

The Reform of Financial Supervision in Europe

Shane Fitzgerald





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Introduction

Financial regulation and supervision share the ultimate aims of ensuring financial stability, deterring malpractice and protecting consumers. Whereas regulation refers to actual rules, supervision describes the monitoring of the application of those rules. As a recent high level report into financial supervision in the European Union made clear, supervision and regulation are interdependent: “competent supervision cannot make good failures in financial regulatory policy; but without competent and well designed supervision good regulatory policies will be ineffective”.²

In responding to the financial crisis, the EU has proposed both new regulations and new supervisory arrangements. It is also reviewing and amending an existing suite of financial services legislation.³ The focus of this paper is the European Commission’s proposals in the area of supervisory reform. It begins with a discussion of the supervision function and the status quo before the financial crisis, before proceeding with a short summary of a report that effectively laid the basis for the EU’s supervisory response to the crisis. It then tracks the policymaking process as it unfolded in 2009 and evaluates the package of draft legislation as it stands now, in late 2009, adopted by the Commission and being negotiated under the co-decision procedure between the European Parliament, Council and Commission. Finally, it considers some issues relating to the establishment and operation of the bodies proposed in the draft legislation and offers some preliminary observations.

Macro-Prudential Supervision and Systemic Risk Analysis

Macro-level supervision seeks to identify those large-scale trends and imbalances that are not susceptible to direct regulation or supervision by national or sectoral authorities, which are mandated only to focus on particular firms in specific sectors. In contrast, macro-prudential supervision concerns itself with the aggregate effect of individual firms’ actions, seeking to generate an overall picture of the functioning of the financial system.⁴

While certain national authorities carry out a macro-prudential function (e.g. the US, UK and China), policy responses to the financial crisis have in many cases focused on ways in which countries and regions can pool their resources so as to create supranational supervisory entities. The newly mandated Financial Stability Board is the leading example of this trend.

Politically, the concept of supranational supervision of financial markets is a sensitive one as, if it is to be effective, it will inevitably clash with national interests and agendas. It also creates an asymmetry whereby the responsibility and power to prevent banking crises is passed upwards to a supranational agency, but it is the national fiscal authorities which will ultimately have to provide the resources to deal with any crisis. Supranational macro-prudential boards will therefore always struggle to exert influence over fiscal policy, which is after all one of the most fundamental attributes of state sovereignty. Yet, as the financial crisis has made clear, fiscal policies can often in themselves pose systemic risks.

Though this dilemma is softened somewhat in the pooled sovereignty of the European Union, stubbornly insoluble elements remain. The idea of establishing a body to monitor and assess systemic risk at the European level was first suggested in the late 1990s, but it has taken over a decade to implement it.⁵ Events have since exposed serious weaknesses in the EU's macro-supervisory framework, which remains fragmented along national lines despite the longstanding establishment of a single market and the ever-increasing importance of cross-border transactions and institutions.

Where supervision is uneven and uncoordinated, the EU now seeks to make it robust and coherent. But even with a robust European supervisory system in place, the fact will remain that markets are global, but supervision is not. For this reason, coordination and cooperation with other supervisors will be a vital function of any new European system.

Systemic risk can be defined as the risk that the distress or failure of a significant part of the financial sector will reduce the availability of credit and so adversely affect the real economy.⁶ Analysis of such risk is nothing new to macro-economists and the central banking community. For example, the G10's Committee on the Global Financial System, made up of central bank representatives from the Group of Ten central banks and others, is mandated to "identify and assess potential sources of stress in the global financial environment through a regular and systematic monitoring of developments in financial markets and systems".⁷ It issued a number of risk warnings ahead of the 2008/2009 crisis, as did other organisations such as the FSF, the IMF, the BIS and the ECB, but in retrospect it is clear that these analyses were not adequately incorporated into the macro-prudential supervisory arrangements that existed at the time, and that these arrangements were not strong enough, nor their scope wide enough, to act as effective early warning systems to the financial and policymaking communities.

The ECB pursued from the outset a research agenda on financial stability and systemic risk.⁸ In 2004, it began to publish a Financial Stability Review twice yearly, noting signs of systemic risk in several subsequent publications in 2006 and 2007.⁹

The IMF also continues to publish a Global Financial Stability Report twice yearly, though chapter two of its April 2006 report provides a cautionary tale for anyone thinking that simply undertaking a programme of macro-prudential analysis and reportage will prevent future shocks. Entitled "The Influence of Credit Derivative and Structured Credit Markets on Financial Stability," it begins:

There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient. Over the last decade, new investors have entered the credit markets, including the credit risk transfer markets. These new participants, with differing risk management and investment objectives (including other banks seeking portfolio diversification), help to mitigate and absorb shocks to the financial system, which in the past affected primarily a few systemically important financial intermediaries. The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently, the commercial banks, a core segment of the financial system, may be less vulnerable today to credit or economic shocks.¹⁰

As the Director of the UK's Financial Services Authority, Adair Turner, noted on the occasion of the launch of *The Turner Review: A Regulatory Response to the Financial Crisis*,¹¹ this assertion wasn't just wrong, but "180° wrong":

*So how do we ensure that we don't in ten years' time get it wrong again, going along with a dominant conventional wisdom? Market prices are subject to self-reinforcing herd effects: policymakers and policy intellectuals can be subject to intellectual herd effects; and there is no failsafe way to offset this human tendency to collective error. But we need as best possible to embed challenge into our institutions.*¹²

Even where macro-prudential analysis was not technically incorrect, it was often of little use to policymakers. As ECB President, Jean-Claude Trichet, has said: "We knew that a storm was brewing but, admittedly, we did not know exactly where. Neither did we know what would trigger it, or when it would come".¹³

And even where, with hindsight, advice was right on the money, it was often ignored. A significant cadre of economists and market analysts, including William White and Claudio Borio of the Bank for International Settlements, continually voiced prescient concerns about dangerous liquidity profiles giving rise to systemic risks, both in policy papers¹⁴ and in various international fora.¹⁵ Their arguments failed to penetrate the prevailing consensus.

In the absence of an authoritative and coherent system of supervision and regulation that effectively combined micro- and macro-prudential functions, it is little surprise that warnings were ineffective, or misjudged, or ignored. Yet in retrospect it is clear that even the gloomier scenarios laid out in risk warning documents relied on a "massive undervaluation"¹⁶ of risk, deriving from two main sources: misjudging or ignoring the probability of certain 'outlier' events occurring, and neglecting to properly conceptualise the effects of an increase in uncertainty at the systemic level.¹⁷ Appropriately accounting for these phenomena will be vital for the success of any new macro-prudential system. Such appropriate accounting will in turn depend on accurate risk data, which can only be provided by constant communication with thorough and well-connected systems of micro-supervision.

Micro-Prudential Supervision and the Lamfalussy Process

Micro-level supervision monitors individual firms' compliance with financial regulation. It involves the collection and analysis of information about firms' systems, their personnel, and their risk profiles.¹⁸

Presently in Europe, national supervisors co-operate within colleges of supervisors, but there are a number of gaps and points of conflict within this arrangement. Many technical rules are determined at member state level but there is considerable variation between member states' approaches. Even where the rules are harmonised, application can be inconsistent. This incoherent system of micro-supervision ultimately undermines the single market, increases disputes and costs and makes effective oversight much more difficult.

In 1999, the European Commission launched its Financial Services Action Plan (FSAP) as a key component of the EU's attempt to create a single market for financial

services. Containing 42 proposals related to the harmonisation of the financial services markets within the European Union, its three core objectives were to provide a single wholesale market, an open and secure retail market, and state-of-the-art prudential rules and supervision.

The Financial Conglomerates Directive of December 2002 formed an important part of the FSAP. It determined how the lead supervisor of a financial conglomerate should be decided and aimed to ensure that gaps in existing supervisory arrangements were filled. This represented the first transposition in the world of the international recommendations on the supervision of conglomerates that were adopted by the G10 and the Bank of International Settlements in 1999.¹⁹ The directive also provided for closer coordination and better exchange of information between the different sectoral supervisory authorities.²⁰

The FSAP called for the creation of a Securities Committee. In responding to this call, an entirely new committee structure was established under what would become known as the Lamfalussy process.

At the European Council in Lisbon in March 2000, an independent 'Committee of Wise Men on the Regulation of European Securities Markets' was set up, chaired by Alexandre Lamfalussy. Its aim was to reduce the backlog in securities market regulation so as to complete the integration of the financial single market by 2005. It recommended a novel approach to the development and adoption of EU financial services legislation, comprising a four-level procedure designed to speed up and streamline the legislative process by dividing legislation into high-level framework provisions and implementing measures. The new arrangements also featured open consultation procedures and greater transparency, and made provision for legislation to be modified as required to keep pace with market and supervisory developments.²¹

The new regulatory and institutional framework in securities that arose out of this process was endorsed by the EU institutions and the experience was considered a model for the transformation of governance in other policy areas.²² A number of FSAP measures have since been adopted using this new framework, including the Market Abuse Directive, the Prospectus Directive, MiFID, the Transparency Directive and the Solvency II review of the capital adequacy regime for the European insurance industry.

The four 'Lamfalussy levels' are:

- Level One - framework legislation, proposed by Commission and voted on through co-decision by the Council and Parliament;
- Level Two - implementing measures for the Level 1 legislation, led by the Commission;
- Level Three - supervisory committees facilitating the convergence of regulatory outcomes; and
- Level Four - enforcement of all EU measures, led by the Commission.

In the case of banking, securities and insurance supervision, Level Two legislation was to be prepared by the Commission on the basis of advice provided by representatives of national supervisory authorities, acting through the so-called 'Level

Three Committees' (CESR, CEBS and CEIOPS).²³ These committees were also mandated to foster supervisory convergence and best practice, principally by issuing (non- legally binding) guidance.

In 2007, a review of the Lamfalussy supervisory system took place, with all interested parties submitting papers to the ECOFIN Council. ECOFIN concluded that the system was working well but recommended a number of changes. The Level Three Committees were in the process of responding to these conclusions when they became the subject of much more far-reaching reform proposals, based on the influential 'de Larosière Report'.

The de Larosière Report

In October 2008, a high-level group on financial supervision, chaired by Mr. Jacques de Larosière, was mandated to investigate a number of issues arising out of the financial crisis. These included: how best to organise the supervision of international financial institutions (IFIs) and markets in the EU; how to strengthen European cooperation on financial stability oversight, early warning and crisis mechanisms; and how EU supervisors should cooperate globally. It issued its final report (hereafter the de Larosière Report)²⁴ in February 2009.

The de Larosière Report was structured into four parts: **I** Causes of the financial crisis; **II** Policy and regulatory repair; **III** EU supervisory repair; and **IV** Global repair.

In **section I**, it identified the following key causes of the financial crisis:

Macroeconomic:	Excess liquidity, low rates, loose monetary policy, mispricing of risk, and too much leverage.
Risk Management:	Lack of transparency, non-oversight of the shadow banking system, the cumulative effects of the 'originate to distribute' model, and the difficulty of modelling for extreme complexity.
Credit Ratings Agencies:	Dramatic failures fueled by major conflicts of interest.
Corporate Governance:	Weak shareholders and management, improper incentive structures.
Regulatory/Supervisory:	Encouraged procyclicality, problems with mark to market system, unregulated OTC derivatives market, and bad readings of macro-prudential risk.
Institutional Weaknesses:	Failures at the IMF, FSF, BIS and G20, plus an overall lack of coordination.

In **section II**, it identified the following general areas in need of policy and regulatory repair:

Macroeconomic policy and macro-prudential analysis; capital requirements and the Basel II regime; credit rating agencies; international accounting standards; insurance; sanctions; oversight of the ‘shadow’ or ‘parallel’ banking system; securitized products and derivatives; and investment funds.

It also advised that there should be a single set of core regulatory rules and supervisory standards in the EU.

In **section III**, the report set out its recommendations in the area of EU supervisory repair. The innovations discussed in this paper have their roots in this section.

There were two main proposals:

The creation of a **European Systemic Risk Council** (ESRC) responsible for analysing trends, imbalances and systemic risks in the financial system as a whole (macro-prudential supervision).

The formation of a **European System of Financial Supervisors** (ESFS) responsible for the day-to-day supervision of individual banks and financial institutions (micro-prudential supervision). This would upgrade the existing ‘L3’ Committees into three new EU Authorities: the European Banking Authority; the European Securities Authority; and the European Insurance Authority.

Finally, in **section IV**, the report made some recommendations with regard to repair at the global level, emphasising how important it is to organise coherent EU representation in the new global economic and financial architecture.

In all, the group made thirty key recommendations, which are useful as a ‘check list’ for policy makers and analysts.²⁵

The Legislative Process

Building on the recommendations of the de Larosière report, the European Commission put forward proposals²⁶ for a new supervisory framework in May 2009. These were fully endorsed at the June EU Council Summit,²⁷ which published a communication calling for the rapid adoption of the necessary legislative texts.

The Commission responded by adopting a package of draft legislation on September 23 2009.²⁸ This package has since been submitted to the European Parliament and Council. If approved, the Commission hopes that the rules can be in place by 2010.

The main recommendations of the de Larosière Report have survived the policymaking process thus far, though the title of the ESRC has been amended to become the European Systemic Risk Board (ESRB). The following sections consider the ESRB and the ESFS in more detail.²⁹

The European Systemic Risk Board

The ESRB is the centrepiece of the EU’s proposed new institutional arrangements.

Building on the suggestions of the de Larosière Report that a systemic risk council be convened with the aim of scanning the horizon for potential systemic threats, the ESRB looks set to wield considerable moral and political authority, even though it will be established as a purely consultative body and will not be able to impose measures or sanctions on member states or financial institutions. In its role as an ‘early warning system’ for macro-level shocks, the ESRB will be able to request data from national authorities, central banks and the new European Supervisory Authorities, as well as issue warnings when it considers it prudent to do so.

Its formal functions are to:

- *define, identify and prioritise all macro-financial risks;*
- *issue risk warnings and give recommendations to policy makers, supervisors and eventually to the public;*
- *monitor the follow-up of the risk warnings;*
- *liaise with international and third country counterparts; and*
- *report at least bi-annually to the EU Council and European Parliament.*³⁰

Members of a General Board will elect the chair of the ESRB for a renewable period of five years. The General Board will be the main decision-making body of the ESRB and will be composed of all EU central bank governors, the president and the vice-president of the ECB, a representative of the European Commission and the chairpersons of the three European Supervisory Authorities. National supervisors and the president of the Economic and Financial Committee will also be board members, but without voting rights.

The ESRB’s operations will be steered by a committee consisting of the ESRB chairperson and vice-chairperson, five additional central bank representatives, the chairpersons of the new European Supervisory Authorities, the president of the Economic and Financial Committee and the Commission representative.

The ESRB will be based at the ECB’s Frankfurt headquarters and ECOFIN has asked the ECB to provide analytical, statistical, administrative and logistical support to the operation, as well as to pass on technical advice from the national central banks and supervisors.

The board will issue recommendations and risk warnings to member states and the European Supervisory Authorities. Recipients will be obliged to comply or else explain why they have not done so. In general, recommendations will also be sent to the Council. Decisions over whether or not to publish ESRB warnings publicly will be made on a case-by-case basis.

*Specific follow-up procedures are also foreseen. For instance, when a national supervisory authority intends to deviate from an ESRB recommendation, it must first discuss and justify it with the competent European authority and will have to take into account its views before answering the ESRB. And if the ESRB feels that the explanations are not convincing, it shall inform the Council.*³¹

The European System of Financial Supervisors

The proposed European System of Financial Supervisors (ESFS) seeks to create a robust network out of national financial supervisors working in tandem with three new functional authorities, the European Supervisory Authorities. These new authorities effectively upgrade the existing 'L3' advisory committees – CEBS becomes the European Banking Authority (EBA), CEIOPS becomes the European Insurance and Occupational Pensions Authority (EIOPA) and CESR becomes the European Securities and Markets Authority (ESMA).

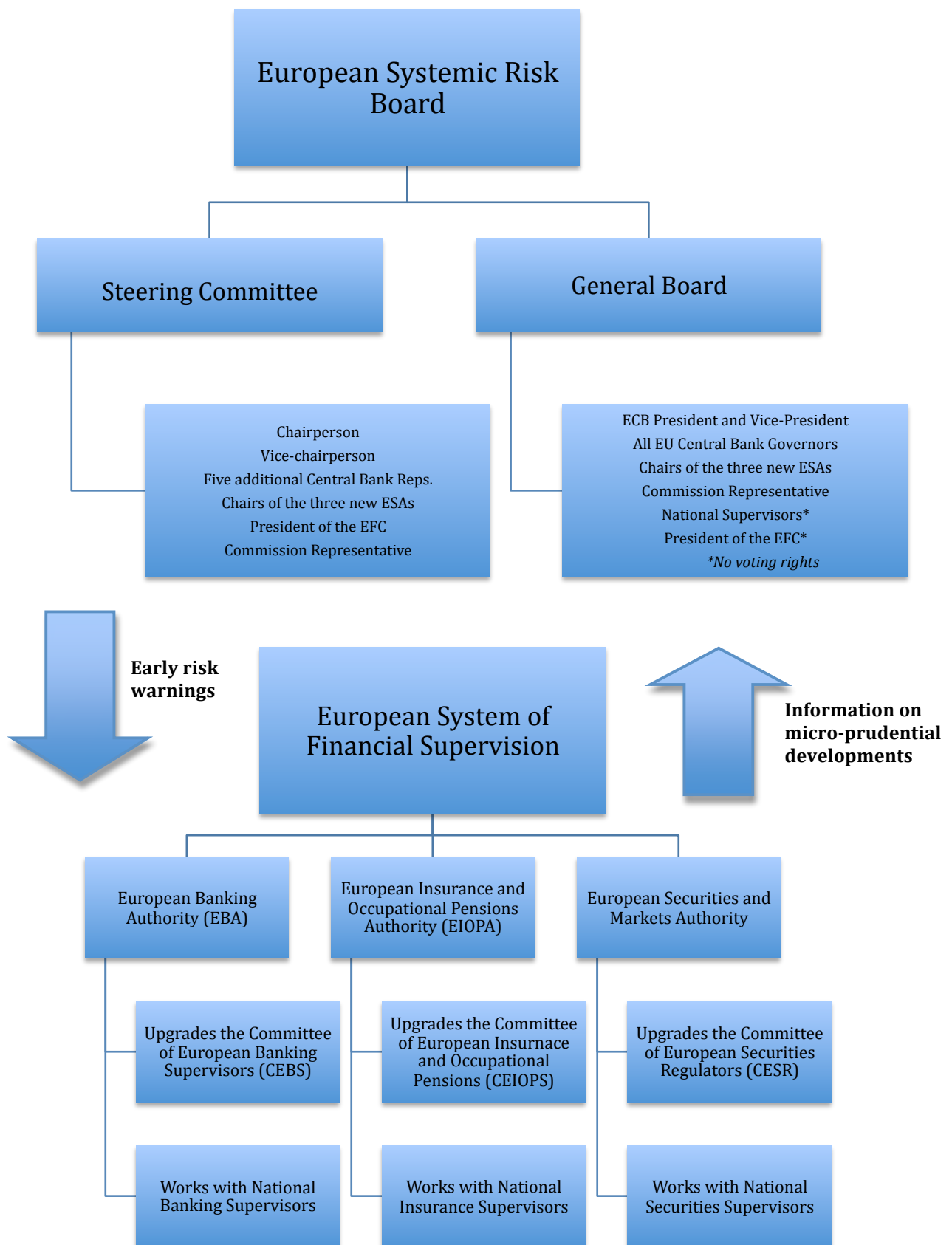
The new agencies will operate with substantially increased authority and workloads and will be related to the macro-supervisory initiative insofar as they will be obliged to respond to recommendations from the ESRB. They will also feed micro-prudential information upwards to the ESRB and benefit from any early risk warnings it issues.

In addition to performing the functions of the existing committees, they will have the following competences:

- Developing proposals for technical standards and working towards a common rulebook by helping to ensure more consistent rules within the EU;
- Ensuring national supervisors take a more coordinated approach by facilitating the exchange of information and resolving cases of disagreement, where legislation requires them to co-operate or to agree;
- Monitoring consistent application of technical Community rules (including through peer reviews) to ensure incorrect or inconsistent application is dealt with quickly and effectively; and
- Adopting a role as coordinator and fulfilling some decision-making functions in emergency situations.
- The European Securities and Markets Authority will exercise direct supervisory powers over Credit Rating Agencies.³²

The new authorities will work towards a common rulebook by developing technical standards in areas to be defined by legislation and by drawing up interpretative guidelines to assist national supervisors in taking individual decisions. The total costs of the new authorities have been estimated at about EUR 37 million in the first full year of operation (2011), rising to about EUR 68 million after three years (2014) due to increases in activity and staff levels. It is proposed that this cost should be split between member states and the Community budget at a ratio of 60 : 40. (It is envisaged that the ESRB will not present any extra cost for the Community budget as it will build, to the extent possible, on existing staff and resources of the European System of Central Banks, with a secretariat provided by the ECB.)

Diagram 1 - The New European Supervisory Arrangements



Observations on the European Systemic Risk Board

As the financial crisis made clear, supervising individual institutions in isolation is not enough. Rather we must think carefully about the broader risks that are presented by particular business models, sectors, and the wider markets and economic conditions in which firms operate.³³

A key issue is ensuring that close and strong links are forged between the realms of micro- and macro-supervision so that day-to-day supervisory tasks are undertaken in the context of a good understanding of the broader systemic risks.

The creation of the ESRB is in line with several other multilateral and international initiatives, including the reinforcement of the IMF's economic surveillance function and the creation of a Financial Stability Board by the G20. A primary and crucial function of the ESRB will be to liaise with these institutions.

Though the conceptual framework has achieved broad consensus, doubts remain over operational aspects of the plan, including whether or not sufficient resources have been allocated to ensure that the new agencies are effective. Meanwhile, the Association of British Insurers has expressed their concern that "the ESRB is dominated by bankers and does not have enough insurance expertise".³⁴

Given the failure of supervisors to prevent or even predict the last crisis, concerns exist about the ambition of the new plans. In an October 2009 speech, Lorenzo Bini-Smaghi, Member of the ECB Executive Board, noted that the ability of the ESRB to perform its tasks "will depend on its understanding of systemic risk, the amount of relevant information at its disposal, the analytical tools that are available to assess the risks, and the framework used to distil the most important results from all these elements".³⁵

Lacking powers of enforcement, the ESRB will essentially be trading on its reputation. There is a worry that any failure by the board to fulfill its duties could seriously undermine both its own credibility and that of the ECB, with which it will be closely intertwined. Mr Bini Smaghi makes the point:

*In particular regarding the issuance of risk warnings, the credibility of the ESRB will rest upon the minimisation and balancing of so-called type I errors and type II errors. Type I errors entail the possibility of identifying those risks that subsequently do not materialise, while type II errors relate to the possibility of failing to identify risks that subsequently do materialise. Identifying a long list of potential systemic risks to financial stability could minimise the probability of making type II errors but may lead to accusations of "crying wolf". The opposite could lead to an important risk to the EU financial system being overlooked, which if it materialised, could harm the ESRB's reputation.*³⁶

Central banks are to play a significant role in the ESRB because "they are well placed to contribute to the analysis of the impact on financial stability of the inter-linkages between the financial sector and the broader macroeconomic environment".³⁷ With regard to the crucial issue of appointments, the ECB president, Jean Claude-Trichet, will almost certainly be elected as chairman and it is very likely that Mervyn King, governor of the Bank of England, will be offered the position of vice-chair.

This probability relates to a large difficulty which has surfaced in the debate over the ESRB out of the disjuncture between the Eurozone, the EU and the EEA. This makes any perceived transfer of authority to the ECB controversial as states outside the Eurozone are reluctant to cede control to an institution that does not speak for them. Plotting the structure and hierarchy of the ESRB has thus been very sensitive but it seems that a workable solution has been reached in the organisation and division of responsibility described.

The Swedish presidency of the European Council is set to now begin negotiations on the establishment of the ESRB with the Economic and Monetary Affairs Committee in the European Parliament.³⁸ The ESRB looks set to go ahead and, if it can work in tandem with the newly empowered Financial Stability Board, may succeed in its mission to provide an effective early warning system that might deflect future threats. In actual fact, though the ESRB is the 'headline' element in this proposal, member states and analysts have much more serious reservations about the ESFS.

Observations on The European System of Financial Supervisors

The ESFS is designed to coordinate actions by national supervisors and the ESAs, and to resolve possible cross-border disputes. However, the proposals do not guarantee the effective resolution of such disputes. As it stands now, the draft legislation proposes the introduction of an appeal mechanism, which member states could turn to should they disagree with decisions taken by the new authorities. This means that it would ultimately be up to the EU Council to mediate conflicts by qualified majority vote. Many analysts agree that this is a cumbersome procedure, and one in which national interests are likely to prevail against the common good.³⁹

At an ECOFIN meeting in Luxembourg on 20 October 2009, final decisions on the creation of the new supervisory arrangements were postponed until a summit on 2 December (this will be the last ECOFIN meeting before the European Council summit on 10 and 11 December at which the Swedish presidency hopes to secure a final deal). Though "broad agreement" on the agenda was reached, ministers "took note of the need for further political negotiations".⁴⁰ Securing agreement from Britain remains the main obstacle to any deal. Alistair Darling, the UK chancellor, said after the meeting that "a number of detailed proposals have come from the Commission that we cannot accept, that we will continue to discuss".⁴¹ The ECOFIN statement therefore included an amendment requested by the UK which made it clear that final agreement on the macro-supervisory proposals had not yet been reached. Sources close to the meeting stated that the UK believes that by being able to re-open discussions on elements of the ESRB, it will gain greater leverage in negotiations on the ESFS.⁴²

The Commission has since adopted additional proposals to change existing directives so as to make them compatible with the ESFS.⁴³ Proposals for further amendments are expected by early 2010, in particular with regard to the insurance sector, which is not covered by the current proposals.

All the Commission's supervision proposals are currently being considered by the Council and Parliament. The Commission is urging early adoption of the entire package so that the new authorities can be up and running before the end of 2010.

However, Sharon Bowles the head of the Parliament's Economic and Monetary Affairs Committee, recently indicated that her committee had no intention on being rushed to approve the legislation, saying that it would take the time to carefully assess the "cumulative effect" of the Commission's plans.⁴⁴

Final Remarks

The European Union's response to the global financial crisis has generated a formidable body of communications, reviews, legislative proposals and amendments, not to mention a great deal of controversy and debate. This document represents an initial attempt to map out the most important institutional changes proposed by the EU in the area of financial supervision. Further studies, taking account of contemporary developments, and of the important proposals in the area of regulation, will follow.

Appendix 1 - European Policy Responses to the Financial Crisis

(i): Supervisory Proposals

Measure	Purpose	Status
Establishment of the European Systemic Risk Board	<p>To:</p> <ul style="list-style-type: none"> • Introduce macro-supervision function; • Act as early risk warning system; and • Liaise with international counterparts. 	The Commission adopted a package of legislation on 23 September. It is currently under negotiation at the European Parliament and Council.
<p>Establishment of the European System of Financial Supervisors, comprising national supervisors plus three new European Supervisory Agencies (ESAs):</p> <ul style="list-style-type: none"> – The European Banking Authority – The European Insurance Authority – The European Securities Markets Authority 	<p>To:</p> <ul style="list-style-type: none"> • Harmonise supervisory practices; • Move towards single rulebooks; • Strengthen oversight of cross-border and pan-European entities; • Establish central database of micro-prudential information; and • Ensure a coordinated response to crises. <p>The ESFS will share information with the ESRB for macro-prudential purposes. The ESRB will in turn issue risk warnings to the ESAs and any Members States or groups of member states which it feels are endangering financial stability.</p>	<p>The ESFS was also proposed in the 23 September Commission package. Supplementary proposals, amending existing directives to make them compatible with the new system, were issued in October.</p> <p>The ESAs are expected to be established as regulatory agencies under EU law, based on Article 95 of the EU Treaty.</p>

(ii): Regulatory Proposals

Amendments to the Capital Requirements Directive (2006/48/EC and 2006/49/EC)	<p>Adopted:</p> <ul style="list-style-type: none"> New rules on securitisation; large exposures; home-host relationships; 'hybrid' capital; liquidity risk management. <p>Proposed:</p> <ul style="list-style-type: none"> Increased capital requirements for trading books and re-securitisations; increased disclosure demands for securitisation exposures; restrictions on remuneration policies. <p>Pending proposals:</p> <ul style="list-style-type: none"> Supplementary measures on capital and liquidity requirements; implementation of new leverage ratio pending from Basel Committee; elimination of national options and discretions; framework for counter-cyclical buffers. 	<p>These technical amendments were adopted in early 2009: their implementation is due by December 2010.</p> <p>The Commission proposed to further amend the CRD in July 2009. Implementation of these proposals is due by 2011.</p> <p>Following a public consultation in the autumn of 2009, proposals in these areas are expected in late 2009 or 2010.</p>
Consultation on Possible Initiatives to Enhance Resilience of OTC Derivatives Markets	<p>To enhance the resilience of OTC Derivatives Markets by:</p> <ul style="list-style-type: none"> Promoting further standardisation; Strengthening the bilateral collateral management for non-CCP eligible contracts Enhancing the use of central data repositories; Moving clearing of standardised OTC derivatives to CCPs; Increasing transparency of prices, transactions and positions; and Moving (part or all of) trading to public trading venues. 	<p>On 3 July 2009 the Commission adopted a Communication analysing the benefits and risks of derivatives markets and their role in the financial crisis.</p> <p>From 3 July -31 August 2009 it staged a consultation, culminating in a high-level conference that took place on 25 September 2009.</p> <p>On 20 October 2009 it adopted a Communication setting out future policy actions. It will come forward with legislative proposals in 2010.</p>
Adoption of the Regulation on Credit Ratings Agencies (CRAs)	<p>To:</p> <ul style="list-style-type: none"> Enhance disclosure requirements; Require registration of CRAs; Improve quality of ratings; and 	<p>This directly applicable regulation was approved by Council and Parliament in April 2009.</p> <p>Implementation by member</p>

	Eliminate conflicts of interest.	states is due by October 2009.
Draft Alternative Investment Funds Managers (AIFM) Directive	<p>To:</p> <ul style="list-style-type: none"> Establish a secure and harmonized framework for supervising risks that AIFMs pose to investors, counterparties, other market agents and overall financial stability; and Permit, subject to compliance, AIFM to provide services and market their products across the internal market. 	<p>Commission proposals were put forward in April 2009.</p> <p>They are currently under consideration by the Parliament and Council. The Parliament's economic and monetary affairs committee are expected to vote on an amended draft in April 2010.</p>
Review of the Deposit Guarantee Schemes Directive (1994/19/EC)	<p>To:</p> <ul style="list-style-type: none"> Strengthen depositor confidence; Enhance financial stability; and Enhance the Internal Market. 	The Commission has produced a consultation document and intends to submit legislative proposals to the Council and Parliament by the end of 2009.
Review of the Application of the Investor Compensation Schemes Directive (1997/9/EC)	<p>To consider:</p> <ul style="list-style-type: none"> The scope of the Directive in terms of services covered, also in light of the implementation of the MiFID Directive (2004/39/EC); The amount of compensation; The funding of compensation schemes; Some technical aspects which may hamper the functioning of the schemes; and Issues related to the treatment of money market funds. 	Following a review of the Directive by Oxera Consulting, commissioned in 2005, the Commission issued a call for evidence in February 2009. Proposals are pending.
Proposals to Review the Application of the Prospectus Directive (2003/71/EC)	<p>To make securities issues more efficient by:</p> <ul style="list-style-type: none"> Increasing legal clarity in the prospectus regime; Reducing administrative burdens for issuers and intermediaries; and Helping investors to more effectively analyse prospects and risks posed by securities. 	Commission proposals put forward in September 2009 under the Action Plan for the Reduction of Administrative Burdens.

Adoption of the UCITS (Undertakings for Collective Investment in Transferable Securities) IV Directive (3605/1/09 REV 1 and 10824/09 ADD1)	<p>To:</p> <ul style="list-style-type: none"> • Reduce administrative requirements for cross-border distribution by simplifying and accelerating notification procedures; • Establish a procedure for cross-border mergers; • Allow the creation of master-feeder structures (across borders); • Introduce standardised Key Investor Information (KII) document; • Strengthen existing regulatory requirements; and • Introduce the Management Company Passport (MPC), allowing for the management of funds across borders. 	<p>Formally adopted in January 2009. Implementation required by July 2011.</p>
Review of the Application of the Market Abuse Directive (2003/6/EC)	<p>To review:</p> <ul style="list-style-type: none"> • The scope of the markets and financial instruments covered by the directive; • The ability of listed issuers to delay disclosure of inside information; • Disclosure of inside information by issuers of commodity derivatives; • The ability of competent authorities to gain access to telephone records and other data; • The obligation to draw up insiders' lists and to report managers' transactions; and • Questions related to short selling. 	<p>In April 2009, the Commission published a call for evidence on its review of the application of this directive.</p> <p>The Commission is due to put forward proposals, building on this consultation, in October 2009.</p>
Review of UCITS and AIF Fund Depositary Functions	<p>To improve the level of protection for UCITS investors by:</p> <ul style="list-style-type: none"> • Investigating better harmonization of depositary safe-keeping and supervisory duties; • Identifying risks relating to improper activity or insolvency; 	<p>In July 2009, the European Commission launched a public consultation on the UCITS Depositary Function.</p> <p>The deadline for responses was 15 September 2009.</p> <p>Proposals arising out of this consultation are pending.</p>

	<ul style="list-style-type: none"> • Inviting views on the introduction of rules on organization and conflict of interests based on existing MiFID rules; and • Investigating the extension of the AIFM proposal requiring depositaries to be credit institutions based to UCITS funds also. 	
Adoption of Solvency II Legislation	<p>To implement a much more sophisticated, ‘risk-based’ approach to capital requirements for insurers and reinsurers.</p> <p>Solvency II will require insurers to consider a wider range of risks – such as asset, credit, operational and group risks – than Solvency I.</p> <p>Central elements of the new regime include:</p> <ul style="list-style-type: none"> • Demonstration of adequate Financial Resources (Pillar 1); • Demonstration of an adequate System of Governance (Pillar 2); • Public Disclosure and Regulatory Reporting Requirements (Pillar 3); and • A Supervisory Review Process. 	<p>The directive text was adopted by the European Parliament on 22 April 2009 and endorsed by the Council of Ministers on 5 May 2009. The new regime should be fully implemented by 31 October 2012.</p>
Policy Action on Remuneration and Bonuses	<p>To ensure that financial institutions have remuneration policies for risk-taking staff that are consistent with and promote sound and effective risk-management, the Commission invited member states to adopt measures in four areas:</p> <ul style="list-style-type: none"> • Structure of pay; • Governance; • Disclosure; and • Supervision. <p>The September 2009 G20 summit has since endorsed a variety of actions put forward by the FSB.</p> <p>The FSB has been asked to propose additional measures as required by March 2010.</p>	<p>In April 2009, the Commission adopted a Communication and two complementary recommendations on remuneration policies.</p> <p>At the April 2009 G20 summit, leaders agreed to give banking supervisors powers to intervene if they thought remuneration practices were encouraging too much risk-taking.</p> <p>The Commission’s proposed amendments to the Capital Requirements Directive deal in some depth with these issues. They are currently under consideration by the Parliament and Council.</p>

Proposed Review of the Markets in Financial Instruments Directive (MiFID)	<p>To investigate whether, by leading to a significant migration of share trading transactions to unregulated OTC broker-dealer venues, the MiFID Directive has allowed these operators to enjoy unfair commercial advantages, which in turn serve to undermine price discovery and market integrity and efficiency.</p>	<p>A review of this Directive is due at the end of 2009.</p>
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Appendix 2 – The de Larosière Recommendations

1. A fundamental review of Basel II rules on banks' capital requirements;
2. A common EU definition of 'own capital', clarifying which hybrid instruments should be considered as Tier 1 capital;
3. Registration and supervision of credit-ratings agencies (CRAs) by a strengthened Committee of European Securities Regulators (CESR), and a fundamental review of CRAs business model;
4. A reflection on the mark-to-market principle in accounting rules so that accounting standards do not “discourage long-term investment”;
5. New rules for insurance companies (“Solvency II”) should be agreed by May and include a group-support regime coupled with sufficient safeguards for host member states, a binding mediation process between supervisors and harmonised insurance guarantee schemes;
6. Authorities in all member states should have sufficient supervisory powers to ensure compliance of financial institutions with applicable rules; national authorities should have strong sanction regimes to counter all types of financial crime;
7. The regulatory net should be extended to all firms or entities conducting financial activities of a potentially systemic nature; all financial markets, notably for hedge funds, should be made more transparent, with hedge-fund managers being required to disclose information about their strategies, methods and leverage; appropriate capital requirements should be imposed on institutions owning a hedge funds, a private-equity fund or companies engaged in proprietary trading;
8. Over-the-counter derivatives should be standardised and simplified; a single, well-capitalised central clearing house should be created for credit default swaps in the EU; issuers of securitised products should retain a meaningful share of the issue on their own books.
9. Existing rules for investment funds in the EU concerning definitions, the codification of assets and rules for delegations should be developed. Supervisory control over depositaries and custodians should be tightened.
10. The European Commission and the level 3 committees to identify national exemptions the removal of which would improve the functioning of the single financial market; reduce distortions of competition and regulatory arbitrage; improve the efficiency of cross-border financial activity;
11. Compensation incentives should be better aligned with shareholder interests and long-term firm-wide profitability;
12. The risk-management function within financial institutions should be made independent and responsible for effective, independent stress-testing;
13. A coherent workable regulatory framework for crisis management in the EU;
14. Harmonised deposit guarantee schemes should be pre-funded by the private sector;
15. Member states should agree more detailed criteria for burden-sharing to be applied when trying to resolve a cross-border crisis;
16. A new body called the European Systemic Risk Council (ESRC) to be chaired by the president of the European Central Bank to pool and analyse all information relevant for financial stability;
17. An effective risk warning system to be set up under the ESRC and the Economic and Financial Committee (EFC)
18. National supervisory authorities should be strengthened to upgrade the quality of supervision in the EU;

19. The EU should develop a more harmonised set of financial regulations by the beginning of 2013;
20. Level 3 committees should receive funding from the EU budget, and work to set up supervisory colleges for all major cross-border firms by the end of 2009;
21. An integrated European System of Financial Supervision (ESFS) should be created in a second stage. Level 3 committees should be transformed into three European authorities dealing with banking, insurance and securities;
22. The functioning of the ESFS should be reviewed three years after its entry into force; additional reforms such as merging the three authorities into two could be considered;
23. Work should begin immediately on planning the two stages of the new system; a new high-level group (made up of representatives of finance ministries, the European Parliament, the Level 3 committees and the European Central Bank, with the European Commission acting as a chair) should be forward before the end of 2009 with a detailed implementation plan;
24. The Financial Stability Forum, in conjunction with international standards-setters (such as the Basel committee of Banking Supervisors), should be in charge of promoting the convergence of international financial regulation;
25. The EU should intensify its regulatory dialogue with key financial partners;
26. Colleges of supervisors for large complex cross-border groups should be set up at an international level and should carry out robust, comprehensive risk assessments, pay greater attention to banks' internal risk-management practices and agree a common approach to promoting the alignment of incentives in private-sector remuneration packages;
27. The IMF, in close co-operation with other bodies like the FSF, the Bank for International Settlements and ESRC, should be put in charge of developing and operating a financial-stability early-warning system;
28. Coordinated efforts should be intensified to encourage currently uncooperative jurisdictions to adhere to the highest level of international standards and to exchange information among supervisors;
29. EU member states should show their support for strengthening the role of the IMF in macroeconomic surveillance and to contribute towards increasing the IMF's resources;
30. Coherent EU representation in the new global economic and financial architecture.

Endnotes

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