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European Financial Supervision

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1. Introduction

On 27 May 2009 the European Commission published its Communication on European financial supervision¹ in which the Commission proposes to follow the recommendations of the High Level Group on Financial Supervision in the EU chaired by Jacques de Larosière (the “De Larosière Group”)² to introduce a significant reform to the supervision of financial institutions in Europe. In its introduction to the Communication the Commission states:

“Experience of the financial crisis has exposed important failures in financial supervision, both in particular cases and in relation to the financial system as a whole. Current supervisory arrangements proved incapable of preventing, managing and resolving the crisis. Nationally-based supervisory models have lagged behind the integrated and interconnected reality of today’s European financial markets, in which many financial firms operate across borders. The crisis exposed serious failings in the cooperation, coordination, consistency and trust between national supervisors”.

The recommendations of the De

¹ Commission of the European Communities, COM (2009) 252 final.

² Report published on 25 February 2009, see: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

Larosière Group suggest the establishment of two new European supervisory authorities, one authority, to be named the “European Systemic Risk Council” (“ESRC”) will be entrusted with a coordinated role in the so-called macroeconomic and macro-prudential supervision. The other authority, called the “European System of Financial Supervisors” (“ESFS”) should play a role in coordinating the application of supervisory standards and guarantee strong cooperation between the national supervisors. To this end, the roles of the current Committee of European Banking Supervisors (“CEBS”), the Committee of European Securities Regulators (“CESR”) and the Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”) should be redefined. In addition, the ESFS would promote the establishment of colleges of supervisors for all major cross-border institutions.

An important element of the report of De Larosière Group, is the attempt to define the differences between macro-prudential supervision and micro-prudential supervision. As it is important to have a clear understanding of the differences between the two areas, we hereby quote the useful definitions of the De Larosière Group in this introduction:

Macro-prudential supervision is addressed as follows:

“The objective of macro-prudential supervision is to limit the distress of the

financial system as a whole in order to protect the overall economy from significant losses in real output. While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the same risk factors. Macro-prudential analysis therefore must pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects³”.

Micro prudential supervision is addressed as follows:

“Micro-prudential supervision has traditionally been the centre of the attention of supervisors around the world. The main objective of micro-prudential supervision is to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institution in question. The fact that the financial system as a whole may be exposed to common risks is not always fully taken into account. However, by preventing the failure of individual financial institutions, micro-prudential supervision attempts to prevent (or at least mitigate) the risk of contagion and the subsequent negative external-

ities in terms of confidence in the overall financial system⁴”.

The De Larosière group also recommends, that there are interdependencies between the two areas of supervision. Such interdependencies must be taken into account at all times in order to effectively exercise the supervision in one of the areas concerned.

In its address to the Spring European Council “Driving European Recovery” of 4 March 2009⁵ the European Commission initially endorsed the recommendations of the De Larosière Group on a new system for European financial supervision. In the Communication of 27 May 2009 the European Commission now communicates in more detail that the new framework must be implemented through the adoption of an act establishing the ESRC not having legal personality on the basis of article 95 of the EC Treaty and through the establishment of an “European Banking Authority”, an “European Insurance and Occupational Pensions Authority” and an “European Securities Authority” each having legal personality. Legislation to embody these proposals will follow in the autumn of 2009 with the aim to have the new regime on supervision of the financial sector to be effective in the course of 2010.

⁴ Paragraph 146 of the report of the De Larosière Group.

⁵ Commission of the European Communities, Communication of 4 March 2009, COM (2009) 114.

³ Paragraph 147 of the Report of the De Larosière Group.

In this working paper, a detailed outline of the proposals of the European Commission as regards corrections in the *micro-prudential supervision model* will follow together with a first analysis how the proposals of the Commission fit into the existing powers and authorities conferred to the national supervisors as regards regulated financial industry participants. We will therefore refrain from detailed comments on the role and responsibilities of the new to be established macro-prudential supervisor, the ERSC.

The working hypothesis of this paper is:

“In which manner did existing regulations on the supervision of (groups of) financial undertakings fail in addressing the financial crisis and in which manner do the proposals of the European Commission published in its Communication of 27 May 2009 adequately result into the required changes in the current regulatory environment?”

2. Existing regulatory framework for pan-European supervision of financial undertakings

2.1. The Lamfalussy process

The Lamfalussy⁶ process launched in 2001 aimed to start the conver-

⁶ The Lamfalussy process is deriving its name from the chairman of the Committee of Wise Men on the regulation of European Securities Markets that published its report and recommendations on 17 July 2000.

gence of the European supervisory practice and to support the execution of the Lisbon agenda of the European Council adopted in its meeting of 23 and 24 March 2000 (the “Financial Services Action Plan”). In the Lamfalussy process regulation for financial services is adopted at four levels:

- (a) framework legislation setting out the core principles of the regulation and regulating the implementing powers adopted through a full co-decision process involving the European Parliament and European Council (“Level 1”);
- (b) technical details of the implementation legislation formally adopted by the European Commission after consultation of one of the relevant committees, being the European Securities Committee, the European Banking Committee or the European Insurance and Occupational Pensions Committee (“Level 2”);
- (c) an advisory process conducted by the European Commission in order to implement the Level 2 implementing measures, through the organisation of advice by one of the “Level 3 Committees” being the CEBS, CESR or CEIOPS (“Level 3”); and
- (d) enforcement of timely implementation and correct transposition by the European Commission of the legislative measures taken at European level into the national legislation, (“Level 4”).

The so-called “Level 3-Committees”

have been established in 2001 (as regards CESR⁷) respectively 2004 (as regards CEBS⁸ and CEIOPS⁹). CESR, CEBS and CEIOPS fulfil two roles: on the one hand they participate in the advisory process concerning the adoption of Level 2 implementing measures, through their participation in the European Securities Committee, the European Banking Committee or the European Insurance and Occupational Pensions Committee and on the other hand by securing more effective cooperation between national supervisors and the convergence of supervisory practices.

2.2. November 2007 Communication on review of the Lamfalussy Process

In its Communication¹⁰ of 20 November 2007 “Review of the Lamfalussy process – Strengthening supervisory convergence”, the European Commission outlined its recommendations for a greater supervisory convergence and cooperation¹¹. Introducing the subject

matter of its review, the Commission had drawn the conclusion that the Lamfalussy process has contributed to speeding up of the adoption of new regulatory frameworks for the financial sector. This improved legislation process was, according to the European Commission, attributable to the technical advice provided by CESR, CEBS and CEIOPS in support of the various Level 1 and Level 2 legislative measures taking over time, among others this concerned the Markets in Financial Instruments Directive¹² (“MiFID”) in which CESR played a fundamental role and the Capital Requirement Directive¹³ (“CRD”) in support of which CEBS adopted twelve Level 3 guidelines. Also, the European Commission addressed in this report of 2007 the contributions of CEIOPS in addressing the technical issues concerning the proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (“Solvency II”) directive¹⁴.

⁷ Commission Decision 2001/527/EC, OJ L 191 of 13 July 2001.

⁸ Commission Decision 2004/5/EC, OJ L 3 of 7 January 2004.

⁹ Commission Decision 2004/6/EC, OJ L 3 of 7 January 2004.

¹⁰ Communication from the Commission, “Review of the Lamfalussy Process – Strengthening supervisory convergence”, COM (2007) 727 Final.

¹¹ The requirement for review of the Lamfalussy process had been set forth in Directive 2005/1/EC of the European Parliament and the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 92/49/EEC and 93/6/EEC and Directives 94/19/EC, 98/78/EC, 2000/12/EC,

2001/34/EC, 2002/83/EC and 2002/87/EC in order to establish a new organisational structure for financial services committees, OJ L 79 of 25 March 2005.

¹² Directive 2004/39/EC, OJ L 145 of 30 April 2004.

¹³ Directive 2006/48/EC, OJ L 177 of 30 June 2006.

¹⁴ Amended Proposal of 26 February 2008, COM(2008) 119 final as at the time of preparation of this working paper being adopted by the European Parliament on 23 April 2009 and currently the final version of the Directive is being prepared by the European Commission for adoption by the European Council early summer 2009.

2.2.1. *Improvements to the Lamfalussy legislative process*

In the Communication of November 2007, the European Commission, firstly, addresses the following proposals for improvement of the Lamfalussy legislative process:

- (a) **Quasi-legislative measures.** Avoidance of quasi-legislative measures through the Comitology-process by granting the European Parliament the right to scrutinise and, if needed, block these measures to safeguard the institutional balance within the European Community;
- (b) **Resolving time constraints in transposition level 1 and level 2 legislation.** Avoidance time constraints due to the unrealistic planning of the transposition time-lines for Level 1 and Level 2 measures, in view of the advisory process organised in the Level 3 Committees, where particular attention is given by the European Commission to the constraints that arose in implementing MiFID and the need to extend of the transposition and application deadlines initially set at adoption of MiFID;
- (c) **Avoidance of “gold plating”.** Measures to drastically reduce “gold plating” at the level of the national transposition measures taken by national legislators by introducing the more frequent use of the legislative instrument of Regulations of the European Parliament and Council with

direct application in the European Union and improved enforcement of the avoidance of “gold plating” by continuing the approach taken following the adoption of MiFID by requiring Member States to justify the adoption of deviations from the rules and regulations set forth in European Directives;

- (d) **Proper Level 4 enforcement.** Measures to improve the timely transposition of European Directives by Member States by introducing tools for measurement of the phases of transposition in the various member states. A first exercise in this respect has been undertaken in the inclusion in article 144 of the CRD of the obligation for supervisory disclosure requiring publication of the status of transposition of the CRD in the Member States. This disclosure has been supported by the introduction by CEBS of a web-based application publishing from time to time the supervisory disclosures in respect of the status of transposition and the exercise of Member State options and discretions.

2.2.2. *Towards enhancement of supervisory convergence*

In the second part of the November 2007 Communication, the European Commission outlines its proposals for enhancing greater supervisory convergence, after noting that the delivery of the Level 3 Committees requires further improvement. To this effect the European Commission

proposed:

- (a) **Political accountability of Level 3 Committees.** The European Commission proposes to take measures to enhance the political accountability of the Level 3 Committees, by setting forth a political statement at the level of the European Parliament and ECOFIN of the expectations of contributions of the Level 3 Committees. There should be a procedure in place where the Level 3 Committees become more accountable towards the European Parliament, the European Council and the European Parliament for non-performance of the objectives, including reporting on supervisory authorities of Member States that do not participate in the achievement of objectives of the Level 3 Committees. In this respect the Commission also recommends to include in the national constitutive charters of the supervisory authorities of the Member States a requirement to cooperate with other European supervisors in order to achieve further European convergence;
- (b) **Legal status of the Level 3 Committees.** It is also proposed to take measures to reinforce the legal status of the Level 3 Committees, by aligning the constitutive charters of the three committees to address the following tasks of the Level 3 Committees: (i) the advisory

function to address the issues in the Level 2 legislative process (ii) contribution to consistent implementation of European legislative measures throughout the European Union and (iii) contribution to converging supervisory practices. Particularly it was felt that the constitutive charter of CESR that dated from 2001 should be aligned to that of the more inclusive charters of later date of CEBS and CEIOPS that had been established three years later in 2004. Also the Commission outlines the need for proper inclusion of the authority of Level 3 Committees into Level 1 legislative measures. In this context, the Commission points out that in the proposal for a Solvency II directive a clear role has been defined for CEIOPS as an example as to how the European Commission intends to use its legislative powers to formalise the roles of the Level 3 Committees into European legislation;

- (c) **Qualified majority decisions rather than consensus based decisions.** The constitutive charters of the Level 3 Committees should be amended in order to allow qualified majority voting on all matters concerning advice to the European Commission, rather than the consensus-driven model as set forth in the constitutive charters of 2001 respectively 2004. Some form of disciplining members of the Level 3 Committees that are taking dissenting opinions after being properly in-

- volved in the majority vote decision making process, should be considered by the Level 3 Committees too.
- (d) **Weight of Level 3 Committee decisions.** In addition, the weight that the Level 3 Committee decisions and proposals carry in the national environment should be improved too. Practice shows that the decisions taken by the Level 3 Committees are not always observed by the national supervisors that carry the ultimate authority to execute the transposition measures. At the time of the adoption of the Commission Communication in November 2007, it was noted that it would be impossible to grant the Level 3 Committees independent regulatory powers.
- (e) **Alignment of powers of national regulators.** It was noted by the European Commission that there is a need for evaluating whether or not the national supervisors in the various Member States have even powers to ensure effective cooperation between the national supervisors at European level.
- (f) **Operational independence.** It was furthermore challenged by the European Commission whether national supervisory authorities in the various Member States were fully independent from the political environment in order to operate effectively.
- (g) **Cooperation between home and host state supervisors.** Whilst some of the European Directives (notably the CRD (article 131) and the Prospectus Directive¹⁵ (article 13)) already provide for the possibility that national supervisory authorities delegate powers to supervisory authorities of other Member States in cases where cross border operation of financial undertakings so requires, this legislative feature has not been implemented throughout the European legislative body for the whole financial sector.
- (h) **Enhancing the role of the “lead” supervisor.** The European Commission recommends in its November 2007 Communication to further enhance this delegation power throughout all legislative measures, particularly also to address the requirements of proper supervision and coordination in respect of groups of financial undertakings operating in multiple Member States. This latter proposal would result into the reinforcement of the powers of the “lead” supervisor for cross-border financial institutions, currently adopted through the roles of the ‘consolidating supervisor’ in the CRD, the ‘coordinating supervisor’ in respect of so-called financial conglomerates¹⁶ and the

¹⁵ Directive 2003/71/EC, OJ L 345, of 31 December 2003

¹⁶ This role is created pursuant to the legislative measures transposing Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial con-

‘group supervisor’ as proposed in Solvency II.

- (i) **Colleges of supervisors.** Similar to the experiences in the banking sector in which colleges of supervisors have been established to coordinate the approach in the cross-border supervision of international banking groups, the insurance and securities industry sectors should also promote the establishment of such colleges. The effective operation of such colleges should be underpinned in legislative measures at European level.
- (j) **Cross border cooperation between CESR, CEBS and CEIOPS.** The European Commission also notes that the three Level 3 Committees are working towards improved cooperation for cross-sectoral and cross border issues in the financial industry. After the adoption of the Joint Protocol on cooperation between CEBS, CESR and CEIOPS in November 2005, the first initiative had been taken by establishing an Interim Working Committee on Financial Conglomerates in 2006.
- (k) **Crisis management.** The European Commission is very brief on its recommendations for cooperation between the Level 3

Committees in cases of crises. The only recommendation made is that the Level 3 Committees should make sufficient preparations to act effectively if circumstances so require.

- (l) **Financial assistance to Level 3 Committees.** The European Commission finally expressed its intention to create a framework for providing independent budgets to the Level 3 Committees, in order to facilitate the proper functioning of such Committees and to avoid to large dependence on the contributions made available by the members of such Committees.

2.2.3. The Lamfalussy process revisited

From the detailed discussion in paragraphs 2.2.1 and 2.2.2 of this working paper it is clear that the European Commission had formulated detailed recommendations as regards the need for improvement of the Lamfalussy process, whilst noting that significant improvements were already achieved after the launch of the new process for adoption and enforcement of legislation in 2001.

The success that was initially achieved at the level of implementation of faster legislative processes in the securities field in the first years after adoption of the “Lamfalussy-recommendations”, resulted into a further dissemination of the principles to other sectors of the financial industry, notably the banking and insurance sectors. The promotion of the Lamfalussy principles for these

glomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, OJ L 35 of 11 February 2003.

sectors resulted into concrete achievements in the banking and insurance sectors, particularly in respect of the endorsement of the supervisory disclosure process at the occasion of the transposition of the CRD resulting into an apparent consistent and synchronised adoption of transposition measures of this important European Directive. Also the effects of the Lamfalussy process were noticeable by the inclusion of the formal role to be played by CEIOPS in the transposition of Solvency II and the fact that CEIOPS has been taking up the responsibilities in this field, by organisation the Quantitative Impact Studies¹⁷.

It should be noted, however, that the recommendations formulated by the European Commission were made in a time where the crisis in the global financial markets was not imminent yet. At the time of publication of the Communication of November 2007, the European Commission did express its concerns about the developments in the financial markets, but also noted in its conclusions:

“Even though risks have been widely spread, the European financial industry has been affected. Fortunately, to date there have been no major cross-border systemic consequences. This recent experience further underscores

¹⁷ See for further information on the four Quantitative Impact Studies organised thus far by CEIOPS and the results of these studies: <http://www.ceiops.org>.

the need to adopt a globally convergent approach to regulation and supervision¹⁸.”

What the Commission did not foresee at that time, was the rapid development of the crisis in the financial markets in the course of 2008, resulting into actual systemic consequences in the financial industry as a result of the failure of significant players in this sector. It is in this perspective that the recommendations of the European Commission made in November 2007 needed a fast follow up in the course of 2008. This resulted into preliminary measures at the level of the constitutive charters of the Level 3 Committees and in November 2008 this resulted into the granting by the European Commission of the mandate to the De Larosière Group to investigate whether or not further improvements are required to the financial supervision system in Europe. As regards the De Larosière recommendations, we will explore the details thereof in paragraph 3 of this working paper when addressing the Communication of the European Commission of 27 May 2009. In the following sub-paragraph we will make a few observations as to the first point addressed, being the revisions of the constitutive charters of CESR, CEBS and CEIOPS.

2.3. Revisions in 2009 in the constitutive charters of the Level 3 Committees
In the course of 2008, an increased pressure on the European Commis-

¹⁸ Communication from the Commission COM (2007) 727 Final, p. 13.

sion was imposed by the European Council to adopt further measures in respect of the constitution of the three Level 3 Committees, being CESR, CEBS and CEIOPS (hereinafter: the “Committees of Supervisors”). In March 2008 this resulted into a recommendation of the European Council to call for a swift improvement of the functioning of the Committees of Supervisors. A follow up decision of the European Council of 14 May 2008¹⁹ was taken to request the European Commission to revise its Commission Decisions of 2001 establishing CESR and 2004 establishing CEBS and CEIOPS in order to: “*ensure coherence and consistency in their mandates and tasks as well as to strengthen their contributions to supervisory coordination and convergence.*”

At this occasion, the European Council also spent attention to the role the Committees of Supervisors should play in maintaining financial stability in a time where the first signs became apparent that the global financial markets were facing severe turmoil.

It is within this perspective that the European Commission adopted the revised Commission Decisions of 23 January 2009²⁰ enacting the revised mandates of the Committees of Supervisors and harmonising the

specific roles and responsibilities of the three Committees. For CEBS and CEIOPS a further regulation has been adopted in the field of the supervision of financial conglomerates, being mixed groupings of banks and insurance companies subject to financial conglomerate supervision pursuant to Directive 2002/87/EC.

An important note to be made at this stage is, that none of the revised mandates grant any regulatory powers to the Committees of Supervisors. Rather, the Committees are considered to be independent advisory groups on the various areas of the financial sector in the European Community, without legislative powers. The Committees shall in this set up only advise the European Commission, in particular as regards the preparation of draft implementing measures in their domain, being banking, securities and insurance.

In order to promote the common and uniform application of Community legislation, the Committees are authorised to issue non-binding guidelines, recommendations and standards. Also, in order to promote the cooperation between national supervisory authorities and to stimulate convergence of supervisory practices and approaches within the European Community, the Committees of Supervisors are granted the following set of tasks and responsibilities:

- (a) *Mediate or facilitate mediation between supervisory authorities in cases specified in the relevant*

¹⁹ Council Conclusions 8515/3/08 Rev 3.

²⁰ Commission Decisions of 23 January 2009, C(2009) 176 final, C(2009) 177 final and C(2009) 178 final.

- legislation or at the request of a supervisory authority;*
- (b) Provide opinions to supervisory authorities in cases specified in the relevant legislation or at their request;*
 - (c) Promote the effective bilateral and multilateral exchange of information between supervisory authorities subject to applicable confidentiality provisions;*
 - (d) Facilitate the delegation of tasks between supervisory authorities, in particular by identifying tasks which can be delegated and by promoting best practices;*
 - (e) Contribute to ensuring the efficient and consistent functioning of colleges of supervisors in particular through setting guidelines for the operational functioning of colleges, monitoring the coherence of the practices of the different colleges and sharing best practices;*
 - (f) Contribute to developing high quality and common supervisory reporting standards;*
 - (g) Review the practical application of the non-binding guidelines, recommendations and standards issued by the Committee²¹.*

Other elements of the European Commission Decisions establishing the Committees of Supervisors con-

tain elements of delegation of authority to such Committees with a similar nature. The Committees are rather equipped without any firm authority to impose measures or binding recommendations on national governments or national supervisors. Also, as regards the ability of national governments and national supervisory authorities to make own interpretations of the recommendations of the Committees of Supervisors, no further regulation has been included in the Commissions Decisions.

As regards the manner of decision making, the relevant constituting charters of 2009 for the Committees of Supervisors are still requiring consensus decisions, be it that if consensus cannot be reached qualified majorities may serve to adopt decisions by the Committees. This new element in the organisation of the Committees addresses the concern the European Commission expressed in its November 2007 Communication. The decision making processes within the Committees could easily be obstructed if consensus was the only applicable principle for the decision making process. In so far, the new European Commission Decisions of January 2009, partially addressed the concerns as promulgated in the 2007 evaluation of the Lamfalussy process.

Taking the revised European Commission Decisions of January 2009 establishing the framework for operation of the Committees of Supervi-

²¹ See: Article 4 of the respective Commission Decisions of 23 January 2009.

sors into account, the preliminary conclusion is, that few changes have occurred in the new framework compared to the situation when the Committees were first established in 2001 (CESR) and 2004 (CEBS and CEIOPS) respectively.

3. Reform of Financial Supervision in Europe

3.1. Proposals of the De Larosière Group

As noted in the introductory paragraph of this working paper, the De Larosière group made recommendations to establish two new authorities, one authority, the ESRC, should be involved in the coordination of efforts in the supervision of macro economical and macro-prudential issues, with the aim to identify and address potential systemic risks in the financial sector. The ESRC should be built on the foundations of the European Central Bank and the European System of Central Banks. This authority should work closely together with the ESFS, that shall be entrusted with the micro-prudential supervision of (groups of) financial undertakings. In the further parts of this working paper, we will only address the recommendations regarding the establishment of the ESFS.

In the recommendations of the De Larosière Group, there are no proposals for fundamental change in the current system of supervision by national supervisory authorities as based on the Directives of the

European Parliament and Council. Rather, a strong participation of the local supervisory authorities will remain the overriding principle, leaving major principles of European supervision based on home state and host state control intact. The De Larosière Group motivates this choice as follows: “[*Finally*], the ESFS should be neutral with respect to national supervisory structures: national supervisory structures have been chosen for a variety of reasons and it would be impractical to try to harmonise them, [...]”²²

The De Larosière group rather focuses on the enhancement of the role of the institutions at European level, which should particularly play a role in the supervision of institutions that have cross-border operations and furthermore, the European institutions should be granted more authority to intervene, where needed, in the conduct of supervision at national level. In its **Recommendation 18**, the De Larosière Group has summarised its viewpoint as follows:

“A European System of Financial Supervisors (ESFS) should be setup. This ESFS should be a decentralised network:

- *existing national supervisors would continue to carry-out day-to-day supervision;*
- *three new European Authorities would be set up, replacing CEBS,*

²² Paragraph 189 of the Report of the De Larosière Group.

CEIOPS and CESR, with the role[to] coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;

- colleges of supervisors would be set up for all major cross-border institutions.

The ESFS will need to be independent of the political authorities, but be accountable to them.

It should rely on a common set of core harmonised rules and have access to high-quality information”.

In brief, the De Larosière Group has not recommended a major overhaul of the current system based on the existing regulatory framework as it has been developed over the last decades. The competences of the national supervisors should remain intact, the embryonic development of “colleges of supervisors” should be further supported and, consistent with the November 2007 Recommendations of the European Commission, the roles of the Colleges of Supervisors should be further enhanced.

In so far, the recommendations of the De Larosière Group did not deviate fundamentally from the views expressed at European Community level in the recent years as to the way the supervision of the financial sector in the European Community must evolve.

The recommendations of the De Larosière Group also outline a plan for the adoption of the new supervisory framework. In the report a phased approach is recommended, focussing primarily in the organisation of the macro-prudential supervision through the establishment of the European Systemic Risk Council and, later in the period 2011-2013, the legislation underpinning the establishment of the new European System of Financial Supervisors should be adopted and implemented. The De Larosière Group is not specific on the methods to be used for creating the legislative framework, nor is it specific on the institutional basis for such legislative framework. These details of the plan are moved to the work of the European Commission needs to undertake in this respect.

3.2. Recommendations of the European Commission of May 2009 on reform

3.2.1. Major principles of the recommendations

In the Communication of 27 May 2009, the European Commission clearly takes into account the need that the reform of the European financial supervision, must be based on politically achievable goals. A clear demonstration of the complexity of this topic in the current political climate in Europe can be found in the discussions on the establishment of further coordination of the rules on the insurance group supervision to be included in Solvency II. The proposed introduction of a sys-

tem of “group support supervision” in which some of the authorities of the national supervisors would be sacrificed to the benefit of an authority playing a coordinating role over the supervision of large groups of insurance companies was not supported in each Member State²³.

It is with this background in mind, that the following principle as proposed by the European Commission must be read:

“The new European financial supervisory framework must be fully accountable to political authorities in the EU. It must develop a common supervisory culture; be sensitive to the interests of all Member States – and the need for a balanced, strengthened confidence building relationship between home and host authorities. 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 work²⁴”.

Based on this statement, the European Commission lays out the concrete and detailed proposals for the reform of the financial supervision in Europe. Different from the recommendations of the De Larosière Group are the proposals to enact the changes in the supervisory sys-

tem as regards macro-prudential supervision and micro-prudential supervision *simultaneously* and *not in a phased approach*. Hereinafter follows a discussion of the plans for the ESFS.

3.2.2. *The case for the reform of European financial supervision*

In an unprecedented display of self criticism, the European Commission promulgates the general principles of the establishment of an European System of Financial Supervisors, noting that certain limits have been reached in the current institutional organisation based on the Lamfalussy process that was only in place for a few years. It is worthwhile to note in this context that only a few months ago, the European Commission enacted the new constitutive measures reinforcing the statutes of CESR, CEBS and CEIOPS in its January 2009 Decisions (see the discussion in paragraph 2.3 of this working paper).

The European Commission defends the case for the reform of the micro-prudential supervision system as follows:

“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

²³ See the article “Finance Ministers to shelve insurance group supervision”, www.euractiv.com/en/financial-services.

²⁴ European Commission Communication, COM (2009) 252, Final, p. 4.

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. The new ESFS will be designed to overcome these deficiencies and provide a system that is in line with the objective of a stable and single EU financial market for financial services – linking national supervisors into a strong Community network²⁵.

It is clear that the European Commission recommends that a balance must be struck between maintenance of the current institutional environment for supervision of the financial sector and the enhancement of the roles of European institutions that should play a more significant role in resolving the issues concerning cross-border institutions. It is also worthwhile noting that clear references are made to the lack of support and the lack of trust between national supervisory authorities to reach out in working together on issues that cannot be resolved by taking stand alone national solutions only. Finally, a significant role is contributed to the current absence of harmonisation of

regulatory and supervisory requirements, often attributed to the existence of Member State options and discretions in transposing the European legislation into the own national legislative environment. It is based on these three fundamental flaws of the current system, that the European Commission outlines the details of the new ESFS.

3.2.3. The roles and responsibilities of European Supervisory Authorities

The three European Supervisory Authorities will succeed the current Level 3 Committees of Supervisors established following the Lamfalussy process. The European Banking Authority (“EBA”) will succeed CEBS, the European Insurance and Occupational Pensions Authority (“EIOPA”) will succeed CEIOPS and the European Securities Authority (“ESA”) will succeed CESR. The three European authorities will form part of the ESFS together with (i) the national authorities authorised to exercise micro prudential supervision and (ii) colleges of supervisors authorised to play coordinating roles in the supervision of financial institutions that have cross border activities, whether by operating multiple branches of a single EU/EEA licensed financial undertaking or by the operation of multiple licensed subsidiaries established in multiple Member States.

It is, therefore, important to note that there will be no fundamental changes to the current institutional organisation of the micro prudential

²⁵ European Commission Communication, COM (2009) 252, Final, p. 8.

supervision in the European Community. Rather, the current line of thinking of the European Commission is to reinforce existing arrangements in place and based on the network of European regulations and European Directives for the financial industry.

Although the institutional changes to the current system of micro prudential supervision are not recommended to change, there is a clear drive to make significant changes to the current framework addressing the relevant powers and authorities of the existing Committees and national supervisors. Whilst the powers and authorities of the latter category of authorities will remain intact, a shift of (mandatory) powers and authorities of the currently existing Level 3 Committees is noticeable. It is particularly in the statues and functions of these Committees, that will rather move to become true supervisory authorities in a number of instances, that the changes will occur.

Within the framework of the new to be shaped ESFS, the EBA, EIOPA and ESA will play, as is now recommended by the European Commission, a different role than the Level 3 Committees played thus far. The three European Supervisory Authorities will have roles in the following **eight areas**:

i) Ensure a single set of harmonised rules;

- ii) Ensure consistent application of EU rules;
- iii) Ensure a common supervisory culture and consistent supervisory practices;
- iv) Full supervisory powers for some specific entities;
- v) Ensure a coordinated response in crisis situations;
- vi) Collect micro-prudential information;
- vii) Undertake an international role;
- viii) Safeguards.

As regards the latter topic, Safeguards for the constitution of the European Supervisory Authorities, we will provide some comments in the next paragraph. As regards the other seven topics, we note the following.

Although the true detail of the proposed changes will only be known once the proposals for legislative measures that the European Commission will develop in the course of autumn 2009 are published, there is only one subject matter in the current proposed list of tasks and responsibilities that is likely to result into the development of true pan-European powers of the Supervisory Authorities. This is related to the topic listed in (iv), being the full supervisory powers for some specific entities. These supervisory powers will be, at least, in the areas of supervision of Credit Rating Agencies and EU central counterparty clearing houses. The pan-European supervision of Credit Rating Agencies is agreed upon by the adoption on 23

April 2009 of Regulation of the European Parliament and of the Council on Credit Rating Agencies.²⁶ The role for a single European authority that will be charged with the supervision of Credit Rating Agencies operating in Europe is likely to be fulfilled by the ESA, as at the discussion of the proposal for the regulation on supervision of Credit Rating Agencies it has been understood that this role should be fulfilled by CESR. The second area of potential pan-European authority to be entrusted to (one of the) European Supervisory Authorities is related to the long discussed and studied area of pan-European harmonisation of regulation of the securities settlement and clearing industry²⁷. It is clear that this proposal of the European Commission is the most far reaching change in the regulation of the financial services industry, as currently there is no equivalent body in Europe that has the authority to grant authorisations to entities that will have a reach of validity throughout the whole EU/EEA. Essentially, this is also currently not the system as it is comprised in the current text of the

Regulation on Credit Rating Agencies, where CESR would rather play a role of coordinating recipient of applications for authorisation, with the objective of passing such applications through to the ultimate end responsible national supervisory authority that is authorised to grant the authorisation to the credit rating agency involved. Unclear is how the proposals of the European Commission of 27 May 2009 as regards the full supervisory authorities for some specific entities, will be transposed into the Regulation on Credit Rating Agencies adopted in April 2009.

With this commentary on one of the elements of the new framework for European Supervisory Authorities we are not suggesting that there is no shift in other areas of the competences and authorities of the new to be established European Supervisory Authorities too. Clearly, the European Commission addresses many of the other concerns expressed by the De Larosière Group on the current functioning of the micro-prudential supervisory framework. Notably in the areas of ensuring a single set of harmonised rules and ensuring consistent application of EU-rules, the European Commission recommends a further shift of authorities and powers to the European Supervisory Authorities. It is particularly in those two areas, that a slightly changed position of the European Supervisory Authorities as compared to the current powers and authorities of the Level 3 Committees will be noticeable. These changes will rather be

²⁶ Regulation as proposed by the European Commission in the Proposal of 12 November 2008, COM(2008) 704 final, as adopted by the European Parliament on 23 April 2009. Adoption by the European Council expected during the Swedish Presidency of the European Council.

²⁷ See for further background: the Giovannini Reports on Cross-Border Clearing and Settlement and the European Commission Communication of 28 April 2004, Communication COM(2004)312.

based on the fact that the current non-binding advisory role of the Level 3 Committees and the powers to intervene if national legislators and regulators are deviating from the harmonised body of European law, will change to rights to impose binding instructions and recommendations to national authorities, whether they be legislators or whether they be supervisory authorities.

As regards the subject matter of ensuring a single set of harmonised rules, the European Supervisory Authorities will be authorised to:

- (a) 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, and
- (b) draw up interpretative guidelines, which the competent national authorities would apply in taking individual decisions, notably as regards the licensing and supervision of financial institutions.

This is a change, because *such binding technical standards nor interpretative guidelines* on individual decisions by national supervisory authorities *do currently belong* to the

authorities of the Level 3 Committees. If one compares the language of the European Commission document of 27 May 2009 with the constitutive charters of the CEBS, CESR and CEIOPS just recently revised in the January 2009 Decisions (see for a more detailed discussion, paragraph 2.3 of the working paper), there is a difference and a shift from “advisory and non-binding” authorities to an actual authority to impose binding recommendations and guidelines. However, one should also appreciate that such powers and authorities will only be given to the European Supervisory Authorities as long as they are backed up by unanimous support and endorsement of the whole European Commission. This suggests that absent unanimous resolutions at the level of the Commission, the relevant authorities of the European Supervisory Authorities will be non-binding and non-mandatory for the national authorities.

3.2.4. The legal basis for the European Supervisory Authorities

This brings us to the complex area of the manner in which the new European Supervisory Authorities will fit into the general framework for the European Community. On this area, the European Commission has recommended in the **eight outlined topic on the powers of the European Supervisory Authorities** (“Safeguards”) the following:

“The framework for the exercise of the above (the seven competences will be specified exhaustively and in precise

detail in the relevant sectoral legislation. The conferring of these competences will be in full conformity with Articles 226²⁸ and 228²⁹ of the Treaty. Without prejudice to the application of Community law, 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. Moreover, any decision by the European Supervisory Authorities or the Commission must be subject to review by the Community Courts³⁰”.

The legal basis for the establishment of the European Supervisory Authorities will be article 114 of the Treaty on the Functioning of the European Union³¹. The Commission explains:

“The tasks to be conferred on the European Supervisory Authorities being thus closely linked to the measures put in place as a response to the financial crisis and to those announced in the Communication on

“Driving European recovery”, they can, thus, in line with the Court's case law, be established on the basis of Article 95 of the EC Treaty³²”.

The basis for the constitution of the European Supervisory Authorities will, therefore, be implemented in the European legislation adopted for the financial sector. This will require very substantial changes to the European Directives for the banking, insurance and securities industry. One should think, among others, of the following Directives that will be subject to change: (i) the CRD, (ii) MiFID, (iii) Solvency II, (iv) the Directive on Financial Conglomerates and (v) UCITS-directive.

How the legislative proposals of the European Commission will exactly be shaped is yet to be seen once the concrete proposals will be published in the autumn of 2009. It will be interesting to see, how the current legislative processes on adoption or amendment of a number of the relevant Directives (such as the CRD, Solvency II, UCITS and the Directive of Financial Conglomerates) will be matched to also address the recommended changes following the proposals of the European Commission on establishment of the European Supervisory Authorities.

3.2.5. Colleges of supervisors

In its outline for the creation of the ESFS, the European Commission also spends further attention to a

²⁸ To be included in the renumbered article 258 of the Treaty on the Functioning of the European Union, see last consolidated text published in OJ C 115/47 of 9 May 2008.

²⁹ To be included in the renumbered article 260 of the Treaty on the Functioning of the European Union, see last consolidated text published in OJ C 115/47 of 9 May 2008.

³⁰ European Commission Communication, COM (2009) 252, Final, p. 12.

³¹ Article 95 of the current Treaty shall become article 114 of the Treaty on the Functioning of the European Union, see last consolidated text published in OJ C 115/47 of 9 May 2008.

³² European Commission Communication, COM (2009) 252, Final, p. 14.

new phenomenon within the European Union, being the so-called *colleges of supervisors*. Such colleges of supervisors are based on the more or less voluntary participation by the national supervisory authorities entrusted with the supervision of regulated financial services companies that perform cross border activities in multiple jurisdictions within the European Union. Such international activities can be through branches of European Union regulated financial services companies applying the freedom of provision of services or establishment through the use of so-called European Passports or by means of an internationally organised group of companies in which one or more regulated financial services institutions are comprised. The European Commission notes the following:

“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. For cross-border institutions, the colleges of supervisors which are being set up will be the lynchpin of the supervisory system and should play an important role in ensuring a balanced flow of information between home and host authorities. The European Supervisory Authori-

ties should participate in meetings of the colleges of supervisors, as observers, so as to contribute to the emergence of a common supervisory culture and consistent supervisory practices. Set up in this way, the ESFS will combine the advantages of an overarching European framework for financial supervision with the expertise of local supervisory bodies that are closest to the institutions operating in their jurisdictions³³.”

There is no formal legislative basis for the establishment of colleges of supervisors. They are rather set up as *ad hoc committees* by national supervisory authorities that have the intention to cooperate on a structural basis if it concerns the supervision of internationally operating groups of financial service providers. The joint statement of CEBS and CEIOPS published in January 2009 defines these colleges of supervisors as follows:

“Colleges of supervisors are permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border groups, specifically large groups³⁴.”

The colleges of supervisors are being established as *a sequel* of the organisa-

³³ European Commission Communication, COM (2009) 252, Final, p. 9.

³⁴ Colleges of Supervisors – 10 Common Principles, publication of CEIOPS, CEBS and the Interim Working Committee on Financial Conglomerates of 27 January 2009, CEIOPS-SEC-54/08, CEBS 2008 124 and IWCFC 08 32, see: <http://www.c-ebs.org/>.

tion of the supplementary supervision of groups of insurance companies, consolidated supervision over groups of banks or coordinated supervision on groups with mixed (banking and/or insurance and/or investment services) activities ('financial conglomerates'). The currently applicable Insurance Directive³⁵, CRD and Directive on Financial Conglomerates already form the basis for the exercise of supplemental supervision (insurance groups), consolidated supervision (banks) and financial conglomerates supervision. The authorities set forth in the relevant European Directives all result into the appointment of a "coordinating" supervisor that will take the initiative for the cooperation between the relevant European supervisory authorities. For insurance groups such role is played by the "group supervisor", for banks this role is played by the "consolidating supervisor" and for financial conglomerates this role is played by the "coordinating supervisor".

To further enhance the manner in which such cooperation should take place, the colleges of supervisors are the platform for the discussions between the national supervisory authorities, often based on bilateral or multilateral agreements on cooperation. The proposals of the European Commission of May 2009,

direct the further establishment of such colleges of supervisors that should play a fundamental role in the ESFS and the European Commission stimulates the fundamental role these colleges should play in the supervision of complex internationally operating groups of financial supervisors.

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³⁵ Directive 98/78/EC of the European Parliament and of the Council on the Supplementary supervision of insurance undertakings in an insurance group of 27 October 1998.

on this Act addressing several provisions of the Dutch legislation on prudential supervision. He currently prepares a comprehensive book on “Prudential supervision of banks, insurance companies and investment firms” due to be published in the course of 2009. He was appointed to the Expert Committee advising the Ministry of Finance in 2006 on the prudential supervision aspects of the proposal for the revisions of the financial services legislation in the Netherlands.