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European Parliament finalises Financial Supervisory Architecture

The European Parliament has now approved a package of legislation¹ setting out the new financial supervisory architecture in the EU (the “**Legislation**”). The new architecture will be up and running from January 2011, and will comprise, as expected, two pillars: a European Systemic Risk Board (“**ESRB**”) and three European Supervisory Authorities (“**ESAs**”). The two pillars are intended to strengthen supervision of the financial system as a whole (macro-prudential supervision) as well as supervision of individual financial institutions (micro-prudential supervision). The legislation takes the form of a number of regulations, and so will have direct effect in EU Member States and will not require domestic legislation in order to implement it. The legislative package was accompanied by a [press release](#) and a set of [FAQs](#).

This follows the European Commission’s proposals for legislation in September 2009 which aimed to address the shortcomings of the current, mainly national based regulatory system in Europe and sought to put in place a new structure to strengthen the European structure. It also concludes the somewhat protracted negotiations between the Parliament, the European Council and the Commission to find a common position on the legislative package– the Parliament had been taking a more radical approach towards the powers to be conferred on the ESAs to intervene at a national level than that taken by the Council. For the most part, it seems that the Parliament’s

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- [¹Resolution](#) on the proposal for a regulation on Community macroprudential oversight of the financial system and establishing a European Systemic Risk Board
 - [Resolution](#) on the proposal for a regulation establishing a European Insurance and Occupational Pensions Authority .
 - [Resolution](#) on the proposal for a regulation establishing a European Banking Authority.
 - [Resolution](#) on the proposal for a regulation establishing a European Securities and Markets Authority .
 - [Resolution](#) on the proposal for a Directive amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, 2009/65/EC in respect of the powers of the EBA, the EIOPA and the ESMA (known as the "Omnibus I Directive").
 - [Resolution](#) on the proposal for a regulation entrusting the European Central Bank with specific tasks concerning the functioning of the ESRB.

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efforts have paid off, and the ESAs have a number of powers that, as the Parliament's press release says, should make them "watchdogs with a bite".

The new architecture is summarised further below.

ESAs – micro-prudential supervision

The Legislation establishing the three new ESAs (the European Banking Authority ("EBA"), the European Insurance and Occupational Pensions Authority ("EIOPA") and the European Securities and Markets Authority ("ESMA")) is likely to have more of an immediate impact.

The ESAs will replace the three existing advisory committees (that is, the Committee of European Banking Supervisors, Committee of European Insurance and Occupational Pensions, and the Committee of European Securities Regulators), but will have considerably enhanced responsibilities and powers. The EBA will have its seat in London, EIOPA in Frankfurt am Main, and ESMA in Paris.

The ESAs' broad remit as set out in the Legislation, will be to:

- > Contribute to the development of a single set of harmonised rules across Europe.
- > Contribute to the consistent application of these rules, and foster common supervisory approaches to the supervision of all financial firms.
- > Regulate national regulators – conduct peer review analyses of competent authorities, including issuing guidelines to strengthen supervisory practices.
- > Promote a coherent functioning of colleges of supervisors.
- > Work with third countries that have concluded relevant agreements with the EEA and permit them to participate in the work of the ESAs.
- > Mediate and settle disagreements between national regulators, including the controversial power to make a binding decision for them where agreement cannot be reached.
- > Impose a decision directly on a national regulator where it is incorrectly applying EU regulations, and if that national regulator fails to comply with the decision, impose that decision directly on a financial institution;
- > Take action in emergency situations - whilst the Council has responsibility for declaring an emergency situation on the advice of the ESRB or an ESA, an ESA can, in certain circumstances specified in the Legislation (and where empowered under sectoral legislation) require national regulators to take action. See for example the power for ESMA to take such action under the [shortselling regulation](#) published a few weeks ago. If such regulators do not comply, an ESA can require a financial institution to take or refrain from taking action.

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ESRB – macro-prudential supervision

The Legislation regarding the ESRB is on the whole relatively uncontroversial, and as we expected. The ESRB's objective under the legislation is to safeguard financial stability by carrying out macro-prudential supervision across the EU financial system. In practice, this means that it will look at the health of the underlying financial institutions in the system and it will perform stress tests and scenario analysis to help determine the system's sensitivity to economic shocks. It will have a broad scope of activity, not limited to a specific type of entity or market. Specifically it will:

- > Determine and collect all information necessary to perform its objectives (the ESAs, European System of Central Banks, national regulators, etc. are all required under the legislation to provide relevant information).
- > Identify and prioritise systemic risks (using a colour-coded system to indicate different risk levels).
- > Issue risk warnings where risks appear to be significant (using the colour-coded system), and where appropriate make these public, as well as give recommendations on measures to be taken.
- > Monitor the follow up to warnings and recommendations.
- > Liaise with the IMF, the Financial Stability Board and third country counterparts.

The ESRB's seat will be in Frankfurt and will have as its chair for the first five years the President of the European Central Bank ("**ECB**"), (which is of course has a key central banking role in the eurozone). During negotiations concerns were raised by countries outside the eurozone (the UK included) that non-eurozone countries would not be represented – but these concerns have not been taken into account - Parliament in its press release justifies the ECB as chair as necessary "to improve visibility and credibility from the outset".

As envisaged in the Commission's proposals, the ESRB's recommendations will not be legally binding, but recipients are expected to act on a "comply or explain" basis. Decisions as to whether to make a recommendation or warning public will be made on a case by case basis, and advance prior notice will be given to the addressees of any warnings and recommendations to be made public.

The Legislation does not address criticisms raised during consultation that the membership of the ESRB is too large - its general board will be made up of the ECB as chair, representatives from the EU member central banks, the three European Supervisory Authorities (see below), plus senior representatives of the national supervisory authorities. Although it will have a smaller steering committee, it remains to be seen as to whether it can make decisions quickly.

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Direct European supervision?

The ESAs' remit clearly envisages three areas where they can impose a decision on a national regulator, and directly on an individual financial institution if the national regulator fails to comply with the decision: when settling disagreements between national regulators; where a national regulator is incorrectly applying EU regulations; and in emergency situations. Whilst the FAQs accompanying the legislation state that the reforms are not the first step towards full-fledged direct European supervision and that day-to-day supervision of financial institutions is best carried out at the national level, we are clearly entering a new phase so far as Europe's ability to intervene at a national, and even at an individual firm level is concerned.

The emergency powers decision is a power that was enhanced by Parliament during the legislative process and is the one that has provoked most comment so far – however the FAQs emphasise that the powers would only apply in exceptional circumstances, and that even in emergencies “the first objective of any of the three European supervisory authorities will be to facilitate and coordinate actions by national supervisors”. The FAQs use shortselling as an example: “an example of how this power might be used would be to adopt harmonised temporary bans on shortselling on EU securities markets, rather than uncoordinated actions in different Member States, as witnessed over the past years”. The power for ESMA to impose such a ban has been introduced in the [shortselling regulation](#) published a few weeks ago.

One check against the intervention of the ESAs at a national level is that they are not permitted by virtue of the “fiscal safeguard clause” in the Legislation to take any decision which impinges on the fiscal responsibilities of Member States. This was an amendment that was lobbied for by Lord Myners on behalf of the UK during consultation to address the concern that a European body might be able to dictate how UK tax payers' money should be spent in the event of a failure of a UK bank.

Although it remains to be seen how this will all work in practice, clearly this new structure is something that needs to be embraced.

Single rule book and application of the rules

A single rulebook is regarded by many as an economic imperative. This is supported in the Legislation by powers conferred on the ESAs to develop technical standards which can be adopted by the Commission as legislation, and is an enhancement of the existing Level 3 committee's powers to produce non-binding guidelines. The FSA clearly anticipates that the advent of the ESAs will bring about changes in the way that it or any successor performs its role as a policy and rule maker. Hector Sants, and other senior individuals at the FSA have been often quoted over the last year that future policy and rules will be determined in Europe and that the FSA, or any successor, will be “a locally-based supervisor delivering European rules”.

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Sectoral approach

As expected the Legislation provides for a sectoral approach to supervision, rather than a single supervisor for all of the banking, insurance, and securities sectors. This is subject to a review clause of 3 years, however, in keeping with the Commission's proposal that it wanted to allow the structure to "evolve over time". There is therefore a possibility that the three authorities could be merged and placed as one body in a European city, should there be the political will.

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