

EPFSF Briefing “Supervisory Architecture”

Summary

The financial crisis revealed the limits and weaknesses of the organisation along national lines of regulation and supervision of an increasingly globalised financial market. Furthermore, too little attention was paid to threats to financial stability and to the interplay between financial stability and the supervision of individual firms.

Building on the *de Larosière* report, the European Commission proposed to revise the architecture of micro and macro-prudential supervision in the EU and put forward a ‘supervisory package’. This includes the establishment of (i) a European System of Financial Supervisors (ESFS), consisting of a network of national supervisors, who would remain in charge of day-to-day supervision, working in tandem with three new European Supervisory Authorities (ESAs), responsible for ensuring even-handed implementation of EU rules and supervisory consistency across the EU; and (ii) a European Systemic Risk Board (ESRB) to identify, monitor and act upon any build-up in risks to the system within the EU. In addition, the package contains a proposal for an ‘Omnibus Directive’, with changes to sectoral financial services legislation, conferring powers to the ESAs and aiming at a single rule book.

While there is broad support for the new architecture, the Ecofin Council has proposed substantial modifications to the micro-prudential proposals by limiting the powers of the ESAs at the EU level. The debate in the European Parliament is ongoing, but MEPs have already expressed clear support for the Commission’s original proposals and, in some cases, go further.

Introduction

The financial crisis has highlighted weaknesses in the global and EU framework for financial supervision. Supervision of cross-border financial institutions was organised along national lines, although substantial progress had been achieved in financial-market integration. Given the increased importance of cross-border business, colleges had been developed for a number of groups to foster international regulatory coordination, and in the EU the Lamfalussy process had improved supervisory convergence. But insufficient attention was paid to the consequential and growing risk to the financial system at the macro level - and there was insufficient interaction between both levels of supervision. Furthermore, it was concluded that more integrated financial markets would reinforce shock absorption, which underlined a need for developing existing EU legislation into a more consistent single rule book and ensuring its uniform application.

As a result, and with the aim of restoring and maintaining a stable and reliable financial system within the EU, the European Commission, building on the February 2009 recommendations of the High-Level Group on Financial Supervision in the EU (the *de Larosière* Group), proposed in September 2009 a ‘supervisory package’ consisting of a European System of Financial Supervisors and a European Systemic Risk Board, described in the following sections.

For the proposed EU supervisory package to function in practice, a number of general issues require close attention of all stakeholders, i.a.

- The tensions that could arise between national supervisory authorities’ competences for day-to-day supervision and the powers of the ESAs to ensure horizontal and vertical consistency in supervisory practices;
- The size of the ESRB and the predominance of members with a banking perspective;
- The cost burden of supporting the new infrastructure, which, notably, comes on top of the major increase in resources of national supervisors;
- The lack of clarity surrounding the individual responsibilities and discretions of member states and those of the EU institutions (e.g. subsidiarity).

European System of Financial Supervisors

A European System of Financial Supervisors (ESFS) is proposed, consisting of a network of national financial supervisors working in tandem with three new European Supervisory Authorities (ESAs), which are transformations of the current Level 3 Committees (CEBS, CEIOPS and CESR). This set-up combines the expertise of local micro-prudential supervisory bodies, that are closest to the institutions operating in their jurisdictions and that remain in charge of day-to-day supervision, with the advantages of an overarching European framework which can ensure consistency in supervisory practices.

The main tasks of the three ESAs -laid down in separate but largely identical proposals for Regulations establishing the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)- are to develop common rules, to ensure consistent application of EU law, to act in emergency situations, to oversee supervisory colleges, to undertake certain direct licensing and supervisory functions for entities or economic activities with Community-wide reach and to settle disagreements between national supervisors. Other tasks include the assessment of market developments, the collection of information and, not least important with increasingly globalised financial markets, to take on a clearer international role.

In line with the European Council's support for a single rule book applicable to all financial institutions in the EU, the ESAs are to be empowered to propose technical standards, which become binding upon endorsement of the Commission. Such technical standards must not involve policy choices and their content is tightly framed by level 1 legislation.

To ensure that the single rule book, once introduced, is interpreted and implemented consistently, the ESAs will be able to investigate alleged incorrect applications of EU law by national supervisors and recommend action to them to comply. If this is not effective, the European Commission may intervene. If the national supervisor still does not comply, the ESAs may adopt an individual decision addressed to a financial institution if the relevant rule is directly applicable to financial institutions. The principle of equality requires that any correction of incorrect application of EU law by a national supervisor is applied, like the EU rule itself, to all financial institutions under the supervision of that supervisor.

It is proposed that the ESAs contribute, as they do with regard to prudential supervision, to the effectiveness and consistency of crisis management. In case of adverse developments jeopardising financial markets or financial stability, the ESAs will coordinate between supervisors. If the Commission has declared an emergency situation, the ESAs may furthermore require supervisors to take the necessary action. If the national supervisor does not comply with that requirement, the ESAs may then adopt an individual decision addressed to a financial institution if the relevant rule is directly applicable to financial institutions.

Where level 1 legislation requires cooperation, coordination or joint decision making, it is proposed that the ESAs may assist national supervisors in reaching agreement. If this is unsuccessful, the ESAs may settle the matter and require specific action. If the national supervisor does not comply with that requirement, the ESAs may then adopt an individual decision addressed to a financial institution if the relevant rule is directly applicable to financial institutions. Care must be taken that the dispute settlement process does not reduce the progress already made in the level 1 legislation towards effective consolidated supervision.

As demanded by the European Council, a safeguard clause is introduced, which holds that no ESA decision concerning action in emergency situations or settlement of disagreements may impinge on the fiscal responsibilities of Member States. It is important to reconcile the effectiveness and consistency of the proposed supervisory framework with a clearly defined scope for the safeguard clause.

To accommodate the necessary amendments to existing legislation in light of the ESA proposals, especially as regards technical standards, dispute settlement and sharing of micro-prudential information, the Commission in October 2009 also proposed one so-called Omnibus Directive (I). A second such directive (Omnibus II) is envisaged, as well as a revision of the Credit Rating Agencies Regulation to provide for direct supervision by ESMA but neither has yet been put forward.

European Systemic Risk Board

A European Systemic Risk Board (ESRB) is proposed to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole.

The ESRB will be responsible for the macro-prudential oversight of the EU financial system, covering all financial institutions, financial markets and financial market infrastructures. In case of system-wide risks that are building up, the ESRB will provide early warnings and, where necessary, issue recommendations for action to deal with these risks.

The effectiveness of the framework to ensure financial stability will depend on the follow-up of the warnings and recommendations of the ESRB, which are coupled with a “comply or explain” mechanism. It is required that the staffing and functioning of the ESRB give it the necessary moral authority for its warnings and recommendations to be implemented.

As the macro-prudential framework covers the EU financial system as a whole, all financial sectors should be adequately represented.

As interaction between the micro and macro levels of supervision is crucial, the various proposals require the ESRB and the ESAs to cooperate, in particular through mutual sharing of information. It is proposed that the ESRB and the ESAs should receive the information they need to effectively fulfil their mandate of, respectively, macro and micro-prudential supervision, with all due respect for confidentiality requirements and avoiding additional layers of supervisory or reporting requirements for financial institutions. More concretely, the ESRB should in principle be able to fulfil its tasks on the basis of information in summary or collective form, delivered through the ESAs.

Co-decision procedure

In October 2009, the Ecofin Council largely supported the Commission’s ESRB proposal.

In December 2009, the Ecofin adopted a political agreement on the ESFS which substantially modified the Commission’s proposal. An important amendment concerns the limitation of the powers of the ESAs to take decisions directed at individual financial institutions, which would only remain possible in case of breach of EU law. In addition, it would be the role of the Council, not the Commission, to decide on the existence of emergency situations. Furthermore, an additional recourse for Member States to challenge ESA decisions is introduced in the safeguard clause. Another Ecofin amendment deletes the reference to exclusive supervisory powers over entities or activities with Community-wide reach from the EBA and EIOPA proposals, and restricts them to credit rating agencies in the ESMA proposal.

In the European Parliament, draft reports on the ESAs were released in February 2010. Before that, the coordinators of EPP, S&D, ALDE and Greens political groups in the European Parliament had expressed their discontent over the Council’s approach. They supported the *de Larosière report*, on which the Commission’s proposals are based and which, they claim, was already the result of a compromise. The European Parliament draft reports on EBA and ESMA also included proposals for EU-level supervision of large cross-border firms and an EU-level protection fund.

The European Parliament is due to vote on the draft reports in the spring of 2010. It is intended that the new ESRB and ESAs should begin operating on 1st January 2011. In a recent speech, Commissioner Barnier said that “*the co-legislators, the Council and the European Parliament have to agree rapidly. Our political credibility is at stake.*”

Conclusion

The reform of the EU supervisory architecture is essential to restore and maintain a stable and reliable financial system in Europe. The goal is effective micro and macro-prudential supervision, with common rules and consistent supervisory practices, taking into account the reality of financial market integration. Regulatory reforms aimed at avoiding or minimising the effects of future crises will only be effective if their application is ensured through a robust supervisory framework.

The positions of the EU institutions currently diverge significantly. A thorough and open debate is needed to make sure Europe gets it right.

The financial services industry is strongly committed to contribute to the debate where appropriate.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

Chairman Financial Industry Members

Guido Ravoet, *EBF Secretary General*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 508 37 11 / Fax: +32 2 502 13 30
E-mail: g.ravoet@ebf-fbe.eu

Secretariat

Catherine Denis, *EPFSF Director*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00
E-mail: cdenis@epfsf.org

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