement cases and opened eleven new infringement cases, five on laws regulating the acquisition of agricultural land and six on intra-EU bilateral investment treaties between Member States. The Commission adopted a reasoned opinion in a case relating to usufruct rights for agricultural land in Hungary.

In the direct taxation area, the Commission launched one new infringement proceeding in 2015. Eleven proceedings were closed after Member States amended the relevant legislation. The Commission also brought a case to the Court of Justice against Greece because of a difference in the treatment of residents and non-residents regarding tax on the first immovable property acquired by inheritance.

4. Main developments supporting the free movement of capital and freedom of payments

Eliminating barriers to cross-border investments

Capital markets in most European countries are still relatively underdeveloped and fragmented when compared to the US. The Action plan on building a capital markets union (CMU) of 30 September 2015 aims to complement Europe's strong tradition of bank financing by unlocking more investment, better connecting financing to investment projects, making the financial system more stable, deepening financial integration and increasing competition.

Eliminating unjustified barriers to the free movement of capital within the EU is essential to build a genuine CMU and increase cross-border investment in Europe. The work ongoing with Member States will continue in the course of 2016 and the Commission is expected to present in the fourth quarter 2016 a report listing the major barriers that can be eliminated proactively by Member States and a roadmap to tackle them.

Several previous EFC reports referred to the issue of intra-EU BITs and the need for a pragmatic and efficient solution for the settlement of disputes between investors and states, compatible with EU law. The Commission has notified the concerned Member States that it considers intra-EU BITs to infringe EU law inter alia by violating the EU rules on free movement of capital, notably by keeping the legal framework for treatment of investment in the single market fragmented. Some Member States have taken action to terminate them. In June 2015 the Commission entered the first stage of infringement proceedings against five Member States and launched an administrative dialogue with the remaining 21 Member States who still have intra-EU BITs in place. On 1 October 2015, the Commission services met with representatives of all Member States to discuss possible solutions to this issue.

Developments in retail financial markets

Despite significant progress in recent years, the EU market for retail financial services and insurance is still fragmented. The Commission issued a Green Paper on retail financial services on 10 December 2015 for an open public consultation until 18 March 2016 with all stakeholders to evaluate how the opportunities from innovation can be optimally used and products from other Member States can receive more trust.

The revised Payments Services Directive (PSD2), adopted in November 2015, aims to better serve the needs of an effective European payments market with a legal and supervisory framework for emerging actors in the payment market, improved security requirements for initiating and processing electronic payments and the protection of consumers' financial data. Furthermore, it widens the scope of the previous directive to include transactions with non-EU countries where only one of the payment service providers is located within the EU ('one-leg transactions'). The Interchange Fee Regulation was adopted by the Council on 20 April 2015 and introduced maximum levels for interchange fees for transactions based on consumer debit and credit cards.

Tax barriers

Aggressive tax-planning by multinationals has been addressed by the Anti-Tax Avoidance Package of 28 January 2016 and the Directive 2014/107/EU, thereby avoiding the resurgence of barriers resulting from the tax-avoiding behaviour of certain companies. The Commission has, in the meantime, finalised technical negotiations with Liechtenstein, Switzerland, Monaco, Andorra and San Marino to align their existing savings taxation agreements with the EU with the OECD Global Standard.

Capital controls

Capital controls are one of the most serious exceptions to the free movement of capital principle when needed to prevent disorderly outflows from causing a financial and economic meltdown. The restrictions imposed in Iceland, Cyprus and Greece are recent examples. In line with the temporary nature of this exception and based on a roadmap adopted in August 2013, the Cypriot authorities gradually relaxed capital controls introduced in March 2013, which finally expired at the end of March 2015. Since then, deposits have remained stable and even increased slightly at the aggregate level, despite short-lived instability related to the worsened situation in Greece in the summer.

In Greece, capital controls were decided by the national authorities on 28 June 2015. The Commission judged the temporary restrictions justified by the need to ensure the stability of the financial and banking system in Greece. Since then, the Greek authorities adopted a number of measures to adjust and alleviate existing capital controls, in particular, (1) cash not withdrawn daily under the initial EUR 60 ceiling can now be withdrawn cumulatively up to the amount of EUR 420 per week; (2) under the central Banking transactions approval committee (BTAC), subcommittees within financial institutions

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can now approve businesses' requests for transfers and payments abroad of up to EUR 150000 per day per client in order to facilitate the import and export of goods and services; (3) a series of adjustments for natural persons have been introduced, such as increasing the exemption for students living abroad to EUR 8,000 per quarter. The EFC welcomes the alleviation of capital control as appropriate and invites the Commission to continue assessing the suitability and proportionality of these measures, taking into account the liquidity and solvency of the banks, in line with the MoU between Greece and the European Commission (acting for the ESM) of 19 August 2015.

Foreign currency loans

Lending in foreign currencies to unhedged borrowers has proven to bear considerable risk in the aftermath of the financial crisis as currency fluctuations can hit borrowers hard and can cause significant systemic risks in countries with extensive foreign exchange lending. In several Member States (RO, PL, HR) where Swiss franc loans were very popular until the beginning of 2008, the sharp Swiss franc appreciation has made these loans significantly more expensive to repay and has resulted in the introduction of new measures which need to be assessed in view of their compatibility with EU law.

Since the appreciation of the CHF, Croatia granted all borrowers the possibility to convert Swiss franc loans into euro loans at historical exchange rates, at a cost of an estimated EUR 1.05 billion (2.44 % of GDP) before tax, to be borne almost exclusively by mostly foreign-owned credit institutions. The Commission services are assessing the Croatian law on its compliance with the Treaty, in particular in light of proportionality.

Whilst in Romania, discussions on solutions to possible concerns regarding Swiss franc loans are ongoing, a Polish law setting up a 'Mortgage assistance fund' was adopted to serve indebted borrowers in financial difficulty.

At EU level, directive 2014/17/EU on credit agreements for consumers relating to residential immovable property - which obliges Member States either to grant consumers a right to convert their foreign currency loan to an alternative currency under specified conditions or to put in place other arrangements to reduce the foreign currency risk - has to be implemented by the Member States by 21 March 2016 and is only applicable to loan agreements concluded after that date. The EFC will continue to monitor these developments on the basis of a regular reporting by the Commission. Measures to address issues raised by legacy stocks of foreign currency loans should give due

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consideration to fair burden-sharing among all stakeholders, which would also help to avoid moral hazard in the future.

Investments in real estate & agriculture

In order to avoid sudden disturbances in land markets, specific derogations from the right to acquire, use or dispose of real estate on the territory of another Member State have been granted to Denmark, Finland, and Malta (secondary residences) and Poland and Croatia (agricultural land; until 30 April 2016 and 30 June 2020 respectively). All other temporary derogations granted on the acquisition of secondary residences and agricultural real estate have expired.

In the period under consideration, the Commission assessed whether the national legislation regulating the acquisition of agricultural and forestry land adopted by five Member States (Bulgaria, Hungary, Lithuania, Slovakia and Latvia) restricts the rights of cross-border investors in a way that breaches EU law on the free movement of capital and freedom of establishment . The Commission sent letters of formal notice to these five Member States. The Commission also requested Hungary to take the necessary measures to comply with EU rules on the rights of cross-border investors to use agricultural land with respect to a law terminating, as from 1 May 2014, certain usufruct rights.

Cross border banking services

In 2014 and 2015, one third of EU countries introduced systemic risk buffers or similar measures. The use of such macro-prudential measures by the Member States has not given rise to major issues in relation to the free movement of capital. However, the European Commission continuously monitors the use of macro-prudential measures and their compatibility with the free movement of capital, especially in respect of restrictions in foreign currency lending.

Since the ESRB and the macro-prudential toolset of the CRD IV/CRR pre-date the banking union, the framework for macro-prudential surveillance became more complex. In light of recent developments and concerns expressed by stakeholders, Commission services have started a comprehensive revision of the EU macro-prudential framework for the coming years. The objective is to combine an effective governance structure with streamlined policy measures that achieve an appropriate balance between national flexibility to address country-specific risks and the smooth functioning of the single market.

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A number of national measures with the effect of ring-fencing bank assets have been taken between 2008 and 2013 in response to the economic and financial crisis. These included measures limiting intragroup exposure, prohibiting intragroup flows of liquidity or capital, or prohibiting the distribution of profits to the parent company. The Single Rule Book should reduce the incentives for ring-fencing measures.

Furthermore, in October 2014 the Commission adopted a Delegated Act (DA) to introduce detailed and harmonised liquidity coverage requirements (LCR) in the EU to promote mutual supervisory confidence between competent authorities and to limit any practices that trap liquidity within national borders. From the date of application of the LCR DA, the supervision of liquidity risk in EU bank branches is the responsibility of the home supervisor and no longer of the host supervisor. Thereby, branches in a host country no longer have to comply with the host country's liquidity rules. A report[1] of the Commission concluded that the LCR DA allows for a preferential treatment for certain outflows and inflows in a group context, which should also facilitate more efficient liquidity management in a group.

5. EU CONTRIBUTION TO GLOBAL DEVELOPMENTS ON CAPITAL MOVEMENTS AND PAYMENTS

In the period, negotiations on free trade agreements with investment protection rules were concluded with Vietnam in December 2015 whilst negotiations are ongoing with Japan, the US, China, Morocco, Myanmar, and Tunisia. The Commission has received authorisations from the Council to start a similar process with Egypt and Jordan, but these negotiations have not yet started.

In order to address the concerns raised over the approach to investment in the TTIP and over the ISDS in particular, the Commission presented a proposal for a new negotiation text in September 2015. The aim is to safeguard the EU's and Member States' right to regulate and to set up a new investment court system composed of qualified judges and including an appeal tribunal. The new negotiation text will become part of the EU's proposal to the US.

[1] COM(2014)327/F1, Report from the Commission to the European Parliament and the Council, *Legal obstacles to the free movement of funds between institutions within a single liquidity sub-group.* http://ec.europa.eu/transparency/regdoc/rep/1/2014/EN/1-2014-327-EN-F1-1.Pdf

In February 2016 an agreement was reached with Canada to include the new approach on investment protection and investment dispute settlement in the EU-Canada Comprehensive Economic and Trade Agreement ('CETA'). The EFC will continue to monitor these issues as appropriate on the basis of a reporting by the Commission.

In 2015, the Commission actively participated to the discussion on the terms of reference for the review of the OECD Code of Liberalisation of Capital Movements, to take place in 2016. The OECD also adopted new recommendations on principles of corporate governance and on guidelines on corporate governance SOEs which are intended to help policymakers evaluate and improve the framework for corporate governance.

Answering the calls of the JHA Council and of the ECOFIN Council, the Commission adopted an Action Plan to strengthen the fight against the financing of terrorism. The EFC strongly supports this work and recalls that combatting terrorist financing should focus, among others, on enhanced cooperation and information exchange, appropriate regulation of payment methods, effective freezing of terrorist assets, targeted financial sanctions, and full implementation of the Financial Action Task Force (FATF) standards and UN Resolutions.

As an observer in the seventh annual meeting of the International Forum of Sovereign Wealth Funds (IFSWF), the Commission presented the Investment Plan for Europe and discussed the relationship between SWFs and external asset managers and the importance of SWFs as countercyclical and responsible institutional investors that can help to close the investment gap in the EU. The EFC follows this with interest.

Restrictive measures including asset-freezing and embargoes are essential tools of Common foreign and security policy. In Iran, the Joint Comprehensive Plan of Action has suspended a number of EU sanctions while in Russia, the restrictive measure aiming to cut off strategic state-owned Russian companies from EU and international financing sources remain. The European Council linked the lifting of EU sanctions to the implementation of the Minsk peace agreements and prolonged sanctions against Russia until 31 July 2016, before which time the Council will review the situation in Ukraine.

CONCLUSION

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The recovery of capital flows in the EU is still weaker than in other world regions and by looking at the overall level of cross-border capital flows, there is still less financial integration between EU countries than there was before the crisis. This economic context strengthens the need for prompt implementation of the Investment Plan for Europe, which should be based on effective free movement of capital and freedom of payments, underpinning a well-functioning single market for capital.

Flagship policies such as the Capital Markets Union aim to unlock the substantial savings held in the EU and help channel these towards productive investment. The Green Paper on retail financial services launched a consultation process that should lead to a stronger single market for consumers and for payments, as should the adoption of the legislative package for an EU-wide market for electronic payments.

A range of new legislation is being introduced that will promote responsible lending practices, reinforce freedom of payments, improve security for payments, fight aggressive tax-planning, and protect borrowers against foreign currency risk.

The EFC supports further developing these policies, in line with relevant Council conclusions, notably on the CMU and the Investment Plan. The fragmentation of the Single Market as a place for investment and the need to boost cross-border investments call for a more stable, transparent and predictable framework for investors. This could contribute to building confidence and enhancing the attractiveness of the EU Single Market as a place to invest for the long term.

The EFC considers that the free movement of capital, as a key principle of the single market, must be upheld, recalls the importance of tackling unjustified barriers to the free movement of capital as a matter of urgency, and continues to support the work to achieve this goal.