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# Financial supervision in the EU

## Incremental progress, success not ensured

**The new European System of Financial Supervision (ESFS) is conceptually convincing, but complex.** Intertwining macro-prudential and micro-prudential supervision draws the right conclusions from the crisis, but the design of the two pillars of the EU's new supervisory system appear overly complex. Institutional arrangements and decision-making processes seem cumbersome and could impair the effectiveness of the arrangements.

**Success of macro-prudential supervision** will depend crucially on the quality of the analysis of systemic risks by the European Systemic Risk Board (ESRB) and its willingness to interpret its mandate widely. Systemic risk has many sources; hence, the ESRB should have a wide purview.

**Initially, the ESRB will probably be cautious in its recommendations.** Many conceptual questions on macro-prudential supervision are still not resolved and tools for macro-prudential control are untested. In addition, experience must be gained on how authorities and markets react to warnings and recommendations from systemic risk supervisors.

**The European Supervisory Agencies (ESAs) are an improvement on the Level 3 committees, but still fall short of what would be needed.** The ESAs will help to create a single rule book for financial supervision and to align supervisory practices. But micro-prudential supervision will continue to sit in an uneasy half-way house between national sovereignty and pan-European arrangements.

**We remain convinced that truly pan-European supervisory powers are desirable.** The financial crisis has demonstrated that the co-existence of national supervision and integrated financial markets is untenable. Hence, the choice is between either preserving an integrated financial market in the EU and creating a corresponding EU-level supervisory framework for it, or allowing the re-fragmentation of Europe's financial markets. The choice is clear.

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**Author**
Bernhard Speyer
+49 69 910-31735
bernhard.speyer@db.com

**Editor**
Barbara Böttcher

**Technical Assistant**
Sabine Kaiser

Deutsche Bank Research
Frankfurt am Main
Germany
**Internet:** www.dbresearch.com
**E-mail:** marketing.dbr@db.com
**Fax:** +49 69 910-31877

**Managing Director**
Thomas Mayer

**Crisis exposed weaknesses in financial supervision**

The financial crisis revealed weaknesses not only in the risk management of many financial institutions, but also in the design of supervisory structures and the execution of financial supervision. This holds true not least for financial supervision in Europe, whose institutional set-up had already been contentious prior to the crisis. Following the crisis the structure of financial supervision came under renewed criticism. The weaknesses were analysed comprehensively in the report of the De Larosière Group, which also delivered the blueprint for the subsequent reforms that took effect on January 1st this year.

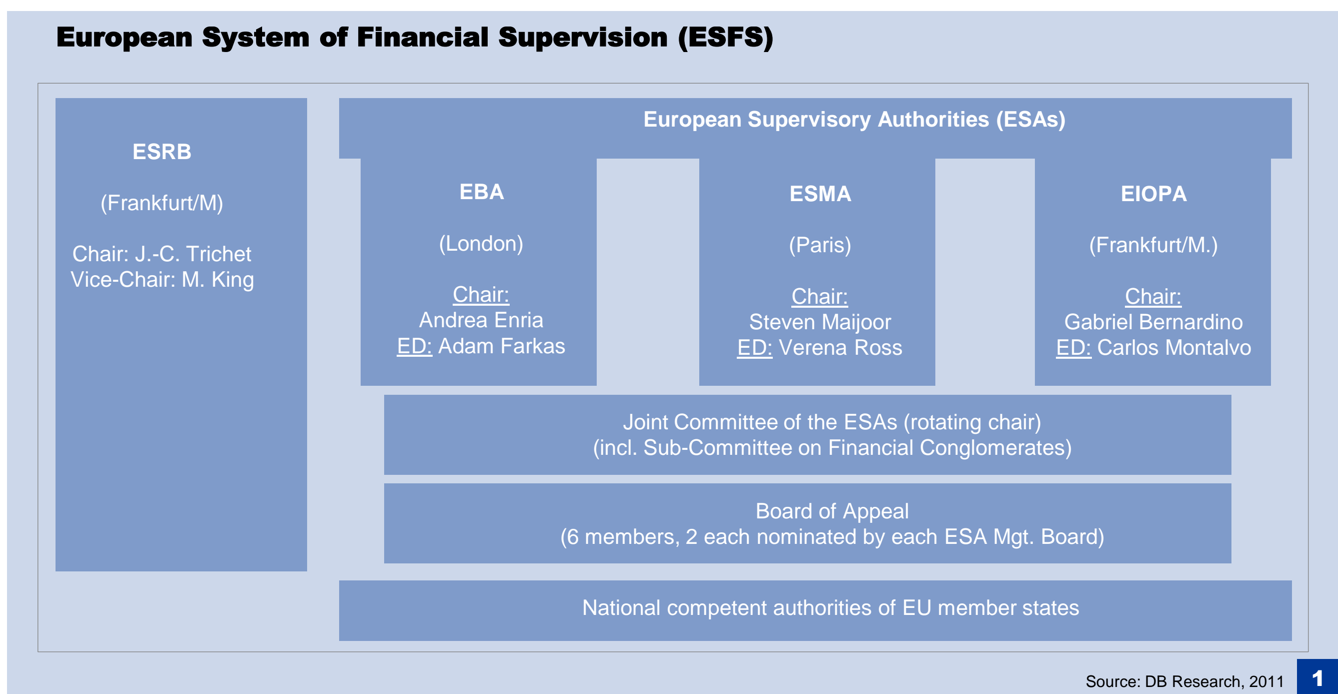
## I) The ESFS

**ESFS as comprehensive and integrated framework**

The new institutional structure of financial supervision in the EU is explicitly designed as a comprehensive and integrated framework comprising macro- as well as micro-prudential supervision. The former is in the hands of the newly created European Systemic Risk Board (ESRB), the latter rests on the interplay between the national competent authorities and the three European Supervisory Agencies (ESAs). These institutions are brought together in the so-called European System of Financial Supervision (ESFS). Combining them under a single roof recognizes that only the effective integration of micro- and macro-prudential supervision will ensure that risks to financial stability will be identified and addressed.

The obvious challenge will be to integrate both processes not only on paper, but also in practice. The institutional set-up and the legal foundations of the ESFS aim to ensure that this is the case: on the one hand, it creates cross-membership amongst the institutions, i.e. the ESA chairs are full members of the ESRB and representatives of the ESRB are non-voting members of the ESA Boards of Supervisors. On the other hand, in the regulations setting up the ESAs and the ESRB all parts of the ESFS are explicitly mandated to cooperate and to ensure an appropriate and reliable flow of information between them.

**European System of Financial Supervision (ESFS)**




Source: DB Research, 2011 1

The ESFS not only combines macro- and micro-prudential supervision, but also national and EU-level elements. While the day-

to-day execution of financial supervision remains in the hand of national authorities – with them acting in concert, such as in supervisory colleges, where needed – the EU-level is strengthened in order to ensure a greater consistency of supervisory rules and practices as well as a comprehensive analysis of system-wide risks.

## II) Macro-prudential supervision: the ESRB

### *The rationale*

**Macro-prudential supervision closes a gap**

The need to attach greater importance to macro-prudential analysis within the overall supervisory framework is one of the lessons drawn from the financial crisis. It is aimed at plugging a gap in the framework exposed by the insight gained during the crisis that all financial institutions, individually, can satisfy supervisory requirements, yet systemic risk can build up. In addition, too often in the past, potential risks to financial stability had been identified, but tools were lacking to translate this analysis into corrective action.[1] Hence, it is necessary to complement traditional micro-prudential supervision with a systematic analysis of systemic risks and a framework for targeted action to address these risks. The term "macro-prudential supervision" has been established in recent years for this type of financial supervision.

A framework for macro-prudential supervision is not only being established in the EU, but in all major G20 countries.[2] In the EU, the task of macro-prudential supervision has been entrusted to the ESRB. The ESRB is mandated to monitor, assess and prioritise threats to financial stability in the EU. This mandate covers all segments and areas of the financial markets, including market infrastructures and guarantee schemes. It will perform stress tests to determine the sensitivity of the financial system to shocks.

**ESRB entitled to issue recommendations**

Based on its analysis, the ESRB is entitled to issue risk warnings and recommendations for remedial action, if it comes to the conclusion that such action is required. The ESRB is also tasked to monitor the implementation of these recommendations. However, the ESRB neither has macro-prudential tools directly at its disposal (e.g. the right to impose counter-cyclical capital charges) nor does it have sanctioning powers against financial institutions or authorities that fail to respond to a risk warning.

**International comparison instructive**

In this context, it is interesting to compare the ESRB with its peers elsewhere. Compared to its US counterpart, the FSOC, the ESRB has a narrower mandate. It is therefore unsurprising that its focus, so far, has been on macro-economic risks rather than issues stemming from regulatory developments. The FSOC is involved more closely in designing financial regulation and in assessing the economic implications of new financial regulation. More importantly, it is also mandated to identify and designate financial institutions as systemically important and subject them to appropriate rules.[3] The

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[1] In this context, it was also revealed that central banks, while clearly having an impact on financial stability through their monetary policy, lack the tools to tackle threats to financial stability. Specifically, it is understood that interest rate policy is too blunt an instrument for this purpose, as it cannot be targeted on specific sources of systemic risk; there is also a risk that fighting financial instability may be incompatible with the primary objective of monetary policy, i.e. safeguarding price-stability.

[2] In the US, for example, the Financial Stability Oversight Council (FSOC) has been established as the systemic risk supervisor and in the UK the task will be in the hands of the Financial Policy Committee (FPC).

[3] Art. 23 of the Regulation setting up the EBA and Art. 23 of the Regulation setting up ESMA gives EBA the task to develop the criteria for the identification and

**ESRB – General Board**

The ESRB's General Board has 65 members:

— ECB president and vice-president
— 27 central bank governors
— ESA chairs (3)
— COM representative
— Chair and 2 vice-chairs of ASC
— Chair of ATC (currently Stefan Ingves)
— President of Economic and Financial Committee (EFC) (non-voting; currently Vittorio Grilli)
— One high-level representative per Member State of the competent national supervisory authorities (non-voting)

**ESRB – Steering Committee**

The ESRB Steering Committee has 14 members:

— the Chair and first Vice-Chair of the ESRB
— the Vice-President of the ECB
— four other members of the General Board who are also members of the General Council of the ECB, elected by and from among the members of the General Board who are also members of the General Council of the ECB (currently Marek Belka, Mario Draghi, Athanasios Orphanides, Jens Weidmann)
— a representative of the European Commission
— the Chairpersons of the 3 ESAs
— the President of the EFC
— the Chair of the Advisory Scientific Committee (ASC)
— the Chair of the Advisory Technical Committee (ATC)

**Advisory Technical Committee (ATC)**

The ATC has 62 members:

— a representative of each national central bank of the Member States
— a representative of the ECB
— one representative per Member State of the competent national supervisory authorities
— one representative each of the three ESAs
— two representatives of the European Commission (EC)
— a representative of the Economic and Financial Committee (EFC)
— a representative of the Advisory Scientific Committee (ASC)

The current chair is Stefan Ingves, President of the Sveriges Riksbank.

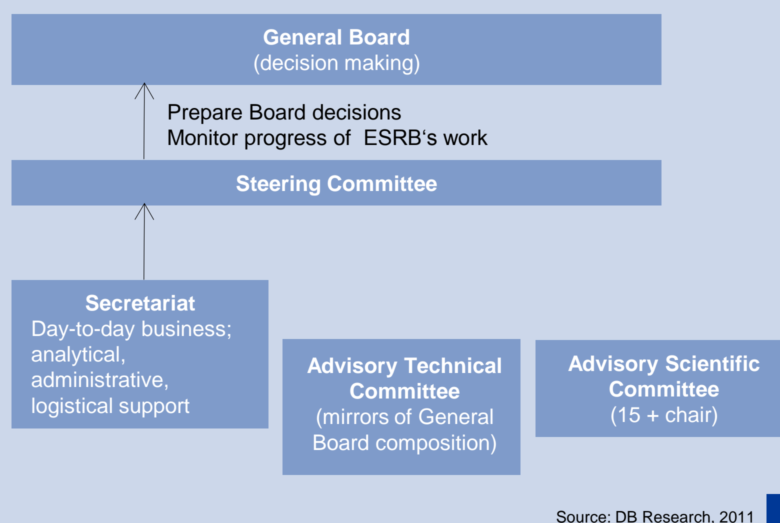
focus of the UK's FPC, in turn, is on risks in the banking sector. Thus, the early work in its existence has been concentrated on issues such as forbearance exercised by banks vis-à-vis their debtors and on encouraging banks to bolster their capital base. This focus is unsurprising given the closeness of the FPC to the Bank of England and the latter's newly acquired responsibility for banking supervision.

### *Institutional set-up*

The ESRB is an EU-level body mandated to act in an impartial way and solely in the interest of the Union as a whole. It shall not take instructions from member states, Union institutions or any other interested party.

The highest decision-making forum of the ESRB is the General Board, consisting of 37 full – i.e. voting – members and 28 non-voting members (for a list of members, see box). The ESRB is based in Frankfurt at (sic!) the ECB. It is chaired, for at least the first five years of its existence, by the president of the ECB.

**ESRB – structure**




Source: DB Research, 2011 **2**

As the General Board of the ESRB is a large body, decisions will be prepared by a Steering Committee, which will also set the work agenda for the ESRB. The Steering Committee has 14 members. The work of the Steering Committee and that of the ESRB as a whole is supported, with regard to both content and organisation, by a Secretariat. The Secretariat will be funded and supported by the ECB. Its head is appointed by the ECB, in consultation with the General Board of the ESRB.[4] The Advisory Technical Committee (ATC), whose composition essentially mirrors that of the General Board, will do the groundwork on technical analysis related to the work of the ESRB.

To pass risk warnings and recommendations, a 2/3 majority is needed in the General Board. Risk warnings can either be specific, i.e. referring to a specific issue, country or market segment, or general. Risk warnings can be directed at authorities in the EU as a whole, to one or more member states, to the ESAs or to national

measurement of systemic risk and to subject credit institutions that may pose a systemic risk to strengthened supervision.

4 Mr. Francesco Mazzaferro has been appointed Head of the ESRB Secretariat in June 2011.

authorities, and they can include suggestions for appropriate legislative initiatives. Recommendations shall have a specific timeline for a response and addressees need to react to these recommendations on a "comply or explain" basis.

**ESRB may make warnings public**

If action by the addressee is deemed inadequate, the ESRB may decide, with a 2/3 majority, to inform the Council or the responsible ESA with a view to having them pursue the matter further. Moreover, as quasi the ultimate weapon, the ESRB may, also with a 2/3 majority, choose to make its warning and recommendation public.

***Assessment***

In assessing the chances of success for the ESRB, four aspects appear to be crucial: The institutional set-up of the ESRB, its powers, the instruments available and the quality of its analysis, and the ESRB's interpretation regarding the scope of its mandate.

**ESRB structure appears unwieldy**

*Institutional set-up:* Without a doubt, the size of the ESRB is a hindrance to its effectiveness. With its 65 members the General Board is too unwieldy. It is interesting to note that the ESRB's peers – the Financial Stability Oversight Council (FSOC) in the US and the UK's Financial Policy Committee (FPC) – are considerably smaller in size (10 voting and 5 non-voting members in the case of the FSOC and 11 voting and 2 non-voting members in the case of the Interim FPC). For practical purposes the effectiveness of the ESRB will therefore hinge on the performance of the Steering Committee and the Secretariat. While there is good reason to assume that these two will be able to act efficiently, the size of the General Board will come into play whenever decisions need to be taken by the ESRB, especially in light of the fact that 2/3 majorities are required for the ESRB to take decisions.

*Powers:* There has been a heated discussion on whether the ESRB will have sufficient teeth to bite, i.e. whether its recommendations will be heeded by addressees. As stated above, the powers available to the ESRB are, indeed, soft in character. It has no hard sanctioning powers. The ESRB cannot order other institutions or actors to alter their behaviour, it can merely issue recommendations. Ultimately, therefore, the success of the ESRB will depend on whether its authority is recognised by the other authorities.

**ESRB's soft powers should not be underestimated**

However, it would be wrong to measure the ESRB's influence in terms of hard powers only. Specifically, one should not under-estimate the importance of sound analysis and communication. The higher the quality of the analysis and the less refutable the quality of the recommendations for addressing the problem identified, the more difficult it will be for addressees to ignore the warnings received. Hence, the success of the ESRB will crucially depend on the quality of its analysis and its communication to the markets. In this regard, it is appropriate to recall that the ESRB can draw on the resources of all EU central banks and supervisory authorities – many of which are in the process of building systemic risk super-visors themselves, so that expertise should be available in ample quantity. The challenge will obviously be to make national authorities share that information with their peers and the ESRB – something that is far from being assured.

One also should not underestimate the importance of the fact that the ESRB may decide to forward its warning to the Council or to make it public. An addressee of an ESRB risk warning will probably want to avoid being called upon to justify its actions in public (so-to-speak), especially if the analysis of the risk is irrefutable.

Incidentally, note should be taken of the fact that the ERB, at a size of 71 members, is a quasi-public forum. It is unlikely that matters of material substance could be kept secret in a forum of that size. In addition, risk warnings that are made public or that are leaked to the outside will, if convincing in their analysis, trigger market reactions which by themselves can either achieve the desired results directly or force authorities to take the required action. In this context, it is probably not unrealistic to expect that, over time, the ESRB will develop a communication style akin to that of central banks, where special key-words will be used to signal degrees of concern about systemic risks.

**ESRB without own instruments**

*Instruments available:* The importance of the quality of the ESRB's analysis and of its communication policy become even more evident in light of the fact that, beyond analysis and recommendations, it lacks instruments to address systemic risks. The ESRB's tool-kit is essentially limited to making recommendations; it does not have access of its own instruments for macro-prudential policy. These will have to be applied by the responsible national authorities. In this context, it is noteworthy that the draft CRD IV leaves traditional macro-prudential tools, such as counter-cyclical capital charges, and variations in LTV / LTI ratios and capital requirements, in the hand of national regulators. In order to limit the scope for arbitrage and the risk of competitive distortions, it would be useful if the ESRB had a coordinating role here by issuing guidelines on the design and use of such instruments.

**Analysis of dangers must not be too narrow**

*Interpretation of scope of mandate:* Risks to systemic stability can originate in many areas. It is therefore important that systemic risk supervisors such as the ESRB cast their net wide. The analysis of potential dangers to systemic stability must not be unduly limited; specifically, it would be a matter of concern if the ESRB ignored dangers originating in macro-economic policies, especially monetary policy. After all, excessive lending growth, asset price bubbles, and excessive risk-taking are almost always preceded by too loose monetary policy.

As a corollary to advocating a broad scope of the mandate, macro-prudential supervisors should also have a broad set of instruments at their disposal to target their interventions optimally. This, in turn, underlines the above-mentioned point that the ESRB should have a strong coordinating role to ensure that actions taken by the national competent authorities are well aligned across the EU. Coordination must also be ensured with the European Commission, as the Commission will acquire a greater role in the context of the new EU-level surveillance procedure.

**ESRB likely to move very cautiously initially**

All in all, it would appear likely that the ESRB will move very cautiously in its initial stages of existence. Several arguments support this assessment:

— First, given the current precarious state of financial markets, the ESRB – like other macro-prudential supervisors – will be careful not to add stress to markets.

— Second, given that macro-prudential analysis and policy instruments are still in their infancy, the precise repercussions of their use are difficult to predict for policymakers.

— Third, if the ESRB were to issue too many risk warnings, some of which would inevitably not materialize, its credibility could suffer.

— Fourth, the size of the ESRB, combined with the fact that a 2/3 majority is needed in the General Board to adopt recommendations, will tend to favour cautious warnings.

— Finally, the exercise of macro-prudential supervisory powers has the potential to be politically controversial. On the one hand, risk warnings by macro-prudential supervisors will often implicitly be tantamount to criticising previous decisions by authorities that have contributed to the accumulation of financial imbalances or have failed to address macro-prudential risks adequately and in a timely fashion. On the other hand, it must be recognised that financial imbalances and asset price bubbles have, in the past, often been allowed to build up, because, in the short-term, rising wealth, e.g. in housing markets, was politically popular. Hence, taking away the punch-bowl by means of macro-prudential policies is likely to be at least as unpopular as central banks raising interest rates to dampen an economic boom.

Against this background, it is very probable that the ESRB will only act if it is very sure of its analysis and the effectiveness of its policy measures. Hence, at least in the initial years of its existence it is more likely to commit type 1 mistakes (not warning when it should have) rather than type 2 mistakes (warning, but no subsequent crisis).

***Impact on banking sector***

**Banks need to monitor macro-prudential supervisions**

For banks, macro-prudential supervision may, ultimately, entail a requirement to change business models, business practices, and risk exposures *irrespective of their own situation and risk profile*. Suppose, for instance, that the ESRB decides that there was a bubble in residential mortgage markets and decides to lower permissible LTV ratios. Then such a decision would affect business opportunities of all banks in a similar way irrespective of an individual bank's capital base or mortgage portfolio risk profile. This is a marked difference to micro-prudential supervision, where individual banks are only the target of supervisory action if there is an institution-specific issue that requires supervisor's attention.

For market participants, the establishment of macro-prudential supervisors also entails a need to monitor closely an additional actor in financial markets. Decisions by the ESRB will affect asset prices, market volumes and the behaviour of market participants – in fact, that is the very purpose of macro-prudential policy. Similar to their traditional practice of central bank watching, banks will therefore need to watch the analyses, statements and actions of macro-prudential supervisors in order to incorporate these into their own business decisions.

## III) Micro-prudential supervision, the ESAs

**ESAs replace 3L3**

The three new European Supervisory Agencies (ESAs) – EBA, ESMA and EIOPA – build on their predecessors, the so-called level 3-committees (CEBS, CESR and CEIOPS; together dubbed the "3L3"), which in turn were established in the wake of the implementation of the proposals initially developed by the Wise Men group, chaired by Alexandre Lamfalussy.[5] Together with the national supervisory authorities, they form the micro-prudential leg of the supervisory system. In addition, there is a cross-sectoral Joint Committee of the ESAs to analyse and monitor risk that cuts across

[5] For a discussion of the weaknesses of the Lamfalussy structure, see Speyer, Bernhard and Norbert Walter (2007). Towards a new structure for EU financial supervision. EU Monitor 48. Deutsche Bank Research. Frankfurt am Main.

financial sectors and to ensure consistency of regulation across sectors to the extent that materially similar activities are conducted within them. The organisation of supervision of financial conglomerates will also be a task of the Joint Committee.

Unlike the 3L3, the ESAs have legal personality. They are mandated to take a pan-European perspective, transcending national interests, and are accountable directly to the Council and the European Parliament.

### *Mandate, powers and their limits*

**ESAs stronger than 3L3**

The ESAs are much stronger than the 3L3. The 3L3 essentially only had advisory powers and could set non-binding technical guidelines. In contrast, ESAs are tasked with ensuring that a single set of harmonised rules and consistent supervisory practices are applied by national authorities. The ESAs are mandated to

— draft technical standards, guidelines and recommendations in their respective areas,
— foster supervisory convergence,
— promote a coherent functioning of supervisory colleges,
— prevent regulatory arbitrage,
— settle disputes between national supervisors,
— conduct peer reviews,
— initiate stress-tests,
— monitor and assess market developments,
— identify and measure, in collaboration with the ESRB, systemic risk,
— promote consumer protection, and
— prohibit or restrict certain activities in emergency situations.

The ESAs have also been given explicit powers to look into consumer protection issues. Specifically, they are mandated to set up committees on financial innovation, which will look into the risks inherent and the potential impact of financial innovations. In addition, the ESAs "*may conduct an inquiry into a particular type of financial institution or type of product or type of conduct in order to assess potential threats to the stability of the financial system and make appropriate recommendations for action to the competent authorities concerned*"[6], which clearly is very close to the mandate of the ESRB and risks some overlap in their mandates. The committees will also look into issues such as consumer literacy and product transparency.

There are of course other ways in which the ESAs can exert influence. The development of supervisory agendas is one; another is through the participation in supervisory colleges. Also, as the EBA stress-test has demonstrated, the ESAs are able to exert influence by means of their management of specific issues. The EBA may, for instance, also conduct inquiries into types of institutions, products or market conduct, thereby turning attention to certain market players or practices. It also has a mandate to help develop resolution regimes and crisis management.

Technical standards set by the ESAs are, after endorsement by the European Commission (see box), binding for the national supervisory authorities. Unlike the 3L3, the ESAs are allowed to

**Endorsement of technical standards**

Under European law, only the European Commission can formally issue delegated acts which have been provided for in the underlying legislation. The reason is that the EP and Council as European legislators can only delegate delegation powers to the Commission, but not to a European agency, such as the ESAs. (Powers of delegation have been conferred on the European Commission by the co-legislators for a period of four years from 16. December 2010; the powers will automatically be renewed for four-year periods unless revoked.) Therefore, any technical standard developed by the ESAs as draft law (rather than merely as a piece of technical advice) needs to be endorsed by the Commission. The Commission will, within three months after receipt, check whether the draft law developed by the ESA is in line with EU law, the underlying legislative act and EU interests and will then endorse the standard fully or in parts, or may amend it. If the Commission decides to (partly) reject or amend the draft law, the ESA will have six weeks to amend the proposal and resubmit it. If, on the expiry of the six-week period, the ESA has not submitted an amended draft or has not taken up the Commission's amendments in a way satisfactory to the Commission, the Commission may adopt the technical standards as it sees fit or reject them. Both the European Parliament and the Council have the right to object, within three months (or within one month if the standard proposed by the Commission is identical to the ESA's proposal), to a regulatory technical standard endorsed by the Commission. In such a case the regulatory technical standard may not enter into force.

[6] Art. 22,4 of the EBA / ESMA Regulations.

participate in the colleges of supervisors, including on-site visits and can request the deliberation of issues in the colleges.

**ESAs can issue binding standards**

The scope of areas where the ESAs can issue binding technical standards is defined in EU financial legislation, where such delegated powers have to be enshrined. In the case of ESMA, such powers can currently be found in a number of pieces of legislation, including the MiFID, the Prospectus Directive, the Transparency Directive and the Market Abuse Directive.[7] In the case of EBA, the CRD is the main source of delegated powers. Before passing technical standards, the ESAs are required to hold public consultations on the drafts of such technical standards, perform cost-benefit analysis and seek the view of their advisory committees, i.e. the Stakeholder Groups.

**No direct supervisory role**

The ESAs do not have a mandate to directly supervise individual financial institutions. This will remain the exclusive competence of national supervisory authorities (though, as mentioned, the ESAs are entitled to participate in the supervisory colleges which have been set up for cross-border financial groups). However, in three narrowly defined cases, the ESAs may take decisions pertaining to individual institutions, which would prevail over previous decisions taken by national competent authorities:

**Competences in case of breaches of EU law, ...**

— The ESAs may investigate – upon request by the European Commission, the EP, the Council, any national supervisory authority, the Banking Stakeholder Group or on its own initiative – alleged breaches of EU law by national authorities. If the national competent authority is found in non-compliance with EU law, and if it does not comply with a Commission opinion requiring it to take necessary action and if, as a consequence of such non-compliance, market disruptions occur, an ESA may issue rulings directly applicable to individual institutions. [8]

**... lasting disagreements ...**

— The ESAs may take binding action in case of lasting disagreements between national authorities, if mediation has failed. Again, should one of the parties concerned not comply with the ESA's ruling, the ESA may adopt an individual decision addressed to the relevant market participant(s).

**... and in emergency situations**

— The ESAs may adopt, in emergency situations, decisions requiring national authorities to act or, if it does not, issue a decision directly applicable to an individual financial institution. Even in those circumstances the priority is on facilitating and coordinating the actions of national supervisors. For this to occur, the ESAs are to be invited as observers to meetings of the relevant national competent authorities. The emergency would have to be declared by the Council, in consultation with the ESRB and the European Commission. An emergency is defined as a situation where adverse developments may seriously jeopardise the orderly functioning and integrity of the financial markets or the stability of the whole or part of the financial system in the EU. In such a case, if satisfactory action by national authorities is not forthcoming, the ESA may temporarily

[7] The total list comprises MiFID, TOD, Settlement Finality Directive, PD, Financial Collateral, MAD, AIFM, UCITS, CRA, Investor Compensation Schemes.

[8] If a national competent authority is found to be in breach of EU law by the ESA, the addressee of such an ESA recommendation must respond within ten working days. If the competent authority does not comply with EU law within one month from receipt of the ESA recommendation, the European Commission may issue a formal opinion requiring the competent authority to act. After that, the competent authority again has ten working days to respond. If the authority still fails to comply, the ESA will be able to issue directions directly to the market participant affected.

prohibit or restrict activities deemed harmful, where the underlying legislation provides a legal basis for such restrictions. Bans on short-selling or the trading of sovereign CDS spring to mind as examples from the recent past where such powers could have been employed. The ESA may also ask the Commission to introduce legislation to make such restrictions permanent.

**"Safeguard clauses" protect national interest ...**

So-called "safeguard clauses"[9] stipulate that decisions by an ESA taken in an emergency situation or taken to settle a disagreement between national competent authorities must not impinge in any way on the fiscal responsibilities of a member state. This safeguard clause responds to concerns by member states that decisions by ESA might have consequences for national budgets without the member state and its parliament having an ex ante say on this matter. The safeguard clause establishes two processes, referring to (i) a decision by an authority to solve disputes between competent national authorities and (ii) a decision taken in response to an emergency situation.

— In case (i), if a member state considers that a decision by an ESA impinges on its fiscal responsibilities, it must notify the ESA and the Commission within two weeks, explaining its case; the decision will then be suspended. Within a month of receipt of the notification, the Authority shall inform the member state whether it maintains its decision or whether it amends or revokes it. If the decision is maintained, the Council, not later than two months later (within 10 working days in case of a decision taken in an emergency), shall decide, by simple majority, whether the Authority's decision is maintained. Should the Council not take a decision to maintain the Authority's decision, the decision shall be revoked.

— In case (ii), the member state must notify the Authority, the Council and the Commission within three working days; again, the decision will be suspended in case of such a notification. The Council shall, within 10 working days, take a decision by simple majority, as to whether the Authority's decision is revoked. If the Council does not a decision to revoke the decision, the suspension shall be terminated. If the member state insists on its position, it can ask the Council to re-consider the matter. In such a case, the Council will be obliged to confirm its earlier decision or to take a new decision.

**... but may only be invoked in exceptional cases**

Note should be taken of the fact that the two processes differ: Whereas in case (i), a majority must be achieved in the Council to *back* the Authority's decision, in case (ii) a majority must be achieved to *revoke* the Authority's decision. This appears sensible in light of the fact that, in an emergency situation, uncertainty about the finality of a decision should be minimised. This interpretation is supported by the fact that the Regulation also makes clear (in Art. 38,5 of the EBA / ESMA Regulation) that member states shall only make use of the safeguard clause when a "*significant and material*" impact on the budget is anticipated to stem from the Authority's decision.

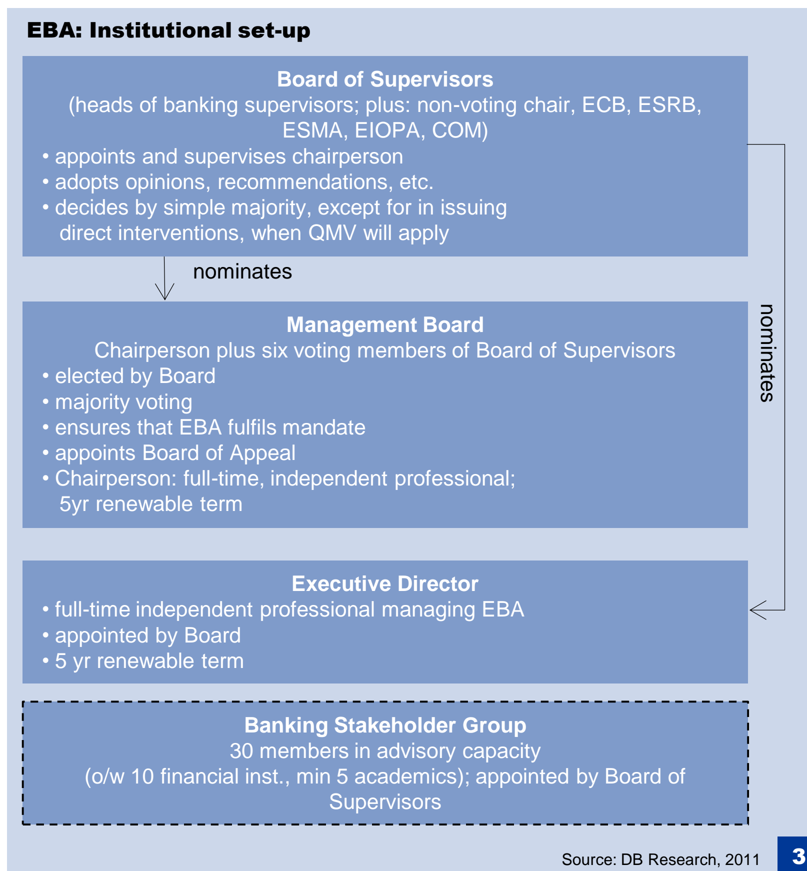
### *Institutional set-up*

The institutional set-up of the three ESAs is similar (see chart p. 12 for a graphical depiction using the example of the EBA). Their main decision-making body is the Board of Supervisors, composed of the

[9] These are enshrined in Art. 38 of the Regulations setting up EBA and ESMA respectively.

heads of national banking supervisors, plus, as non-voting participants, a chair and a representative each of the ECB, the ESRB, the Commission and the respective other two ESAs. The Board appoints and supervises the chairperson, and adopts opinions and recommendations. It decides by simple majority, except for issuing direct interventions, when qualified majority voting will apply.

**EBA: Institutional set-up**




Source: DB Research, 2011 3

**ESA Board of Supervisors**

The Board is composed of

— the heads of the respective national competent authorities
— the Chairperson of that ESA
— representatives from the respective two other ESAs, from the European Commission, and from the ESRB

Only the representatives of the national supervisors are voting members.

The Board of Supervisors also nominates the Management Board, which is tasked with ensuring that the ESA fulfils its mandate on a day-to-day basis. The Management Board is tasked with developing the work programme and dealing with issues concerning budget and personnel. It is chaired by a full-time professional and, in addition to this Chairperson, is composed of six voting members drawn from the Board of Supervisors. The Management Board decides by simple majority. Its members shall act independently and in the sole interest of the Union as a whole. The Board of Supervisors also nominates the Executive Director, a full-time independent professional tasked with managing the day-to-day work of the ESA.

Decisions by the ESAs can be appealed against at the Board of Appeal, composed of six members, two each of which are nominated by each of the ESAs. The members of the Board of Appeal will be well-reputed individuals with knowledge in the respective fields and professional experience. The decisions of the Board of Appeal will be made by majority vote.

In order to provide a regular and organised framework for discussion with stakeholders, the ESAs have set up Stakeholder Groups, each comprising 30 members representing not only financial institutions but also representatives of employees, consumers and users of financial services.

**Joint Committee**

*Composition:* The Joint Committee is composed of the Chairpersons of the ESAs and the Chairperson of any sub-committee established by the Joint Committee, especially the Sub-Committee on Financial Conglomerates.

*Mandate:* The Joint Committee serves as a forum for cooperation amongst the ESAs, aiming to ensure cross-sectoral consistency, especially in the areas of

- financial conglomerates
- accounting and auditing
- micro-prudential analyses of cross-sectoral developments, risk and vulnerabilities
- retail investment products
- measures combating money laundering
- cooperation with the ESRB

### *Differences between the ESAs*

While the ESAs are similar as regards their institutional set-up, they differ in their competences. Compared to its peers, ESMA has a greater role in regulation, being frequently referred to EU legislation with a rule-setting role, e.g. on derivatives markets. In contrast, EBA's work is more geared to prudential supervisory issues, with no direct supervisory powers except for in the exceptional circum-stances mentioned above. ESMA also has a far broader remit of competences, spanning securities, securities markets, clearing houses, fund managers, and credit rating agencies (CRA). As regards the latter it even has a direct supervisory role, as in the regulation on credit rating agencies the right to authorize and supervise CRA is conferred onto ESMA. ESMA is therefore unique in being the only ESA that has direct supervisory powers. In this context, ESMA will be given power to request information, launch investigations and perform on-site inspections. It would be sensible (and indeed build on the same logic) if similar powers were conferred onto ESMA for other pan-European structures and organisations, such as clearing houses. However, the reaction of national competent authorities and member states to such ideas was less than welcoming, pointing to the fact that the transfer of direct supervisory powers to the EU-level is still anathema to many national authorities and member states.

### *Assessment*

**New framework has some positive aspects ...**

The new framework for micro-prudential supervision in the EU and the establishment of the ESAs undoubtedly has some positive aspects. Specifically, the following aspects must be regarded as contributions to overcoming some of the weaknesses of the previous arrangements:

- In contrast to the work of the 3L3, ESA technical standards and guidelines will be binding on all member states.
- The development of a single rule-book, if successfully achieved, would be a significant step towards supervisory harmonisation. It would not only provide the basis for a consistent treatment of investors across the EU, but would also provide a regulatory level playing field for financial services providers.
- The presence of the ESAs in the supervisory colleges and the fact that national supervisors will henceforth conduct their work under the shadow of potentially binding decisions by the ESA will probably help to enhance the quality and consistency of supervisory decisions. Only time will tell, though, whether this will be sufficient to materially improve the effectiveness of supervisory decisions.

**... but leaves supervisory framework in half-way house**

Nonetheless, it is impossible to ignore that the new arrangement, while addressing some of the obvious weaknesses of the previous regime, does not mark a revolutionary change, but merely constitutes another uneasy compromise regarding the sharing of supervisory competences between the EU-level on the one hand and the national level on the other. While the reform has shifted power slightly in favour of the EU-level, the new balances is ways apart from truly pan-European supervision. Specifically:

- Lacking substantial resources of their own[10], ESAs will have to rely on national competent authorities to perform their task; the

[10] The combined budget of the three ESAs for 2011 amounts to EUR 40 m, funded by obligatory contributions from national authorities, the EU's General Budget and fees for services provided by the ESFS to national regulators such as arbitration

**Dependent on support from national competent authorities**

same holds true for access to data. Hence, a supportive stance of the national authorities will be crucial to the ESAs success – which is a precarious state of affairs, given that some national authorities may view the ESAs as a threat to their own competences. The peer reviews which the ESAs are tasked with will be a crucial test-point for the credibility of the ESAs and for their forcefulness vis-à-vis national supervisors. In this regard, the insistence of EBA on a stringent peer review and a thorough vetting of results in the recent EBA stress testing exercise is a positive development, even if it may have angered some national authorities.

— None of the ESAs has micro-prudential supervisory powers.[11] Whether or not they will be able to establish themselves as forceful actors, will depend on their chairpersons and executive directors. It will also depend on the willingness of the ESAs to stand up to national authorities and to members states to assert pan-European views and the powers of the ESAs.

— The "half-way house-character" of the new arrangement also shows in the contribution of the ESAs to crisis management: On the one hand, EBA will have no direct supervisory powers, on the other hand, Art. 24 of the Regulation setting up EBA tasks EBA to *"ensure it has specialised and ongoing capacity to respond effectively to the materialisation of systemic risks (...) in particular, with respect to institutions that pose systemic risk."* Similarly, the ESAs must source their information through the national competent authorities and may only in exceptional cases address their requests directly to the institution concerned.

## IV) Conclusion and outlook

**ESRB is a positive step**

Does the reform of supervisory structures in the EU amount to a significant step and will it materially help to enhance the resilience of the European financial system? The establishment of the ESRB as a macro-prudential supervisor certainly fills a gap in the previous supervisory structure. Whether the ESRB – and, for that matter, systemic risk supervisors elsewhere – will actually manage to identify threats to systemic stability and take appropriate course to address these effectively is something that only time will tell. The ESRB will certainly be able to assemble and build adequate expertise for the task and the institutional framework for the task appears, on the whole, conducive to the task in spite of looking overly complex and unwieldy. However, the actual effectiveness will ultimately hinge on the level of political support for the ESRB – a factor more difficult to predict.

**ESAs are a compromise**

As regards the reform of micro-prudential supervision, the establishment of the ESAs is undoubtedly another step in the evolutionary approach that started with the Lamfalussy Process. But it still leaves the supervisory framework in an uneasy half-way house between national and supra-national structures for financial supervision. This construction reflects that the structure, which took effect at the start of the year, is a hard-fought compromise between the European Parliament and the Commission, who wanted stronger powers for the EU-level institutions and a transfer of direct

and mediation. Staff levels are expected to total 150, expected to rise to 300 within four years. This pales in comparison to the budgets of national supervisors: the UK FSA, in the budget period 2010/11, had a budget of more than GBP 470 m a year and a staff of almost 3,300 (on an FTE basis); Germany's BaFin, in 2010, had a staff of almost 2,000 and a budget of EUR 143 m.

[11] Except for ESMA's aforementioned limited powers vis-à-vis CRAs.

supervisory powers over at least the largest financial institutions in the EU to them, and (majority of) the Council, which wanted to preserve the influence of national supervisors. As the heated discussion about EBA's role in the latest round of European stress-tests has shown, this leaves the ESAs caught between high expectations on the one hand and limited powers and head winds from national supervisors on the other. As a result, the new structure of micro-prudential supervision constitutes an uneasy arrangement: If handled well, the integrated structure of national and EU-level institutions could be tantamount to a pooling of the strengths of both levels; it is at least equally likely, however, that conflicts over competences will be frequent making supervision less effective.

**Review is scheduled and welcome**

Against this background it is more than appropriate that the EU regulations establishing the ESFS stipulate that the entire structure be reviewed after three years (i.e. at end-2013), and every three years thereafter. This will provide an opportunity to assess whether the new structure has made financial supervision in the EU more efficient and more effective. In this context, the geographic scattering of the ESAs across three locations should also come under scrutiny, as it clearly impedes on the effectiveness of their work. An effective integration with the work of the ESRB would suggest that Frankfurt is the best choice for a joint location.

**Pan-European supervision remains desirable and necessary**

It is somewhat ironic that the recitals[12] in the ESA Regulations actually explicitly recall the weaknesses and the limits of the previous institutional structure based on the 3L3 – but then falls short of really addressing these weaknesses by a bold step towards pan-European supervision. We remain convinced that truly pan-European supervisory powers remain not only desirable, but absolutely necessary. The financial crisis has demonstrated that the co-existence of national supervision and integrated financial markets is untenable. As has been observed, financial institutions "live globally, but die nationally". Hence, the choice is between either preserving an integrated financial market in the EU and create a corresponding EU-level supervisory framework for it, or to allow the re-fragmentation of Europe's financial markets. Or to put it more succinctly, quoting Lord Turner: "We either need less Europe or more Europe (…)."[13] The choice is clear.

Bernhard Speyer (+49-69-910-31735, bernhard.speyer@db.com)

[12] Cf., e.g., recital 8: „The Union has reached the limits of what can be done with the present status of the Committees of European Supervisors. The Union cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible supervisory decisions for cross-border financial institutions; where there is insufficient cooperation and information exchange between national supervisors; where joint action by national authorities requires complicated arrangements to take account of the patchwork of regulatory and supervisory requirements; where national solutions are most often the only feasible option in responding to problems at the level of the Union, and where different interpretations of the same legal text exist.

[13] Adair Turner, FSA, at press conference on 9 February 2009.

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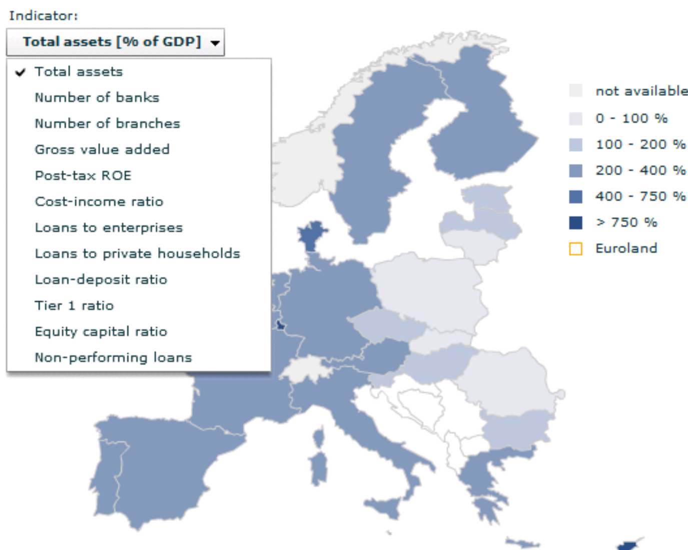


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