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European Union Committee

20th Report of Session 2010–12

The EU Financial Supervisory Framework: an update

Report

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Sub-Committee Staff

The current staff of the Sub-Committee are Antony Willott (Clerk), Laura Bonacorsi-Macleod (Policy Analyst) and Sarah Yusuf (Committee Assistant).

Contacts for the European Union Committee

Contact details for individual Sub-Committees are given on the website. General correspondence should be addressed to the Clerk of the European Union Committee, Committee Office, House of Lords, London, SW1A 0PW. General enquiries 020 7219 5791. The Committee's email address is euclords@parliament.uk

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References in footnotes to the Report are as follows:

Q refers to a question in oral evidence as listed in Appendix 2;
FSF 1 refers to written evidence as listed in Appendix 2.

EU Financial Supervisory Framework: an update

CHAPTER 1: INTRODUCTION

1. The recent global financial crisis demonstrated that existing structures for supervising financial institutions and monitoring systemic risks were inadequate. This triggered a debate on how best to redesign the financial supervisory architecture of the European Union. These issues were examined by the High-Level Expert Group on EU Financial Supervision chaired by Mr Jacques de Larosière. The recommendations of their report (the ‘de Larosière report’), published in February 2009, were adopted by the European Commission and in September 2010 EU legislation was passed which laid the foundation of a new EU supervisory architecture.¹
2. The new supervisory framework comprises two levels. At the top is the European Systemic Risk Board (ESRB). This is a new body that is responsible for macro-prudential oversight of the EU financial system. It will assess, and propose recommendations to reduce, systemic risks in the financial sector. Below the ESRB is a system of European financial supervisors, consisting of three European Supervisory Authorities (ESAs). These are: the European Banking Authority (EBA); the European Securities and Markets Authority (ESMA); and the European Insurance and Occupational Pensions Authority (EIOPA). The ESAs have replaced what were known as the ‘Level 3 Lamfalussy committees’.² Those committees were a mechanism for Member States to coordinate their activities and ensure consistent implementation of supervisory standards across Member States. The ESAs have taken over this role but they have a wider remit. They are tasked with: harmonising and coordinating the work of Member States’ national regulatory bodies; drafting and implementing technical regulatory standards; and mediating between national supervisors where conflicts arise. When an emergency situation is declared by the Council the ESAs have enhanced powers to coordinate Member States’ responses and, if necessary, make binding decisions on national supervisory authorities or on individual financial institutions. In general, however, financial institutions will continue to be supervised by national authorities (with the exception of credit rating agencies which have been placed under the direct supervision of ESMA). Finally, below the EU level supervisory structures, national supervisors remain responsible for the day to day supervision of financial institutions. In the UK this is primarily the responsibility of the Financial Services Authority (FSA) at present, although the Government has put forward plans for its reform. We discuss this reform in more detail in chapter 4.

¹ This legislation comprised: Regulation (EU) No 1092/2010; Regulation (EU) No 1093/2010; Regulation (EU) No 1094/2010; Regulation (EU) No 1095/2010; and Regulation No 1096/2010.

² The Committee of European Banking Supervisors, based in London, has been replaced by the European Banking Authority; the Committee of European Insurance and Occupational Pensions Supervisors, based in Frankfurt, has been replaced by the European Insurance and Occupational Pensions Authority; and the Committee of European Securities Regulators, based in Paris, has been succeeded by the European Securities and Markets Authority.

3. This Committee examined the legislation setting up the new EU financial supervisory system in its 2009 inquiry on *The future of financial regulation and supervision*,³ and has subsequently continued to scrutinise new legislation and proposals in this area.⁴ A letter sent to Lord Myners, then Financial Services Secretary, in November 2009 summarised many of the Committee's views on the new supervisory system and is attached as Appendix 4. The Committee's overall view has been that the new European financial architecture is a positive step towards a more effective system of financial supervision. The new supervisory bodies will have more effective rule-making and enforcement powers which will strengthen financial stability and promote a stronger single market in financial services. We have, however, previously expressed concern about the extended powers given to ESAs in emergency situations. In addition, recent legislation has proposed giving the ESAs a number of additional tasks, including more direct regulatory responsibilities. For example, the draft Regulation on OTC derivatives, central counterparties and trade repositories⁵ assigns the supervision of trade repositories to ESMA. Amendments to the proposal currently being negotiated in Brussels may result in ESMA directly supervising central counterparties as well. Although not linked to specific legislation, the European Banking Authority is responsible for conducting the second round of EU-wide bank stress tests to assess the resilience of Europe's banking sector, with results expected to be published in mid 2011.
4. The three European Supervisory Authorities were established on 1 January 2011. We felt it timely to take evidence from the UK Financial Services Authority and the European Banking Authority to discuss how matters have progressed, and to explore key issues that we have previously raised with the Government in our scrutiny work.
5. **We make this report for debate.**

³ European Union Committee, 14th Report (2008–09): *The future of EU financial regulation and supervision* (HL Paper 106)

⁴ See *Correspondence with Ministers* <http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-economic-and-financial-affairs-and-international-trade-sub-committee-a/scrutiny-work1/correspondence-with-ministers/>

⁵ COM(2010) 484

CHAPTER 2: THE ESAS' POWERS

A 'single rule book'

6. The new European Supervisory Authorities have a wider and more influential role than the previous EU-level supervisory committees. Mr Alexander Justham, Director of Markets at the FSA and the FSA representative on ESMA, told us that while the old committees “provided guidance and recommendations only”, the European Supervisory Authorities will be working “to provide binding technical standards around the legislation”. Since “it is absolutely anticipated” that the Commission will just adopt the ESAs’ proposed standards, this amounts to an important, almost legislative role, for the new ESAs.⁶
7. This regulatory role is intended to produce “an overall improvement in the regulation of financial institutions and the introduction and implementation of a so-called single rule book that will unify financial regulation across the EU”.⁷
8. Until now, financial regulation has often been implemented through Directives which have resulted in a series of similar, but not identical, national regulatory regimes. The ESAs will draft technical standards which will be directly implemented at an EU level. Over time, this will help reduce national variations in financial regulation. Mr Andrea Enria, Chairman of the EBA, described some of the advantages of this approach: it will “limit or even rule out the possibility for regulatory competition”; it will “foster more joined-up supervision” and it will ensure that national authorities have the same powers and responsibilities.⁸
9. **We have previously expressed our support for the introduction of a single rule book⁹ and we continue to do so. Given the cross-border nature of many financial services, it is important that national supervisors apply the same regulatory standards, enforced with the same powers, across Member States.**
10. While we strongly support efforts to apply consistent standards and regulations across the EU, we recognise that the financial services sector is a global market and often requires global solutions and cooperation. Mr Justham acknowledged this point with respect to credit rating agencies: “it probably only makes sense, when you look at agencies that operate on a global basis, to try and have a degree of harmonisation at an EU level, or most desirably at a global level”.¹⁰ We believe the same approach applies in many other areas of the financial services.
11. Mr Enria told us that the EBA appreciated the need for international cooperation:

“We know very well that the financial industry is a global industry so we also have important relationships to establish at the global level. We now

⁶ Q 19

⁷ Q 18

⁸ Q 1

⁹ See Appendix 4

¹⁰ Q 42

sit in the Basel Committee on Banking Supervision. The Commission will now involve us in the bilateral dialogue that the European Union establishes with other jurisdictions such as the US, India and China. We will be involved also in this type of bilateral dialogue with other supervisory authorities in other jurisdictions”.¹¹

12. **The financial sector is a highly mobile global industry. Global cooperation is essential to ensure that risks are minimised, rather than simply relocated.**

Override powers

13. Our greatest concern about the powers granted to the ESAs has always been that they might have the power to apply a decision directly to an individual institution if they feel that a national supervisor is failing to implement an EU decision.¹² **We are pleased to note that the principle that day to day supervision of financial institutions should remain at a national level has now been firmly established.**¹³ **This principle should be reflected in any new legislation proposed at an EU level.** There are, however, a number of situations in which ESAs could overrule national supervisors.

Dispute mediation

14. The ESAs have the power to mediate disputes among Member States in relation to the regulation of cross-border entities. Mr Thomas Huertas, Director of Recovery and Resolution at the FSA and Alternate Chair of the EBA, described the situation with respect to the EBA. In normal circumstances the EBA can intervene only if there is “a disagreement among national supervisors with respect to the interpretation of EU law concerning a particular institution”. In addition “the EBA has to be asked to mediate that dispute”.¹⁴ The FSA later clarified, however, that while binding mediation “can be instigated at the request of one or more of the competent authorities concerned”, the EBA can itself initiate mediation where “on the basis of objective criteria, disagreement between competent authorities from different Member States can be determined”.¹⁵
15. If mediation produces no agreement, the EBA may take a decision which “will have binding effects for the competent authorities concerned”. If the competent authority does not comply, the EBA can then adopt an individual decision addressed directly at the financial institution involved requiring it to comply with the EBA’s decision.¹⁶

Emergency powers

16. In a crisis the ESAs will have significantly greater powers to issue binding decisions on national supervisors and financial firms. Mr Huertas

¹¹ Q 12

¹² See Appendix 4

¹³ See Letter from Mark Hoban MP to the Chairman, dated 26 July 2010, in *Correspondence with Ministers May–October 2010*
<http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubAMay-Oct10.pdf>

¹⁴ Q 27

¹⁵ FSF 1, para 6.2

¹⁶ FSF 1, para 6.3

summarised these emergency powers: “the powers of the supervisory authority are much more streamlined ... and the ability of the supervisory authority to act is much enhanced”.¹⁷ Mr Enria stated that, although the EBA’s emergency powers were not yet fully defined, he expected that, as further legislation was agreed, they would be similar to the emergency powers conferred on national supervisors. He was keen to stress, however, that these emergency powers were not unlimited, they would “be in areas that are clearly identified in Community legislation”.¹⁸

17. We questioned the FSA over safeguards that exist to prevent these powers being used inappropriately. Mr Justham confirmed that the ESAs’ emergency powers could not be used unless an emergency had been formally declared by the Council. He clarified that “ESAs cannot themselves declare an emergency”¹⁹ and so these powers still came “within national control”.²⁰ Mr Enria concurred. He added, though, that the EBA could “take initiative and issue a confidential recommendation to the Council to declare that there is a crisis”.²¹
18. Mr Justham described one additional safeguard: an ESA cannot order a Member State to do something “that would have adverse fiscal implications” for that state. This is a measure that the Committee have supported since it was first proposed.²² Mr Adam Farkas, Executive Director of the EBA, thought that, since “regulators typically tend to think of measures that would have fiscal implications”, this measure would be “a relatively strict and severe limit on the powers that we can apply or use” in an emergency situation.²³ Mr Enria added that a Member State could appeal an EBA decision to the Council on the grounds that it would have fiscal implications.²⁴
19. **We welcome these assurances. They are necessary restrictions to ensure that Member States retain primary oversight of national financial institutions in normal circumstances. We note, however, Mr Huertas’s statement that “only time will tell whether in practice they will prove to be sufficient”.**²⁵
20. Our witnesses were clear that these powers would be used sparingly. Mr Justham’s expectation was that “any ESMA or EBA override of a national authority will be taken with great care”, noting that national supervisors will be “sitting round the table knowing that we could all be in that situation one day”.²⁶ Mr Enria described the EBA’s emergency powers as “more as a nuclear deterrent than an actual power”.²⁷
21. **We recognise the FSA’s belief that the ESAs’ use of emergency powers to override national supervisory authorities will be**

¹⁷ Q 28

¹⁸ Q 5

¹⁹ Q 29

²⁰ Q 19

²¹ Q 5

²² See Appendix 4

²³ Q 5

²⁴ Q 6. For the legislative text setting out these safeguards, see the EU Regulations set out in footnote 1.

²⁵ Q 28

²⁶ Q 29

²⁷ Q 1

infrequently exercised. We hope that time proves this belief correct. The Committee would like to be consulted if the Government were to envisage asking the Council to declare an emergency, or if they detect that another Member State or ESA is likely to request that one be declared. In addition, the Government should inform this Committee immediately should the Council declare an emergency and if any of the ESAs subsequently use their emergency powers.

Temporary bans

22. Mr Justham strongly supported investing national supervisors with the power to ban temporarily certain financial activities and products at a national level, stating that “we should have that ability to intervene and I think that people across Europe should have that power too”.²⁸ He argued that the recent crisis showed the dangers inherent in having a “huge patchwork of implementation ... that probably was not constructive”, and sometimes even resulted in “beggar-my-neighbour-type consequences”.²⁹ Mr Justham hoped that “the European legislation will provide ... a degree of harmonisation and the ability to coordinate, or an obligation to be coordinated in one’s effort”.³⁰
23. **We support the principle that national supervisory authorities should intervene in exceptional circumstances to impose restrictions necessary to ensure financial stability.**
24. **Given the cross-border nature of financial services across Europe, we strongly believe that such actions should take place in a uniform and coordinated way across the EU to avoid market disruption or temporary regulatory arbitrage. We welcome the ESAs’ coordinating role in these cases.**
25. The ESAs have similar powers to enforce temporary bans when an emergency is declared by the Council. In addition, however, the legislation setting up the ESAs allows for the possibility that the power to temporarily prohibit certain activities without a Council-declared emergency may be conferred over time in different product areas by individual pieces of legislation. It is therefore difficult to determine to what extent these powers will grow as new legislation is passed and existing legislation is refined and updated. Mr Enria described the EBA’s powers:
- “we then have an additional power which has been inserted in the area of consumer protection: the ability for us to constrain or ban certain financial activities for a certain period ... This decision will have to be reviewed regularly; every month, it expires until it is renewed with an explicit vote of the board of supervisors”.³¹
26. Mr Enria added that these bans could be appealed against by individual financial institutions or national supervisory authorities.³²
27. Mr Justham noted that this aspect of the ESAs’ powers is one where the FSA “would want to be slightly more vigilant”,³³ and added that the FSA was

²⁸ Q 35

²⁹ Q 35

³⁰ Q 36

³¹ Q 14

³² Q 14

³³ Q 29

concerned that these powers would affect the “balance of power between the national authorities and ESMA or any of the ESAs”.³⁴

28. In particular, Mr Justham expressed concern about the Commission’s recent proposal on short-selling and certain aspects of credit default swaps,³⁵ noting that the current proposal would allow ESMA to “declare its own emergency ... and make a temporary ban”.³⁶ The proposal suggests that ESMA could do so in circumstances where a situation has “cross border implications and competent authorities have not adequately addressed the threat”. In such circumstances, ESMA would override any conflicting measures put in place by national authorities.³⁷
29. The Government does not, at present, support this aspect of the proposal. Mr Justham explained that “the question is whether ESMA should do something that would have a serious impact on a Member State if that Member State was in disagreement”.³⁸ He noted that such measures often have to be put in place quickly and that “trying to get all 27 round the table and agreeing may take some time”.³⁹
30. The FSA recognised that, in addition to the risks, there would be benefits arising from the proposals. Mr Justham suggested that an ability to ban certain products “could be potentially to our advantage, in that we might want to impose some changes on someone else”,⁴⁰ and added that “it is not so much ESMA imposing something on us, but ESMA stopping someone else doing something that was detrimental”.⁴¹
31. **As a general principle, we consider that ESAs should only have the power to ban temporarily certain activities or products in a crisis, when an emergency has been declared by the Council. We recognise that the legislation setting up the ESAs allows for the possibility that specific sectoral legislation will grant the ESAs such enhanced powers in certain areas without the need for the Council to declare an emergency. We believe that future sectoral legislation should confer such powers as the exception, and not the rule.**
32. **We have previously examined⁴² the specific case of the Commission proposal on short selling and certain aspects of credit default swaps and concluded it should be an exception to this general principle. Given the highly cross-border nature of the CDS trade, giving ESMA such intervention powers might be necessary to preserve financial stability in the EU. We therefore urge the Government to review its objection to these provisions, and instead acknowledge their necessity while ensuring that adequate safeguards are put in place.**

³⁴ Q 30

³⁵ COM(2010) 482

³⁶ Q 29

³⁷ COM(2010) 482, p 10

³⁸ Q 39

³⁹ Q 35

⁴⁰ Q 31

⁴¹ Q 40

⁴² See Letter from the Chairman to Mark Hoban MP, dated 8 March 2011, in *Correspondence with Ministers December 2010–May 2011*

<http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/CwMSubADec10-current.pdf>

CHAPTER 3: CONTRIBUTING TO MACROPRUDENTIAL STABILITY

33. The Committee concluded in its recent inquiry, *The future of economic governance in the EU*, that the interconnection of the sovereign debt and banking sectors was one of the principal elements that contributed to the recent euro area crisis.⁴³ Financial stability is therefore of the greatest importance, not only to financial institutions but to the wider economic stability of all EU countries. The new supervisory framework puts the new European Systemic Risk Board in charge of macro-prudential supervision, with an objective to identify and prevent risks to financial stability and with the power to issue systemic risk warnings. The three ESAs have representatives on the ESRB.
34. It is clear that the ESAs must have a prominent place on the ESRB to act as its eyes and ears within the financial sector. In addition, the EBA's work on bank stress tests will directly feed into the ESRB's assessment of systemic risks. Mr Huertas described this as the ESAs' indirect contribution to financial stability. We welcome his assurance that "a very good exchange of views has already started to take place".⁴⁴

Information sharing

35. Mr Huertas stated that there were "tensions with respect to data about individual institutions", noting that "there is a natural curiosity on the part of the supervisory authorities and ... the European Systemic Risk Board to have data about individual institutions".⁴⁵ Mr Enria argued that the EBA had the responsibility to assess risks at an EU level, which required an ability to "request information and data from national authorities, including confidential data".⁴⁶
36. **The ESRB has a vital role to play in detecting systemic imbalances in the EU. Ensuring that the ESRB has all the relevant information that it needs to make an informed assessment of systemic risks within the European financial system should be a priority for the ESAs.**
37. **Tensions over the level and range of information to be shared between national authorities, the ESAs and the ESRB should be resolved as soon as possible. In general national supervisors should be responsible for micro-prudential regulation and information, but we believe such information should be provided to EU level institutions when appropriate to support their macro-prudential oversight roles. Guidelines should be drawn up to codify the exchange of information among these organisations and clarify their respective responsibilities.**

⁴³ European Union Committee, 12th Report (2010–11): *The future of economic governance in the EU* (HL Paper 124)

⁴⁴ Q 18

⁴⁵ Q 20

⁴⁶ Q 1

Bank stress tests

BOX 1

Bank stress tests

Bank stress tests are a tool designed to determine whether banks have enough capital and liquidity to survive future economic shocks. The stress tests subject banks to possible future scenarios in which the financial environment deteriorates, and measures how they would fare. They are designed to find weaknesses at an early stage and help banks take preventative measures.

The 2010 round of stress tests was run by the Committee of European Banking Supervisors, the EBA's predecessor. The stress tests covered 91 EU banks of which seven failed. Significantly, Allied Irish Banks and Bank of Ireland passed the test just a couple of months before they almost failed, triggering a bail-out by the Irish government. The stress tests were subsequently criticised for being too lenient, undermining their credibility as a reliable means of determining the financial health of banks.

38. The credibility of bank stress tests has been in doubt since Ireland's banking system failed only months after the stress tests were introduced in 2010. The EBA is setting the criteria for the 2011 stress tests. Mr Huertas identified the stress tests as an area of tension amongst representatives in the EBA, noting that "some Member States are in favour of tough standards and other Member States are in favour of a test that might be somewhat easier to pass".⁴⁷ Mr Enria stated that the EBA was strengthening the stress tests by moving to "a more adverse scenario", although he acknowledged that it had still "been criticised to some extent as not being severe enough".⁴⁸
39. Mr Enria pointed to several areas where the EBA was strengthening the tests used in 2010. In terms of process, he noted that the EBA would introduce a "strong peer review and quality assurance process" which he argued would improve the consistency and reliability of the results.⁴⁹
40. We have always been doubtful that the commitment by the finance ministers of France, Germany, Italy, Spain and the UK at the G20 in Seoul in November 2010 that there will be no losses for the private sector on sovereign debt issued before 2013 ('the Seoul commitment') would prove sustainable.⁵⁰ We hoped, therefore, that the EBA would not use this guarantee as a core assumption for its tests. Mr Huertas stated that the EBA's stress tests will subject government bonds held by banks to "further declines in the market price", and "assure that there is full disclosure". He stated that it is "not the position of the banking supervisor to say whether there will, will not, should or should not be any type of restructuring or rescheduling of the debt concerned",⁵¹ adding that the EBA has "underlined to the Council, to the Commission and to the European Systemic Risk Board the importance of having remedial measures in place".⁵²

⁴⁷ Q 20

⁴⁸ Q 3

⁴⁹ Q 3

⁵⁰ European Union Committee, *The future of economic governance in the EU*, para 203

⁵¹ Q 33

⁵² Q 34

41. **We welcome Mr Huertas's assurance that the bank stress tests currently being designed by the EBA will be strengthened in light of the failure of last year's tests. In addition, we are pleased to note that the Seoul commitment will not be viewed as absolute for the purposes of the stress tests. The stringency of the stress tests will be an important test of the independence of the EBA.**

CHAPTER 4: THE UK'S INFLUENCE

42. The ESAs are a significant development in European financial regulation and, given the importance of financial services to the UK economy, it is vital that the UK plays a leading role in these organisations. This is particularly true for ESMA, given the predominance of London as a trading centre for securities.
43. As Mr Justham summarised, the UK is now “in a position of influence as opposed to being sole determinants”. He added, however, that the new system also meant “that there is an opportunity to influence a much wider spectrum”. Indeed, although the UK is proportionately more affected by decisions made by the ESAs, and by ESMA in particular, “the flip side of having the concentration of the markets is that we have the insight and the information” and the opportunity to offer intellectual leadership to “influence and get the right outcomes on a Europe-wide basis”.⁵³ Mr Justham stated one of the FSA’s key aims was putting forward “factual positions”, and he thought that the FSA had done so in a “positive way” that “is broadly very well received”.⁵⁴
44. **The UK is the centre of financial services in the EU. The new financial supervisory framework offers the UK an opportunity to take advantage of its expertise and experience in this field to raise the standard of financial regulation across the EU. It is therefore vital that the Government and FSA take a leadership role. We commend the constructive approach the FSA has taken to engaging with the ESAs. It is essential that it continues to engage constructively in the work and governance of these organisations.**
45. **We believe that earlier regulation has failed as much in its implementation as in its design. In addition to constructing technical standards, the ESAs have a peer review role.⁵⁵ The FSA should ensure that this is seen as an important aspect of its work, and is used to ensure that financial regulations are being effectively implemented across the EU.**

The ESAs’ resources

46. Mr Huertas told us that the ESAs were simply too small to achieve their goals without the help of national supervisory authorities. He argued that “given the range of tasks that the EBA and the other European Supervisory Authorities have been asked to do, the only way they can possibly accomplish them is to continue to bind in the national supervisory authorities into their workings”. This has benefited the UK since “those Member States ... that are willing and able to put capable staff on to the working parties have a considerable opportunity to influence the results”.⁵⁶ Other Member States with smaller supervisory authorities find “it is practically impossible for them to identify staff to go to all these different working groups”.⁵⁷

⁵³ Q 22

⁵⁴ Q 21

⁵⁵ Q 1

⁵⁶ Q 22

⁵⁷ Q 23

47. This situation is likely to continue. The EBA, for example, although their budget will nearly double over the next two years, will still only have 121 staff by 2013 compared to approximately 3,500 staff at the FSA.⁵⁸ As Mr Huertas described, “relative to the tasks that the EBA and the other supervisory authorities are being asked to perform I would say that it is certainly a modest-sized institution”.⁵⁹
48. **The European Supervisory Authorities are small compared with national supervisory authorities in some Member States. We note that this enhances the ability of the UK and other Member States with large national supervisory authorities to take a leadership role in these organisations. This is an opportunity that the UK should seize to enhance further its ability to lead within the ESAs.**

The changing structure of UK supervision

49. As we publish this report the FSA is going through a process of reform. Under Government proposals the FSA will be abolished and three new bodies created to replace it: a Financial Conduct Authority (FCA), responsible for how financial institutions conduct their business; a Prudential Regulatory Authority (PRA), responsible for the day to day regulation and supervision of financial firms; and a new Financial Policy Committee (FPC) that will be responsible for maintaining financial stability. At present, it is proposed that the FCA will represent the UK at ESMA while the PRA will lead at the EBA and EIOPA.
50. This reform has created concerns in some quarters that that the UK’s influence in the ESAs will be undermined by separating market supervision in the UK into three parts. For example, Sharon Bowles MEP, Chair of the European Parliament Economic and Monetary Affairs Committee, has stated that the FCA will be responsible for only about half of ESMA’s remit, “leaving the UK views on substantial and relevant issues essentially unrepresented”.⁶⁰
51. The ESAs divide regulatory responsibilities between different subject areas (banks, insurance and securities), while the new UK regulatory bodies will be instead be split into prudential and conduct regulation across all subject areas. Mr Justham recognised this “means that there will be a significant requirement, as the Government acknowledges ... to coordinate across the future regulatory bodies in terms of the representation within Europe”.⁶¹
52. **We are concerned that the forthcoming changes to its national supervisory authorities may compromise the leadership role the UK has been able to take in the ESAs. We would like the Government to detail, in their response to this report, exactly what structures and mechanisms they plan to put in place to ensure that the FCA, PRA and FPC work together effectively to present a cohesive and unified face within the three ESAs.**
53. One consequence of the ESAs’ quasi-legislative role (see paragraph 6) is that they will have “to craft a compromise among the positions of the Member

⁵⁸ Q 25

⁵⁹ Q 25

⁶⁰ Financial Times, FSA reform threatens influence in Brussels, 5 October 2010

⁶¹ Q 21

States such that the proposed binding technical standard can reach a majority”.⁶² Mr Huertas described how he thought the “same type of tensions that we see in EU legislation will be transposed” into ESA discussions. Mr Justham concurred: “the forum now is a 27-type forum with qualified majority voting” which would lead to “Council-type negotiation”.⁶³

54. **The FSA has not had to lead Council-type negotiations in the past. We recommend that it, and its successor bodies, ensure that training and expertise in such negotiations is urgently made available to relevant staff.**

⁶² Q 20

⁶³ Q 21

CHAPTER 5: SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Chapter 2: The ESAs' Powers

A 'single rule book'

55. We have previously expressed our support for the introduction of a single rule book and we continue to do so. Given the cross-border nature of many financial services, it is important that national supervisors apply the same regulatory standards, enforced with the same powers, across Member States (para 9).
56. The financial sector is a highly mobile global industry. Global cooperation is essential to ensure that risks are minimised, rather than simply relocated (para 12).

Override Powers

57. We are pleased to note that the principle that day to day supervision of financial institutions should remain at a national level has now been firmly established. This principle should be reflected in any new legislation proposed at an EU level (para 13).

Emergency Powers

58. We welcome these assurances. They are necessary restrictions to ensure that Member States retain primary oversight of national financial institutions in normal circumstances. We note, however, Mr Huertas's statement that "only time will tell whether in practice they will prove to be sufficient"(para 19).
59. We recognise the FSA's belief that the ESAs' use of emergency powers to override national supervisory authorities will be infrequently exercised. We hope that time proves this belief correct. The Committee would like to be consulted if the Government were to envisage asking the Council to declare an emergency, or if they detect that another Member State or ESA is likely to request that one be declared. In addition, the Government should inform this Committee immediately should the Council declare an emergency and if any of the ESAs subsequently use their emergency powers (para 21).

Temporary bans

60. We support the principle that national supervisory authorities should intervene in exceptional circumstances to impose restrictions necessary to ensure financial stability (para 23).
61. Given the cross-border nature of financial services across Europe, we strongly believe that such actions should take place in a uniform and coordinated way across the EU to avoid market disruption or temporary regulatory arbitrage. We welcome the ESAs' coordinating role in these cases (para 24).
62. As a general principle, we consider that ESAs should only have the power to ban temporarily certain activities or products in a crisis, when an emergency has been declared by the Council. We recognise that the legislation setting up the ESAs allows for the possibility that specific sectoral legislation will grant

the ESAs such enhanced powers in certain areas without the need for the Council to declare an emergency. We believe that future sectoral legislation should confer such powers as the exception, and not the rule (para 31).

63. We have previously examined the specific case of the Commission proposal on short selling and certain aspects of credit default swaps and concluded it should be an exception to this general principle. Given the highly cross-border nature of the CDS trade, giving ESMA such intervention powers might be necessary to preserve financial stability in the EU. We therefore urge the Government to review its objection to these provisions, and instead acknowledge their necessity while ensuring that adequate safeguards are put in place (para 32).

Chapter 3: Contributing to macroprudential stability

Information sharing

64. The ESRB has a vital role to play in detecting systemic imbalances in the EU. Ensuring that the ESRB has all the relevant information that it needs to make an informed assessment of systemic risks within the European financial system should be a priority for the ESAs (para 36).
65. Tensions over the level and range of information to be shared between national authorities, the ESAs and the ESRB should be resolved as soon as possible. In general national supervisors should be responsible for micro-prudential regulation and information, but we believe such information should be provided to EU level institutions when appropriate to support their macro-prudential oversight roles. Guidelines should be drawn up to codify the exchange of information among these organisations and clarify their respective responsibilities (para 37).

Bank stress tests

66. We welcome Mr Huertas's assurance that the bank stress tests currently being designed by the EBA will be strengthened in light of the failure of last year's tests. In addition, we are pleased to note that the Seoul commitment will not be viewed as absolute for the purposes of the stress tests. The stringency of the stress tests will be an important test of the independence of the EBA (para 41).

Chapter 4: The UK's Influence

67. The UK is the centre of financial services in the EU. The new financial supervisory framework offers the UK an opportunity to take advantage of its expertise and experience in this field to raise the standard of financial regulation across the EU. It is therefore vital that the Government and FSA take a leadership role. We commend the constructive approach the FSA has taken to engaging with the ESAs. It is essential that it continues to engage constructively in the work and governance of these organisations (para 44).
68. We believe that earlier regulation has failed as much in its implementation as in its design. In addition to constructing technical standards, the ESAs have a peer review role. The FSA should ensure that this is seen as an important aspect of its work, and is used to ensure that financial regulations are being effectively implemented across the EU (para 45).

The ESAs' resources

69. The European Supervisory Authorities are small compared with national supervisory authorities in some Member States. We note that this enhances the ability of the UK and other Member States with large national supervisory authorities to take a leadership role in these organisations. This is an opportunity that the UK should seize to enhance further its ability to lead within the ESAs (para 48).

The changing structure of UK supervision

70. We are concerned that the forthcoming changes to its national supervisory authorities may compromise the leadership role the UK has been able to take in the ESAs. We would like the Government to detail, in their response to this report, exactly what structures and mechanisms they plan to put in place to ensure that the FCA, PRA and FPC work together effectively to present a cohesive and unified face within the three ESAs (para 52).
71. The FSA has not had to lead Council-type negotiations in the past. We recommend that it, and its successor bodies, ensure that training and expertise in such negotiations is urgently made available to relevant staff (para 54).

APPENDIX 1: EU SUB-COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS AND INTERNATIONAL TRADE

The members of the Sub-Committee who conducted this inquiry were:

Lord Harrison (Chairman)
 Lord Hamilton of Epsom
 Lord Haskins
 Baroness Hooper
 Lord Jordan
 Lord Kerr of Kinlochard (from 17 May 2011)
 Baroness Maddock
 Lord Marlesford
 Lord Moser
 Lord Trefgarne (until 21 June 2011)
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

Declaration of Interests

Lord Harrison
None relevant

Lord Hamilton of Epsom
Director Jupiter Dividend & Growth Trust (Investment Fund)
Director IREF Global Holdings (Bermuda) Ltd (Property Fund)
Director IREF Australian Holdings (Bermuda) Ltd (Property Fund)

Lord Haskins
None relevant

Baroness Hooper
None relevant

Lord Jordan
None relevant

Lord Kerr of Kinlochard
Deputy Chairman Royal Dutch Shell plc
Non-executive Director, Rio Tinto plc
Non-executive Director, Scottish Power plc
Non-executive Director Scottish American Investment Co Ltd
Chairman of Court and Council, Imperial College London Chairman, Centre for European Reform (London) Vice President, European Policy Centre (Brussels)
Advisory Board Member, BAe Systems Plc

Baroness Maddock
None relevant

Lord Marlesford
Director of Gavekal Research (Hong Kong)
Advisor to Sit Investment Associates (USA) and Independent National
Director Times Newspaper Ltd

Lord Moser
None relevant

Lord Trefgarne
None relevant

Lord Vallance of Tummel

Member Supervisory Board Siemens AG, Member International Advisory Board, Alliance SE

Lord Woolmer of Leeds

None relevant

A full list of registered interests of Members of the House of Lords can be found at <http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/>

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at <http://www.parliament.uk/hleua> and available for inspection at the Parliamentary Archives (020 7219 5314)

Oral evidence

- (Q1–17) Mr Andrea Enria, Chairman, European Banking Authority and Mr Adam Farkas, Executive Director, European Banking Authority
- (Q18–46) Thomas Huertas, Director of Recovery and Resolution, The Financial Services Authority and Alexander Justham Director of Markets & Capital Markets Sector Leader, The Financial Services Authority

Written evidence

- (FSF 1) Financial Services Authority

APPENDIX 3: GLOSSARY

EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	UK Financial Services Authority
Macro- prudential supervision	The analysis of wide economic trends and imbalances and the detection of risks that these trends may pose to the financial system
Micro-prudential supervision	The supervision of individual financial institutions
PRA	Prudential Regulatory Authority
Systemic risk	The inherent collapse of an entire system, as opposed to the risk carried by any one individual entity or component of a system

APPENDIX 4: LETTER FROM RT HON LORD ROPER, CHAIRMAN OF THE HOUSE OF LORDS EUROPEAN UNION COMMITTEE, TO LORD MYNERS, FINANCIAL SERVICES SECRETARY, HM TREASURY, 25 NOVEMBER 2009

The reform of EU financial supervision

Thank you for providing evidence to the Committee on 10 November on the Commission's proposals for a Directive on Alternative Investment Fund Managers and also on the reform of the structure of financial supervision within the European Union. In this letter we set out our points of concern relating to the proposals for the reform of financial supervision and what we hope you can achieve in your negotiations on the proposal.

European Systemic Risk Board

We welcome the establishment of the European Systemic Risk Board (ESRB). It can play an important role in the detection of systemic risk in the European Union and in a global "early warning system" in terms of imbalances within the financial system. A future crisis will affect EU or global institutions, rather than be limited to a single country, and risk detection systems at a level higher than national bodies can provide will be needed. A European Union wide body will be more effective at identifying problems in the EU than one based exclusively within any member state but global imbalances by definition can only be detected by global bodies. It is therefore crucial that the ESRB work in coordination with the Financial Stability Board and that data exchange occurs between these two bodies.

We recognise that the ESRB will not have binding powers and it will be advisory only. However, concerns have been raised that the ESRB could seek to insist that individual Member State governments conform to its own economic or fiscal policies. We assume the UK will be working, both during negotiations and after agreement of the proposals, to ensure that the ESRB will not bring pressure to bear on individual governments in this way.

As you know, we have concerns over the organisation and structure of the ESRB. As the proposal is drafted the Board will have 61 members; this is too many to achieve effective decision making, particularly in a possible crisis situation. We acknowledge that the Steering Committee will be able to increase the effectiveness of the ESRB and it is vital that the United Kingdom has guaranteed representation on this committee.

The Directive as drafted would entrust the secretariat of the ESRB to the European Central Bank (ECB) and we welcome the use of the ECB. It is well placed to collect data on systemic risk and has sufficient expertise to carry out this task.

European Supervisory Authorities

We welcome the overall objective of the European Supervisory Authorities (ESAs)—to work towards a single European rulebook and to facilitate increased cooperation between European supervisory authorities—as both positive in terms of increasing cooperation between national supervisors and an important step in creating a true single market in financial services.

We understand that the authorities are to be constituted under Article 95 of the EC Treaty. The power given to the ESAs to provide opinions on the success of individual Member States' implementation of decisions and their dispute settlement powers cast doubts over whether Article 95 can be used in this way. We urge you to work towards ensuring that all powers of the ESAs are within the bounds granted to them by the Treaty. We would be grateful if you could provide details of changes to the legal base that will occur as a result of the coming into force of the Lisbon Treaty.

Our specific concern, which we know you share, is that an ESA will have the power to apply a decision directly to an individual institution if a national supervisor fails to implement that decision. As decisions are decided by Qualified Majority Voting, this could lead to a decision being directly applied to UK financial institutions, without the Financial Services Authority (FSA) having the power of veto. This appears to go against your assertion, with which we strongly agree, that day-to-day supervision must remain the responsibility of the national supervisor. We urge you to ensure that decisions made in an ESA to apply a rule directly to a national financial institution must be done so by unanimity or alternatively that the ESAs have no power directly to apply a decision to a financial institution in an individual member state. Any other outcome would amount to day-to-day supervision and intervention being effectively in the hands of the ESA.

Finally, we acknowledge concerns that have been raised over the process for appeal where decisions impinge upon Member States' fiscal authority. We urge you to push for clarification on the system of safeguards which will prevent the ESAs from seeking to enforce decisions that impinge on Member State fiscal authority.

In conclusion, we believe these proposals are a positive step toward a unified system of financial supervision which will have benefits both for financial stability and the single market in financial services. However, the key concerns raised above need to be addressed before the proposals are agreed in Council. In view of the huge importance of the proposals to the financial institutions of the United Kingdom and our serious concerns over the proposed powers of the ESA we intend to retain the document under scrutiny.

We appreciate that if the proposal is amended as we suggest in relation to the ESAs more attention will be needed to be given to the problem of home-host supervision but we believe that the problems around this subject can and will be resolved as the ESAs bed down and gain experience.