The “Europeanization” of Financial Supervision in the Aftermath of the Crisis

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In the aftermath of the economic crisis, that began in 2007 in the U.S.A. and spread to the European economy, weakening the EU, every discussion about its causes and how to address them was linked to the absence of a suitable supervisory[1] framework. The EU has been accused of lacking sufficient legal tools both at a precautionary level as well as for crisis management.[2] Even though the internal market of financial services had been making progress, up until 2007 there were no truly centralized[3] mechanisms and tools to supervise financial activities, identify their complexity, their risks and the interconnections between the financial institutes, as indicated by the De Larosière Report.[4] Adam Smith's "invisible hand" and de-regulation[5] as a dominant approach had been proven insufficient to address the fragmentation of financial institutes, which were acting on a European level, but were supervised nationally.[6]

The EU responded with a reform and established a new supervisory system consisting of the ESFS[7] (European System of Financial Supervision) and the SSM[8] (Single Supervisor Mechanism). ESFS is a network of European agencies and national authorities that applies to the whole financial sector. The SSM constitutes the first pillar of the banking union, applies only to credit institutes, and is a composite administration of the ECB and the national competent authorities.

This article seeks to explore this new infrastructure by examining its tasks and the sanctions it can address. For the purpose of this contribution, I use the term "Europeanization" in quotation marks in order to describe this reform, because ESFS and SSM do not possess the same level of centralization. As far as the ESFS is concerned, the supervision remains mainly on a national level, but the EU agencies play a significant role in unifying its application. On the contrary, SSM constitutes a fully centralized supervisor.

I. European Supervisory System

1. Macroeconomic[9] Level

To undo the mistakes of the past,[10] the EU set up the ESRB (European Systemic Risk Board) with the mandate to oversee risks in the financial system as a whole. The outburst of the crisis made it apparent, that macroprudential supervision had been neglected. Therefore, the establishment of the ESRB seeks to remedy this deficiency and defines in Art. 2 lit. (c) Reg. 1092/2010 the notion of systemic risk.

The ESRB was established by Regulation (EU) No 1092/2010 and entered into force on 26 December 2010. It is founded upon Art. 114 TFEU, the title of which is "Approximation of laws". The question that arises is whether the set-up of a committee can be regarded as an approximation measure. This question will be addressed in relation to the other parts of the ESFS, as they share the same legal basis.

Because its Secretariat is supported and located within the European Central Bank (ECB), the legal framework of ESRB is complemented by the Council Regulation (EU) No 1096/2010, which confers specific tasks upon the ECB concerning the functioning of the ESRB. This regulation is based on Art. 127 § 6 TFEU.

The ESRB is part of the ESFS pursuant to Art. 1 § 2 Reg. 1092/2010 and constitutes an advisory committee without legal personality, which selects and analyzes information about systemic risks for the first time. Its powers and legal acts will be examined in Section II. of this paper.

2. Microeconomic[11] Level

Both ESFS and SSM operate at the microeconomic level. The ESFS will celebrate its fifth anniversary on 1 January 2016, whereas the SSM was established one year ago, on 4 November 2014. However, as already

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mentioned, the ESFS applies to the entire financial sector, whereas SSM is limited to credit institutes, defined by Art. 4 of the Capital Requirements Regulation.[12]

a) ESFS

The ESFS comprises of the EBA[13] (European Banking Authority), EIOPA[14] (European Insurance and Occupational Pensions Authority), ESMA[15] (European Securities and Markets Authority), their joint committee, the ESRB and the national competent authorities. EBA, ESMA and EIOPA are mentioned in their regulations as European Supervisory Authorities (ESAs). Because ESAs are founded following the same concept, their regulations have similarities in wording and numbering. In this article the Regulation of EBA (Regulation) will be used as an example, and where differences occur, the relevant regulation will be referred to.

The legal status of ESAs is declared in Art. 5 of the Regulation, which defines ESAs as a "… Union body with legal personality", implying that they fulfil the characteristics of an agency. The term "agency" is a term originating from jurisprudence, that is not legally binding and that describes a body that has a legal personality, is endowed with autonomy, and has a specific scope of tasks, as in the case of ESAs. Indeed, they function as regulatory agencies, as opposed to executive agencies.

ESAs, like the ESRB, are based on Art. 114 TFEU according to the 17th recital of the Regulation, and as already noted, the question arises, as to whether the establishment of a European body can be regarded as an approximation measure. This is not the first time that the EU has set up agencies using Art. 114 TFEU, and this procedure has already been challenged in the case[16] of the ENISA agency, where the CJEU stated, that Art. 114 TFEU is not addressed to Member States only, but can also refer to the EU level. In that case, the establishment of an EU body is in compliance with Art. 114 TFEU, if it contributes to a harmonisation process and has a close link to the objectives of the internal market. In the 17th recital, the Regulation itself cites the ENISA case, in an attempt to prove the ESAs' conformity and to dismiss any criticism about the choice of Art. 114 TFEU.

b) SSM

The SSM constitutes one of the four pillars of the European Banking Union, together with the Single Resolution Mechanism (SRM),[17] the Deposit Guarantee Scheme and the Single Rulebook. It functions as a composite administration of the ECB and the national competent authorities according to Art. 2 § 9 and Art. 6 of the SSM Regulation. It was founded by Council Regulation (EU) 1024/2013 (cited as SSM Regulation) pursuant to Art. 127 § 6[18] TFEU, while the cooperation of ECB and national authorities within the SSM is regulated in Regulation (EU) 468/2014 of the ECB (cited as SSM Framework Regulation) pursuant to Art. 132 § 1 TFEU.

The SSM is originally designed for the Member States that belong to the Euro area (Art. 2 § 1 SSM Regulation), but it remains open to the other Member States, if they are willing to participate in its regime and form a close cooperation, (Art. 7 SSM Regulation).

In the course of the SSM, the supervision of the credit institutes can be classified into two categories: direct and indirect supervision. The decisive criterion that distinguishes these categories is the systemic significance of the institute according to Art. 6 § 4 SSM Regulation. Their classification is determined by the ECB according to Art. 43 SSM Framework Regulation. Crucial factors for the assessment of systemic significance are the size of the institutes, their importance for the economy and their cross-border activities. The three biggest credit institutes of a Member State always fall into the category of direct supervision, which also applies to those institutes that are financially supported by the ESFS[19] or the ESM[20].

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For the systemically significant institutes, the SSM becomes the centralized supervisor in place of the national authorities (Art. 9 SSM Regulation) and the ECB forms joint supervisory teams with the national authorities pursuant to Art. 3 SSM Framework Regulation. In contrast, the less significant ones fall within the national competence under the instructions of the SSM, and therefore under the indirect supervision of the SSM. However, the SSM always retains the possibility to take over direct supervision, even of the less significant institutes, (Art. 6 § 5 lit. b SSM Regulation).

Currently, about 120 banking groups, this amounts to 1.200 entities that possess 85% of the banking assets in the EU, fall within the direct supervision of the SSM, in comparison to about 3.500 banking entities that remain under national supervision.

II. Powers and Sanctions

1. Macroeconomic Level

The ESRB is not vested with binding powers, yet its foundation is a novelty, as it is the first committee at the EU level mandated with macroprudential oversight. In order to fulfil this mandate according to Art. 2 Regulation 1092/2010, it collects and analyses the relevant information and prioritizes the risks. It provides the ESAs with the necessary information and fosters the exchange of information between the competent supervisory authorities pursuant to Art. 15 of the relevant regulation. Furthermore and more importantly, it can provide warnings and issue recommendations, that can be addressed to the EU as a whole, to one or more Member States, to the ESAs, or to national competent authorities, (Art. 16 of the regulation). Although warnings and recommendations lack legal binding effect, the addressee is obliged to comply or explain according to Art. 17, and according to Art. 18, the ESRB has the possibility to publish its warnings and recommendations. Both the “comply or explain” principle and the publication exert pressure on the addressee. Therefore, in order to avoid this process, the addressee can choose to comply, and in this way, the powers of the ESRB produce a de-facto binding effect.[21] This explains why these “tools” are perceived as compensation for the lack of legal binding powers.[22]

2. Microeconomic Level

a) ESFS

With the creation of ESAs, financial supervision, as already stated, remains national and thus decentralized,[23] but the ESAs foster the convergence, coordination, and unified application of law, especially with the Single Rulebook, which aims at the creation of a unified substantive law. To fulfil these tasks, the ESAs are equipped with non-binding powers. In specific situations und under specific conditions, however, they possess binding powers, which is a striking feature for agencies

As far as non-binding powers are concerned, the ESAs draft technical regulatory (Art. 10 of the Regulation and Art. 290 TFEU) and implementing (Art. 15 of the Regulation and Art. 291 TFEU) standards, which become binding when endorsed by the Commission either in form of a regulation or a decision and they form the Single Rulebook. They also issue guidelines and recommendations requiring the national authorities to “comply or explain” (Art. 16 of the Regulation) and issue opinions (Art. 34 of the Regulation).

Although ESAs are agencies, they are equipped with binding powers and can address decisions under specific conditions both against national authorities and against financial institutions circumventing the national authorities. This can only happen, however, when EU law is breached (Art. 17 of the Regulation), in emergency situations (Art. 18 of the Regulation) and when a settlement agreement between national author-

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ities has been reached (Art. 19 of the Regulation). Because of the legal nature of decisions and this power being bestowed on an agency, it is conceived as *ultima ratio* after following a three-step mechanism. Firstly, the relevant agency addresses a recommendation to the competent authority. If the national authority does not comply, then the Commission issues an opinion. If, again, the national authority does not comply, then ESAs can circumvent the national authority and address a decision to financial institutions in the case of Arts. 17 and 18, or, as in the case of Art. 19, the decision is addressed to the national authorities. These decisions can be appealed to the CJEU, but also within the ESAs to the Board of Appeal according to Arts. 58 and 60 of the Regulation. The conferral of binding powers constitutes an unprecedented phenomenon, adding centralization elements to the role of the ESAs.[24]

b) SSM

In general, the powers of the SSM and, subsequently, the sanctions it can address depend on its acting as a direct or indirect supervisor. However, there is an important exception: the SSM decides upon the authorisation, the withdrawal of the authorisation and the acquisition or disposal of qualifying holdings for all credit institutes, regardless of their systemic relevance according to Art. 6 § 4 of the SSM Regulation.

Beyond this exception, the SSM has the typical investigatory and supervisory powers that a competent national authority has, when acting as the direct supervisor (Art. 9 SSM Regulation). In the course of its investigatory powers (Arts. 10-13 SSM Regulation), the SSM can request information from the credit institutes, examine books, require the submission of documents, interview people and carry out on-site inspections.

As far as the supervisory powers are concerned, they are regulated in Arts. 14-18 of the SSM Regulation. They include the authorisation, the withdrawal of the authorisation and the acquisition or disposal of qualifying holdings, which applies to all, systemic and non-systemic, credit institutes. Furthermore, the SSM can require the supervised entities to take measures at an early stage to comply with the supervisory requirements (capital adequacy, liquidity, etc.), to hold own funds, to minimise risks, to limit remuneration, to restrict or prohibit distributions to shareholders, to report more often, or to remove members from the management board. If the supervised entities breach the requirements of directly applicable Union law, which entails administrative penalties, the SSM can impose them. If the breach of the requirements does not involve directly applicable Union law, the SSM can then require the national competent authorities to take action and impose administrative penalties.

III. Conclusion

The new European supervisory system attempts to counteract the weaknesses of the former, nationally driven system of financial supervision. The set-up of the ESRB as a committee at the macroeconomic level, the role of the agencies as part of the ESFS at the microeconomic level, and especially the foundation of the SSM as a direct supervisor have totally changed the previous supervisory system. This is an important step towards Europeanization. It remains to be seen, whether this new system will actually be more efficient.

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1. For a definition, see e.g. banking supervision “It covers the regulatory and monitoring apparatus that is directed towards helping to preserve the financial health and safety of banks… Supervision has a wider interest in the prudential health of banking at a market and generalized level.”, P. Newman, M. Milgate, J. Eatwell, The New Palgrave Dictionary of Money and Finance, Volume 1, 1992, p. 156.↩
2. “Die Krise hat … deutliche Schwachstellen des Aufsichtsrahmens offenbart.” Lehmann, Manger-Nestler : Die Vorschläge zur neuen Architektur der europäischen Finanzaufsicht,in *EuZW* 2010, p. 87.↩
3. The European forum of coordination of national supervisors mainly consisted of the level- 3 committees of the Lamfalussy-process. The Lamfalussy-process is a legislative and supervisory process for the financial sector based on comitology since 2001, named after Alexandre Lamfalussy, who chaired the group of wise men, and who proposed this process to enhance and accelerate legislation in the financial sector. Lembke Martin, “Eine Aufsichtsbehörde für den europäischen Kapitalmarkt”,*Peter Lang*, Frankfurt am Main, 2010, p. 62.↩

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4. The High-Level Group of Financial Supervision in the EU, chaired by Jacques de Larosière, Report, Brussels, 25 February 2009. In the aftermath of the crisis, a group of wise men chaired by Jacques de Larosière was assigned by the Commission to point out the weaknesses and propose reforms. See J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, pp. 383 - 384.↩
5. About the different approaches of supervisory de-regulation and re-regulation, see in this respect P. Newman, M. Milgate, J. Eatwell, The New Palgrave Dictionary of Money and Finance, Volume 1, 1992, p. 157.↩
6. See J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 382.↩
7. ESFS comprises of EBA, EIOPA, ESMA, their joint committee, ESRB and national authorities.↩
8. Council Regulation (EU) No 1024/2013.↩
9. "Macroprudential supervision focuses on the soundness of the financial system as a whole. Macroprudential analysis must … pay … attention to common or correlated shocks … contagious knock-on effects … interactions between financial institutions and their environment … as well as the dynamics … over time." J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 393.↩
10. "… the financial crisis of 2007 - 2009 highlighted the important distinction between both concepts (microprudential and macroprudential supervision)", J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 393.↩
11. "The intermediate objective of microprudential supervision is to supervise and limit the distress of individual financial institutions … The fact that the financial system as a whole may be exposed to common risks is not (fully) taken into account.", J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 393 and pp. 385 - 386.↩
12. Regulation (EU) No 575/2013. Art. 4§1 (1) of the Reg. : "… undertaking … take deposits or other repayable funds … and grant credits".↩
13. Regulation (EU) No 1093/2010.↩
14. Regulation (EU) No 1094/2010.↩
15. Regulation (EU) No 1095/2010.↩
16. CJEU C-217/04, *United Kingdom v European Parliament and Council of the European Union*, 02.05.2006.↩
17. Regulation (EU) No 806/2014.↩
18. Its legal basis is strongly criticised, because Art. 127 § 6 TFEU speaks for the conferral of specific tasks upon the ECB. Turning the ECB into a direct supervisor seems to exceed the mere conferral of specific tasks. See K. Peters, "Die geplante europäische Bankenunion – eine kritische Würdigung", in *WM*, Issue 9, p. 399.↩
19. European Financial Stability Facility, Agreement of 27 Member States of EU on 9 May 2010↩
20. European Stability Mechanism, Treaty Establishing the European Stability Mechanism of 2 February 2012↩
21. "Wenngleich derartige Instrumente keinen verbindlichen Rechtscharakter aufweisen, so kommt ihnen doch eine faktische Bindungswirkung zu, da sie als abstrakt-generelle Normen konzipiert sind und ihre Vorgaben von den Adressaten letztlich doch umgesetzt werden müssen." S. Nicolas, Rechtsschutz gegen Maßnahmen der neuen europäischen Finanzaufsichtsagenturen, in *BKR* 2012, p. 9.↩
22. See Rötting, Lang, "Das Lamfalussy-Verfahren im Umfeld der Neuordnung der europäischen Finanzaufsichtsstrukturen", in *EuZW* 2012, p. 10.↩
23. J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 385.↩
24. See, in this respect, "National supervisors will want to avoid being overruled by the ESA. If this happens too often, their reputation will be hurt.", J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 387. Comparing the three ESAs, ESMA seems to act more as a centralized supervisor, because of its exclusive supervisory powers over rating agencies registered in the EU. See J. de Haan, S. Oosterloo, D. Schoenmaker, "Financial Markets and Institutions, a European perspective", Cambridge, 2012, p. 386. This also concerns ESMA's power to temporarily prohibit or restrict certain financial activities, Art. 9 § 5 Regulation (EU) 1095/2010. See CJEU C-270/12, *UK v. Parliament and Council*, 22.01.2014 about ESMA's power to prohibit short selling, article 28 Regulation (EU) 236/2012 and "The legal limits to agencification in the EU? CJEU C-270/12 UK v. Parliament and Council" in http://europeanlawblog.eu/?p=2176.↩

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