

The new European System of Financial Supervision – institutional reform within the EU

Background

Lord Turner described the 2010 EU regime for the regulation of financial institutions as 'unsafe and untenable'. The financial crisis and the Icelandic banks fiasco have exposed serious weaknesses in the system. In 2008 Lord Turner posed the policy question – should reform of the EU be directed at 'more Europe' or 'less Europe'. Institutional reform at the EU level has now been agreed. The Commission has also published its extensive work program (a sort of post crisis Financial Services Action Plan). Our report on the EU Commission's work programme can be found [here](#).

So far, the trend is clearly for 'more Europe' not less. Initially described as 'decaffeinated,' the European Parliament has negotiated additional powers for the new EU agencies. However, domestic regulators, such as FSA / PRA will continue to supervise firms and will not be replaced by a pan-European supervisory body (as the ABI had proposed for the insurance sector). Nonetheless, the new ESFS will have important consequences for all regulated firms.

The reforms

On 23 September 2009, the European Commission adopted legislative proposals aimed at addressing regulatory weaknesses at the micro- as well as macro-prudential level through the creation of a European System of Financial Supervisors (ESFS) and a European Systemic Risk Board (ESRB).

These proposals were fiercely debated by the European Parliament and Council. An agreement on the draft regulations establishing the ESRB and ESMA was finally reached on 2 September 2010 following intensive negotiations. The Council endorsed the agreement on 7 September and the European Parliament –following agreement by all member states - subsequently adopted the texts of the draft regulations on 22 September 2010.

The new supervisory structure came in on 1 January 2011.

Whilst there are discussions about treaty changes to deal with the Euro crisis (and the enhanced arrangements for the single currency under the EFSF - the European Financial Stability Fund and Facility), the ESFS and ESRB are being established without any changes to the EU Treaty. In contrast, the UK, for example' is passing domestic legislation to enshrine a new financial stability objective and to give the new domestic authorities broader powers to achieve this goal. The European Commission not only avoided any treaty change, it also shoe-horned the new EU legislation into article 95 of the EU Treaty, so that it could be passed on a qualified majority basis (and could not be blocked by a single or small group of states). (The UK's House of Lords favoured legislation under Article 308 requiring unanimous approval which they felt would have provided a more secure basis (less open to legal challenge) for the new legislation.)

Institutional structure charts

We have prepared a chart to show the new European institutions and their roles and relationships. We have also included an additional chart to enable you to compare the new institutional structure with the previous position at the EU level. To view these charts on our RegZone, please click [here](#) and [here](#).

The ESFS

The ESFS is based around three new European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). These have been created by transforming the existing level 3 committees for the banking, insurance and occupational pensions and securities sectors (CEBS, CEIOPS and CESR). For the first time, each of these bodies will have its own internal resources (rather than being dependant on work by the national supervisors) and have staffed up their offices in London, Frankfurt and Paris respectively.

Framework legislation and detailed EU rules will continue to be made at level 1 through the EU Lamfalussy process (which involves Commission, Parliament and Council) and, at level 2, by the Commission working with the existing sectoral committees and taking advice from the level 3 ESAs.

The role of the ESAs will involve both policy coordination and detailed rule setting, and the coordination of supervision of individual firms. The ESAs will have an enhanced role at level 3 and will produce technical standards for the detailed application of the rules at level 1 and 2. The Commission has published a list of possible areas for this type of detailed harmonization. The scope of these powers is limited by the legislation (at levels 1 and 2) concerned and by the need for many measures to be adopted by the Commission.

The ESAs will be involved in international discussions and liaison with regulators outside the EU. In addition, the ESAs have new powers (as well as taking over all the functions of the existing level 3 committees). Many of these powers involve coordinating national authorities and their supervision of individual firms and groups through:

- The coordination of supervision of firms/groups across borders by several national regulators/supervisory authorities including colleges of supervisors and the exchange of information between those authorities;
- Collection of information (e.g. for stress testing or for the ESRB); and
- Working to establish a common supervisory culture across the national bodies of all member states, for example, by peer reviews.

Guidelines and instructions. There will also be a role for the ESAs in ensuring the consistent application of EU rules. The ESAs are empowered to issue guidelines and recommendations to national supervisors or individual financial institutions. Where EU rules are incorrectly implemented, the ESAs may advise the Council to issue instructions to the national supervisor. Failing corrective action, the ESAs have the option to issue instructions directly to the individual institution concerned.

Emergency action. In an emergency (defined as a situation which seriously jeopardises the stability of financial markets), the ESAs are able to adopt decisions requiring national supervisors to take specific remedial action. They have the power to temporarily prohibit or restrict certain financial activities or harmful products, and may ask the Commission to introduce legislation to prohibit such activities or products permanently. The Commission, ESRB and ESAs are empowered to ask the Council to declare an emergency.

Tiebreakers. There are various situations where ESAs have powers to resolve disagreements between national regulators, or otherwise enforce decisions on national authorities. Where agreement cannot be reached, the ESAs are able to intervene, at their discretion, and impose legally binding mediation on national supervisors. If the authorities remain unable to reach a consensus, the ESAs may impose binding supervisory decisions. Such decisions may be directly applicable to individual financial institutions.

Sectoral powers. The ESAs have roles dictated by their sector remit. For example, ESMA has exclusive supervisory powers over Credit Rating Agencies registered in the EU. In addition, the ESAs will perform EU-wide risk assessments and stress tests to assess the vulnerabilities and overall resilience of the relevant EU sector. In this respect, post crisis stress testing of the EU banking and insurance sectors has already been undertaken. The ESAs are also invested with the authority to temporarily prohibit or restrict certain financial activities that threaten the orderly functioning of the European financial system in cases specified in sectoral legislation. An example of how this discretion might be used would be in the adoption of harmonised temporary bans on short selling on EU securities markets, rather than each domestic regulator acting of its own accord.

The ESAs can operate either by qualified majority or on a simple-majority basis. The Commission, European Parliament and Council will review the position after three years to consider whether, amongst other things, the ESAs' powers should be strengthened.

The ESRB

The ESRB role is more as a forum for coordination and discussion without formal powers. It comprises principally of heads of the European Central Bank (ECB), national central banks, ESAs and national supervisors and will be chaired by the President of the ECB for the first five years. It has no legal personality and no legal powers over member states, and in the exercise of its broad, macro-prudential function, the ESRB will merely issue warnings and recommendations. Its mandate is to monitor and predict risk in various areas, including in the banking sector, in relation to asset bubbles and with respect to market infrastructures.

The ESRB has the task of identifying any potential systemic risks and issuing recommendations to the country, group of countries or ESA concerned. These warnings and recommendations will be colour-coded, according to a system the ESRB will devise, to illustrate the type and degree of risk in question. If an addressee of an ESRB recommendation does not comply with the recommendation, it will need to explain the reasons for its non-compliance. Further, if the ESRB does not consider the explanations to be convincing, it will have the possibility of informing the Council of Ministers.

The ESRB President will brief senior members of the European Parliament as well as the chair and vice-chairs of the Parliament's Economic Affairs Committee through regular confidential discussions. The ESRB will also work closely with the ESA bodies, presenting them with the necessary macro-prudential input to assist in the carrying out of their supervisory functions.

The expected impact

Policy/rule-making – an even more standardised EU rulebook for FIs

The aim is to increase (even further) the harmonization of the rules applicable to FIs across the EU; the objective is a 'single rulebook' applicable in each country with common guidance and interpretation. This will be achieved by

- More direct EU legislation by regulation (which takes effect without any national implementation) rather than by directives (which require member states to adapt their national legislation/rules). This will mean member states will lose the ability to finesse EU rules to fit their domestic requirements and policy. It will also mean that firms and trade associations will need to be alive to (and be seeking to influence) emerging EU proposals at an earlier stage
- Maximum harmonization. The trend is towards maximum harmonization and away from national discretions and gold-plating.
- Increased delegation under the Lamfalussy process. As we have seen with Solvency II, there is an increasing use of framework style legislation with many of the key issues being left to the European Commission under the level 2 procedures.
- More detailed standards set at the EU level via the ESAs; this further harmonisation will apply to micro-prudential/financial regulation of firms and other areas such as conduct of business.

The new chair of the EBA, Andrea Enria, has been anxious to stress that the EBA will use the 'true power' of a single set of rules to impose more uniform oversight on banks. The new approach will be more 'top-down' with the senior people at the EBA engaging in real policy discussions, taking decisions and making things happen.

The sovereignty debate

The new ESAs (acting on a majority – single or qualified – vote) can overrule national regulators and issue directions to firms in various situations. The mechanisms by which these powers are exercised, reviewed and appealed are extremely convoluted – a classic European balancing act between the national and EU bodies. Nonetheless, there are real concerns about the notion of a majority of continental countries being able to overrule the UK regulators in this way. The areas are limited, in normal times, to interpretation of established EU rules, inter-regulatory supervisory disputes and prohibition of toxic financial products as dictated by sectoral legislation. However, EU legislation often leads a lot to "interpretation" and in an emergency, a majority within an ESA has even greater powers.

The last UK government made much of the fiscal override – a convoluted appeal process to block an exercise of the ESA's emergency or tiebreaker powers. These appeal and review processes may make the ESA's powers difficult to exercise, at least quickly. It is difficult to know what in practice the UK might or might not be able to block under the fiscal override. It seems that the previous and current UK governments have been out-manoeuvred – about the loss of sovereignty. The Coalition government will no doubt say that they were unable to stop the loss of sovereignty (which was a matter of concern for UK parliamentary committees). In reality, the EU already makes the rules for the regulation of financial institutions by majority vote – so the UK has no veto or special privilege even though it hosts the EU's major financial centre in the City of London.

There are, however, clear benefits for UK firms in that the new regime should lead to a more level playing field, with some member states being forced to improve local supervision and their compliance with EU rules. Firms will also need to consider the impact on policy-making and rule interpretation – this will be a significant further move from FSA/UK authorities to the EU (and the requisite "majority" of its members).

Supervision

There will be greater co-ordination between domestic supervisors in different member states -

- Particularly in relation to their regulation of cross-border/international firms/groups.
- Firms will be more aware of/involved with the arrangements for their supervisory college of EU regulators.
- ARROW-type visits and inspections may involve the authorities of several member states and the relevant ESA.
- Firms may need to report to the relevant ESA (directly or via their local supervisor), for example, in relation to information that is required by the ESRB.
- ESAs may provide advice to the European Parliament, the Council and the Commission regarding the prudential assessments of cross-border mergers and acquisitions.
- Closer coordination via the ESAs should assist firms in dealing with cross-border issues such as the approval of a single internal model for use at group and solo/subsidiary levels.

The future:

Every three years, the Commission will report on the functioning of the new ESAs, in particular on whether to combine the separate supervision of banking, securities, and insurance, on the benefits of having all the ESAs headquartered in one city and on whether the ESAs should be given further supervisory powers.