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The EU's new supervisory architecture – evolution or revolution?

by Philip Whyte

In early September EU finance ministers approved the Commission's proposals for reforming the EU's supervisory architecture for financial services. The reforms were hailed by finance ministers and the Commission as an important step in rectifying the fault-lines exposed by the global financial crisis; criticised by integrationists as falling short of what was required; and assailed by eurosceptics in Britain as a 'power grab' that would give the EU important new powers over the City of London. The reforms raise several questions. Why were they necessary at all? How will they differ from existing arrangements? And do they presage a fundamental change in the balance of power between EU institutions and the member-states?

Since the late 1980s, the EU has expended great efforts to encourage theemergence of a single, integrated market in financial services. To do so, it has leant heavily on the principle of mutual recognition (also known as the 'passport'). In essence, this has allowed financial institutions established in one member-state to provide services across the EU without having to obtain separate authorisations from each host country to do so. However, greater market integration was not accompanied by much of an increase in supervisory integration. Home countries formed ad hoc 'colleges' with authorities in host countries to supervise firms whose activities straddled borders. But the home countries were largely responsible for supervising the firms they authorised.

The global financial crisis exposed the fragility of these arrangements. Integrationists had long complained that co-operation between supervisory authorities in different EU countries was not up to scratch. When the crisis erupted, cross-border co-operation often broke down completely. The Benelux countries failed to mount a co-ordinated rescue of Fortis. Countries unilaterally increased the ceilings on their deposit protection schemes. And critical questions were raised about the passport: how, for example, could host countries allow foreign banks to operate on their territory if home countries were financially unable to compensate depositors in host countries?

The crisis left the EU with a choice. It could recognise that host countries should be handed back some of the powers that the passport took away from them – an option that would mark a retreat from the single market, since it would pave the way for new protectionist barriers. Or the EU could try and rescue the single market by strengthening the pan-European regulatory and supervisory edifice. The EU went for the latter option. The new architecture largely follows the blueprint proposed by a working group headed by Jacques de Larosière. It establishes a new European Systemic Risk Board (ESRB), under the aegis of the European Central Bank (ECB); and it creates three new European Supervisory Authorities (ESAs) for banking, securities and insurance.

The new edifice is a compromise. It tries to reconcile the need for greater supervisory effectiveness with the hostility of some governments towards greater institutional integration. It does not create the single European supervisory authority that some had called for. The ESRB, which will monitor threats to financial stability, will only have an advisory role. And financial institutions will continue to be supervised by national authorities, not by the ECB or the ESAs. (The only entities that will be directly supervised by an ESA are credit rating agencies.) The tasks of the ESAs will be to develop common rules, mediate between national authorities when conflicts arise, settle disputes if mediation fails and co-ordinate risk management.

It is hard to argue that these various reforms add up to a radical transfer of powers from the member-states to EU institutions. The ESAs will be modestly staffed and their secretariats will mostly be seconded from national authorities. Their boards will be composed of the heads of the 27 national supervisory authorities. And the ESAs will only be able to take legally binding decisions in exceptional circumstances. One of these will be if a member-state is in manifest breach of EU law. Another will be if EU countries agree there is an 'emergency'. Even in the latter case, however, the ESAs will not be allowed to impinge on a country's fiscal autonomy: they will not, for example, be able to instruct a country to bail out a bank.

The new arrangements mark a subtle shift in power from the member-states to the EU. It is possible that they could evolve in time into something more ambitious. But this is unlikely to happen if political pressures turn the ESAs into arenas for skirmishes between member-states. The ESAs will only develop a pan-European supervisory culture if they work by consensus rather than confrontation.

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