European Financial Supervision: The Long Road to Reform

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The financial crisis has shown the inadequacy of financial market regulation and supervision in the EU. As the integration of Europe's financial market progressed, market participants continued to be supervised nationally and the scope of regulation remained mainly limited to microprudential aspects. Leading experts therefore called for financial supervision to be integrated at EU level and for regulators to place a greater emphasis on systemic risk. Following lengthy negotiations, the Council of the European Union and the European Parliament have since approved a reform based on proposals made by the European Commission. The legislative process for implementing the reform – in fact a good example of how legislative decision-making procedures work under the provisions of the Lisbon Treaty – highlighted the political interests of the parties involved and the differences between them. The new supervisory architecture that came into force on January 1, 2011, was designed to sustain financial stability.

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Like all markets, financial markets have to be embedded in a suitable institutional framework[2] in order to function. The purpose of this framework is to assure that treaty requirements are fulfilled and that market participants can compete on a level playing field. Such a framework has the key aims of ensuring consumer protection and financial stability, particularly by preventing financial market crises and panics with a systemic dimension. Other problems that may arise in financial markets are the asymmetry of information between borrowers and lenders and negative external effects, since the difficulties encountered by one financial market participant can undermine confidence in other market participants whose actions are sound.[3] More recently, for example, the collapse of Lehman Brothers in September 2008 shook confidence so profoundly that activities on the interbank market came to a virtual standstill. Aside from the advantages that smoothly functioning financial markets hold for a modern economy, avoiding instability moreover entails substantial cost savings. Laeven (2011) estimates that financial crises have led to average cumulated output losses of 33.7% of GDP since 1970 and caused sovereign debt to rise by 26.2% of GDP on average.

The current financial and economic crisis has exposed substantial weaknesses in this institutional framework. The assumption that self-regulation would suffice to discipline the markets, and that "light touch" supervision would safeguard financial stability proved to be misguided.[4] Supervisory structures focusing exclusively on the national market were no longer adequate in light of the increasing amount of cross-border activity of financial institutions. This created a need for extensive reforms of financial supervision at the European and the international level in order to eliminate these weaknesses.

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[2] *Here, institutions are understood to be rules created by society to structure political, economic and societal interactions (North, 1991).*

[3] *See Baltensberger (2005).*

[4] *See the Turner Review published by the U.K.'s Financial Services Authority (2009).*

This article outlines the ensuing reform at EU level, from the assessment of the existing problems and the description of the legislative process through to the introduction of a new supervisory framework. It focuses in particular on the interaction between the legislative bodies of the EU involved in the process: the European Commission, the Council of the EU and the European Parliament. This interaction was key in shaping the new financial supervisory structure yet took place, in part, "behind closed doors." Hence this paper aims at highlighting how the new regulations were adopted. Moreover, the underlying legislative process merits a closer look as such, given its relevance for both monetary policy and financial markets. The article is based on draft proposals and minutes of meetings as well as on interviews with members of the EU Council and of the European Parliament who participated in informal negotiations during the legislative process. The insights thus gained should make the motives and intentions of the parties involved as well as their contributions to the outcome of the reform more transparent. The paper is not intended to assess the institutions that evolved from this reform process, because such an assessment would be premature at the current juncture.

The article is structured as follows: Section 1 briefly outlines the causes of the crisis, focusing mainly on the weaknesses in the supervisory structures that used to be in place. Section 2 describes the proposals put forward by groups of experts which resulted in a number of draft regulations and draft directives proposed by the European Commission. These draft proposals, which are discussed in section 3, formed the basis for the ordinary legislative procedure, which ultimately led to the creation of the new European System of Financial Supervisors (ESFS), the new European supervisory authorities and the European Systemic Risk Board (ESRB). This legislative procedure is outlined in section 4. Section 5 reports on the initial measures taken by the new financial market supervisors and evaluates the entire process. Section 6 summarizes and draws conclusions.

1 The Lessons of the Crisis for Financial Supervision

There is already extensive (and growing) literature on the causes of the financial market crisis and its transmission across the globe.[5] The De Larosière report (High-Level Group on Financial Supervision in the EU, 2009) and the Turner Review (Financial Services Authority, 2009) also provide key policy recommendations regarding regulation and supervision. The identified causes for financial crisis include macroeconomic factors, inadequate risk management by market participants and regulatory authorities, and misjudgments by credit rating agencies – as well as weaknesses in the existing supervisory framework and in both microprudential and macroprudential supervision.[6]

[5] *Blanchard (2009) provides a brief overview of the triggers and amplification mechanisms of the crisis. De la Dehesa (2010) identifies 12 types of market and government failures that led to the financial crisis. Laeven (2011) provides a comprehensive review of the current literature on the crisis and on possible solutions. Johnson and Kwak (2010), for example, give a broader overview of the current problems on the financial market, particularly in the United States. Kindleberger and Aliber (2005) and Reinhart and Rogoff (2009) provide systematic analyses of major financial market crises in recent centuries.*

[6] *See the De Larosière Report (2009), p. 7ff.*

The primary objective of microprudential supervision is to monitor individual financial institutions and ensure that they do not default, thus protecting both the institution itself and its customers. By contrast, macroprudential oversight aims to identify risks to the entire financial system and prevent negative effects for the whole economy.

Microprudential supervision has not kept pace with the progressive integration of the financial markets. Within the EU, cross-border bank activities had increased substantially in the years prior to the crisis. Supervision, meanwhile, remained divided along strict national lines. The powers of supervisory authorities varied across countries, both in terms of how audits were carried out and in terms of the options for sanctioning institutions found to have deficiencies, and this created a breeding ground for regulatory arbitrage. Furthermore, cooperation between the supervisory authorities was not always adequate, particularly for cross-border banking groups. In addition, EU requirements were not always consistently applied and implemented. The so-called Lamfalussy process launched as early as 2001 in order to foster convergence in national supervisory practices across the EU, while having entailed improvements in many areas, had failed to effectively solve the underlying problems. One of the outcomes of the Lamfalussy process was the creation of three "level 3 committees":

– the Committee of European Securities Regulators (CESR),
– the Committee of European Banking Supervisors (CEBS),
– and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

These three committees, essentially administrative networks of national supervisors installed to prepare legislative and implementing measures at the expert level were also tasked with harmonizing supervisory activities within the EU – but they could issue only recommendations that were not binding for the individual members. In addition, the committees had no effective tools for arbitrating or mediating between the "home" and "host country" supervisors in conflicts over a bank's cross-border activities, or in cases of noncompliance or malcompliance with EU law.

Another problem was the lack of supervision at the macroprudential level. The supervisory authorities focused on the individual institutions, particularly on banking institutions, thus taking little account of systemic risk. However, the origins of the current financial crisis – most notably the rising real estate prices in the U.S.A. – and previous crises show that deviations of asset prices from their fundamentally justified levels are often contributing factors. Last but not least, the increase in cross-border financial market activities simplified the transmission of financial shocks.[7]

The fact that macroprudential oversight was defective is somewhat surprising given that the importance of the macroeconomic setting in the onset of financial crises was far from unknown[8] and that the potential systemic risks arising from externalities in the finan-

[7] *See Allen et al. (2011), chapter 2, for a comprehensive overview of the effects of cross-border bank activities on financial market stability.*

[8] *See Kindleberger and Aliber (2005); the first edition of this book was published as early as 1978.*

cial sector had long been a topic of research.[9] The De Larosière report therefore cites ineffective early warning mechanisms for detecting macroprudential risk as one of the root causes of the financial crisis.

2 The Basis of the European Supervisory Reform

The financial and economic crisis highlighted the need to reform the European financial supervision architecture, a need that was voiced on a number of occasions also by the Oesterreichische Nationalbank (OeNB). In several press releases in 2008[10] the OeNB recommended establishing a decentralized European System of Banking Supervisors, based on a roadmap with defined milestones and timelines. The OeNB argued that progress toward a fully integrated internal market and the evolution of cross-border banking groups had rendered the national supervisory structures insufficient, making it necessary to "Europeanize" supervision.

To initiate the reform of the European supervisory framework, the European Commission appointed a high-level expert group chaired by Jacques de Larosière. In February 2009 this group presented its report ("High Level Group on Financial Supervision in the EU," or "the De Larosière report"), which analyzes the causes of the crisis and contains 31 recommendations concerning both the supervision and the regulation of the financial markets. The recommendations comprise a comprehensive list of specific strategies for correcting weaknesses in regulation and supervision. The key proposals outlined in the De Larosière report include introducing a European Systemic Risk Council for monitoring macroprudential risk; strengthening the national supervisors; and transforming the level 3 committees into independent authorities that have binding mediation powers over banks with cross-border activities and are authorized to adopt binding supervisory standards and technical decisions. Moreover, the report called for harmonizing regulatory and supervisory powers further. Another key requirement specified in the report was to expand the tasks of the ECB and the ESCB in macroprudential oversight, in line with the financial stability mandate of central banks. The recommendations in the De Larosière report were received favorably among other experts.[11]

In its Communication for the Spring European Council of 2009, the European Commission[12] welcomed the recommendations outlined in the De Larosière report and announced an ambitious reform of the European financial system for that very year. The Communication stated that the Commission would "present a European financial supervision package" before the end of May 2009 and that the legislative changes to adopt these proposals would follow in the autumn. The aim of the reform was to ensure that all financial market participants would be subject to appropriate regulation and supervision, grounded in the values of accountabil-

[9] *See the survey by De Bandt and Hartmann (2002).*

[10] *www.oenb.at/de/presse_pub/aussendungen/2008/2008q4/masterplan_europaeisches_bankenaufsichtssystem.jsp#tcm:14-155036 and www.oenb.at/de/presse_pub/aussendungen/2008/2008q4/pa_20081113_gouverneur_nowotny_spricht_sich_in_bruessel_fuer_europaeisches_modell_der_bankenaufsicht_aus.jsp#tcm:14-180447 (both retrieved on October 4, 2011).*

[11] *See Acharya (2009) and Goodhart and Schoenmaker (2009).*

[12] *See European Commission (2009a).*

ity, integrity, transparency and consistency.

On May 27, 2009, the European Commission[13] published its ideas regarding a reform of the European financial supervisory architecture, proposing the creation of a European Systemic Risk Council (ESRC) and a European System of Financial Supervisors (ESFS). The European Commission stated that the task of the ESRC would be to monitor and assess potential threats to financial stability ("macroprudential oversight"). The ESFS, on the other hand, would be responsible for supervising individual financial firms ("microprudential supervision") and would consist of a network of national financial supervisors working in tandem with the new European Supervisory Authorities to be created from the existing level 3 committees. The European Council approved this Communication in its meeting on July 18 and 19, 2009, and expressed its support for reforming financial supervision despite resistance from some countries (section 4).[14] On this basis, in September 2009 the European Commission published a comprehensive first legislative package on the new supervisory architecture.

3 The Legislative Package for Supervisory Reform

On September 23, 2009, the European Commission adopted a package of five legislative proposals[15] for establishing a European System of Financial Supervisors (ESFS) consisting of three European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) – and the national financial supervisors; and for creating a European Systemic Risk Board (ESRB). In addition, a regulation was published entrusting the European Central Bank with specific tasks with regard to the day-to-day running of the ESRB. To ensure the smooth functioning of the ESFS, the existing financial services directives had to be adapted in a way that the new powers of the financial supervisory authorities are adequately reflected; this was achieved through two omnibus Directives, passed in October 2009 (Omnibus I) and January 2011 (Omnibus II). As the proposals of the European Commission serve as the basis for the legislative process, these proposals for the new bodies shall be described in greater detail in the following.

3.1 Regulation Establishing a European Systemic Risk Board

The ESRB was designed to be an early warning system for detecting systemic risk. It would be an independent body to be set up under the auspices of the ECB without legal personality, and its seat was to be in Frankfurt am Main. It would be responsible for macroprudential oversight of the financial system within the EU and for identifying and assessing systemic risks to financial market stability. To achieve this, it should be able to issue risk warnings and recommendations for remedial action and, where appropriate, make them public. These warnings and recommendations might be addressed to the EU as a whole, or to one or more

[13] *See European Commission (2009b).*

[14] *www.euractiv.com/financial-services/eu-leaders-back-financial-supervision-overhaul/article-183341 (retrieved on July 18, 2011).*

[15] *See European Commission (2009c and 2009d).*

Member States, or to one or more of the national supervisory authorities and the ESAs. The ESRB's recommendations would not be legally binding, but the addresses would have to provide adequate justification for inaction should they not act on the recommendations ("act or explain"). The ESRB was to be composed of a General Board, a Steering Committee, an Advisory Technical Committee and a Secretariat. The General Board would take the decisions necessary to ensure the performance of the tasks entrusted to the ESRB. The Steering Committee would assist in the ESRB's decision-making process by preparing its meetings. The Chair and first Vice-Chair of the ESRB should be elected for a term of five years by and from among the members of the General Board, who are also members of the General Council of the ECB. The Secretariat, to be based at the ECB, was to be tasked with providing the ESRB with analytical, statistical, administrative and logistical support. Moreover, the ESRB was to be assisted by an Advisory Technical Committee.

Each member of the General Board with voting rights would have one vote. Votes would be taken by simple majority; a quorum of two thirds of members with voting rights would be required for any vote to be taken by the General Board. In the event of a tie, the Chair would have the casting vote. Decisions to make public warnings or recommendations would have to be obtain at least two thirds of the General Board's votes.

Table 1

Organizational Structure of the ESRB

CHAIR
ESRB chair
ESRB vice chair
(the ESRB chair and vice chair are elected by the members of the General Board, who are also members of the General Council of the ECB)
GENERAL BOARD
With voting rights:
President of the ECB
Vice-President of the ECB
All ESCB governors
1 European Commission representative
Chairpersons of the 3 ESAs
Without voting rights:
1 high-level representative per Member State of the competent national supervisory authorities
President of the Economic and Financial Committee (EFC)
STEERING COMMITTEE
ESRB chair
ESRB vice chair
1 European Commission representative
Chairs of the 3 ESAs
President of the EFC
5 members of the General Board (who are also members of the General Council of the ECB)
ADVISORY TECHNICAL COMMITTEE
1 NCB representative each of all EU Member States
1 ECB representative
1 representative each of the competent national supervisory authority
1 representative each of the 3 ESAs
2 European Commission representatives
1 EFC representative

Source: OeNB.

3.2 Regulations Governing the ESAs

The European Supervisory Authorities were designed to be responsible, in particular, for promoting harmonized regulations, consistent supervisory practices and consistent implementation. They would be independent authorities with legal personality, based in Frankfurt am Main (EIOPA), London (EBA) and Paris (ESMA).

The main tasks of the ESAs would include:

– developing common regulatory and supervisory standards (guidelines, recommendations and technical standards);
– ensuring that EU law was applied consistently, by issuing recommendations to the national supervisors in cases where there appeared to be a breach of EU law (if the national authority in question did not follow the recommendation, the Commission might issue a formal opinion; if

the national authority did not comply with this formal opinion, the ESA might then adopt decisions addressed directly to individual financial institutions);
– adopting binding decisions addressed to national supervisors and firms in emergency situations[16] and in the event of disagreements between national supervisory authorities;
– the direct supervision of institutions operating throughout the EU (e.g. credit rating agencies).

The ESAs would be composed of a Board of Supervisors (as the actual decision-making body), a Management Board, a Chairperson, an Executive Director and a Board of Appeal. In addition, the three ESAs would share a Joint Committee.

To prevent the ESAs' decisions from having any fiscal impact on national budgets, a safeguard clause was to be implemented which would empower the Member States to contest the decisions taken by the ESAs in emergency situations or when settling disagreements. Regarding the voting modalities, the draft proposals of the European Commission required the Board of Supervisors to adopt technical standards, issue guidelines and recommendations and take decisions in relation to financial provisions by (weighted) qualified majority voting. A qualified majority would also be required for EU Council decisions on whether ESA decisions concerning the safeguard clause were to be maintained or revoked. All other decisions would be taken by simple majority, based on the "one member – one vote" principle.

Table 2

Organizational Structure of the EBA

BOARD OF SUPERVISORS
With voting rights:
Heads of the national banking supervisory authorities
Without voting rights:
EBA chair
1 European Commission representative
1 ECB representative
1 ESRB representative
1 representative each of the other ESAs
1 representative of the respective NCB (optional)
MANAGEMENT BOARD
EBA chair
1 European Commission representative
4 members of the supervisory body
CHAIRPERSON (full time)
EXECUTIVE DIRECTOR (full time)
BOARD OF APPEAL

Source: OeNB.

4 How Agreement Was Reached on the Supervisory Package

The European Parliament, the European Commission and the Member States represented in the Council of the European Union are all involved in the EU legislative process. At the level of the Council, the economics and finance ministers (Ecofin) were responsible for dealing with the supervisory reform; in the European Parliament, the dossier was examined by the Committee on Economic and Monetary Affairs (ECON). The presidency of the Council, which rotates every six months, was held by Sweden when the European Commission made its legislative proposals. Spain took over the presidency at the beginning of 2010 and Belgium held the presidency when the regulations were adopted in the autumn of 2010.

[16] *It should be noted that the European Commission adopts decisions determining the existence of an emergency situation either independently or at the request of the ESAs, the EU Council or the ESRB.*

Box 1

The EU's Ordinary Legislative Procedure

Since the Lisbon Treaty came into force in December 2009, the EU's ordinary legislative procedure has been the co-decision procedure, in which the Council of the European Union and the European Parliament are equal co-legislators, with the Parliament and the Council working like a dual chamber system. Legislative proposals may, as a rule, be put forward only by the European Commission, i.e. the Commission has the "right of initiative" to submit proposals – once adopted by the college of 27 Commissioners – to the Council and the European Parliament. Alongside the co-decision procedure, the consultation procedure and the consent procedure still exist, but are used only occasionally. In the consent procedure the European Parliament has the power to accept or reject but not amend legislative proposals from the Council, whereas in the consultation procedure the European Parliament is only entitled to provide an opinion.

The co-decision procedure essentially works as follows: The European Parliament (i.e. the relevant committee) is the first to act; it delivers a position on, and proposes amendments to, the legislative proposal. If the Council of the EU subsequently adopts the proposal amended in the light of the Parliament's position, the proposal is deemed to have been adopted into EU law at first reading. If the Council adds its own amendments to the proposal, however, it goes to a second reading during which the European Parliament may then adopt the draft proposal, as amended by the Council, and the proposal will become EU law. Parliamentary amendment or rejection of the draft proposal as amended by the EU Council requires an absolute majority (50% of all members of the European Parliament (MEPs), i.e. 369 votes). If the European Parliament has introduced amendments, the EU Council can subsequently adopt the act by double majority (by qualified majority from 2014 onwards) if the European Commission has incorporated all the amendments into its amended proposal, or unanimously if this has not been done. If the Council of the EU rejects the European Parliament's position again, a Conciliation Committee consisting of 27 representatives of the Member States (usually the Permanent Representatives of the Member States to the EU) and 27 members of the European Parliament (including a Vice-President of the European Parliament, the chair of the relevant parliamentary committee and the rapporteur) is convened. The European Commission is also represented on the Conciliation Committee but has no voting rights. If the Conciliation Committee cannot agree on a joint text, the act is deemed not to have been adopted and the procedure ends. If it does agree on a joint text, the Council of the EU and the European Parliament must accept the act (this time with simple parliamentary majority), and it is deemed to have been adopted at the third reading.

Certain deadlines apply for the individual steps in the ordinary legislative procedure (box 1); for example, the European Parliament has three months to approve or reject the Council position at the second reading. Fully exploiting all of the legal possibilities would considerably prolong the legislative procedure. However, most of the dossiers entering into the co-decision procedure are adopted at the first reading. To speed up the process, negotiations between the Council of the EU, the European Commission and the European Parliament already take place during the first reading. These informal "trialogues" are based on mutual agreement; they are not mentioned in the Treaty on the Functioning of the European Union (TFEU). The trialogues bring together the current Council presidency, the European Parliament's rapporteurs and the chair of the relevant parliamentary committee. These "mediators" (relais actors) are becoming increasingly important and can have a considerable impact on the legislative process. Hix and Høyland (2011) point out that the greater efficiency in the legislative process goes hand in hand with reduced transparency, as the trialogue negotiations take place “behind closed doors.” Häge and Kaeding (2007) argue that the European Parliament has an advantage over the EU Council in the trialogues because the Council does not have enough resources for lengthy negotiations that extend to a Conciliation Committee and therefore has a greater incentive to bring the legislative process to a close at an earlier stage. The European Commission is likewise represented in the trialogues and can help the European Parliament and the EU Council to reach a common position. If need be, the European Commission can swiftly clarify technical details, thus speeding up the negotiations. As the European Commission is represented in all key bodies involved, it has a very clear overview of how the negotiations are progressing: the European Commission participates in and makes declarations at the European Parliament’s sittings and is also present at the meetings of the Council of the EU, thus gaining insights into the opinions expressed there and into how the current presidency of the Council is reporting back to the other Member States on the trialogue negotiations.

4.1 Negotiations within the Council of the EU

Based on the European Commission’s Communication on European Financial Supervision of May 27, 2009, the Ecofin Council approved conclusions on June 9, 2009, after a round of strained negotiations, in preparation for a meeting of the European Council. These conclusions largely corresponded to the Commission’s Communication. Key amendments affecting macroprudential oversight included the renaming of the European Systemic Risk Council (ESRC) to European Systemic Risk Board (ESRB), the question of who was to chair the General Board (the President of the ECB, as requested by European Commission; or the President of the ECB or alternatively a central bank governor, as requested by the Council of the EU) and the question of how many central bank members of the ESRB should be on the Steering Committee in addition to the Chair and the Vice-Chair, which was particularly important for the national central banks (whether it should include five additional central bank governors represented on the ESRC, as requested by the Commission; or only two central bank governors represented on the ESRB, as requested by the Council). Reaching a compromise among the Member States proved more difficult when it came to matters of microprudential supervision.

The Ecofin Council failed to reach an agreement on three points:[17] First, the question of whether disagreements among national supervisory authorities should be resolved through a binding decision by the ESAs. Second, whether the ESAs should be given direct responsibility for specific entities with a pan-European dimension (e.g. credit rating agencies). Third, whether the ESAs should have, in crisis situations, the power to adopt specific emergency decisions (e.g. prohibiting short selling). Although a majority of the Member States were in favor of this approach, a few were against it as they believed it would impinge on Member States’ fiscal responsibilities.[18] The Ecofin Council eventually called on the European Commission to ensure that the legis-

[17] *See Federal Ministry of Finance, Germany: Monthly Report June 2009, p. 34 (in German only).*

[18] *See Conclusions of the 2,948th Ecofin Council meeting (June 9, 2009), p. 14.*

lative proposals presented in the autumn of 2009 would not impinge on Member States' fiscal sovereignty.

Once the European Commission had published the legislative package governing the new supervisory architecture on September 23, 2009, the Member States immediately started negotiations, with those on macroprudential supervision making decidedly more progress than those on microprudential supervision. The ERSB regulation (and the corresponding Council decision) was discussed in the "Working Party on Financial Services" on September 28, October 7 and October 12, 2009, and in the Permanent Representatives Committee (Coreper)[19] on October 14, 2009. The intention was, among other things, to come to an agreement on a general approach at the Ecofin meeting on October 20, 2009.[20] The most controversial subjects in the negotiations were the voting modalities applicable to the General Board (Article 10 in conjunction with Article 16.5 and 18.1) and the composition of the Steering Committee.[21] With respect to the voting modalities for issuing recommendations and making public warnings or recommendations, some Member States were in favor of a simple majority as envisaged in the European Commission's proposal, whereas others pushed for a majority of two thirds. There were also discussions regarding whether there should be five (as in the European Commission's proposal) or two members of the General Council of the ECB on the Steering Committee. A text was agreed upon on October 21, 2009: it was decided that a two-thirds majority should be required in the above-mentioned cases and that there should be five representatives of the General Council of the ECB on the Steering Committee, of which three should represent euro area countries and two non-euro area countries.

At its meeting on October 20, 2009, without prejudice to ongoing national parliamentary procedures, the Ecofin Council reached broad agreement on the substance on the legislative texts concerning macroprudential oversight.[22] The Ecofin Council invited the presidency of the Council of the EU to start negotiations with the European Parliament on the ESRB regulation with a view to reaching an agreement at the first reading. It also took note of the need for further political negotiations before a final agreement could be reached on the complete package in December 2009.

The negotiations on microprudential supervision proved to be far more lengthy and contentious. In particular, the new EU authorities' direct powers of intervention (Article 10(3) and Article 11(4)), which allowed them to adopt binding decisions addressed to individual financial institutions were found to be controversial, as was the question of whether and over which cross-border financial institutions the new EU authorities should have direct and exclusive supervisory powers. Other points of controversy were the voting modalities (Article 29) for settling disagreements, as some Member States were in favor of discarding the "one member –

[19] *Coreper comprises the heads of mission of the EU Member States, the Permanent Representatives. It is a forum for representing the interests of the individual Member States vis-à-vis the other Member States and EU institutions and reaching compromises.*

[20] *See Coreper's public report to the Ecofin Council dated October 15, 2009.*

[21] *See the Secretariat's public report to Coreper dated October 9, 2009.*

[22] *See conclusions of the 2,967th Ecofin Council meeting (October 20, 2009), p. 8.*

one vote" principle for qualified majority voting, where the number of votes given to each Member State is weighted according to its population;[23] as well as the "safeguard clause" (Article 23), which stipulates that a Member State can contest a decision adopted by the EU authority under Articles 10 or 11 that is addressed to the national supervisory authority if this decision impinges on the Member State's fiscal responsibilities. The wording of the negotiated document agreed upon in preparation for the Ecofin Council meeting of December 2, 2009, was supported by 21 delegations;[24] 5 delegations[25] refused their support – particularly concerning the safeguard clause and the voting modalities – even after several rounds of negotiations. The negotiated document, therefore, did not contain a reference to the EU authorities' direct powers of intervention over individual financial institutions in emergency situations and in the event of disagreements between the competent authorities of different Member States. However, further adaptations to the text allowed the Ecofin Council to come to an agreement on the general approach that microprudential supervision should take. In other words, it was possible to start negotiations with the European Parliament.

4.2 The Position of the European Parliament

In ECON, "rapporteurs" examined the European Commission's respective legislative proposals, with advice from the other political groups' "shadow rapporteurs." The following members of the European Parliament were named as ECON's rapporteurs for the draft regulations:

- José Manuel García-Margallo/Spain (Group of the European People's Party – EPP) on the EBA,
- Sven Giegold/Germany (Group of the Greens/European Free Alliance – EFA) on the ESMA,
- Peter Skinner/United Kingdom (Group of the Progressive Alliance of Socialists and Democrats – S&D) on the EIOPA and
- Sylvie Goulard/France (Group of the Alliance of Liberals and Democrats – ALDE) on the ESRB.

Therefore all four of the European Parliament's major political groups were involved in this dossier from the outset. ECON's aim was not only to reverse the amendments that the Council of the EU had introduced to the proposal of the European Commission but also to go further than the proposal itself.[26]

On November 23, 2009, the MEPs met for their first exchange of views on the supervisory package in ECON, and the rapporteurs subsequently presented their draft reports on February 23, 2010. In the intervening period they had held a number of meetings to broadly coordinate their positions in order to reach a common stance. When the draft reports were presented, the EBA rapporteur, José Manuel García-Margallo, clearly stated that it was out

[23] *In accordance with Article 16(4) of the Treaty on European Union (TEU) and Article 3 of the Protocol (No. 36) on transitional provisions.*

[24] *See Corepor's public report to the Ecofin Council dated November 27, 2009.*

[25] *Germany, France, Italy, the Netherlands and the United Kingdom.*

[26] *See the the joint declaration by Jean-Paul Gauzès (EPP), Udo Bullmann (S&D), Sylvie Goulard (ALDE), Sven Giegold (the Greens/EFA) "Europäisches Parlament wird sich gegen die Verwässerung der neuen Aufsichtsbehörden stellen" of December 2, 2009 (in German only) and www.europarl.europa.eu/en/headlines/content/20100910FCS81938/012/html/Parliament-gives-green-light-to-new-financial-supervision-architecture (retrieved on October 4, 2011).*

of the question for the European Parliament to accept the amendments by the Council that fell short of the De Larosière report's recommendations, which he considered to be highly pragmatic already. The European Parliament supported the idea of strengthening the European supervisory framework by giving the EBA legally binding powers.

When presenting her report, the ESRB rapporteur, Sylvie Goulard, stated that the Chair of the ESRB should not be elected by the General Board as proposed by the European Commission but that the President of the ECB should chair the ESRB ex officio because he or she would have the necessary high profile and stood ready to represent the ESRB in the international arena.[27] Furthermore, rather than being supported by an Advisory Technical Committee composed of NCB/ECB representatives, as proposed by the Commission, the ESRB should be able to draw on the expertise of an Advisory Scientific Committee of independent experts.

The consistency between the draft reports shows that the process of coordination among the rapporteurs was effective. This is illustrated by the provisions on elaborating technical standards: the European Commission had stipulated that the ESAs should present their standards to the Commission for endorsement and that the Commission would be able to amend the envisaged standards where the Community interest so required. In contrast, all three ECON reports were in line with the new concept of implementing acts, laid down in the Implementing Acts Regulation made under Articles 290 and 291 TFEU, which provide for the adoption of technical standards by delegated or implementing acts. In this respect the European Commission should, in both cases, be bound by drafts produced by EBA insofar as it would only be allowed to amend those drafts following renewed consultation, subject to strict deadlines and subject to explanations. Moreover, both the European Parliament and the EU Council should have the power to veto the adoption of technical regulatory standards according to Article 290 TFEU, thus significantly curtailing the decision-making powers of the European Commission. The areas for which technical standards may be developed are to be defined in the relevant legislation.[28] These and other amendments are specified in almost identical wording in all three of the draft reports on the ESAs.

The MEPs were able to propose amendments to the legislative texts in ECON until March 11, 2010. A total of 798 amendment proposals were made for the EBA draft, 635 for the ESMA draft, 572 for the EIOPA draft and 244 for the ESRB draft. A vote was taken on all of these amendment proposals on May 3, 2010. ECON's joint position,

[27] *Some non-euro area Member States were far from enthusiastic about this stance; for example, the Economist reported as early as June 2009 that the U.K.'s HM Treasury "dislikes the idea of the ECB's president chairing what would be the EU's macroprudential overlord."*

[28] *See recital 12 of Directive 2010/78/EU: "Matters subject to technical standards should be genuinely technical, where their development requires the expertise of supervisory experts. The technical standards adopted as delegated acts should further develop, specify and determine the conditions for consistent harmonisation of the rules included in basic instruments adopted by the European Parliament and the Council, supplementing or amending certain non-essential elements of the legislative act. The technical standards adopted as implementing acts should set conditions for the uniform application of legally binding Union acts. Technical standards should not involve policy choices."*

which was based on a broad majority,[29] was to propose an integrated system of financial market supervision organized as a network of national and EU supervisory authorities. It specified that all three EU authorities and the ESRB should be based in Frankfurt am Main, thus improving communication and enabling more efficient cooperation, particularly in crisis situations.

The ECON draft reports expanded the powers of the ESRB and the ESAs. In its original draft the European Commission had given itself the power to determine an emergency situation (i.e. a serious threat to financial stability); the ECON drafts, on the hand, stipulated that the ESRB should be conferred with this power.

The drafts defined protecting depositors and investors as one of the EBA's tasks. The EBA draft therefore stipulated that a European Deposit Guarantee Fund should be established. It also proposed the creation of a European Banking Stability Fund to finance the rescue interventions or orderly winding-up of financial institutions facing difficulties. These two requirements are also based on the De Larosière report's recommendations.

The European Parliament supported giving the ESAs direct powers of intervention over national authorities and, in particular, financial institutions. The ECON draft also envisaged that the ESAs should have a mediation role to solve conflicts between national supervisors and, as a last resort in situations where the competent national supervisory authorities do not come to an agreement, adopt decisions. ECON considered that this would significantly strengthen the European supervisory framework and that the national authorities would have a greater incentive to reach a more rapid agreement. The EBA was also to be given the power to temporarily prohibit or restrict certain types of transactions. Such powers were requested also for ESMA, which should moreover have the power to intervene in financial institutions and remove executives.

Compared with the EU Council, ECON also took a very different approach to the issue of the budgetary impact of decisions (the aforementioned safeguard clause). ECON specified that if a Member State considered that an EBA decision impinged directly and in a significant manner on its fiscal responsibilities, it should carry out an impact assessment and present this to the EBA, the European Commission and the European Parliament within ten working days after notification of the decision.[30] In cases where the EBA maintains its decision, the EU Council should be able to revoke this decision by qualified majority. In neither of these cases would the votes of the Member State concerned be taken into consideration. ECON also decided that EBA's decisions should generally be taken by simple majority, with each member having one vote (and by qualified majority in the areas proposed by the European Commission). This served to underscore the fact that EBA is a body of experts and that the heads of the national supervisory authorities are represented and have voting rights in EBA by virtue of their expertise rather than in order to represent the interests of the individual Member States.

[29] *ECON approved the report on the EBA regulation by 37 of all 42 votes, the report on the ESRB by 34 of 38 votes, that on ESMA by 31 of 35 votes and that on EIOPA by 29 of 34 votes.*

[30] *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0120:0161:EN:PDF; p. 71 (retrieved on October 4, 2011).*

4.3 Reaching a Compromise through Trialogue Negotiations

In early May 2010, immediately after ECON had voted on the reports, the trialogue negotiations between the European Parliament, the Council and the European Commission began.[31] The European Parliament was represented by the chair of ECON, Sharon Bowles, and the rapporteurs; the Spanish presidency of the Council led the discussions on the Council's behalf. The European Commission also participated in the discussions. It proved difficult to reach a compromise: the ESAs' direct powers of intervention over financial institutions, their role in the colleges of supervisors and the additional powers for ESAs called for by the European Parliament (particularly the prohibition of certain transactions) were particular subjects of contention. The European Parliament's rapporteurs had agreed from the outset that they would only negotiate on the proposals as a package. Despite belonging to different political groups, they presented the Council of the EU with a joint European Parliament position.

On May 26, 2010, the European Commission published a Communication supporting the establishment of ex ante bank resolution funds. The Communication expressed the European Commission's intention to present legislative proposals on both crisis management and resolution funds by early 2011. Preparations for reforming the deposit guarantee schemes were already underway, and on July 12, 2010, the European Commission published a proposal for a Directive which gave the EBA a role in supervising deposit guarantee schemes. This obviated the need to negotiate the European Parliament's demands to this effect any further.

The negotiations between the Spanish presidency of the Council and the European Parliament did not reach a conclusion and were continued from July onwards by the Belgian presidency. As a way of signaling to the European Parliament that it had to be possible to reach a timely agreement, on July 13, 2010, the Member States in the Ecofin Council agreed a new political orientation by common accord to guide the presidency of the Council's negotiations.[32] Votes on the ECON reports on financial market supervision were put on the agenda for the European Parliament's plenary in early July. This heightened the pressure on the Council to approve the proposed compromise, since otherwise the proposal would have to go to a second reading, substantially prolonging the process of implementation. On July 7 the European Parliament plenary approved all of the amendments requested by ECON. However, the plenary abstained from the final vote for all of the proposals in accordance with Rule 57 of the European Parliament's Rules of Procedure; without this legislative resolution the draft proposals do not pass into law, meaning that further negotiations were possible at the first reading.[33] All the proposed amendments received majorities of over 600 votes in the plenary, which was also a way of signaling to the Council that it would be easy to obtain the quorum of 359 votes needed to amend the Council's position.

Having continued into the European Parliament's summer recess, the

[31] *18 meetings were scheduled for May and June.*

[32] *See Federal Ministry of Finance, Germany: Monthly Report August 2010, p. 34.*

[33] *The European Parliament used this tactic again in the spring of 2011 during the negotiations on reforming economic governance and the Stability and Growth Pact.*

trialogue negotiations reached a conclusion in early September. The trialogue agreed to keep the EBA seat in London, the ESMA seat in Paris, and the EIOPA seat in Frankfurt am Main, as defined in the original draft of the European Commission and in the Council's position. However, it specified that these seats and the ESAs' powers should be reviewed after three years and possibly expanded, and that cooperation between the ESAs should be coordinated via a Joint Committee, which was to meet at least once every two months. The trialogue agreed that the European Parliament would be entitled to veto the appointment of ESA chairpersons and that the ESRB would be part of the ESFS (the ESAs, the national financial supervisors and the Joint Committee of the ESAs). The main objective of the ESFS would be to ensure that financial sector rules are applied consistently and to safeguard financial market stability and consumer protection.

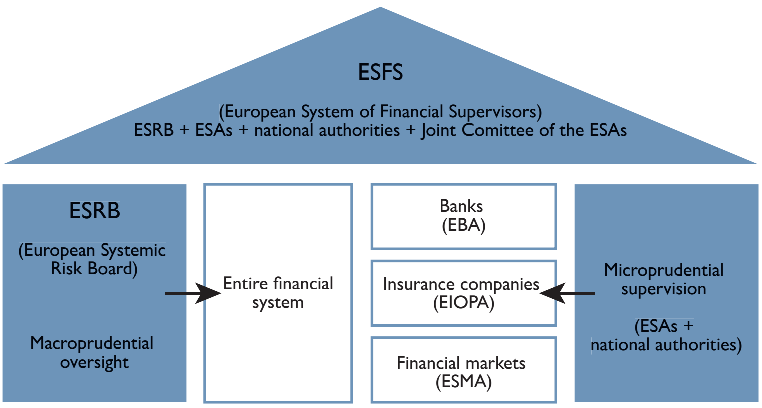
The Council retained the right to determine an emergency situation, as it had requested. The ESRB or the ESAs can make confidential recommendations to the Council. The ESRB remained a body of experts that monitors and assesses systemic risk and can issue recommendations or warnings on a case-by-case basis but does not take decisions. This significantly reduces the ESRB's effectiveness, as, according to Kindleberger and Aliber (2005, p. 92) *"[t]he historical record provides little support for the view that statements from government officials have much of an impact in dampening euphoria. [...] The likelihood that investors and speculators would heed the warning of a government official when asset prices are increasing at annual rates of 20 to 30 percent a year is not especially high."*

As urged by the Council of the EU, the safeguard clause which Member States can invoke against ESA decisions that impinge on their fiscal responsibilities was retained (section 4.1). However, in the recitals the Regulation clearly states that this safeguard clause should not be abused and that the decision in question must have a significant or material fiscal impact.[34]

The Council managed to push through its requests on key issues such as the seat of the authorities, the safeguard clause and the power to determine crisis situations. For its part, the European Parliament succeeded in expanding the ESAs' powers. The ESAs now have a stronger role in the colleges of supervisors and have more comprehensive functions in the fields of consumer protection, financial transactions and resolution and insolvency procedures. Furthermore, the ESAs are tasked with helping to strengthen the European system of national deposit guarantee schemes and to develop

Chart 1

The New European Supervisory Architecture



Source: OeNB.

[34] *One of the points raised in the parliamentary debate was that minor costs, such as the costs of officials traveling to ESA meetings, should not be relevant for purposes of the safeguard clause.*

a European system of bank resolution (including funding arrangements). The final Regulation also reinforced the European dimension by awarding the ESAs direct powers of intervention over national authorities and financial institutions. The European Parliament succeeded in its wish for the ESRB to be chaired by the President of the ECB ex officio; moreover the Advisory Scientific Committee of independent experts that it had proposed has been set up alongside the originally envisaged Advisory Technical Committee.

After the trialogue had reached an agreement, the new supervisory architecture in its current form was adopted by the European Parliament on September 22, 2010, and confirmed by the Ecofin Council on November 17, 2010. This meant that the Regulation was implemented on time and that the ESAs were able to start work on January 1, 2011.

4.4 Assessing the Legislative Procedure

Regarding the balance of power among the parties participating in the trialogue, it should be pointed out[35] that the theory posited by Häge and Kaeding (2007) (see above) of the European Parliament having an advantage over the EU Council because it gains increasing influence during more lengthy procedures is not entirely valid in this case, as all the legislators were under significant time pressure. It was intended from the outset of the negotiations that the new supervisory architecture would be in place by January 1, 2011. Any delays would have caused meant reputational losses of all participants. As the Council of the EU had already adopted a common position in December 2009 and the European Parliament did not vote on the proposal until May 2010, the Council might have been able to blame the Parliament for such delays.

Participants in the trialogue process noted that the Spanish and Belgian presidencies took rather different approaches to leading the negotiations. The Spanish presidency of the Council led the negotiations with the European Parliament mainly at attaché level, whereas under the Belgium presidency the responsible minister usually took part in the trialogue. The participants considered the inclusion of a high-ranking political representative crucial, as this increased the negotiating leeway under the Belgian presidency. Attachés are technical experts, but a member of the Ecofin Council may be better able to assess what political concessions the other Member States might be prepared to make to the European Parliament. The European Commission was likewise represented by high-ranking officials (a Commissioner or Director General) in the trialogue negotiations.

Belgium's experience in the financial crisis might have been one reason why it showed such strong political commitment in the supervisory reform. In September 2009 the Belgium government had been forced to buy up shares worth EUR 4.9 billion in the distressed bank Fortis and had thus suffered at first hand the bitter consequences of having an insufficiently integrated supervision of cross-border banks in the EU.

Together, Christian Democrats and Social Democrats have a vast majority in both the European Parliament and the Council. However, the differences of opinion during the negotiations hardly ever ran along party lines; the real divides were between the institu-

[35] *This assessment is based, among other things, on interviews with participants in the negotiation process.*

Table 3

Requests and Final Regulation (ESRB and EBA)

	Position of the European Commission	Position of the European Parliament	Position of the Council of the EU	Final Regulation
Seat of the ESAs	like the level 3 committees	Frankfurt	Commission position	Commission position
Seat of the ESRB	Frankfurt	Frankfurt	Frankfurt	Frankfurt
Chair of the ESRB	to be elected by the General Board/by members of the Governing Council of the ECB	President of the ECB	Commission position	President of the ECB
Number of additional NCB members in the Steering Committee (other than ESRB chair and/or vice chair)	5	4	5	4
Advisory Scientific Committee of the ESRB	–	+	–	+
Power of direct intervention by EBA at national authorities	+	+	+	+
Power of direct intervention by EBA at financial institutions	yes – 1) consistent application of Community law, 2) action in emergency situations, 3) settlement of disagreements between national authorities	Commission position	yes – consistent application of Community law	Commission position
EBA: Development of binding technical standards (to be adopted by the European Commission)	+	in the form of regulatory technical standards and implementing technical standards	Commission position (subject to additional consultation of EBA regarding items amended or rejected)	in the form of regulatory technical standards and implementing technical standards
Tasks of EBA with regard to consumer protection, financial activities, resolution and liquidation procedures, the European deposit insurance scheme	–	+	–	+
Power to determine emergency situations	European Commission	ESRB	Council	Council
Role of EBA in the college of supervisors	Observer	Lead	Observer	Lead
Safeguard clause	Council may revoke/maintain ESA decisions when settling disagreements/in emergency situations by qualified majority – ESA decisions are upheld if the Council does not take a decision	Safeguard clause only in emergency situations; Council may uphold ESA decisions by simple majority or reject them by qualified majority (Member State involved has no vote)	*Settling disagreements:* Council may maintain ESA decisions by a majority of the votes cast; ESA decisions are terminated if the Council does not take a decision; *emergency situations:* Member State may notify the ESA, European Commission and Council not to implement the ESA decision – suspension of the ESA decision – Council may revoke ESA decisions by simple majority; suspension of the ESA decisions are terminated if the Council does not take a decision (the Member State involved has a vote in both cases)	Council position
Voting modalities	General principle: "one member – one vote"; Art. 7, Art. 8, Chapter VI: qualitative majority voting	Commission position	Commission position, but panel procedure for settling disagreements between competent authorities in cross-border situations; adoption of panel decision by simple majority (subject to agreement of the blocking minority).	Council position

Source: OeNB.

tions. Given the EU's two-chamber system, it is less surprising that the MEPs agreed on and maintained a common position throughout the negotiations despite belonging to different political groups. Hix and Høyland (2011) point out that the European Parliament almost always presses for more European integration than the EU Council in legislative proposals. The European Parliament wished to strengthen the European level and its own competences, while members of the Council, who represent national governments, often focus primarily on retaining their country's sovereign powers.

5 Initial Experience with the New Supervisory Structure

As an agreement was reached on time,[36] the ESAs and the ESRB were able to begin their work on schedule, on January 1, 2011. The main focus in the first few months was on setting up the institutions. In February 2011 the chairpersons of the three ESAs were elected; the European Parliament's role was confined to hearing the designated candidates. The internationally renowned experts Andrea Enria (EBA), Stephen Maijoor (ESMA) and Gabriel Bernardino (EIOPA) were elected as the chairpersons of the supervisory authorities. In the spring of 2011 the ESRB elected Mervyn King, Governor of the Bank of England, and the EBA chair Andrea Enria as the Vice-Chairs to the ESRB Chair.

According to information provided by the European Commission in the spring of 2011, the ESAs might eventually be staffed with up to 350 employees.[37] As defined in the underlying regulations, there will be a review three years after the regulations entered into force to evaluate, among other things, whether the resources of the supervisory authorities are adequate.

In the first few months of its existence, one of the EBA's most high-profile activities was carrying out the EU-wide bank stress test. The capital position of 91 banks in 21 Member States was assessed against certain simulated shocks. The EBA coordinated the implementation of the tests, the ECB created the macroeconomic scenarios and the national supervisory authorities examined the effects on the banks in their countries. The stress test included several rounds of peer reviews to ensure that the results were consistent. The EBA then published recommendations to the national supervisory authorities of countries in which a bank's core tier 1 ratio was below the threshold in the test scenarios.[38]

In response to the stress test, Hampl and Tomšík (2011) criticized the influence of supranational authorities on national budgets, a concern already raised by some of the Member States during the negotiations on the supervisory reform. In the current system the EBA makes decisions that can entail substantial costs (e.g. recapitalizing banks). If no private investors can be found, these expenses usually have to be financed from the national budgets, as sufficient funds are not available at the EU level. This means that finance ministers, who are held to political account by their countries' taxpayers,

[36] *It was important to come to an agreement in September 2010, as otherwise the lead times involved with the legislative process (e.g. translating the Regulations into all 22 EU languages) might have made it impossible for the supervisory authorities to start operations in January. The Regulations were published on December 15, 2009 in the Official Journal of the EU.*

[37] *See Barnier (2011).*

[38] *See European Banking Authority (2011).*

have to implement decisions made by authorities that are only very indirectly answerable to taxpayers. Nonetheless, integrated financial markets require integrated supervision, otherwise there is a danger of regulatory arbitrage. The new legal provisions governing the crisis management arrangements for cross-border banks, which envisage the creation of a European crisis fund with sufficiently large resources, could form part of the solution to this problem.

6 Conclusions

The financial crisis has clearly illustrated the inadequacy of the existing financial supervisory structure in Europe. A high-level group of experts developed proposals addressing the main challenges of supervisory reform, such as the identification of systemic risk, supervisory responsibility for cross-border financial institutions and the powers of the supervisory authorities. Many of these proposals were taken up by the European Commission and incorporated into a package of legislative proposals.

Under the EU's ordinary legislative procedure, the Council and the European Parliament had to agree on a common legislative text; first the different interests of the Member States were weighed up in the Council and then those of the various political groups in the European Parliament. The negotiations between the European Parliament, the Council and the European Commission were highly strenuous given that the Council and the European Parliament took very different positions regarding the new ESAs. While the EU Council was in favor of the EU authorities having more of a coordinating role in the supervisory process, the European Parliament wanted the new institutions to have far-reaching powers, with a view to protecting consumers and investors. The proposal to give the EU authorities direct powers of intervention over national supervisors and financial institutions was also controversial.

After lengthy negotiations, the Council and the European Parliament agreed on a supervisory reform; the final legislation is a compromise which brings together certain requests from both sides. The legislative process illustrated the preferences of the institutions involved; the Member States in the Council wanted to retain their sovereign rights and the European Parliament strove to strengthen the EU level, and thus its own powers. Supervisory decisions can entail substantial costs, and the question of political accountability for these expenses was therefore key. In view of their budgetary sovereignty, the Member States were able to push through the inclusion of certain rights to contest the ESAs' decisions.

The reform of financial supervision has equipped the EU with institutions that are better able to react to the challenges of an integrated financial market. Now it is up to the new financial supervisory authorities and the ESRB to demonstrate in practice that they are capable of fulfilling the legislators' expectations.

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