Financial Supervision in the EU
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Introduction

On 1st January 2011 new institutions of the EU came into being to supervise the three parts of the financial services sector – banking, securities trading and insurance. They replaced three consultative committees which had operated for most of the previous decade but which lacked executive powers. Together with the European Systemic Risk Board and national supervisors, these institutions form the European System of Financial Supervisors.

There is much debate in the UK about the proposals for banking reform brought forward by Sir John Vickers’ committee; this paper explains what is happening in the EU. It begins by explaining the reasons behind the establishment of these institutions – which co-ordinate the work of national regulators and do not replace them – and then details their role in European financial supervision.

Background

As a result of the banking and financial crisis of 2007-08, the EU established a high level group to look at the question of financial supervision in the EU. Chaired by former IMF Managing Director Jacques de Larosière (also a past President of the European Bank for Reconstruction & Development), and including the former Chairman of the British Financial Services Authority Sir Callum McCarthy, it reported in 2009.1

The report recommended a new framework for financial services in the EU across three areas:

1. a new regulatory agenda – in order to (amongst other things) reduce risk, improve risk management and strengthen transparency;
2. stronger co-ordinated supervision – using existing structures but working more closely together and within the internal market;
3. effective crisis management procedures – designed to build confidence amongst financial supervisors and give everyone confidence in the sector in the EU.

The report identified that existing financial supervision structures tended to focus on individual businesses (micro-prudential supervision) rather than on the health of the financial system as a whole (macro-prudential supervision).

This conclusion reflects the fact that financial services are a cross-border economic activity and as a result the actions of a financial institution in one country can have serious consequences in other countries. Some 70 per cent of banking assets in the EU are owned

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by 43 banking groups with substantial crossborder activity within the EU. The EU had an internal market in financial services, the report said, but one where most regulation in the sector was at national level resulting in serious shortcomings in the oversight system because of an absence of co-ordination.

The supervisory committees for banking, securities and insurance, established after the Lamfalussy report (2001) on financial services in the EU were, the high level group argued, ineffective. It cited a number of examples where the committees were unable to adopt common approaches to supervision, including the absence of common reporting formats and their inability to regulate credit rating agencies at EU level. These failings were partly a consequence of the legal framework under which the committees had been established but also of a lack of confidence in these arrangements within Member States.

To provide a broader approach to supervision, the Larosière report recommended new EU-wide structures, replacing the advisory committees. These EU-wide institutions would be run by the national supervisors in the relevant sector working together and would utilise the existing staff and assets of the advisory committees. The high-level group also wanted to overcome historic divisions between regulators of different parts of the financial system (e.g. of banking and of insurance) by bringing the various supervisory bodies together so that the overall health of the financial system in the EU was monitored more effectively.

The new institutions would provide a mechanism for establishing common rules on financial supervision and for ensuring co-operation and a common approach between national supervisors. They would have the authority to make binding technical rules and to enforce them. National supervisors would remain responsible for the day-to-day supervision of firms. Importantly, the new EU-wide supervisors would be independent – that is, not under the direction of Member State governments.

The New Institutions

The European Commission brought forward legislative proposals in 2009 to implement the recommendations of the Larosière report; after consideration and amendment in the Council and the European Parliament, they were adopted in September 2010 and came into force in January 2011.

European Banking Authority (EBA)

Based in London, the EBA has the job of safeguarding the banking system in the EU through setting standards to be met by all banks across the EU in co-operation with central banks. It may adopt common standards, agree technical rules and arbitrate between national central banks. It is probably most well-known for its responsibility for assessing the health of banks across the EU through periodic stress tests.

All Member States have a representative on its board of supervisors (in the case of the UK it is currently the FSA) and the three EEA countries have observers. A smaller management board meets more frequently; the Commission is represented on both bodies.

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2 Matthias Mors, Martin Merlin & Laurence Houbar, supra n. 1, cited on p. 71
European Securities & Markets Authority (ESMA)

The second of the new supervisory institutions is concerned with ensuring the proper functioning of the securities markets. Its regulatory work is designed to ensure a level-playing field for investors in the EU to provide both a common standard of protection through effective regulation and supervision and to ensure fair competition. As with the EBA, ESMA (which has its headquarters in Paris) is overseen by a supervisory board with representatives from national financial supervisors.

Of particular importance to ESMA is the process of ensuring that Member State implementation of EU financial services legislation has been done in compliance with the intent of the original legislation. The Larosière report highlighted the fact that there were wide variations in the national legislation of Member States making regulatory compliance expensive for the sector and undermining the effectiveness of supervision.

ESMA will have responsibility for regulating the credit reference agencies in the EU because they operate across internal borders.

European Insurance & Occupational Pensions Authority (EIOPA)

EIOPA replaced the Committee of European Pension and Occupational Pension Supervisors on 1 January 2011; it is based in Frankfurt. Like the other new institutions, it has been transformed from an advisory committee into an independent supervisor with executive powers.

As with the other EU financial supervisors, the core task of EIOPA is the protection of the stability of the financial system. They are obviously especially concerned with protecting the interests of insurance policyholders and pension beneficiaries. EIOPA is responsible for carrying out insurance stress tests, to assess the health of insurance companies and produces regular reports on the stability of the pensions and insurance sector. The stability reports enable EIOPA to consider such things as the impact of natural disasters on EU insurance companies, as well measuring the potential problems that sovereign debt could cause both the pensions and insurance industries. Reports such as these are considered by the European Systemic Risk Board as part of its EU-wide monitoring work.

European Systemic Risk Board (ESRB)

This is not a new institution but a co-ordinating body. It has overall responsibility for macro-prudential supervision, providing oversight over the whole financial system in the EU to ensure that the risks that derive from a complex, interconnected financial system are properly assessed and responded to.

The ESRB is based in Frankfurt, is chaired by the President of the European Central Bank and is overseen by a general board made up of representatives of national financial supervisors with representatives of the new supervisory institutions, the European Central Bank and the European Commission. A smaller steering committee, some of whose members are elected by the general board, provides day-to-day management between quarterly meetings of the board. When the general board meets representatives of relevant national supervisors, for example the FSA or the Bank of England, will take part according to the items under discussion.
Assessment & Future Developments

It is too soon to come to any conclusions about the effectiveness of the new financial supervisory arrangements in the EU. Taken together, the restructuring of financial supervision ought to increase transparency in the system, improve the market knowledge of supervisors and thereby provide greater protection against instability. But as with any regulatory system, it will only be effective if the participants have the commitment to make it work. Better co-ordination is often desirable but hard to achieve in practice, especially in a community of 27 (very different) Member States.

Interest has largely focused on the financial stability benefits of the changes but there should also be benefits to competition from the adoption of common regulatory requirements in Member States for those companies operating across borders. This development should further strengthen the internal market in financial services.

The relationship between the EU-wide supervisors and national supervisors will obviously be important. Trust will need to be established on both sides and detailed co-operation will be essential when dealing with companies with crossborder businesses. The EU regards the new system as a “hub and spoke” one; in other words, EU-level supervision will be the hub and national supervision the spokes. Performance of national supervisors has historically been uneven and for such a hub and spoke system to work, the performance of the weakest will need to be improved.

The resources of the new EU institutions will be very limited – they will have about 300 staff in total by 2015 compared to 3,300 staff at the FSA in Britain today.

While the new EU financial supervisors will have greater authority than the advisory committees they replace, the bailing out of financial institutions will remain a national responsibility. There is also a procedure for dealing with objections from Member States who feel their fiscal responsibilities have been impinged upon by the supervisors.

The establishment of the new supervisors is part of the EU’s response to the G20’s call for reforms to the regulation of financial markets – the USA has introduced the Dodd-Frank Act as part of a similar process. Further measures have been proposed by the European Commission; some of these, such as those relating to short selling, are controversial and have yet to be agreed.

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Senior European Experts

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