



EUROPEAN COMMISSION

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Public consultation ESFS review

Background Document

Introduction

In 2010, in response to the financial crisis which exposed important failures in financial supervision, the EU established the European System of Financial Supervision (ESFS), composed of

- three European Supervisory Authorities (ESAs):
 - the [European Banking Authority](#) (EBA),
 - the [European Insurance and Occupational Pensions Authority](#) (EIOPA),
 - the [European Securities and Markets Authority](#) (ESMA),
- the [European Systemic Risk Board](#) (ESRB); and
- the competent national authorities of the Member States.

The ESAs were established with the objectives to contribute to:

- (i) improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision,
- (ii) protecting depositors, investors, policyholders, consumers and other beneficiaries,
- (iii) ensuring the integrity, efficiency and orderly functioning of financial markets,
- (iv) safeguarding the stability of the financial system,
- (v) strengthening international supervisory coordination.

In order to meet these objectives, each ESA is required to contribute to ensuring the coherent, efficient and effective application of the relevant Union law.

The ESRB was created as the EU body in charge of macro-prudential oversight. Essentially, its role is to contribute to the prevention and mitigation of systemic risks to EU's financial stability by means of *ex ante* warnings and recommendations.

The ESFS regulations provide for a review by the Commission of the European Systemic Risk Board (ESRB) by 17 December 2013 and the European Supervisory Authorities (ESAs) by 2 January 2014 and for regular reviews thereafter.

Article 81 of the ESA Regulations says that the Commission shall publish a general report on the experience acquired as a result of the operation of the Authorities and procedures laid down in these Regulations. This report shall be forwarded to the European Parliament and to the Council, together with any accompanying proposals, as appropriate.

Article 20 of the ESRB Regulation (1092/2010) says that the European Parliament and the Council shall examine the Regulation on the basis of a report from the Commission and, after having received an opinion from the ECB and the ESAs, shall determine whether the mission and organisation of the ESRB need to be reviewed. They shall, in particular, review the modalities for the designation or election of the Chair of the ESRB.

A similar review clause is included in Article 8 of the [second ESRB Regulation \(1096/2012\)](#), which defines the modalities of the ECB's support to the ESRB.

When carrying out the review of the ESFS, the Commission takes into account that the necessary legislation is not yet fully in place. Therefore the review is without prejudice to ongoing work on various relevant legislative proposals put forward by the Commission which are currently under negotiation (e.g. proposal on bank recovery and resolution, MIFID, etc.) by the European Parliament and the Council.

The review will also address the potential impacts of the creation of a single supervisory mechanism (SSM) on the ESAs, the ESRB and the ESFS given the core role attributed to the ECB and will assess whether this necessitates further adaptations to the legal framework underpinning the ESFS.

In the context of the review the Commission also takes into account the principles set out in the Common Approach of the European Parliament, the Council of the EU and the European Commission on decentralised agencies of July 2012, which aims at making the set of existing EU agencies more coherent by improving their governance, efficiency and accountability.

The responses to this consultation will provide important information on the effectiveness and efficiency of the ESAs and the ESRB within the ESFS and on the ESFS as a whole and will support the Commission to prepare the relevant reports.

The public consultation is organised into five sections:

- I. ESAs (Effectiveness and efficiency of the ESAs, Governance)

- II. ESRB (mandate and experience with systemic risks; institutional framework and governance of the ESRB; access to data; external relations and communication)
- III. Cooperation and interaction between the ESAs (micro level) and ESRB (macro level)
- IV. Structure of the ESFS
- V. Miscellanea

I. The European Supervisory Authorities (ESAs)

1. Effectiveness and efficiency of the ESAs in accomplishing the tasks which have been entrusted to them

The ESAs took over all the tasks of the previous European supervisory committees (CEBS, CESR, CEIOPS), but in addition were attributed significantly increased responsibilities, defined legal powers and greater authority.

The most important elements of the ESAs' mandates include, among others,

- The power to contribute to the development of a single rule book by developing draft technical standards, guidelines and recommendations;
- the power to ensure the consistent application of Union law;
- the power to take action in emergency situations;
- the task to take a leading role in promoting transparency, simplicity and fairness for consumers and investors;
- the power to settle disagreements by binding mediation between national supervisory authorities;
- the ability to participate in colleges of supervisors and receive all relevant information;
- the obligation to play an active role in facilitating a common European supervisory culture and ensuring consistent supervisory practices;
- the task of assessing market developments;
- an international and advisory role;
- the task of collecting information;
- the obligation to closely cooperate with the ESRB; and

- direct supervisory powers for the registration and supervision of credit rating agencies (ESMA).

1.1. Work towards achieving a single rulebook - regulatory activities

The Authorities may, in areas specified in the relevant sectoral legislation, develop draft technical standards (i.e. Articles 10-15 ESAs Regulations). In order to give them legal effect the Commission needs to subsequently endorse these draft standards in the form of regulations or decisions.

Furthermore, the ESAs shall issue guidelines and recommendations "with a view to establishing consistent, efficient and effective supervisory practices within the ESFS and to ensuring the common, uniform and consistent application of Union law" (Article 16 ESAs Regulations).

Finally, the Authorities may "provide opinions to the European Parliament, the Council and the Commission on all issues related to its area of competence" such as, for instance, technical advice. (Article 34 ESAs Regulations).

1.2. Common supervisory culture/convergence of supervisory practices

The Authorities shall "contribute to promoting and monitoring the efficient, effective and consistent functioning of the colleges of supervisors" and "shall be able to participate in the activities of the colleges" (Article 21(1) ESAs Regulations).

The ESA Regulations further empower the Authorities to carry out various activities in view of "building a common Union supervisory culture and consistent supervisory practices", as well as to ensuring "uniform procedures and consistent approaches throughout the Union" (Article 29 ESAs Regulations).

In order to "further strengthen consistency in supervisory outcomes" the Authorities shall periodically organise and conduct peer reviews (Article 30(1) ESAs Regulations).

To carry out these duties the Authorities may request national competent authorities to provide them with all the necessary information including at recurring intervals and in specified formats (Article 35 ESAs Regulations).

1.3. Consistent application of legally binding Union acts

The founding Regulations enable the ESAs to assist national authorities at the request of one or more authorities in reaching a common approach or settling the matter, including direct decision making powers requiring financial institution to comply with the obligations under Union law (Article 19 ESA Regulations). So far, the ESAs have not used these powers.

Similarly the ESAs are entitled to address recommendations to national authorities when a national authority appears to be in breach of union law and, following a pre-defined procedure and as a last resort, to directly address decisions to financial

institutions to ensure respect of Community law which is directly applicable to them (Art. 17 ESAs Regulations). So far, the ESAs have not addressed any recommendations to national authorities nor addressed individual decisions to financial institutions. However, the ESAs have made use of "soft" informal measures to bring about conformity of EU law.

1.4. Emergency situations

The founding Regulations set out that the ESAs shall fulfil an active coordination role between national supervisory authorities, in particular, in case of adverse developments which potentially jeopardise the orderly functioning and integrity of financial markets or the stability of the financial EU financial system. Following the determination of an emergency situation by the Council the ESAs may, as a last resort, adopt individual decision directly to financial institutions/insurers requiring the necessary action including the cessation of any practice (Art. 18 ESAs Regulations). So far, no emergency situation has been declared. However, the ESAs have undertaken significant preparative work to ensure their capability to act efficiently in case an emergency action was declared.

1.5. Coordination function (Art 31 ESAs Regulations)

Beyond their coordination role in emergency situations the ESAs are required to "promote a coordinated Union response" particularly in adverse market conditions by e.g. facilitating information exchange between authorities, determining the scope/reliability of information to be made available by national authorities and centralising information received, carrying out non-binding mediation, notifying to the ESRB potential emergency situations; taking all appropriate action to facilitate action by national authorities (Article 31 ESAs Regulations).

1.6. Tasks related to consumer protection and financial activities

The founding Regulations require the ESAs to take "a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services". The ESAs may also "issue warning in the event that a financial activity poses a serious threat" to the ESAs' objectives and may, under specific circumstances, even "temporarily prohibit or restrict certain financial activities" which threaten the integrity of financial markets or the stability of the financial system (Article 9 ESAs Regulations). So far, the ESAs have issued three warnings which were published on the relevant websites.¹

1.7. Direct supervisory powers

ESMA is exclusively competent for the registration and supervision of Credit Rating Agencies (CRAs) in the European Union. Following the entry into force of the European Market Infrastructure Regulation (EMIR) nr 648/2012 of 4 July 2012, ESMA is expected to assume responsibilities in the area of post-trading including direct supervision of trade repositories.

¹ See <http://www.esma.europa.eu/page/News-investors#>

2. Governance of the ESAs

2.1. General governance issues

Article 42 of the ESAs regulations stipulates that the Members of the Board of Supervisors shall enjoy a high degree of independence in order to objectively fulfil their mission. In particular, the Chairperson and voting members of the Board of Supervisors shall act independently, and in the sole interest of the European Union and shall not take any instruction either from Union institutions or from any national governments.

In order to ensure proper accountability and allow for a high degree of transparency this independence is balanced by strong accountability requirements vis-à-vis the Council and the European Parliament (Art. 50 ESAs Regulations). The Chairpersons shall report in writing on the main activities of the respective authority and the Council and the European Parliament have the power to invite the Chairperson of each ESA to make a statement and answer questions.

2.2. Decision-making bodies and voting modalities

Each ESA has two decision making bodies: The Board of supervisors (BoS) and the Management Board (MB).

The main decision-making body is the BoS (Articles 40-44 ESAs Regulations) which is, among other things, responsible for the adoption of draft technical standards, opinions, recommendations, and decisions. It is composed of the Chairperson of the respective ESA, who chairs the meeting, the heads of the relevant national supervisors, a representative of the Commission, a representative of the ESRB and a representative of each of the other two ESAs.² In addition, the BoS can also decide to admit observers (e.g. for representatives of Member States of the European Economic Area). As a general rule, decisions by the Board are taken by simple majority (one representative, one vote), with the exception of decisions in the regulatory domain – guidelines and recommendations, technical standards, temporary restrictions or prohibitions of products or activities – and budgetary matters which are subject to qualified majority voting. The chairperson and the representatives of the Commission, the ESRB, and the two other ESAs are non-voting members. In order to facilitate an impartial settlement of disputes, the BoS of each ESA set up an independent panel, consisting of the chairperson and two other members.

The second decision making body is the MB (Articles 45-47 ESAs Regulations) which ensures that the Authority carries out its mission and performs the tasks assigned to it. In particular, it is responsible for preparing the Authority's work programme, adopting the rules of procedure, and plays a central role in the adoption of its budget. It is composed of the ESA's Chairperson, who presides over meetings of the MB and six members elected by the Board of Supervisors among its members. The Executive Director and a representative of the Commission participate in meetings of the

² For the EBA, the ECB participates also as a non-voting representative in the meetings of the BoS.

Management Board without the right to vote. The Commission representative has the right to vote on budgetary matters. Decisions by MB are adopted on the basis of a majority of the members present (one member, one vote).

2.3. Financing and resources

In order to guarantee their full autonomy and independence, the ESAs are granted an autonomous budget (Article 62 ESAs Regulations). Revenues of the ESAs may consist of any combination of obligatory contributions from the national supervisory authorities, a subsidy from the Union and fees paid by the industry to the Authority under specific EU legislation. At present, the budget is funded 60% by the national authorities and 40% by the EU (recital 68 ESAs Regulations). In the case of ESMA, these proportions apply to the public funding while the Authority also receives fees from Credit Rating Agencies, which it supervises directly.

Articles 62-65 ESAs Regulations specify the procedures for the annual establishment, the implementation and control of the budget. As EU Regulatory Agencies, the financial rules of the ESAs are based on a Framework Financial Regulation, itself derived from the Financial Regulation applying to the EU budget. The Authorities are subject to the annual discharge procedure by the European Parliament, through which it decides whether to approve the way the Authorities have implemented their budgets. In relation to staffing issues the Staff Regulations of the EU institutions as well as relevant inter-institutionally agreed rules apply to the staff of the ESAs, including the Executive Directors and the Chairpersons (Article 68 ESAs Regulation).

2.4. Involvement and role of relevant stakeholders

To ensure a structured liaison with stakeholders the ESAs regulations established specialised separate Stakeholder groups for each ESA (Article 37 ESAs Regulations). Each stakeholder group is composed of experts on the sector in question, representing in a balanced proportion a broad scope of stakeholders reaching from financial institutions, employees' representations, consumers and users of financial services, representatives of SMEs and independent top-ranking academics. Members of the stakeholder groups are appointed by the BoS, following proposals from the relevant stakeholders. The ESAs are required to consult the respective stakeholder groups before adopting draft regulatory or implementing technical standards, guidelines and recommendations.

2.5. Joint bodies of the ESAs

The ESAs have two joint bodies: The Board of Appeal (BoA) and the Joint Committee (JC).

The BoA (Articles 58-60 ESAs Regulations) ensures that any natural or legal person, including national supervisory authorities, may, in first instance, appeal against decisions adopted by the ESAs. For reasons of efficiency and consistency the BoA is a joint body of the three ESAs and deals with issues related to banking, insurance and securities. It is independent from the ESAs' administrative and regulatory

structures. The BoA has six members and six alternates with relevant knowledge and experience, excluding current staff of the national supervisory authorities or other national or Community institutions involved in the activities of the Authority. Two members of the BoA and two alternates are appointed by the MB of each ESA from a short-list proposed by the European Commission.

The objective of the JC (Article 54-57 ESAs Regulation) is to ensure appropriate cross-sectoral cooperation between the three ESAs and to contribute to mutual understanding, cooperation and consistent supervisory approaches between the three ESAs. This is of particular importance to reflect the trend of convergence between financial sectors and identify common principles and understand possible differences. The JC has no legal personality and any decisions on, for example the Financial Conglomerates Directive, are considered to be taken by the individual ESAs. However, the JC ensures that common decisions are taken by the ESAs in parallel. The JC is composed of the Chairpersons of the ESAs. The Executive Directors, a representative of the Commission, the ESRB and of any Sub-Committees may participate as observers. The Chairperson of the JC is appointed on an annual rotation basis from among the Chairpersons of the ESAs. The JC established four Sub-Committees: the Sub-Committee on Financial Conglomerates, the Sub-Committee on Cross Sectoral Developments, Risks and Vulnerabilities, the Sub-Committee on Anti-Money Laundering and the Sub-Committee on Consumer Protection and Financial Innovation.

II. ESRB

The European Systemic Risk Board (ESRB) is tasked with monitoring and assessing macro-prudential risks to the stability of the EU financial system.

1. ESRB's mandate and experience with systemic risks

1.1. Risk identification and prioritisation

The ESRB is responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union arising from developments within the financial system. It contributes to the smooth functioning of the internal market and thereby ensures that the financial sector plays a sustainable role in fostering economic growth.

The regulation stresses the preventive role of the ESRB in that it should 'contribute to the prevention (...) of systemic risks' and 'avoid periods of widespread financial distress'. In addition, the ESRB should 'identify and prioritise systemic risks'.

The ESRB legislation defines systemic risk as "a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree" (Article 2c of ESRB Regulation).

1.2. Timeliness and appropriateness of warnings and recommendations

When significant risks to financial stability are identified, the ESRB shall provide warnings and, where appropriate, issue recommendations for remedial action (Article 3 of ESRB Regulation). Five public recommendations have been issued since the inception of the ESRB.

1.3. Implementation of warnings and recommendations

Warnings and recommendations are not binding but they can be made public by a decision by the General Board on a case by case basis. The follow-up of recommendations is supported by an 'act or explain' mechanism.

2. Institutional framework and governance of the ESRB

The institutional framework of the ESRB encompasses: a General Board; a Steering Committee; an Advisory Technical Committee; and an Advisory Scientific Committee. Its work is supported by the ESRB Secretariat.

The ESRB General Board, comprising 65 members, is the main decision-making body of the ESRB. The Steering Committee, comprising 14 General Board members, is responsible for the preparation of the General Board's meetings. The role of the Advisory Technical Committee (made up of the representatives of National Central Banks; National Supervisory Authorities; the three ESAs, the European Commission; the European Central Bank and the European Financial Committee) and of the Advisory Scientific Committee (consisting of 15 members representing a wide range of skills and expertise), is to advise the General Board and assist it on issues relevant to the work of the ESRB.

The ESRB Secretariat (provided by the ECB) is responsible for the day-to-day work of the ESRB. It provides the analytical, statistical, administrative and logistical support to all the structures of the ESRB.

2.1. General governance issues

2.1.1. Key principles for good governance

Governance can be defined as 'the rules, processes and behaviour that affect the way in which powers are exercised'. Five general principles underpin a good governance model: openness; participation; accountability; effectiveness; and coherence³.

2.1.2. Accountability and transparency

The ESRB is required to provide information about its actions to the European Parliament and the Council (Article 19 ESRB Regulation).

³ White Paper of the European Commission on European Governance of 25.7.2001, COM(2001)428 final.

At least annually and more frequently in the event of widespread financial distress, the Chair of the ESRB is invited to an annual hearing in the European Parliament.

2.1.3. Decision-making bodies and voting arrangements

- **Voting arrangements for the designation or election of the Chair of the ESRB**

For the first five years of its existence, the President of the ECB is the Chair of the ESRB. The review of the ESRB Regulation should reflect on the arrangements for the designation or election of the Chair of the ESRB (Article 5 of ESRB Regulation).

- **Composition and functioning of the General Board**

Each member of the General Board with a voting right has one vote, and the General Board normally acts by a simple majority, while a majority of two-thirds of the votes is required to adopt a recommendation or to make a warning or recommendation public (Article 10 ESRB Regulation).

Members of the General Board without voting rights comprise one high-level representative per Member State of the competent national supervisory authorities and the President of the Economic and Financial Committee (EFC).

2.1.4. Internal organisation

According to the ESRB Regulation, Article 4 the ESRB shall have a Secretariat. The Secretariat is responsible for the day-to-day business of the ESRB. It provides analytical, statistical, administrative and logistical support to the ESRB under the direction of the Chair and the Steering Committee in accordance with Council Regulation (EU) No 1096/2010.

3. ESRB access to data

According to the ESRB Regulation, the ESRB cannot request data directly from financial institutions but it can send request to the ESAs, the European System of Central Banks, national supervisors, or national statistic authorities. When it sends requests for information not in summary or aggregate form, it shall demonstrate that the request is justified and proportionate.

4. ESRB external relations and communication

The ESRB's role is to monitor and assess risks to the financial system but it relies on other bodies and Member States to implement macro-prudential policies to mitigate those risks. Its performance is therefore contingent on how well it manages relations with other stakeholders and the Member States. It also relies on information from these bodies to inform its work.

4.1. Positioning of the ESRB as an authoritative policy institution focused on monitoring and preventing systemic risks

Following the wording of the Regulation 1092/2010 establishing the ESRB, the Union needs a specific body responsible for macro-prudential oversight across its financial system, which would identify risks to financial stability and, where necessary, issue risk warnings and recommendations for action to address such risks. Consequently, the ESRB was established as a new independent body, covering all financial sectors as well as guarantee schemes.

III. Cooperation and interaction between the ESAs (micro level) and the ESRB (macro level)

One of the major lessons of the financial crisis was, that in order to have a stable financial system, micro-prudential supervisors need to interact closely with the macro-prudential level. Both pillars of the new supervisory system are essential to achieve valuable synergies between the micro- and macro-level, to mutually reinforce the impact on financial stability and to benefit from a fully integrated supervisory framework.

1. Assessment of market developments

The interconnectedness of financial institutions and markets clearly implies that the monitoring and assessment of potential systemic risks should be based on a broad set of relevant macro-economic and micro-financial data and indicators. Micro-prudential supervisors have detailed knowledge of developments in financial markets and in major firms and have critical information to assess stability risks. One of the tasks of the ESAs is therefore to monitor, assess and report on market developments, potential risks and vulnerabilities in the banking, insurance and securities sector.

The identification of systemic risks relies to a large extent on the monitoring of stress in systemically important EU financial institutions. The ESAs, in cooperation with the ESRB, have the important task to initiate and coordinate stress tests to assess the resilience of financial institutions to adverse market developments and evaluate the potential of systemic risk. The current role of the ESAs, in cooperation with the ESRB, is to ensure the use of consistent common methodologies and of common approaches for the communication on the outcomes of the stress test. Furthermore, the ESAs may address recommendations to the competent authorities concerned to correct issues identified in the stress test. However, the role of the ESAs is limited to coordination while the tests themselves are carried out at the national level.

So far, only EBA and EIOPA have initiated and coordinated stress tests, in the banking and insurance sector respectively. Furthermore, EBA carried out a recapitalisation exercise in 2011/12 to restore confidence in the EU banking sector. ESMA will contribute to supervisory stress testing in 2013 by developing a stress test framework for Investment Managers, Exchanges and Central Counterparties (CCPs).

In general, the ESAs do not have the power to request direct information from financial institutions and can only indirectly access information from financial institutions by requesting it from national supervisors. Only in exceptional cases, where information is not made available by national supervisors, the ESAs can directly access information from financial institutions (Article 35 ESAs Regulations).

The ESRB Regulation (Article 3(g)) obliges however, to closely cooperate with all the other parties to the ESFS; and where appropriate to provide the ESAs with the information on systemic risks required for the performance of their tasks. This collaboration with the ESAs should in particular entail developing a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk.

2. Aspects of macro-micro interaction

The participation of micro-prudential supervisors in the work of the ESRB as well as the participation of the ESRB in the work of the ESAs is essential to ensure that the assessment of macro-prudential risk is based on complete and accurate information about developments in the financial system.

The ESAs Regulations (Article 36) also specify the procedures to be followed by the ESAs to act upon recommendations by the ESRB and how the ESAs should use their powers to ensure timely follow-up to recommendations addressed to one or more competent national supervisory authorities.

IV. Structure of the ESFS

Article 81 of the ESAs Regulations requires the Commission inter alia to assess in its review whether (i) it would be appropriate to simplify the ESFS, in particular, to enhance the coherence between the macro and the micro level, (ii) whether the ESFS evolves in a fashion consistent with global developments, (iii) whether the EFSF is able to continuously attract highly qualified and diverse staff; and finally (iv) whether a single seat for all ESAs would enhance better coordination.

The Commission's legislative proposals of September 2012⁴ on establishing a single supervisory mechanism (SSM), with a core role for the European Central Bank (ECB), constitute a first step towards a banking union. After unanimous agreement reached in the Council on 13 December 2012, the Parliament and the Council reached a political agreement on the legislative package, which is expected to enter into force in July 2013 so that the ECB could assume its tasks in full one year later.

⁴ Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions of 12.9.2012, COM(2012)511 and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No.../... conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions of 12.9.2012, COM(2012)512.

The ECB will carry out its tasks within the framework of the ESFS and will have to closely cooperate with the ESAs. The EBA will keep its powers and tasks to further develop the single rulebook and ensure convergence and consistency of supervisory practice. In addition EBA is assigned the specific tasks of developing a supervisory handbook and is given a stronger role on stress tests along with strengthened rights in data collection. The ECB will not take over any tasks of the EBA. Similarly the composition of the board of supervisors of EBA will remain unaffected and representatives from national competent authorities will continue shaping decision-making in the EBA. There will be, however, safeguards for non-euro zone Member States by means of double majority voting requirements for EBA decisions on binding mediation, breaches of EU law and on technical standards. This will ensure that relevant decisions are backed by both a majority of the participating and the non-participating Member States.