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The New EU Financial Supervisory Architecture

A new EU financial supervisory structure is expected to be in place from January 2011. There will be three new European Supervisory Authorities, one for each of the banking, securities and insurance and occupational pensions sectors. Each will have a much broader and deeper mandate for regulatory supervision than the existing supervisory committees, including important legislative and emergency oversight powers. There will also be a new European Systemic Risk Board with responsibility for oversight of systemic risk issues. This new framework represents a considerable shift in power from national regulators to the European centre, and will effectively create a two-tier system of financial regulation in the EU.

Introduction

One result of the post mortem of the financial crisis was the identification of flaws in the EU regulatory regime, in particular a perceived lacuna in the monitoring and oversight of systemic issues at EU level and a failure among the various EU agencies and national regulators to coordinate efforts to take preventative measures. Both have been identified as important contributory factors in exacerbating the financial crisis. To address these issues, legislation has been agreed and adopted by the European Parliament and European Council providing for the establishment of the European System of Financial Supervisors ("ESFS").¹ The ESFS is designed to achieve greater harmonisation and consistency of rules applicable to financial market participants across Europe, and to reduce the scope for regulatory arbitrage. The ESFS will comprise:

- The European Systemic Risk Board ("ESRB"), which will be responsible for macro-prudential oversight;
- Three European Supervisory Authorities (the "ESAs"), namely:

¹ In February 2009 a High Level Group on Financial Supervision in the EU made recommendations, via the 'de Larosière Report', to the EU Commission (the "Commission") with a view to strengthening the financial regulatory framework within the EU. Consequently the Commission published legislative proposals on September 23 2009 ('Proposal on a European Systemic Risk Board, Regulation on banking, insurance and securities supervision'). The Commission's proposals, in amended form were adopted by the European Parliament on 22 September 2010, having been endorsed by the European Council (the "Council") on 7 September 2010.

- the European Banking Authority ("EBA"), based in London, with responsibility for the banking sector (which effectively replaces the existing Committee of European Banking Supervisors);
- the European Securities and Markets Authority ("ESMA"), based in Paris, with responsibility for the securities sector and other areas such as credit rating agencies and (possibly) clearing and alternative investment fund managers (which effectively replaces the existing Committee of European Securities Regulators); and
- the European Insurance and Occupational Pensions Authority ("EIOPA"), based in Frankfurt, with responsibility for the insurance and occupational pensions sector (which effectively replaces the existing Committee of European Insurance and Occupational Pensions Supervisors);
- National regulators; and
- A "Joint Committee" of the ESAs.

The Joint Committee of the ESAs will deal with cross-sectoral issues to ensure relevant market trends and risks in cross-border business are adequately monitored and addressed in the ESFS framework. Individual decisions will be made by the ESAs, but it will be the Joint Committee's responsibility to ensure a consistent supervisory policy and cooperative approach between the ESAs. The Joint Committee will initially consist of a main committee and a sub-committee on financial conglomerates (that is, institutions with both banking and insurance arms). In future, further sub-committees may be created.

The ESFS will have an overarching remit to protect the integrity and stability of the financial system, the transparency of markets and financial products and the position of investors. The EU institutions within the ESFS will not be able to interfere in the fiscal affairs of individual member states, and member states will be able to refer to the Council any decisions of an ESA that arguably infringes its sovereignty on fiscal matters.

Systemic Risk Oversight

The ESRB will be a new macro-prudential regulator, with responsibility for monitoring the financial system as a whole throughout the EU. Primarily the ESRB will assess risks to financial stability at national and EU level and act as an early warning system with powers to recommend preventative action to deal with systemic risks. The ESRB will use a 'risk dashboard' in collaboration with the ESAs to produce colour-coded indications of the levels of risk posed by specific cross-border financial institutions and in relation to certain market practices or products that are deemed to raise systemic concerns. The system of recommendations will operate on a comply, act or explain regime.

The ESRB will provide analysis, warnings and recommendations on the basis of micro-prudential information provided to it by other bodies in the ESFS. As the ESRB will not be given any direct legislative or supervisory powers, non-compliance issues will be delegated to the Commission. If a decision by the Commission is not needed because, for example, there are existing laws that can be invoked against the institution, the relevant ESA will be charged with enforcing the decision on the institution, effectively 'over-reaching' the national regulator.

The ESRB will be chaired by the President of the European Central Bank (the "ECB") for the first five years. A secretariat will also be provided by the ECB. It will be located in Frankfurt (which is also the seat of the ECB).

An interesting parallel is the proposed establishment of a Financial Policy Committee ("FPC") as part of the Bank of England in the UK. The FPC will be charged with the responsibility for oversight of the UK's national financial system as a whole, identifying dislocations or structural weaknesses in the financial markets or the economy. Unlike the ESRB, it is proposed that the FPC will have wide-ranging powers, including the power to require the proposed new UK national regulatory bodies

(the Prudential Regulatory Authority and the Consumer Protection and Markets Authority) to impose additional regulatory requirements on UK firms.

The ESAs

The ESAs will each comprise a Board of Supervisors, a Management Board, a Chairperson, an Executive Director, a Board of Appeal and Secretary Generals. The central body of each ESA will be the Board of Supervisors which will decide on standards, guidelines and relevant recommendations to be adopted by that ESA. Each Board of Supervisors will comprise the heads of the relevant national supervisors (who will be voting members) as well as the head of that ESA and a representative from each other ESA, the ESRB, and the Commission (who will all be non-voting members). In addition, each ESA will have a chairperson (appointed for a five-year term by the board of supervisors, subject to confirmation by the European Parliament) and secretary general, both of whom will be full time independent professionals. Each ESA will have its own legal personality.

The key functions and powers of the ESAs in relation to their respective sectors are as follows:

- Rulemaking powers. The ESAs will be able to prepare draft technical standards, guidelines and recommendations in their respective areas, following consultation with interested parties. The aim of giving the ESAs responsibility for preparing draft technical standards, which will be subject to endorsement by the Commission and accompanied by impact studies, is ensuring greater harmonisation of financial services laws throughout the EU as well as the protection of investors and consumers. It also illustrates the recognition now given to the specialist expertise the current supervisory committees have developed in their individual areas. Currently, the supervisory committees can issue guidelines and recommendations but these have no legal binding effect (although they are generally followed by the industry).
- Emergency powers. The ESAs will be able to impose bans and restrictions on financial activities or trading in certain products in the event of an 'emergency situation' – 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. The ESAs may temporarily prohibit or restrict harmful trading activities where legislation so provides (e.g. by ESMA in relation to short selling or sovereign CDS) and may also ask the Commission to introduce legislation to make such restrictions permanent.
- Supervision. The ESAs will not have general powers directly to supervise financial institutions or markets, except for certain specific powers of ESMA (as discussed below). However, the ESAs will be empowered to take decisions which are directly applicable on individual financial institutions in cases of (a) manifest breach or non-application of EU law by a national regulator or (b) disagreement between the national regulators. Where a national regulator does not comply with any such decision, the relevant ESA may address a financial institution directly.
- Coordination of national regulators. In the event of disagreements between national supervisors on issues concerning the interpretation of EU law, the ESAs will be able to impose legally binding mediation upon request or of its own motion. In the event of disagreement among colleges of supervisors (the existing groups of national regulators which oversee cross-border financial groups), the ESAs may also impose decisions on the financial group concerned.
- Investigation Powers. The ESAs will have powers to investigate entities, products or institutions in relation to systemic risk issues by way of gathering information at a micro-prudential level and disseminating that information to national supervisors and the ESRB.

ESMA and additional powers of national regulators in exceptional circumstances

The ESMA is likely in many respects to be the most influential of the ESAs since its remit, encompassing securities, markets, credit rating agencies, (possibly) clearing houses and fund managers, will cover a much broader scope of financial activity than that of the other two ESAs.

ESMA will have powers to introduce its own intervening measures should it be satisfied that intervention is required to address a threat to the orderly functioning, integrity or stability of the financial markets. This would only be permitted in instances where there are cross-border implications and if the relevant national regulators have not taken measures sufficient to address the threat. In such circumstances, ESMA may exercise any of the powers that would be available to national regulators, but on a pan-European basis. ESMA is also given powers in exceptional circumstances to prevent a person from entering into a transaction relating to a financial instrument, or to limit the value of transactions that may be entered into for a particular financial instrument. ESMA must, no less than 24 hours before the measure is intended to take effect, notify national regulators of the details of its proposed measures and provide evidence of why the measures are considered necessary. The measures will take effect when the notice is published, or at a time specified in the notice and will prevail over any previous measures taken by national regulators. In effect, national regulators will be over-reached in such circumstances.

Implementation and next steps

It is expected that the new EU supervisory bodies will be operational from 1 January 2011. The functions, powers, size and location of the ESFS supervisory bodies will all be subject to regular reviews by the European Parliament. Such monitoring of the ESFS is seen as an essential component of the new supervisory architecture, given the potential areas of overlap between the ESAs and national regulators and the aim of ensuring greater harmonisation and cooperation among national regulatory regimes. Effectively, the ESFS is a significant step towards a two-tiered regulatory regime, with a lesser degree of power retained at a national regulatory level. It is an untried, unprecedented and untested structure which will understandably suffer from teething problems, particularly in relation to the power balance between the EU and national regulators. The geographic dislocation of the three ESAs and possible related language issues may also require remedying in future. That said, greater harmonisation and consistency of application of existing EU legislation in this area is a welcome development.

The ESFS is to have an annual budget of €68m, 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 and mediation. The funding initially seems substantial, but considering the UK FSA spends £323m a year and the US regulators close to \$1bn annually, there are legitimate concerns as to whether the ESFS will have sufficient resources effectively to discharge the wide-ranging responsibilities.

The new ESFS is a sweeping re-formulation of the financial supervisory architecture of the EU, imposed on a community of national regulators chastened by their (perceived) failings in the run-up to the financial crisis. A number of member states, especially those that are home to significant financial centres, had favoured more limited reform that would allow national regulators to retain a greater degree of autonomy and flexibility. The European Parliament favoured more fundamental root and branch reform. The resulting legislation represents a compromise, and a softening of the original proposals issued by the Commission. There is still scope for greater powers to be transferred to the EU in the future. Whether this is desirable remains to be seen.

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