Appendix: European Financial Supervision: Summary of key elements in the Commission Communication

This summary is prepared by Graham Bishop and intended only to highlight the most important elements of the proposal, rather than be a comprehensive and balanced review. Bold italics are this editor's highlights.

1. INTRODUCTION

This Communication is a key milestone and sets out the basic architecture for a new European financial supervisory framework. The Commission invites the European Council to endorse this architecture ..., the legislative changes to give effect to the framework for EU supervision set out in this document will follow in the autumn of this year, after further consultation of stakeholders, and should be ***adopted in time for the renewed supervisory framework to be up and running during 2010.***

2. A NEW SUPERVISORY FRAMEWORK FOR THE EU

a European Systemic Risk Council (ESRC) which will monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole ("macro-prudential supervision"). To this end, the ESRC would provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks. ***The creation of the ESRC will address one of the fundamental weaknesses highlighted by the crisis, which is the vulnerability of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks;*** and

b European System of Financial Supervisors (ESFS) consisting of a robust network of national financial supervisors working in tandem with new European Supervisory Authorities to safeguard financial soundness at the level of individual financial firms and protect consumers of financial services ("micro-prudential supervision"). The new European network will be built on shared and mutually reinforcing responsibilities, ***combining nationally based supervision of firms*** with centralisation of specific tasks at the European level so as to ***foster harmonised rules*** as well as coherent supervisory practice and enforcement. This network should be based on the principles of partnership, flexibility and subsidiarity. It would aim to enhance trust between national supervisors by ensuring, inter alia, that host supervisors have an appropriate say in setting policies relating to financial stability and consumer protection, thereby allowing cross-border risks to be addressed more effectively.

.... In parallel, ***differences in the national transposition of Community law*** stemming from exceptions, derogations, additions or ambiguities in current directives ***must be identified and removed, so that one harmonised core set of standards (a single rulebook) c***an be defined and applied throughout the EU by all supervisors. This process could be strengthened by ***introducing more directly applicable rules*** at the EU level, where possible..... It must be a system that is based on high supervisory standards, applied equivalently, fairly and consistently to all market actors, while respecting the independence of supervisors to carry out their work.

With this initiative, the EU is not just responding to its calls in the G20 framework for international action to build a stronger, more globally consistent, regulatory and supervisory system for the future financial sector, but also ***setting out a modern and comprehensive regional framework, whose principles should be taken up at international level***.

3. EUROPEAN SYSTEMIC RISK COUNCIL (ESRC)

3.2. Role and responsibilities of the ESRC

... The warnings and recommendations issued by the ESRC could be of a general nature or could concern individual Member States and there would be a specified timeline for the relevant policy response. These warnings and/or recommendations would be channelled through the ECOFIN Council and/or the new European Supervisory Authorities. The ESRC would also be responsible for monitoring compliance with its recommendations, based on reports from the addressees.

The ESRC would not have any legally binding powers. However, the ESRC would be expected to exert major influence on the addressees of warnings/recommendations through the high quality of its analysis... The addressees of warnings and recommendations would therefore be expected to act on them unless inaction could be adequately justified. In short, the ***follow-up to warnings and recommendations would be ensured by an "act or explain" mechanism***. The ESRC would decide in each case whether a recommendation should be kept confidential or made public, on the basis of its own judgement. However, bearing in mind that the recommendations by the ESRC would not be binding, public disclosure would be expected to increase their effectiveness.

The ESRC would be fully accountable to the Council and the European Parliament.

3.3. Composition and functioning of the ESRC

(Membership is specified in the Annex)

Central banks should have a leading role in macro-prudential supervision.... the chairpersons of the three European Supervisory Authorities of the ESFS as well as senior representatives of the national supervisory authorities should be involved. To ensure that the ESRC can work efficiently, the membership of supervisors in the ESRC would be limited to the three chairpersons of the European Supervisory Authorities. However, each central bank governor should be accompanied by one senior representative of the national supervisory authorities as observer (i.e., a 1+1 formula)..... ***Participation of Finance Ministries in the ESRC could be perceived as blurring its role in providing independent technical analysis of macro-prudential risks.*** However, as budgetary and/or taxation policies can contribute to or mitigate financial-stability risks, the Economic and Financial Committee ***(EFC) chairperson would represent the finance ministries by participating as an observer*** in ESRC meetings.... In order to streamline the decision-making process, however, only ESRC members would have the right to vote, i.e. only the President of the ECB, national central bank governors, the chairmen of the European Supervisory Authorities and the Commission member. ***Votes would not be weighted and decisions would be taken by a simple majority***.... In line with the recommendation made in the de Larosière report, the chairperson of the ESRC should be the ECB President (in which case, the chairperson of the ESRC being independent, the ECB Vice-President should also be a member). As the chairperson comes from a central bank within the Eurosystem, it would seem appropriate that a ***vice-chairperson should be elected from among those Member States outside of the euro area.***

A small steering committee – consisting of the ESRC chairperson and vice-chairperson, five additional central bank members of the ESRC, the chairpersons of the new European Supervisory Authorities and the Commission member - should be established to prepare and ensure efficient ESRC meetings. In addition, an advisory technical committee should be established to support the ESRC, including preparing detailed technical analysis of financial stability issues.... The ECB will provide the Secretariat to the ESRC as well as analytical, administrative and logistic support.

3.4. Legal basis for the ESRC

Having considered a range of possible options, the Commission considers it appropriate that the ESRC should be established on the basis of Article 95 of the EC Treaty as a body without legal personality. This legal basis would allow the ESRC to have the core features outlined above and to have a mandate covering the whole financial sector without exceptions, including insurance.... This choice of legal base does not prevent the conferring of responsibilities on the ECB in respect of tasks in respect of the ESRC by means of an act adopted on the basis of Article 105(6) of the EC Treaty.

4. EUROPEAN SYSTEM OF FINANCIAL SUPERVISORS (ESFS)

4.1. The case for micro-prudential reforms

On micro-prudential supervision, the ***EU has reached the limits of what can be done with the present status of the Committees of European Supervisors*** (Level 3 Committees) - which remain advisory bodies to the Commission. In spite of a number of improvements to these Committees, ***the EU 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 institutions;*** where there is insufficient cooperation and information exchange between national supervisory authorities; where joint action by national authorities requires a tour de force to take account of the patchwork of regulatory and supervisory requirements; where national solutions are most often the only feasible option in responding to European problems, where different interpretations of the same legal text abound.

4.2. Role and responsibilities of the ESFS

(Structure is specified in the Annex)

The ESFS should become therefore an operational European network with shared and mutually reinforcing responsibilities. At the EU-level, the three existing Committees of Supervisors would be replaced by three new

European Supervisory Authorities, i.e., a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities Authority (ESA), which would each have legal personality. These new European Supervisory Authorities will take on all the missions of the current Committees of Supervisors, but in addition have increased responsibilities, defined legal powers and greater authority. They would also contribute to the ***development of a single set of harmonised rules***, improve the supervision of cross-border institutions by ***developing common supervisory requirements and approaches*** and help ***settle possible disputes between national supervisors***.

The focal point for day to day supervision would remain at the national level, with national supervisors remaining responsible for the supervision of individual entities, for example with respect to capital adequacy. This reflects, for the time being, that the financial means for rescuing financial institutions remains at the Member State level and with national tax payers, as the current crisis has demonstrated.

In order for the ESFS to work effectively, flanking measures and changes to the sectoral legislation will be needed to ensure a more harmonised set of financial regulations. The goal will be to bring about more harmonisation in the rules that have to be applied by supervisors as well as greater consistency in the national powers and sanctions available to them.

To achieve its objectives, the new European Supervisory Authorities will need to be equipped to fulfil the following functions:

(1) Ensure a single set of harmonised rules

The Authorities will:

- develop binding technical standards in specific areas and on the basis of criteria which will be specified in Community legislation (e.g. supervisory standards for colleges of supervisors and technical standards for internal model validation). Such standards shall apply within a fixed period of time, ***provided the Commission endorses by non-opposition,***

- ***draw up interpretative guidelines***, …

(2) Ensure consistent application of EU rules

- *Disagreement between national supervisors* …In the case of diverging opinions between national supervisory authorities, the European Supervisory Authorities should facilitate a dialogue and assist the supervisors in reaching a joint agreement. If, after a phase of conciliation, the latter have not been able to reach an agreement, ***the European Supervisory Authorities should, through a decision, settle the matter***. However, this would clearly be a last resort option as in most cases the respective national authorities should be able to come to an agreement in the preceding conciliation procedure.

- *Manifest breach of Community Law*…the European Supervisory Authorities ***could also be empowered to adopt decisions directly applicable to financial institutions*** in relation to requirements stemming from EU Regulations

(3) Ensure a common supervisory culture and consistent supervisory practices …They could also promote the ***use of delegation of tasks and responsibilities*** from one national supervisory authority to the other.

(4) Full supervisory powers for some specific entities …***The European Supervisory Authorities shall be given the responsibility for the authorisation and supervision of certain entities with pan-European reach***, e.g., credit rating agencies and EU central counterparty clearing houses.

(5) Ensure a coordinated response in crisis situations…The European Supervisory Authorities should have a strong coordinating role in crisis situations: they should facilitate cooperation and exchange of information between the competent authorities, ***act as mediator when needed, verify the reliability of the information that should be available to all parties*** and help the relevant authorities to define and implement the right decisions. As for the latter, ***the introduction of a European mandate by mid-2009*** will allow national authorities to consider financial stability concerns in other Member States … ***progress on burden sharing and resolution mechanisms is critical to reinforcing trust*** between national authorities and strengthening the functioning of the ESFS,… In specific crisis situations, the ***European Supervisory Authorities could have the power to adopt some emergency decisions*** (e.g. on short-selling) - the scope of these emergency procedures should be defined in Community legislation.

(6) Collect micro-prudential information … a ***central European database*** should be established and managed by the European Supervisory Authorities. The information would be available for the relevant authorities in

colleges of supervisors and may be forwarded in aggregated and/or anonymous format to the ESRC…. To this end, existing sectoral legislation may need to be amended.

(7) Undertake an international role …The European Supervisory Authorities could also assist the Commission in preparing ***equivalence decisions pertaining to supervisory regimes in third countries.***

(8) Safeguards …The framework for the exercise of the above competences will be specified exhaustively and in precise detail in the relevant sectoral legislation…..and recognising the potential liabilities that may be involved for Member States, decisions under the above ***mechanisms shall not directly impinge on the fiscal responsibilities*** of the Member States.

4.3. Composition and operational structure of the ESFS

The chairpersons and secretary generals of the European Supervisory Authorities should be full-time independent professionals. The chairperson will be nominated after an open competition. Appointment would be confirmed by the European Parliament and should be valid for a period of 5 years.

The European Supervisory Authorities' decisions on technical rules would be taken, through the board structure, ***by qualified majority*** based on the Treaty weighting for Member States.

… The European Supervisory Authorities would however be ***fully accountable to the Council, the European Parliament and the Commission.***

4.4. Legal basis for the ESFS

The establishment of the ESFS, and the three European Supervisory Authorities, ***will be accompanied by the development of a single rule book which will ensure uniform application of rules i***n the EU and thus contribute to the functioning of the internal market.

The Court of Justice has acknowledged that Article 95 of the EC Treaty relating to the adoption of measures for the approximation of legislation for the establishment and functioning of the internal market provides an appropriate legal basis for setting up a "*Community body responsible for contributing to the implementation of a process of harmonisation*", when the tasks conferred on such a body are closely linked to the subject-matter of the acts approximating the national legislations.

5. COOPERATION BETWEEN THE ESFS AND THE ESRC

The Commission will propose that the necessary information would be passed to the European Supervisory Authorities by the national supervisory authorities.... Given the sensitivity of the data and information, ***ensuring necessary confidentiality*** in the cooperation between the ESRC and the ESFS would be crucial and adequate legal safeguards should be in place.

6. CONCLUSION

The Commission invites the European Council to:

- endorse the creation of a new European Systemic Risk Council (ESRC),

- agree on the establishment of a new European System of Financial Supervisors (ESFS)

- welcome the Commission's intention to bring forward, ***as soon as possible, the legislative changes*** to put in place the new framework for EU supervision, ***on the basis of the orientations*** set out in this Communication.

- in addition, support the acceleration of work to build a comprehensive cross border framework to strengthen the European Union's ***financial crisis management/resolution systems, including guarantee schemes and burden sharing.***

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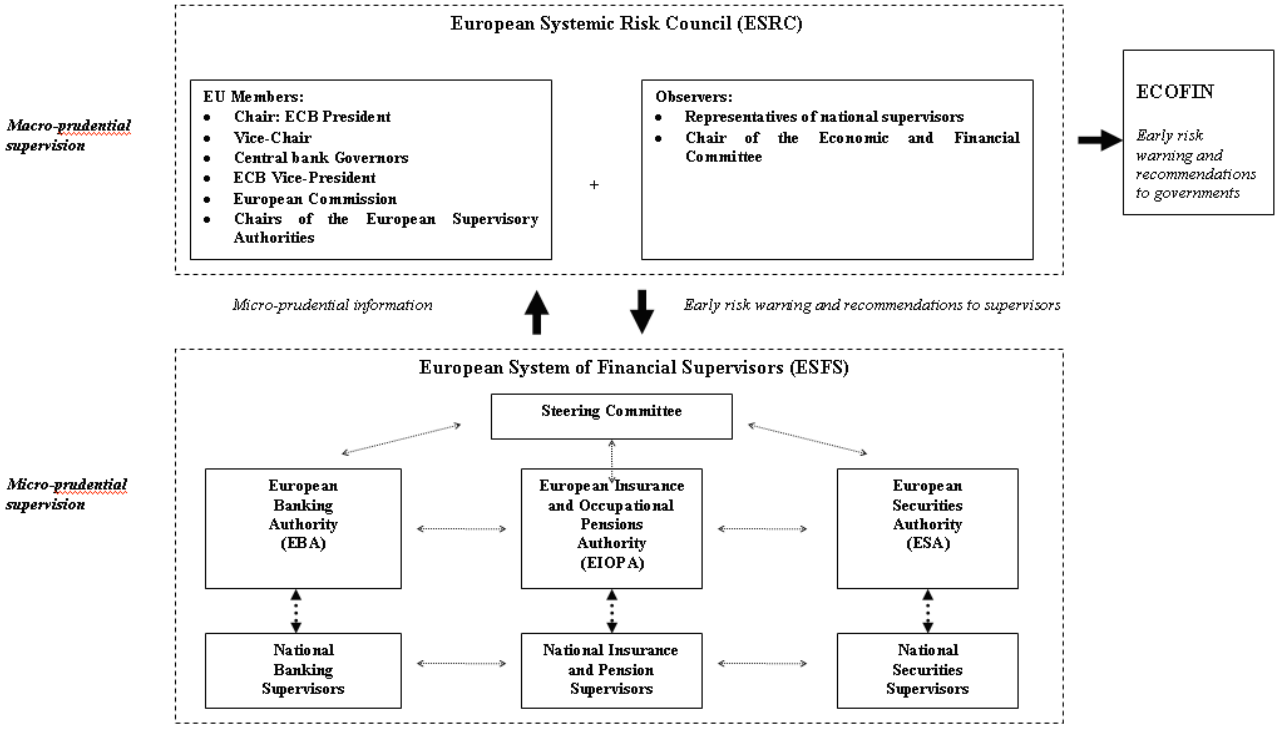
Annex: **A new European Framework for Safeguarding Financial Stability**



Sources: European Commission and *GrahamBishop.com*