News Bulletin

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The New EU Financial Regulatory Framework

Following a meeting of the Economic and Financial Affairs Council ("ECOFIN") on 7 September 2010, the Council of the European Union ("EU") announced[1] that it has endorsed the agreement reached with the EU Parliament on 2 September 2010[2] on reforming the EU financial supervisory framework.

Their "agreement in principle" was outlined in a report of the EU Council dated 6 September 2010 on "Financial Supervision Reform,"[3] and covered the following areas:

- The text of the draft Regulations concerning the European Systemic Risk Board ("ESRB") and the European Banking Authority ("EBA");
- The alignment of the text of the draft Regulations establishing the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA") on the text agreed for EBA, with necessary modifications; and
- Certain outstanding issues relating to the EU Commission's proposal for a Directive amending a number of existing financial services directives (the "Omnibus Directive").

Background

According to many EU politicians, the recent financial crisis exposed serious failures in the supervision of financial institutions and markets in the EU. In particular, it has been argued that despite substantial integration of EU financial markets, regulation has remained fragmented among different member states, as a result of which inconsistencies in approach have developed and the current regulatory arrangements have not been fully effective in supervising financial institutions or managing the systemic risks they pose at the cross-border level.

This issue, among others, was considered by a High Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière. This Group was established in October 2008 and tasked with the review of existing EU

[1] EU Council Press Release: Council approves compromise with Parliament on financial supervision (7 September 2010), http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/116303.pdf.
[2] EU Parliament Press Release: EP adds bite to EU financial watchdog rules (2 September 2010), http://www.europarl.europa.eu/news/expert/infopress_page/042-80951-245-09-36-907-20100902IPR80950-02-09-2010-2010-false/default_en.htm; EU Parliament Story: MEPs secure overhaul of EU financial regulation (2 September 2010), http://www.europarl.europa.eu/news/public/story_page/042-80931-252-09-37-907-20100902STO80930-2010-09-09-2010/default_en.htm.
[3] EU Council Report: Financial Supervision Reform (6 September 2010), http://register.consilium.europa.eu/pdf/en/10/st13/st13179.en10.pdf.

financial supervisory arrangements and making recommendations to the EU Commission on how to strengthen them.

Based on the Group's report dated 25 February 2009 (commonly known as the "de Larosière Report"), the EU Commission published a Communication dated 27 May 2009 detailing its proposals to reform European financial supervision and inviting comments from interested parties until 15 July 2009. The Commission's proposals were two-fold and called for the establishment of an overarching European System of Financial Supervisors ("ESFS"), comprising:

- the ESRB, a newly created macro-prudential authority which will monitor and assess threats to financial stability, providing an early warning system and, where necessary, recommending remedial action to deal with systemic risks;
- three new ESAs will be established, namely the EBA, EIOPA and ESMA. These authorities will replace the current coordinating committees, i.e., the Committee of Banking Supervisors ("CEBS"), the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS") and the Committee of European Securities Regulators ("CESR"), respectively;
- the Joint Committee of the ESAs;
- the national supervisory authorities of the member states; and
- the EU Commission.

In order to enable the ESFS to work effectively, the Commission also proposed changes to the existing financial services directives in order to provide appropriate scope to the more general powers provided for in the regulations establishing the ESAs. The principal area of debate was whether the ESAs should have direct supervisory and/or enforcement powers.

The EU Commission published its legislative proposals on 23 September 2009.[4] Once ECOFIN had endorsed the Commission's proposals in December 2009, the EU Parliament started negotiations with the EU Council on the exact scope of powers to be granted the ESAs.

The EU Parliament favoured the ESAs being granted such direct powers but this was met with significant opposition by national governments concerned about their national supervisory authorities being required to cede some of their jurisdiction.

The latest agreement announced on 7 September 2010 is a compromise between the two positions. It gives ESAs powers to intervene directly in exceptional circumstances, whilst leaving day-to-day supervision and enforcement with national supervisors (at least for the time being).

The more controversial proposals to give ESAs direct supervisory powers over pan-European financial institutions, or to centralise the powers of the three ESAs into a single regulator, will be re-considered at the next review by the EU Commission in three years' time.

[4] EU Commission Proposal for a Regulation on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (23 September 2009), http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/com2009_499_en.pdf.

The New European Financial Supervisory Framework

We summarise below the key features of the proposed new EU financial supervisory bodies composing the ESFS.

ESRB

Purpose

As mentioned above, the ESRB will be a new macro-prudential regulator for the financial sector throughout the EU. Its primary purpose is to act as an early warning system and provide oversight of the systemic risks against financial stability.

Organisation

The president of European Central Bank ("ECB") will chair the ESRB for the first five years. Its secretariat will also be provided by ECB. As a natural consequence, the ESRB will be located in Frankfurt where the ECB is also headquartered.

Function and Powers

As recommended in the EU Commission proposal, the ESRB will develop an elaborate set of indicators to produce uniform ratings for the different levels of riskiness of specific cross-border financial institutions and to make it easier to identify the specific risks.

In response to the risks identified, the ESRB may issue recommendations for remedial action and where appropriate, make them public.

Furthermore, in an "emergency situation," i.e., where adverse developments may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU, the ESRB may issue an emergency warning, subject to follow-up procedures.

The ESRB chairman must report at least annually to a hearing of the EU Parliament, marking the publication of the ESRB's annual report to the EU Parliament and the EU Council.

ESAs

Purpose

The EBA, ESMA and EIOPA will be created as pan-EU supervisory authorities, and replace the existing coordinating committees CEBS, CESR and CEIOPS. They will be charged with oversight of the EU banking, securities and insurance markets, respectively.

Organisation

The board of each ESA will be made up of national supervisors. Their staff will comprise about 40 to 60 people in the first year and is expected to grow to about 100 after three years.

Of negligible substantive import, the seats of the three ESAs have nevertheless been the subject of political negotiations. The latest press reports have stated that these will initially be split between London (EBA), Paris (ESMA) and Frankfurt (EIOPA). Previous proposals had been for all three ESAs to be based in Frankfurt.

Function and powers

The ESAs will take over all the existing functions from the respective coordinating committees which they replace, and be responsible for setting common supervisory rules to be applied by all competent authorities across the EU, to share information and coordinate harmonised and effective action by the colleges of supervisors and to arbitrate any disputes between the competent authorities.

They will not normally have direct powers to supervise individual financial institutions or markets, except the ESMA will have direct supervisory powers over European credit rating agencies[5] pursuant to the EU Regulation on Credit Rating Agencies.[6]

Exceptionally, however, the ESAs will be granted supranational powers to take decisions which are directly applicable to individual financial institutions in cases of (i) manifest breach or non-application of EU law and (ii) disagreement between the competent authorities of member states, as described below.

The following are envisaged as the key functions and powers of the ESAs in relation to the specific financial market sector within their supervisory remit:

- Monitoring and enforcement: The ESAs will monitor how national supervisors implement their obligations under EU laws. If these are implemented incorrectly, the ESAs may raise the alarm and issue instructions to the national supervisor concerned. If the instructions are not complied with, the ESAs will be able to directly instruct financial institutions to remedy any breach of EU law.
- Binding mediation: The ESAs will also be able to impose legally binding mediation on national supervisors where they disagree. If agreement cannot be reached among the national supervisors, the ESAs will be able to impose supervisory decisions directly on financial institutions.
- Power to impose ban or restriction on financial activities or products: If specific financial legislation so provides, or in an "emergency situation," the ESAs will have the power to temporarily prohibit or restrict harmful financial products (e.g., "toxic" products) or activities (e.g., naked short selling). They will also have the power to ask the EU Commission to introduce legislation to prohibit such activities or products permanently.
- Power to investigate: The ESAs will have the further power to investigate specific types of financial institution, financial product or financial activity, to assess what risks they pose to a financial market.
- Review clause for increased powers: It is envisaged that ESAs' powers may well be gradually expanded over time, with the EU Commission required to report to the EU Parliament and the EU Council every three years on such matters as:
  - whether it is desirable to integrate the separate supervision of banking, securities, and insurance and pensions into a single EU regulatory body;
  - whether all the ESAs should be headquartered in the same city; and
  - whether the ESAs should be entrusted with further supervisory powers, notably over individual financial institutions with pan-European operations.

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[5] *See* Morrison & Foerster client alert: CESR consultations on the EU CRA Regulation (26 May 2010), http://www.mofo.com/files/Uploads/Images/100526CESR.pdf.
[6] Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF, came into effect on 7 December 2009, except that (i) certain provisions of Article 4 (relating to the use of credit ratings) apply from 7 December 2010 and (ii) other Article 4 provisions shall apply from 7 June 2011.

Joint Committee of the ESAs

A Joint Committee of the ESAs will be established to serve as a forum in which they cooperate and ensure cross-sectoral consistency in relation to: (i) financial conglomerates; (ii) accounting and auditing; (iii) micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability; (iv) retail investment products; (v) anti-money laundering measures; and (vi) exchanging information and developing relationships with the ESRB.

Next Steps

The EU Parliament is expected to approve the agreed texts at first reading during its plenary session on 21 September 2010.[7] Thereafter, the EU Council will formally approve them at a subsequent meeting without discussion.

Subject to these approvals, it is intended that the ESFS including the new EU supervisory bodies will be operational from 1 January 2011.

Although national supervisors will retain responsibility for supervision and enforcement in their jurisdiction, the proposals represent a significant move towards co-ordinating prudential regulatory rules and standards in the EU. The EU parliament has succeeded in obtaining regular reviews of the supervisory architecture, including the supervisory powers of the ESAs, which could give rise to ongoing tensions between the European authorities and national governments over coming years.

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[7] *See* EU Parliament's Legislative Observatory-Procedural File: European Systemic Risk Board (ESRB): establishment; macro-prudential oversight of the financial system, http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=2&procnum=COD/2009/0140.