House of Commons

Treasury Committee

# The Committee's Opinion on proposals for European financial supervision

## Sixteenth Report of Session 2008–09

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# Summary

The banking crisis which began some two years ago and is still playing out today has prompted calls for new systems of international regulation. There is a drive for better macroprudential oversight to look at risk across financial systems as a whole, and for more co-ordinated microprudential regulation to look at individual company risk. We support those aims.

In September 2009 the European Commission published its detailed legislative proposals for European reform. They were based on agreements reached by ECOFIN and the European Council. The regulations proposed would establish a European Systemic Risk Board (ESRB), to undertake macroprudential issues, and for a system of European Supervisory Authorities (ESAs), for Banking, Securities, and Insurance and Occupational Pensions, to encourage greater consistency and co-operation between national regulators in their microprudential work. There are extensive links between the ESRB and the ESAs.

While the intention of the new regulations is widely welcomed, there is a great deal of unease about the detail. There is still more unease about the speed with which it is hoped to agree them; the Presidency is pressing for their adoption by ECOFIN at the Council on 2 December. We consider that is far too fast: the proposals will set in place a framework which should last for many decades, and there should be proper time for consideration.

The timetable would be less worrying (although still over hasty) if the proposals were without controversy. However, even on a short examination we have found serious cause for concern. It is not clear how these proposals relate to global initiatives for regulatory reform. There are concerns about the size and composition of the ESRB. There is doubt about the extent to which it is desirable or possible to delegate discretionary powers to the European Supervisory Authorities; there is unease about the potential power they will have to override the decisions of national regulators; there are concerns that the Commission will have unilateral power to declare an emergency, which will give ESAs power to direct national regulators still further. Most significantly, the proposals do not appear to give due weight to ECOFIN's conclusion in June 2009 which stressed that the measures "should not impinge on the fiscal responsibilities of the Member States." We believe the proposals go far beyond the ECOFIN agreement, and need to be reconsidered. Lord Myners indicated that he would be prepared to use his veto power if necessary; we set out some of the circumstances in which we believe it would be appropriate to do this.

However, the financial industry should not take our recommendation that the regulations be considered in a more measured and thorough way as a signal that the world is about to return to "business as usual". The events of the last two years have shown there was a real gap in national and international regulation; the question is not whether to fill that gap, but how best to do so. We will keep the European proposals under review, and we hope they can be improved.

# 1 Introduction

1. In late September this year, the European Commission published a series of regulations, which, if approved by the European Council, would change the way financial regulation and supervision were undertaken in the European Union, and, indeed in the wider European economic area. They provide for a European Systemic Risk Board which would carry out macro prudential oversight (ie to look for systemic weaknesses in the financial system), and a series of sectoral supervisory bodies to co-ordinate microprudential regulation and supervision.[1]

2. The Swedish Presidency is pushing for ECOFIN to agree to the proposals at its meeting on 2 December. The scrutiny system in the House of Commons means that the European Scrutiny Committee is required to scrutinise these documents, and the Explanatory Memorandum from the Government which accompanied them (which was received on 15 October). If that Committee considers the documents warrant it, it can recommend that they are debated in Committee or on the floor of the House before the Government gives its final view in the European Council. The European Scrutiny Committee considered the proposals sufficiently important to ask us to give an Opinion on them before making any

1 13645/09, Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, (hereafter 13645/09).http://register.consilium.europa.eu/pdf/en/09/st13/st13645.en09.pdf

13648/09, Proposal for a regulation of the European Parliament and the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, (hereafter 13648/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13648.en09.pdf

13652/09, Proposal for a regulation of the European Parliament and the Council establishing a European Banking Authority,(hereafter 13652/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13652.en09.pdf

13653/09, Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, (hereafter 13653/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13653.en09.pdf

13654/09, Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, (hereafter 13654/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13654.en09.pdf

13656/09, Commission Staff Working Document - accompanying document to the - Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority - Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority - Proposal for a Regulation of the European Securities and Markets Authority, Possible amendments to Financial Services legislation, (hereafter 13656/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13656.en09.pdf

13657/09, Commission Staff Working Document - accompanying document to the - Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European System Risk Board - Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board - Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority - Proposal for a Regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority - Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, Impact Assessment, (hereafter 13657/09) http://register.consilium.europa.eu/pdf/en/09/st13/st13657.en09.pdf

13658/09, Commission Staff Working Document - Summary of the Impact Assessment, http://register.consilium.europa.eu/pdf/en/09/st13/st13658.en09.pdf

recommendation for a debate.[2] We launched an urgent inquiry on 20 October, calling for evidence by 13 November, and taking oral evidence on 3 and 4 November.[3]

3. In addition to normal evidence gathering, our staff canvassed the views of a wide range of academics and stakeholders informally, both by telephone and in meetings. Some have agreed that we may refer to their views explicitly in this report. We are extremely grateful to all those who were so generous with their time and opinions; they have enriched our understanding of the proposals. However, the fact that it was necessary to proceed in this way is a mark of the speed with which we have had to consider the documents in question.

4. We were also able to arrange two evidence sessions. On 2 November we took evidence from Dr Kern Alexander, Senior Research Fellow, Centre for Financial Analysis and Policy, Cambridge University, Dr Jon Danielsson, Department of Finance, London School of Economics, and Professor Richard Portes CBE, Professor of Finance, London Business School, and a second panel containing Mr Stuart Popham, Senior Partner, Clifford Chance, Mr Simon Gleeson, Financial Regulatory Partner, Clifford Chance, Ms Barbara Ridpath, Chief Executive of the International Centre for Financial Regulation, and Mr André Villeneuve, Chairman, City of London's EU Advisory Group. On 3 November we took evidence from Lord Myners CBE, the Financial Services Secretary, Mr Gary Roberts, Head of Financial Services Strategy, and Mr Stephen Pickford, Managing Director International and Europe, HM Treasury. We are extremely grateful to our witnesses for making themselves available at such short notice. We are also grateful to all those who submitted written evidence so quickly.

5. It is clear from the initial stages of this inquiry that the proposals from the European Union could have profound effects. We are also aware that the European Scrutiny Committee has now published a Report calling for a debate on the floor of the House to take place before the December ECOFIN meeting, but after our Opinion has been published.[4] To ensure that the House has the opportunity for informed debate before 2 December, we are publishing the Opinion requested in the form of this interim report. We will reflect on whether a further Report is needed when we have received further written evidence and have had the opportunity to discuss the proposals at our forthcoming evidence sessions with the Bank of England and the Financial Service Authority.

## Background

6. The economic crisis which began to unfold in mid-2007 was global and the effects have been felt across Europe, not just in the UK. The responses have included state aid by Belgium, Luxemburg and the Netherlands to Fortis Bank and Fortis Bank Luxemburg and the creation of the German Financial Markets Stabilisation Fund. There appears to be a consensus that better systems for global regulation and supervision are necessary, both to

2 European Scrutiny Committee, Thirtieth Report of Session 2008-09, *Documents considered by the Committee on 21 October 2009*, HC 19-xviii

3 "Treasury Committee launches inquiry into proposals for European macro and micro prudential regulation", Treasury Select Committee Press Notice, 21 October 2009

4 European Scrutiny Committee, Thirty-Second Report of Session 2008-09, *Documents considered by the Committee on 4 November 2009,* HC 19-xxx

look at systemic risk (macro prudential regulation), and to examine the risks at the level of individual institutions (micro prudential regulation). It was also acknowledged that the links between the two have not been properly appreciated in the recent past, and that actions which appeared reasonable, or even advantageous, for individual firms could threaten the wider financial system. Work to improve regulators' understanding of the interplay between micro and macro prudential regulation, and to draw up new standards for regulation is being undertaken at many levels. In the United Kingdom, the Turner Review was the first step of the FSA's consideration of these issues; at a global level, the G20 and the Basel Committee on Banking Supervision are working to draw up new financial standards and to improve international monitoring of systemic risk.

7. The European Union already has a system intended to ensure "a more efficient system for EU institutions to prepare, adopt and implement new financial services legislation"—the so called Lamfalussy arrangements[5] to "to allow the EU to respond rapidly and flexibly to developments in financial markets in order to achieve greater market integration and improved competitiveness".[6] The Financial Services Authority provides the following explanation of the operation of the 'four level' approach of the Lamfalussy arrangements:

> Level 1 - framework legislation, voted on by the Council and Parliament
>
> Level 2 - implementing measures for the Level 1 legislation, led by the Commission
>
> Level 3 - supervisory committees facilitating the convergence of regulatory outcomes
>
> Level 4 - enforcement of all EU measures, led by the Commission
>
> Under the Lamfalussy arrangements, the Commission proposes framework legislation and it is adopted under the 'co-decision' procedure. This involves both the European Council and the European Parliament (Level 1). It is supplemented at Level 2 by more detailed implementation measures, adopted by the Commission and endorsed by a qualified majority of Member States.
>
> The detailed Level 2 legislation is prepared by the Commission on the basis of advice provided by representatives of national supervisory authorities, acting through the 'Level 3' committees ([Committee of European Banking Supervisors] CEBS, [the Committee of European Insurance and Occupational Pensions Supervisors] CEIOPS and [Committee of European Securities Regulators] CESR). In finalising their advice, the Level 3 committees consult extensively with providers and users of financial services.
>
> The Level 3 committees also aim to foster supervisory convergence and best practice, principally through the creation of (non legally binding) guidance. Finally, at Level 4,

5 Europa, Financial markets: Commission welcomes Parliament's agreement on Lamfalussy proposals for reform, IP/02/195, Brussels, 5 February 2002

6 Europa, Financial markets: Commission welcomes Parliament's agreement on Lamfalussy proposals for reform, IP/02/195, Brussels, 5 February 2002

> the Commission ensures that Member States are complying with applicable legislation and it pursues enforcement action where required.[7]

8. The crisis revealed that the Lamfalusy arrangements were not able to cope with the serious cross-border problems that developed when a failed financial institution had operations in several states. Indeed, this Committee has already noted the impact of European law in this area. In our Report *Banking Crisis: The impact of the failure of the Icelandic banks*, we concluded that:

> Our Banking Crisis inquiry, and specifically the problem of the failure of the Icelandic banks, has raised issues surrounding the cross-border regulation of financial institutions. Considerable taxpayer support has been required to provide rapid compensation to onshore UK depositors in Icelandic banks that 'passported' into the UK. This area of European law requires further consideration, and we will return to this topic ...[8]

9. In its recent response to our Report on *Banking Crisis: regulation and supervision,*[9] the FSA made some interesting comments about the way in which regulation of cross border banks, and in particular, European cross border banks, might evolve:

> 53. However much we improve confidence in supervisory processes across Europe, it can never wholly exclude the risks created to host country depositors by cross-border operation, nor the dangers to the system in the case of large banks headquartered in smaller countries which might lack the resources to rescue them. As we said in The Turner Review, we have to recognise that in addressing it there are only two intellectually pure ways forward. One would be to accept full supervisory integration, underpinned by one pre-funded European deposit insurance scheme and by a shared European fiscal responsibility for a rescue if ever required and appropriate. The other would be to remove branch passporting rights, with host countries free to demand separate subsidarisation of potentially stand alone national operations. Each of these intellectually pure answers would achieve an alignment of responsibility with power, but in two radically different ways.
>
> 54. The one certainty in the debate has been that there is no support for either of these intellectually pure solutions. Instead we will continue to seek to combine a single market with a still national approach to ultimate fiscal responsibility, and with supervision delivered by national authorities which are close to the operations of the regulated firms. That compromise can be made to work and deliver stability; however, it will also require greater coordination and cooperation through the ESAs, and ensuring that legitimate host country national interests are recognised by making it clear that host states have the right to receive all prudential information about entire groups.

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7 FSA website, www.fsa.gov.uk

8 Treasury Committee, Fifth Report of Session 2008-09, *Banking Crisis: The impact of the failure of the Icelandic banks*, HC 402, para 112

9 Treasury Committee, Fourteenth Report of Session 2008-09, *Banking Crisis: regulation and supervision*, HC 767

> 55. This approach will also require allowing host states to take proportionate and measured steps to restrict the activities of branches in response to clear prudential weakness not adequately addressed by the firm or its home supervisor ahead of any. We appreciate that there may be concern that powers of this sort could be abused and used for commercial or protectionist measures (rather than for market confidence or consumer protection reasons), and we are willing to debate how best to reduce the possibility of abuse, for example through the ability of home states to appeal to the ESA.[10]

The FSA's comments give a context in which to examine the current proposals. Since the solution is a compromise between the single market and national fiscal responsibility do they adequately safeguard the legitimate interests of Member States? Do they recognise the need to allow host countries to take actions where necessary? Is the balance right?

10 Response from the Financial Services Authority (FSA) to the Treasury Select Committee report on *Banking Crisis: Regulation and Supervision*

# 2 The context and evolution of the current proposals

## Responses to the crisis

10. The European Union is not the only forum for cross-border financial policy making. The financial crisis has prompted a plethora of activity as policy makers recognise the importance of international cooperation to ensure financial stability in an environment where the degree of global financial integration has risen sharply. In particular, the G20 has played a leading role in efforts to strengthen the international regulatory architecture and shape the future international regulatory agenda. At the London G20 summit in April 2009, the G20 agreed to take a number of steps to reform the international financial system, including:

- To establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain and the European Commission;
- That the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- To reshape regulatory systems so that authorities are able to identify and take account of macro–prudential risks;
- To establish supervisory colleges for cross–border firms and to implement the FSF principles for cross–border crisis management;
- To extend regulation and oversight to all systemically important financial institutions, instruments and markets.[11]

11. We asked witnesses about the interaction of efforts to reform the financial system at global level with the proposals put forward to reform the regulation of financial markets at EU level and also whether there would be any impact on the competitiveness of the EU financial services industry. Mr André Villeneuve, Chairman of the City of London's EU Advisory Group, welcomed those parts of the Commission's proposals that would lead to a "level playing field with a single rule book and single application of these rules", but cautioned that it would be problematic if "the EU forges ahead of international standard setters such as the FSB or the Basel Committee on Banking Supervision".[12] Mr Villeneuve went on to stress the importance of ensuring policy makers within the EU adopting a global perspective—not just an EU–centric perspective—taking into account what other important financial centres such as Switzerland and the USA were thinking and doing.[13] Simon Gleeson, Financial Regulatory Partner at Clifford Chance LLP, told us that

11 G20 Leaders Statement: The global plan for recovery and reform, London, 2 April 2009

12 Q 57

13 Q 72

cooperation at a global level was especially important for countries such as the UK with a large financial services sector, explaining that from the UK perspective controlling a crisis meant being able to deal closely with large financial and economic powers outside the EU, such as the USA and potentially China and India. By contrast, he explained that a focus on regulation at the EU level was much more important for some other EU states because "cross–border deposit–taking was much more common across continental Europe than it is between continental Europe and the UK".[14]

12. The British Bankers' Association (BBA) told us there was a need to ensure the proposals were:

> consistent with the, inter alia, regulatory agenda being set by the G-20 and the Basel Committee on Banking Supervision. This is particularly the case in relation to the conduct of supervisory colleges at the EU and global level.[15]

Mr Villeneuve also gave a powerful caution against the EU rushing ahead of other financial centres or global discussions with its proposals in this area:

> It is extremely important that anything which is done in the EU is synchronised with what the USA in particular does but also Asian countries do. If we front–run the US, that is very bad for the EU and for London.[16]

## The de Larosière proposals

13. In October 2008, the President of the European Commission—Jose Manuel Barroso—asked Jacques de Larosière, a former Managing Director of the IMF, to chair a High–Level Group examining the future of European financial regulation and supervision. The Group, which published its findings in February 2009, proposed a new framework for European supervision, including steps to reduce risk and improve risk management, reduce pro-cyclicality (ie the tendency of banks' behaviour to increase the effects of the financial cycle) and build crisis management procedures.

14. The Report also advocated upgrading macro–prudential supervision at the EU level, specifically through the establishment of a European Systemic Risk Council (ESRC), chaired by the President of the ECB, with its membership including, amongst others, representatives from the National Central Banks of all 27 Member States. Where necessary, the ESRC would issue risk–warnings and recommendations to policymakers and supervisors and the Report called for mechanisms to be put in place to ensure that identified risks were properly addressed at national level.

15. The Report also called for a greater role for the EU in micro–prudential supervision, primarily through the establishment of a European System of Financial Supervision (ESFS). This would entail the creation of three new 'authorities': a European Banking Authority, a European Insurance Authority and a European Securities Authority. The

14 Q 84

15 Ev 34

16 Q 115

'authorities' would coordinate the application of supervisory standards, ensure strong cooperation between national supervisors and would have binding powers over national supervisors on supervisory standards. Day–to–day supervision would, however, remain the responsibility of national regulators. De Larosière also called for the establishment of a college of supervisors for the supervision of cross–border banks within the EU.[17]

## Subsequent developments

16. In May 2009 the Commission presented a Communication which proposed establishing a European system of financial supervisors, and a European systemic risk board. These proposals were considered at ECOFIN and at the European Council over the course of the next few months. At its meeting on 18-19 June 2009 the European Council endorsed the proposals, welcoming:

> the Commission's intention to bring forward, by early autumn 2009 at the latest, the legislative proposals to put in place the new framework for EU supervision, fully respecting the balance of competences and financial responsibility and taking full account of the Council conclusions of 9 June 2009.[18]

The ECOFIN conclusions of 9 June 2009, to which this refers, are appended to this Report. They do indeed conclude that the Commission should proceed with drawing up legislation to put in place a new supervisory framework, but also emphasise there should be strong links between the new systems and the Council, stress Member States' fiscal responsibilities, and make it clear that some states had substantial reservations about conferring too much power on the new bodies.

17. The Commission held consultations on both the de Larosière report and on its own communication. There was broad agreement for a better regulatory and supervisory structure, but consultees expressed concerns about some of the details involved, and about the timescale for producing legislation with such far reaching effects.[19]

### *Outline of the current proposals*

18. The current proposals are twofold. There will be a European Systemic Risk Board (ESRB), equivalent to de Larosière's European Systemic Risk Council, which will have the Governors of Member States' central banks as voting members, and will also be attended by national regulators, a Commission representative and representatives of the three supervisory authorities (see below). The secretariat of the ESRB will be provided by the European Central Bank. The ESRB will not have any direct power; its task will be to monitor systemic risk and issue warnings to appropriate authorities. There is provision for these warnings to be made public, if the ESRB wishes.

17 The High–Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, 25 February 2009

18 Council of the European Union, Brussels European Council, 18/19 June 2009, Presidency Conclusions, 11225/2/09, para 21

19 http://ec.europa.eu/internal_market/consultations/2009/fin_supervision_may_en.htm

19. There will also be a system of European Supervisory Authorities (ESAs). As recommended by de Larosière, there will be three of these: a European Banking Authority, a European Insurance and Occupational Pensions Authority, and a European Securities and Markets Authority. They will be composed of the national supervisory authorities, with representation from the Commission, other ESAs and the ESRB. Their tasks will be to develop technical standards and guidelines; to supervise cross-border institutions directly where provided for in community legislation;[20] to settle disagreements between the regulatory and supervisory bodies of different nations; and to ensure consistent application of community rules; in general their task will be to promote a coherent and consistent regulatory environment across Europe. Each Authority will be part of the European System of Financial Supervisors, which will include Member States' supervisors, a Joint Committee of the three ESAs and, in some cases, the Commission.[21]

20. Although the ESRB has no formal powers, it is important to note that there will be extensive links between the ESRB and the European Supervisory Authorities. If its analyses convince the ESAs that action is needed, they can use their powers to take action. It is also worth bearing in mind that, as the FSA pointed out in its recent discussion paper, these matters are not solely technical ones. As the FSA says, there are trade-offs "between the benefits of reduced financial instability and the costs which may arise from a higher price, or reduced volume, of credit extension and maturity transformation". The paper goes on to say:

> Part of this trade-off is about social choice—consumers might value stability sufficiently highly to prefer prudential standards set above the level implied by an attempt at pure maximisation of long term output—and the FSA recognises that this raises issues for other decision-makers such as central government.[22]

In discussing current EU proposals, it is important for us to be confident that the balance between the different supervisory and regulatory authorities and between these authorities and Member States is appropriate.

## Other changes to EU law

21. There are a number of directives which will need to be changed. Some of these changes will be to recognise the new supervisory structure. Some will give the European Union greater powers. In June 2009 ECOFIN appeared to conclude that the process of identifying amendments to the relevant directives should take place in parallel with agreeing the bodies which would enforce that legislation:

20 Currently it is expected that they will regulate credit rating agencies

21 13652/09, 13653/09, 13654/09

22 Financial Services Authority, *Turner Review Conference Discussion Paper, A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact*, Discussion paper 09/4, October 2009, para 4.16

> The framework for the exercise of the above competences should be specified exhaustively and in precise detail in the relevant sectoral legislation in parallel with the creation of the ESAs. [23]

In fact, the first tranche of proposed legal changes has only just been published; more is awaited. Mr Gleeson was critical of this:

> It seems to me that what this draft seeks to do is complete the establishment of these bodies and then to leave it to themselves to decide what they will do and how. My personal view is that that determination should be made by the Member States and not by the bodies once they have been established, and I think that that discussion should precede the finalisation of these documents.[24]

22. **We consider it would be imprudent to establish a new supervisory system before there was clarity about the laws which that system would monitor.**

## Justification for the proposals

23. Most of our witnesses considered that, in principle, the new bodies could improve both macro and micro prudential supervision. Stuart Popham, Senior Partner at Clifford Chance, welcomed the principle underpinning the European Commission's proposals on reforming financial regulation at EU level, telling us that if the proposals achieved "a uniformly enhanced supervisory regime over financial systems throughout the EU that can only be good for everybody".[25] Dr Kern Alexander told us:

> UK financial regulation is already undergoing major changes that will lead to increased costs for the financial sector. More intrusive regulation, if applied effectively, can result in more effective control of the social costs of financial risk-taking. The Commission's adoption of the Regulations creating the ESRB and ESFS have this objective in mind: the monitoring and control of systemic risks in the European financial system. It is for this reason that UK policymakers should support these important regulatory initiatives.[26]

The Investment Managers' Association welcomed the prospect of a harmonised, and possibly less intrusive, rulebook:

> A harmonised regulatory and supervisory framework is therefore of great importance to the industry: it is very expensive and inefficient to operate under 27 different sets of rules, or 27 differing interpretations of the EU rules. In too many areas of financial markets regulation, and especially supervision, national differences remain strong beneath a veneer of European harmonisation. There has also been too

23 Council Conclusions on Strengthening EU financial Supervision, 2948th ECONOMIC & FINANCIAL AFFAIRS, 9 June 2009, (see Appendix).

24 Q 104

25 Q 58

26 Ev 46

> much gold-plating of the EU rules, with national regulators adding requirements on top of the EU requirements as they see fit.[27]

24. Lord Myners also welcomed the proposals, saying:

> I think the European Systemic Risk Board in particular will play an important role in co-ordinating the views of central banks across Europe and bring together the major central banks in developing a consensus around areas where there is a risk of systemic danger. I think the ESAs will play a very important role in raising standards, in developing a single rule book and in securing more effective enforcement.[28]

He told us "the representations made to us by the City of London and other major banking institutions in the UK are that they have a very strong preference for a single rule book which covers the totality of the European Union."[29]

25. However, as we explore in this Report, there is a great deal of unease at some of the detail of what is proposed: although there is agreement about the direction of travel, many witnesses feared the process was being rushed.

## What next?

26. There is frequently a very lengthy period between the Commission issuing draft legislation and the European Council agreeing to it. During this time, the proposals are examined intensively in working groups, and may be substantially redrafted as a result of negotiations between Member States. In evidence, several of our witnesses cited the redrafting of the directive on Alternative Investment Fund Managers (which is not directly related to the measures in question) as an example of a case where unacceptable proposals were being redrawn as a result of wide consultation.[30] That Directive was originally published on 29 April 2009, and it is reported that the Council of Ministers will not come to a decision on it until late 2010.[31]

27. The BBA told us:

> we urge the Council and European Parliament not to rush through an agreement, but to take their due time to examine the proposals in detail. It is important to get these questions right rather than achieving a quick result that does not meet the objectives set out. We also note that care is needed to ensure that consistency is achieved between the EU supervisory package, the many proposed changes to the EU regulatory framework (for instance through changes to the Capital Requirements

27 Ev 39

28 Q 124

29 Q 139

30 Q 143

31 *Financial Times*, 23 October 2009, p 1, ECB warns rush to hedge fund regulation would prompt exodus

Directive), and also, from a UK perspective, the potential re-shaping of the domestic regulatory architecture.[32]

28. **Reaching agreement on such an ambitious package as presented here in less than three months is extremely ambitious: we believe it is overambitious. Even though there is a consensus that reform of the European financial institutions is needed, that reform needs to be carefully established: it is better to be right than quick. In the time available to us we have not yet been able to examine the documents fully; but even on a cursory examination there are serious problems with the Commission's proposals which need to be dealt with before the Council agrees to the draft legislation and it moves on to the next stage.**

## Use of Article 95 of the EC Treaty

29. Later in this report we look at the ESRB and the ESAs in more detail, but some witnesses suggested there were fundamental problems with the basis on which these proposals were to be decided. The first criterion for any new system should be that it is on a sound legal base. If it is not, there is a real danger that a successful challenge could result in legislation simply being declared invalid. The Commission proposes that the Regulations to establish the ESRB and each of the ESAs should be made under Article 95 EC, which deals with matters pertaining to the single market. However, the justification for this is not self evident:

> (5) The financial and economic crisis has created real and serious risks to the stability of the internal market. Restoring and maintaining a stable and reliable financial system is an absolute prerequisite to preserving trust and coherence in the internal market, hence to preserve and improve the conditions for the establishment of a fully integrated and functioning internal market in the field of financial services. Moreover, deeper and more integrated financial markets offer better opportunities for financing and risk diversification, and thus help to improve the capacity of the economies to absorb shocks.[33]

30. When we asked witnesses their views on this conflation of the single market, and financial stability, Barbara Ridpath, the Chief Executive of the International Centre for Financial Regulation expressed some scepticism:

> Financial integration and financial stability are sadly not mutually reinforcing. They are important. Financial integration and capital flows are critical but unfortunately financial integration permits more rapid transmission of crisis and contagion, not less, and what you need is effective circuit breakers to contain that contagion.[34]

31. It is obviously desirable to avoid financial shocks, insofar as possible, but it is not clear that these proposals are inherently related to the single market, rather than the orderly

32 Ev 34

33 13652/09, 13653/09, 13654/09, Recital 5

34 Q 56

functioning of the financial system. When Lord Myners told us "The current proposals use Article 95 to set up the three ESAs and the ESRB and Article 105 to ask the ECB to provide the secretariat for the ESRB", we detected a certain reservation in his attitude.[35] The European Union has a residual power to take action (which would include establishing bodies such as the ESRB and the ESAs), but that is under Article 308. Decisions made under Article 95 depend on qualified majority voting; Article 308 allows Member States to exercise a veto.

32. **There are doubts about whether Article 95 EC is the appropriate treaty basis in this case, although we acknowledge that some previous challenges to its use as the basis for European legislation have been unsuccessful. However, Article 95 is not the only treaty basis under which a new financial supervisory system could be established: several European Union agencies have been established under Article 308 EC. The objective of better, more consistent financial supervision across the entire European Economic Area is desirable. It will not be well served if the legal basis for that regulation is unsound. We recommend that the Government should do its utmost to ensure that the system put forward is not vulnerable to legal challenge.**

35 Q 144

# 3 The European Systemic Risk Board

33. The European Commission has proposed the establishment of a European Systemic Risk Board (ESRB), which will have responsibility for macro–prudential oversight within the European Union. The ESRB will have three core objectives:

- Developing a European macro–prudential perspective to address the problem of fragmented individual risk analysis at national level;
- Enhancing the effectiveness of early warning mechanisms by improving the interaction between micro– and macro–prudential analysis; and
- Allowing for risk assessments to be translated into action by the relevant authorities.

34. The ESRB will be composed of (a) a General Board; (b) a Steering Committee and (c) a Secretariat, with the General Board to act as the decision making body of the ESRB. The membership of the General Board (with voting rights) is to consist of:

- Governors of the 27 national central banks;
- The President and the vice-President of the European Central Bank;
- A Member of the European Commission; and
- The Chairpersons of the three European Supervisory Authorities.

Additionally, one high level representative per Member State of the competent national supervisory authorities and the President of the Economic and Financial Committee will also sit on the General Board, but will not have voting rights. This means that the General Board will consist of 61 members, 33 of whom will have voting rights. Decisions of the General Board are to be adopted by simple majority. The Chair and Vice Chair of the General Board will be elected to serve a five year term. They will be elected by those voting members of the General Board who are also members of the General Council of the ECB.[36]

35. The Commission has said that, given the size of the General Board, a Steering Committee will assist the decision-making process of the General Board with the task of preparing the meetings of the General Board, reviewing documents to be discussed and monitoring the progress of the ESRB's on-going work. The Steering Committee is to comprise the Chair and Vice-Chair of the General Board, the Chairpersons of the three ESAs, the President of the EFC, a member of the Commission and five members of the General Board who are also members of the General Council of the European Central Bank (ECB) and who are elected on the same basis as the Chair and Vice Chair.[37]

36 13648/09, Article 5. The General Council of the ECB consists of central bankers from all 27 Members of the EU.

37 *Ibid.*, Article 11

### *Composition and size of the ESRB General Board*

36. There was concern that the voting members of the General Board of the ESRB will be dominated by central bankers; central bankers will also have a majority, although a less pronounced one, on the Steering Committee. Daniel Gros, Director of the Centre for European Policy Studies, considered that this was sensible, on the grounds that central bankers tended to be more cautious and risk averse than regulators, who could become too close to the industries they regulated, although he would support the addition of some independent experts to the ESRB Steering Committee.[38] However, other witnesses expressed concern that a committee of central bankers might be focused on the last crisis, while other financial services, such as insurance, might be the source of future shocks. Professor Buiter was one of the most vociferous critics of the composition of the ESRB, describing the institution as being "ludicrously lopsided in favour of central banks in general and of the ECB in particular". He argued that it was difficult to see why central banks should be given such a prominent role given that "the ECB, the Eurosystem NCBs and the rest of the EU NCBs have not exactly covered themselves with glory in the area of macro–prudential supervision and regulation during the past decade". Professor Buiter also brought home some of the tensions that could emerge, for example, from whether central banks in control of the ESRB would be "conflicted" in the use of policy instruments by the "potentially clashing demands of price stability and financial stability".[39]

37. We have already noted that micro and macro prudential regulation can in principle involve trade-offs in which central government policymakers have a legitimate interest. Professor Buiter considered that the proposed membership of the ESRB did not take those legitimate interests appropriately into account. More specifically, he argued that macro–prudential regulation and supervision involved guiding and directing the "actions of, and even determining the fate of, large systemically important financial institutions"—and that "such institutional life–or–death decisions involve property rights and other important distributional and wider political dimensions, as well as technical issues". As a result, he argued that such decisions:

> Are inherently political, even party-political. The independence of the ECB in the area of price stability could be undermined if it were to play a dominant role in macro–prudential regulation and supervision.[40]

38. Professor Buiter also stressed that the composition of the ESRB ignored the central fiscal dimension of financial stability.[41] This point was also raised by both Dr Danielsson and Dr Alexander, who expressed strong concern at the lack of treasury or finance ministry representation on the General Board. Dr Danielsson felt that the balance on the Board was "broadly wrong" because an important lesson to emerge from the current crisis was the importance of national treasuries, given the role of the taxpayer in providing resources to stabilise the banking sector. As a result, he argued that, at the very least, "the Treasuries of

38 Telephone conversation and email correspondence with Committee staff.

39 Ev 23

40 *Ibid.*

41 *Ibid.*

the most important countries should be represented" on the ESRB.[42] Dr Alexander agreed that "in crisis management it is essential to have the Treasury involved" because it was the Treasury that would "raise the money to fund any type of bail-out".[43] Professor Portes, however, described adding the Treasuries of all Member States to the Systemic Risk Board as "absurd", and considered would further increase the size of an already unwieldy board. Professor Portes considered it impossible that membership of the Board could be restricted to the Treasuries of the most important Member States.[44]

39. The large size of the General Board was mentioned by a number of other people we spoke with, with a general consensus that a body consisting of up to 61 members would be too large to make effective decisions. Professor Buiter described the total membership as "enough to run a small football league" and concluded that with such a large membership this was not "a body that will do anything useful".[45] Mr Villeneuve summed up the views of many, telling us that he could not imagine during a financial crisis "having 100 people in the room, albeit desirable participants, and getting a reasonable quick answer".[46]

### *Non-eurozone representation*

40. A number of witnesses felt that the size of the General Board meant that the Steering Committee would play the key role. Dr Alexander believed that the Steering Committee could provide an "effective executive function in discharging the responsibilities of the Systemic Risk Board" and that there potential for the Steering Committee to grow into "a more effective and cohesive decision-making unit".[47]

41. The potential importance of the Steering Committee as the key decision-making body within the ESRB has fuelled concerns about whether non-eurozone Member States would have adequate (or indeed any representation) on such a body. We were told that the importance of non-eurozone representation on the Steering Committee lay in the fact that a significant proportion of European Union and European Economic Area financial services are provided from outside the eurozone; not simply from the UK, but also from countries such as Sweden.

42. There are no provisions in the proposals as currently drafted to ensure that non-eurozone Member States are represented on the Steering Committee. As discussed previously, the Steering Committee will consist of the Chair and Vice-Chair of the General Board, the Chairpersons of the three ESAs, the President of the EFC, a Commission representative and five members of the General Board who are also members of the General Council of the ECB. Although it is perfectly possible, and even likely, that the Governor of a non-eurozone central bank might fill one of the elected places, there is nothing in the Regulation to require this.

42 Q 12

43 *Ibid.*

44 *Ibid.*

45 Ev 23

46 Q 95

47 Q 15

43. Those we consulted considered it was inconceivable that non-eurozone countries and, in particular, the UK would not play a full role on the Steering Committee. For example, André Villeneuve said that:

> Given the importance of the City of London, it would be crazy not to have the Bank of England playing a very strong role in that Committee … I cannot imagine that they would want the Bank of England not to play a strong role.[48]

Lord Myners told us that the UK Government was making representations that the Steering Committee must contain individuals from non-eurozone countries, and indeed his letter to the European Scrutiny Committee of 26 October, indicates that he had succeeded.[49] However, he did not believe such a requirement should be included within the regulations, arguing that it was not "appropriate" to do so.[50] We are surprised at this since the ECOFIN conclusions of 9 June suggested that in addition to the Chairman and Vice Chairman there should be two central bank representatives on the Steering Committee "(one from a euro area Member State and one from a non-euro area Member State)".[51]

44. The Commission has proposed that the Secretariat to the ESRB should come from the European Central Bank. It is envisaged that the Secretariat will receive instructions directly from the Chair of the General Board. Some concern was expressed that a Secretariat drawn from ECB staff could be overly focussed on economic and finance developments within eurozone countries to the neglect of elsewhere within the eurozone.[52]

45. **Currently it may appear politically inconceivable that non-eurozone countries will not secure adequate representation in the ESRB and, in particular, the Steering Committee. However, these regulations will set the institutional framework of the ESRB for years, perhaps decades. Political understandings may change. It is a matter of concern that there is nothing in the proposals as currently drafted which requires the interests of non-eurozone countries to be represented on the Steering Committee, which will guide to deliberations of the ESRB. As long as major European financial centres lie outside the eurozone it would be appropriate for the Regulation to provide that they are adequately represented on the ESRB Steering Committee.**

46. **There are a number of further questions about the membership and size of the ESRB and its committees, ranging from whether the dominance of central banks is appropriate, to whether the interests of non-eurozone countries should be explicitly safeguarded. We do not come to a firm opinion on the substance of these matters, but we are convinced they need a longer consideration than provided by the current timetable.**

48 Q 73

49 http://www.parliament.uk/parliamentary_committees/european_scrutiny.cfm

50 Q 149

51 See Appendix

52 Private briefing to staff.

### *Powers of the ESRB*

47. The Regulations state that the ESRB will not have any binding powers to impose measures on Member States or national authorities. Instead, Commission proposals describe the ESRB as a "reputational body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority".[53] To this end, the ESRB is tasked with providing "high quality assessment of the macro–prudential situation" and may "issue risk warnings and recommendations which identify potential imbalances in the financial system which are likely to increase systemic risks and the appropriate remedial action". Such warnings and recommendations can be general or specific in nature and could be addressed to the Community as a whole or to one or more member States, or to one or more of the ESAs, or to one or more national supervisory authorities.[54]

48. Whilst ESRB recommendations are not legally binding they cannot simply be ignored. Addressees of recommendations must state whether they agree with the recommendation or not. If they agree, the addressees are expected to communicate what action they are taking whilst if they disagree and choose not to act, the reasons for inaction must be properly explained.[55]

49. The inability of the ESRB to issue binding recommendations has led some to describe it as a 'toothless' 'talking shop', which will duplicate activities already undertaken by other national and international institutions. Professor Portes explained that prior to the present crisis, institutions such as the IMF and the Bank for International Settlements had been "warning of the dangers that were being created in the system" and that these institutions already undertook the role of providing early warnings.[56] Ms Ridpath agreed, telling us that the Bank of England's Financial Stability Reports were very good at identifying risks within the system, but that the problem was the lack of subsequent action. She expressed concern as to whether people would listen to warnings issued by the ESRB and said the key problem was the ESRB's lack of "tools" to take action to follow up on early warnings it had issued.[57] Stuart Popham, however, was more optimistic, telling us that "if these organisations [the ESRB] are staffed with people who are well respected across the financial communities they will be heard", though he considered that if they were staffed by "unknown bureaucrats" whom "nobody recognises they will not be heard".[58]

50. Others, however, believed the establishment of the ESRB—even without binding powers—represented an important addition to the financial stability framework within the European Union. Dr Alexander argued that the ESRB was an "incremental improvement"

53 13648/09, Explanatory Memorandum, 6.2

54 13648/09, Article 16

55 13648/09, Article 16

56 Q 29

57 Qq 96-97

58 Q 97

and that linking macro–prudential oversight with micro–prudential supervision was an important step.[59]

### How powerful is the ESRB?

51. Despite the fact the ESRB itself has no legally binding powers to ensure that its warnings and recommendations are acted upon, its links with the ESAs may mean that it has more direct influence than at first appears to be the case. As noted previously, Article 16 of the Commission's proposals establishing the ESRB states that the ESRB can make warnings and recommendations to the three ESAs who would under the proposals as they currently stand have the powers to act or compel national regulators to take appropriate action. Lord Myners acknowledged that the ESRB "does not have the powers itself. It has the capacity to influence those who do have the powers".[60] That influence may be considerable. The Chairpersons of the three ESAs constitute members of the ESRB Steering Committee—indeed they make a quarter of its membership—they may be likely to support ESRB recommendations for action.

52. The ESRB will also have the ability to influence the Commission, most notably if it recommends declaration of an emergency (see paras 72–76 below), and Member States' governments. Professor Portes was robust in dealing with the suggestion that a public recommendation from the ESRB could damage market confidence:

> If you go down that road you might as well try to muzzle Robert Peston, that is to say, yes, anybody saying an institution is in trouble, better do something about it, can provoke a run; that is absolutely standard. There is not much you can do about that. There is no authority here, however. Dr Alexander is perfectly right—there is no authority here and I do not know who is maintaining that there might be some hidden authority. If so, it is hidden awfully well. I just do not believe this. It is quite explicit that there shall be no such powers.[61]

It is true that the ESRB will have influence rather than power, and that its effectiveness will, in the long run, depend on its credibility, but it would be a mistake to underestimate the extent of the ESRB's potential to trigger real effects.

59 Q 31

60 Q 155

61 Q 34

# 4 The European Supervisory Authorities

53. In our view, the greatest problems arise from the proposals for the three European Supervisory Authorities (ESAs). The Explanatory Memorandum from the European Commission sets out the way they will function:

> The Board of Supervisors is the main decision making body of the ESAs and will among other things be responsible for the adoption of the draft technical standards, opinions, recommendations, and decisions described in section 6.2 of this explanatory memorandum. The Board of Supervisors shall be composed of:
>
> – the Chairperson of the respective ESA, who will chair the meetings of the Board, but shall be non-voting;
>
> – the Head of the relevant national supervisory authority in each Member State;
>
> – one representative of the Commission who shall be non-voting;
>
> – one representative of the ESRB who shall be non-voting;
>
> – one representative of each of the other two European Supervisory Authorities who shall be non-voting, and
>
> – where relevant, the Board may decide to admit observers.[62]

54. The 27 national supervisors will dominate the Boards of Supervisors. There will be less external influence than there is in the ESRB where central bankers (with voting rights) are to be accompanied by national supervisors (without such rights). There are likely to be many matters of detail which need more consideration. Some of these are explored in the written evidence published with this Report; here, we focus on the legal powers to be given to these authorities, the fiscal reserve, which should prevent the authorities from taking actions which would impinge on Member States' fiscal responsibilities and their action in emergency situations.

## ESAs: delegated powers

55. The European Council conclusions of 19-19 June 2009 noted "the European Council agrees that the European System of Financial Supervisors should have binding and proportionate decision-making powers in respect of whether supervisors are meeting their requirements under a single rule book and relevant Community law and in the case of disagreement between the home and host state supervisors, including within colleges of supervisors. ESAs should also have supervisory powers for credit rating agencies." [63]

62 13652/09, 6.3.1,13653/09, 6.3.1, 13654/09, 6.3.1

63 COUNCIL OF THE EUROPEAN UNION, Brussels, 10 July 2009, 11225/2/09, REV 2CO_CL http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/108622.pdf

56. Professor Portes welcomed the fact that the ESAs would have powers to take decisions, saying that the new system would allow final settlement of disputes:

> and to see it extended in this way at least there is a possibility that you might get some outcomes. As it stands, if you go to a meeting of CESR[64] or CEBS[65] you say, "What am I here for? What are they here for?" That is one of the few of my new promising possibilities here, that you might actually get these fiercely independent—jealous of their authority—agencies to come to some common principles that would actually be imposed on the recalcitrant ones.[66]

In contrast, Dr Danielsson was concerned about the potential use of such powers:

> I do worry about the fact that they do already say, as I said earlier, that the Authority may be able to take actions that require national supervisors to apply requirements effectively. They are already assuming some power even at this early stage.[67]

57. Many witnesses shared Dr Danielsson's concerns; in particular, the ESAs' apparent powers to direct individual institutions were criticised.[68] The European Commission defended this power:

> Direct decisions are a last resort option, which each national authority can avoid by simply complying with the recommendation or decision addressed to it in the first place, and which will thus hopefully never be needed in practice. This will provide assurance that the law will be applied in the same way in other Member States Furthermore, decisions will be taken by national supervisors themselves in the Board of the ESAs, therefore they will only do so when it is absolutely necessary - taking into account the concerns of their peers. Furthermore, actions taken under these provisions do not represent 'day to day' supervision. They are by definition exceptional circumstances.[69]

The Commission drew attention to a similar power given to the Commission in the European Competition network, which had not been used but had been highly efficient in improving cooperation between authorities.[70]

58. In fact, it is far from clear whether the Supervisory Authorities will have powers to make binding decisions. Stuart Popham and Simon Gleeson of Clifford Chase LLP raised doubts in their memorandum:

> The ESAs will not have power to take decisions or to make rules—European law requires that these powers are reserved to the Commission, and we believe that this

64 Existing Committee on European Securities Regulation

65 Existing Committee on European Banking Regulation

66 Q 21

67 Q 23

68 Ev 34, Ev 36

69 Ev 41

70 *Ibid.*

> could not be changed without an amendment to the EU treaty. The attempt to give the committees the power to review the issue of whether individual national regulators have correctly implemented EU legislation appears to be an attempt to stretch this point. This is done by
>
> (a) Conferring on the ESA the power to issue "guidelines" and imposing on competent authorities an obligation "to make every effort to comply with those guidelines", and
>
> (b) Conferring on the ESAs a power to take action against a particular national regulator where it has not "correctly" applied "the relevant EU legislation." By issuing a recommendation to that national regulator to change its policy.
>
> The power to "settle disagreements" is also troublesome. What is proposed here is that where there is a dispute between national regulators as to practices, an ESA should have the right to make a determination as to which is right and, if its decision is not accepted by a national regulator, to adopt an individual decision addressed to an individual market participant. This comes very close to giving the ESA the power to regulate individual market participants directly. Thus from the day that the regulation is enacted it will potentially have significance for individual firms.
>
> There is nothing inherently objectionable from a practical perspective in these policies. However the legislative approach which has been adopted runs the risk of creating significant legal uncertainty during the hiatus period after these entities have been created but before they have determined their powers, practices and procedures.[71]

When we asked for further explanation in our evidence session, Simon Gleeson at first appeared confident that, as a matter of law, the Supervisory Authorities would not in fact be able to exercise its discretionary powers:

> there is a power to address requests directly to individual financial institutions but what the request is to do is to comply with the directives that already exist, so in theory, although the power exists, it is a power to do nothing more than to say, "Comply with the law as it already stands". It is mysterious as to what use that power could be.[72]

His colleague, Stuart Popham, enlarged on the problems:

> It is clear as a matter of European law that the European Court of Justice will not permit the Commission, or, for that matter, the Council, to grant to any subsidiary body the power to exercise discretion. Consequently, what this draft does is attempt to draft around that to create a regulator without the power to make rules or the

71 Ev 27

72 Q 65

> power to exercise discretion. This is why we find it so hard to work out what a regulator thus constituted can actually do.[73]

59. However, as the initial memorandum suggested, the Regulations certainly appear to endow the authorities with decision-making powers. Article 9 (Consistent application of Community rules) provides that an authority can investigate incorrect application of community law. It can decide on the correct interpretation, and "address to the competent authority concerned a recommendation setting out the action necessary to comply with Community law". If the authority does not comply the matter goes to the Commission, which may require the [national] authority to take action. Nonetheless, it is clear that where it considers it necessary, Authorities can direct individual institutions to take to refrain from particular actions:

> Without prejudice to the powers of the Commission under Article 226 of the Treaty, where a competent authority does not comply with the decision referred to in paragraph 4 of this Article within the period of time specified therein, and where it is necessary to remedy in a timely manner the non compliance by the competent authority in order to maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system, the Authority may, where the relevant requirements of the legislation referred to in Article 1(2) are directly applicable to financial institutions, adopt an individual decision addressed to a financial institution requiring the necessary action to comply with its obligations under Community law including the cessation of any practice.[74]

60. Similarly, Article 10 (Action in emergency situations) gives the Authority, once an emergency situation has been declared, to "adopt individual decisions requiring competent authorities to take the necessary action in accordance with the legislation referred to in Article 1(2) to address any risks that may jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system by ensuring that financial institutions and competent authorities satisfy the requirements laid down in that legislation" and if the national authority in question does not comply

> the Authority may, where the relevant requirements laid down in the legislation referred to in Article 1(2) are directly applicable to financial institutions, adopt an individual decision addressed to a financial institution requiring the necessary action to comply with its obligations under that legislation, including the cessation of any practice.[75]

61. Article 11 allows an Authority to settle disagreements between national authorities, and if conciliation does not work "the Authority may take a decision requiring them to take specific action or to refrain from action in order to settle the matter, in compliance with Community law."[76]

73 Q 69

74 13652/09, Article 9, 13653/09, Article 9, 13654/09, Article 9

75 *Ibid.*, Article 10, para 3

76 *Ibid.*, Article 11, para 4

62. Mr Gleeson's initial assessment was that these powers were limited by the requirement that they had to be in compliance with Community law. However, when we asked what would happen if the powers were exercised, we were told:

> **Mr Gleeson:** If that is the case then the risk is that the European Court of Justice will take the view that these directives are effectively ultra vires to the treaty.
>
> **Mr Popham:** And at that stage they will cease to exist.[77]

In Mr Gleeson's view, it would require a treaty revision to confer binding powers from the European Supervisory Authorities; the proposals put forward were so novel that they existed "on the outer edge of the possible".[78]

63. The Government is alive to these problems. Lord Myners told us:

> we must have a robust framework which clearly complies with law and legal principle and reduces the areas at risk of challenge. As currently proposed, we can see that it could give rise to numerous ways in which a judgment by any ESA could be challenged and that clearly would not be consistent with the overall objective of the structure that Jacques de Larosière has encouraged us to address here.[79]

64. **The evidence we have received makes it clear there is a fundamental difficulty in the powers to draft regulations purportedly given to the European Supervisory Authorities. They may be unexercisable, in which case the proposal seems little advance on the current system. Alternatively, they push at the limits of what is permitted under European Union legislation without a treaty amendment, and there must be a real danger that, if challenged, the regulations as a whole will be quashed. Lord Myners told the European Scrutiny Committee that the roles proposed for the new bodies "are legally complex and there is significant case law on how European agencies should operate. We need to ensure that the bodies' powers do not have too wide discretion or undermine the roles of the courts."[80] ECOFIN would be wrong to agree draft regulations before this matter was clarified.**

## *Takeovers*

65. The Takeover Panel expressed its concern that the Regulation to establish the European Securities and Markets Authority could "fundamentally undermine the proven system of takeover regulation in the UK".[81] The Panel is concerned that the power to issue guidelines could undermine the flexibility given to national regulators and the proposals could disrupt effective takeover regulation. **The Takeover Panel's concerns about the effects of the proposals on takeover regulation should be scrutinised carefully.**

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77 Q 111

78 Q 113

79 Q 147

80 Letter to the European Scrutiny Committee, 26 October 2009, http://www.parliament.uk/parliamentary_committees/european_scrutiny.cfm

81 Ev 51

### *Voting in the ESAs*

66. Decisions made by a Supervisory Authority's Board about the setting of draft technical standards and guidelines and decisions in relation to the articles on financial provisions will be taken by qualified majority voting. Mr Villeneuve considered that:

> the system of qualified majority voting should also recognise the size and importance of financial services relative to each country's GDP, and certainly from a practitioner point of view I would like to see that.[82]

In contrast, Professor Portes considered that "Qualified majority voting could not, in practice and in political practice, override a really strong objection, backed up by substance, from the most important financial centre in the European Union."[83] But our second panel of witnesses told us that the FSA had in fact already been overridden in the existing Committees, and that it could happen again.[84]

67. While under existing rules all decisions in the current supervisory committees are made by QMV,[85] under the new proposals decisions on matters under Article 9 (Consistent application of Community rules), Article 10 (Action in emergency situations) and Article 11 (Settlement of disagreement between national supervisory authorities) such as the settlement of disputes, will be taken by simple majority.

68. The Impact Assessment explains the voting structure as follows:

> Concerning voting procedures, the baseline is QMV as applied in the level 3 committees. For the purposes of adopting proposals for binding technical standards, it would be coherent with the adoption procedures for other binding acts, to retain the use of QMV, since the role of European Supervisory Authority voting members in that case would be similar to that of Member States. The use of QMV excludes the chairman having a vote, as he will not be representative of a Member State; however there remains the question of whether the chairman should vote when simple majority voting applies.
>
> For other matters, simple majority voting would be appropriate, as QMV is more suitable when the Authorities are adopting draft horizontal legislative and quasi-legislative acts which will apply in the whole of the EU, including guidelines and recommendations, and also for budgetary and financial matters. On the other hand, for individual acts of the Authorities concerning specific cases a simple majority voting procedure would be adequate, as such acts are implementation of Community legislation already adopted.[86]

82 Q 77

83 Q 22

84 Q 117

85 13657/09 1234: Commission Impact Assessment of the Proposals, 6.1.2.2

86 13657/09, 6.1.2.2

We did not have the opportunity to explore this with Lord Myners. In our view, the Explanatory Memorandum is over simplistic in saying that decisions on specific cases are implementation of legislation already adopted and, as such, should be decided under simple majority. The ESAs will only need to vote on matters such as this when there is deep disagreement between national supervisory authorities, or between supervisory authorities and the ESA itself; in such cases we think it is likely that the interpretation of legislation already adopted will be far from clear.

69. Lord Myners told us:

> It is not envisaged that the ESAs will have any power to direct or regulate individual entities. They will work to achieve a common rule book and common standards of supervision and enforcement but not to overreach national regulatory bodies when it comes to individual organisations. [87]

70. But, as currently drafted, the regulations would allow an ESA to direct an individual institution. As we have already explored, Articles 9, 10 and 11 each provide that the Authority can "adopt an individual decision addressed to a financial institution requiring the necessary action to comply with its obligations under Community law including the cessation of any practice." Lord Myners stated:

> the position of the Government … is that the European supervisory authorities should have certain powers over the rating agencies but not over directly regulated entities within nations.[88]

We agree with the Government position. The ESAs should communicate with national regulatory bodies, not with individual institutions within Member States.

71. Ultimately, the extent to which voting powers matter depends on the legal responsibilities of the institution. **If it proves legally possible to give the European Supervisory Authorities delegated powers, then there should be wholesale re-examination of the proposals to ensure they respect the principles of subsidiarity. In particular, we believe it is wrong for an ESA to be given power to override the decision of a national regulator and to direct individual institutions. Further, any decision-making process retained which does not recognise the vastly different scales of regulated activity in Member States is inappropriate. The main purpose of the ESAs should be information exchange, best practice development and facilitating market-wide financial services activity by acting as a means of discussing regulatory variances.**

## Emergency powers

72. Article 10 covers action in emergency situations. The process envisaged is that the Commission should declare an emergency "In the case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the

87 Q 156

88 Q 128

stability of the whole or part of the financial system in the Community". It can do this on its own initiative, or at the request of a supervisory authority, the Council or the ESRB.

73. Once an emergency has been declared "the Authority may adopt individual decisions requiring competent authorities to take the necessary action in accordance with the legislation referred to in Article 1(2) to address any risks that may jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system by ensuring that financial institutions and competent authorities satisfy the requirements laid down in that legislation."[89] As we have noted, if the competent authorities do not take that action, the Supervisory Authority has a reserve power to direct individual institutions.

74. There was some criticism about the lack of definition of what an emergency might be,[90] although Professor Portes defended this, on the grounds that "It is very hard to specify in advance what the nature of any given crisis is going to be. All crises are somewhat different."[91] Dr Alexander and Dr Danielsson agreed, on the grounds that "there is always a danger, if you specify regular structure for monitoring your reaction of whatever is related to the past that creates inflexibility in dealing with the future."[92] We agree that it is impossible to give an advance definition of the form the next crisis will take, but we believe that it might be possible to produce some more clarity about what the "adverse circumstances" which would trigger an emergency declaration might be. However, we are more concerned by the consequences that could potentially flow from a unilateral declaration of emergency by the Commission.

75. Many of our witnesses were unsure of the benefit of involving the Supervisory Authorities in emergency situations. Stuart Popham and Simon Gleeson said:

> The proposed role for the ESAs in 'crisis management' is very unclear. The current proposal is that the commission will 'declare an emergency', and thereafter the relevant ESR will have the power to require national regulators to take action in accordance with relevant EU legislation (subject to a fiscal safeguard). However there is no public material which indicates how an ESA would use this power, in what cases or to what end. It is also unclear whether and to what extent such a 'declaration of emergency' could inhibit national regulators from taking immediate steps. Given that it is very unlikely that an ESA will be able to act promptly or without notice (this is not a criticism, but a necessary consequence of the EU-wide composition of these agencies), there is a real risk that this power may have a chilling effect on national regulators considering action to address financial turbulence.[93]

Lord Myners agreed that, as currently drafted, the prospect of the compulsory involvement of the European Supervisory Authorities "could have a chilling consequence, and that is

89 13652/09, Article 10, 13653/09, Article 10, 13654/09, Article 10

90 Q 99

91 Q 24

92 Q 27

93 Ev 27

why we need to ensure that that is not where we end up in terms of the responsibilities of the Commission."[94]

76. **One of the most troubling aspects of the draft Regulations is the wide discretion they allow the Commission to determine when an emergency should be declared, without the involvement of Council. Lord Myners told us: "I cannot conceive of a situation in which the Commission would be the natural body to be able to formulate a view on what constituted an emergency situation." We agree.**

## Fiscal Safeguard

77. Supervisory decisions may have fiscal consequences. Indeed, in March this year, Charles Goodhart and Dirk Schoenmaker argued

> … a European financial supervisory structure needs a European fiscal arrangement. Without such a European fiscal arrangement, crisis management has to remain at national levels, leading to financial protectionism. Moreover, leaving expensive crisis management at national level, while shifting supervisory powers towards the supra-national level, could be described as national taxation without proper control and national representation…[95]

78. The FSA has also noted that the intellectually pure approach to supervision would be to ensure fiscal responsibility and supervisory authority were placed at the same level, whether national or supranational. The European Council in June recognized the link between supervision and fiscal consequences, but clearly decided that the solution was to that ensure supervisory decisions should not have fiscal implications. Its support for the new supervisory bodies has one qualification: "Recognizing the potential or contingent liabilities that may be involved for Member States, the European Council stresses that decisions taken by the European Supervisory Authorities should not impinge in any way on the fiscal responsibilities of Member States."[96]

79. The current regulations each contain a fiscal safeguard clause, stipulating that "The Authority shall ensure that no decision adopted under Articles 10 or 11 impinges in any way on the fiscal responsibilities of Member States." It also provides a mechanism for Member States to appeal to the European Council if they consider this provision has been breached.

80. However, the Impact Assessment for the proposals suggest that the Commission is less than wholehearted about the safeguard, and has devised a mechanism which, in its own words, "should lead to it being used sparingly and only in cases where genuinely important fiscal issues are at stake". We think it sufficiently revealing to quote at length:

94 Q 181

95 "The de Larosière Report: two down, two to go", Charles Goodhart and Dirk Schoenmaker, ft.com economistsforum, 13 March 2009

96 Brussels European Council, 18/19 June 2009, 11225/2/09, para 20.

> It is however of high importance to ensure that the safeguard clause is not abused by Member States. Its use should therefore be limited to well-justified cases so as to avoid disrupting the effective functioning of the Authorities. To achieve this, clarity about how and when the process can be triggered, and how it is judged, is essential. ...
>
> A broad prohibition of taking any decisions which might, directly or indirectly, impinge on the fiscal responsibilities of Member States, could considerably reduce the scope of activity of the Authorities. On the other hand, a general and imprecise statement that European Supervisory Authorities must not impinge on the fiscal responsibilities of Member States, without specific remedial mechanisms in place in case they do so, would not protect the fiscal interests of Member States. Neither of these options would therefore be effective in achieving the desired objective.
>
> Only a safeguard procedure could provide a rigorous framework for determining if a decision by a European Supervisory Authority could genuinely impinge on the fiscal responsibilities of Member States, with an ultimate decision being taken by the Council under QMV. Such a procedure might be considered to be burdensome, but the very length of the procedure should lead to it being used sparingly and only in cases where genuinely important fiscal issues are at stake.[97]

81. The fiscal safeguard only applies to actions taken under Article 10 (Action in emergency situations) and Article 11 (Settlement of disagreements between national supervisory authorities) of the regulations. But actions taken under other Articles could also have fiscal consequences. For example, Article 21 sets out the actions a Supervisory Authority should take in response to recommendations from the ESRB:

> 4. On receipt of a warning or recommendation from the ESRB addressed to the Authority, it shall convene a meeting of the Board of Supervisors without delay and assess the implications of such a warning or recommendation for the fulfilment of its tasks.
>
> It shall decide, by the relevant decision-making procedure, on the actions to be taken in accordance with the powers conferred upon it by this Regulation for addressing the issues identified in the warnings and recommendations.
>
> If the Authority does not act further to a recommendation, it shall explain to the ESRB its reasons for not doing so.
>
> 5. On receipt of a warning or recommendation from the ESRB addressed to a competent national supervisory authority, the Authority shall, where relevant, use the powers conferred upon it by this Regulation to ensure a timely follow-up.
>
> Where the addressee intends not to follow the recommendation of the ESRB, it shall inform and discuss with the Board of Supervisors its reasons for not acting.

97 13657/09: Commission Impact Assessment of the Proposals, 6.1.1.7. Safeguard for fiscal responsibilities of Member States

> The competent authority shall take due account of the views of the Board of Supervisors when informing the ESRB in accordance with Article [17] of Regulation (EC) no …/…[ESRB].
>
> 6. In discharging its tasks set out in this regulation, the Authority shall take the utmost account of the warnings and recommendations of the ESRB.[98]

82. The Commission considered that it was appropriate to restrict the safeguard clause to Articles 10 and 11 because "these are the relevant areas to this article given they will relate to specific decisions which could interfere with fiscal responsibilities". The Commission claims that other ESA powers are in areas where fiscal responsibilities are not at stake, but then goes on to say:

> While the Authorities may look at fiscal implications when developing the standards, once a standard is endorsed it is a general rule applicable throughout the Community. According to long-standing case law, Member States cannot invoke financial grounds for not complying with Community law, as this would undermine the equal application of the law across the Community. Incorrect application of Community law cannot be justified by financial grounds. The remainder of the Authorities decisions are either not directed to individual supervisors, or non-binding, therefore by definition cannot have fiscal implications.[99]

The Commission also considered that giving the fiscal safeguard the status of a Member State veto would mean "the effectiveness of the ESA's binding decisions and the independence of the Authorities from political influence would ultimately be at risk". But as we have explored elsewhere in this Report, there is an interplay between technical supervisory matters and real political choices. We do not necessarily agree with the Commission that "it would be problematic if a Member State could simply invoke the safeguard clause and suspend the ESAs decision forever, or if the Member State concerned could block a vote against it".[100]

83. Dr Alexander agreed that the extent of the reserve needed to be qualified.[101] It may be a supervisory authority would be unable to take action which impinged on fiscal responsibility under Article 21, but this is not beyond doubt. Nor is it beyond doubt that decisions taken under other articles of the Regulations could not affect Member States' fiscal responsibilities. Lord Myners considered "The Commission has gone rather further than the Council contemplated." [102] The Government objects to the safeguard as currently drafted, and Mr Pickford told us "We think the safeguard should extend over all of the Regulation rather than part." [103]

98 See 13652/09, 13653/09 and 13654/09

99 Ev 41

100 *Ibid.*

101 Qq 53–54

102 Q 134

103 Q 132

84. **We recommend that the Regulations provide proper protection for the fiscal position of Member States. It needs to be far stronger than the current provisions. We do not understand why the Commission has departed so far from the ECOFIN conclusions of June this year and we insist that UK Ministers do not agree to any of these provisions until the fiscal sovereignty of the UK is protected by a veto.**

# 5 Conclusion

85. In the time available to us, we have been able to deal with only a few of the issues raised by the proposed regulations; there may be a great deal more to unravel. The written evidence we have received raises further questions and we believe that even on such a hasty examination, the proposals, as currently drafted, raise serious questions that should have proper discussion. We do not believe the time allowed is sufficient. Nor do we accept that there is a real need to hurry this package through without adequate scrutiny and negotiation.

86. In the course of our inquiries, staff heard suggestions that on 2 December ECOFIN would only deal with the ESRB proposals and the regulations establishing the ESAs would be deferred. However HM Treasury told us that the intention was to agree all the regulations at the December meeting.[104] As we have seen, even though the ESRB has no legal personality, its recommendations may be implemented through the ESAs; we consider the regulations are properly part of the same package, and should be considered together.

87. If the Commission is correct that Article 95 EC is the proper legal basis for the regulations establishing the ESRB and the ESAs, they will be decided by qualified majority voting. However, the regulation providing that the European Central Bank will provide the secretariat of the ESRB requires unanimity, as it is put forward under Article 105 EC. In evidence, Lord Myners told us he would be prepared to use the veto if necessary to protect the United Kingdom's fiscal position.[105] We consider that it would be appropriate to use the veto in any of the following circumstances:

- if attempts are made to split the package so that the ESRB proposals are considered separately from those establishing the ESAs;
- if the legal uncertainties around the Regulations are not satisfactorily resolved;
- if the fiscal safeguard is not extended to cover all ESA decisions;
- if the Commission retains power to declare an emergency unilaterally.

It may be that these issues can be resolved by 2 December. However, we think it highly unlikely this will happen, and we urge Member States to consider a more measured and realistic timetable for reform of the European supervisory and regulatory system.

88. Dr Alexander told us the haste with which EU proposals were being considered was because of "the economic necessity of adopting institutional and legal reforms while the political climate supports the necessity of regulatory and supervisory reforms".[106] We agree that reform is necessary. The fact that we believe that the proposed European Legislation

[104] Q183

[105] Q176

[106] Ev 46

requires more careful consideration should not be taken as a signal to the financial world that 'business as usual' is acceptable. The events of the past years have shown clearly that failures in the financial system have profound consequences in the wider economy. We strongly support attempts to ensure that European financial regulation and supervision is best structured to ensure financial stability. The system that Europe is putting in place will need to last for decades; it is more important to get it right than to put it in place fast. It is also of paramount importance that the European Union does not act in advance of, or out of concert with, other international fora, and does not introduce supervisory or regulatory measures which could be regarded as protectionist.

# Conclusions and recommendations

## Changes to EU Law

1. We consider it would be imprudent to establish a new supervisory system before there was clarity about the laws which that system would monitor. (Paragraph 22)

2. Reaching agreement on such an ambitious package as presented here in less than three months is extremely ambitious: we believe it is overambitious. Even though there is a consensus that reform of the European financial institutions is needed, that reform needs to be carefully established: it is better to be right than quick. In the time available to us we have not yet been able to examine the documents fully; but even on a cursory examination there are serious problems with the Commission's proposals which need to be dealt with before the Council agrees to the draft legislation and it moves on to the next stage. (Paragraph 28)

## Use of Article 95 of the EC Treaty

3. There are doubts about whether Article 95 EC is the appropriate treaty basis in this case, although we acknowledge that some previous challenges to its use as the basis for European legislation have been unsuccessful. However, Article 95 is not the only treaty basis under which a new financial supervisory system could be established: several European Union agencies have been established under Article 308 EC. The objective of better, more consistent financial supervision across the entire European Economic Area is desirable. It will not be well served if the legal basis for that regulation is unsound. We recommend that the Government should do its utmost to ensure that the system put forward is not vulnerable to legal challenge. (Paragraph 32)

## ESRB: Non-eurozone representation

4. Currently it may appear politically inconceivable that non-eurozone countries will not secure adequate representation in the ESRB and, in particular, the Steering Committee. However, these regulations will set the institutional framework of the ESRB for years, perhaps decades. Political understandings may change. It is a matter of concern that there is nothing in the proposals as currently drafted which requires the interests of non-eurozone countries to be represented on the Steering Committee, which will guide to deliberations of the ESRB. As long as major European financial centres lie outside the eurozone it would be appropriate for the Regulation to provide that they are adequately represented on the ESRB Steering Committee. (Paragraph 45)

5. There are a number of further questions about the membership and size of the ESRB and its committees, ranging from whether the dominance of central banks is appropriate, to whether the interests of non-eurozone countries should be explicitly safeguarded. We do not come to a firm opinion on the substance of these matters, but we are convinced they need a longer consideration than provided by the current timetable. (Paragraph 46)

## ESAs: delegated powers

**6.** The evidence we have received makes it clear there is a fundamental difficulty in the powers to draft regulations purportedly given to the European Supervisory Authorities. They may be unexercisable, in which case the proposal seems little advance on the current system. Alternatively, they push at the limits of what is permitted under European Union legislation without a treaty amendment, and there must be a real danger that, if challenged, the regulations as a whole will be quashed. Lord Myners told the European Scrutiny Committee that the roles proposed for the new bodies are legally complex and there is significant case law on how European agencies should operate. We need to ensure that the bodies' powers do not have too wide discretion or undermine the roles of the courts." ECOFIN would be wrong to agree draft regulations before this matter was clarified. (Paragraph 64)

**7.** The Takeover Panel's concerns about the effects of the proposals on takeover regulation should be scrutinised carefully. (Paragraph 65)

**8.** If it proves legally possible to give the European Supervisory Authorities delegated powers, then there should be wholesale re-examination of the proposals to ensure they respect the principles of subsidiarity. In particular, we believe it is wrong for an ESA to be given power to override the decision of a national regulator and to direct individual institutions. Further, any decision-making process retained which does not recognise the vastly different scales of regulated activity in Member States is inappropriate. The main purpose of the ESAs should be information exchange, best practice development and facilitating market-wide financial services activity by acting as a means of discussing regulatory variances. (Paragraph 71)

## Emergency powers

**9.** One of the most troubling aspects of the draft Regulations is the wide discretion they allow the Commission to determine when an emergency should be declared, without the involvement of Council. Lord Myners told us: "I cannot conceive of a situation in which the Commission would be the natural body to be able to formulate a view on what constituted an emergency situation." We agree. (Paragraph 76)

## Fiscal safeguard

**10.** We recommend that the Regulations provide proper protection for the fiscal position of Member States. It needs to be far stronger than the current provisions. We do not understand why the Commission has departed so far from the ECOFIN conclusions of June this year and we insist that UK Ministers do not agree to any of these provisions until the fiscal sovereignty of the UK is protected by a veto. (Paragraph 84)

# Appendix: Extract from ECOFIN conclusions, 9 June 2009

On the establishment of a European System of Financial Supervisors:

7. Following up from the roadmaps agreed on 14 May 2008,[107] the Council AGREES that the recommendation by the de Larosière Group to establish a European System of Financial Supervisors (ESFS) should be carried out and completed without delay. To this end, the Council invites the Commission and all other relevant parties to take the appropriate initiatives, which i.a. should aim at:

– Upgrading the quality of supervision and strengthening national supervisors by setting in motion a process leading to far stronger and consistent powers for supervisory and sanctioning regimes in the Member States, aligning supervisors' competences, mandates and powers to the fullest extent possible;

Strengthening oversight of cross-border groups by completing the setting-up of supervisory colleges for all major cross-border financial firms in the EU by the end of 2009;

– Moving towards the realisation of a single rulebook, with a core set of EU-wide rules and standards directly applicable to all financial institutions active in the Single Market, so that key differences in national legislations are identified and removed.

8. The Council RECOMMENDS that a European System of Financial Supervisors be established as an operational European network with shared and mutually reinforcing responsibilities. At EU level, the current EU Committees of supervisors (CEBS, CEIOPS and CESR) should be transformed into European Supervisory Authorities (ESAs) with a legal personality under Community law: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). National supervisors should remain responsible for day-to-day supervision of individual firms. A steering committee of the ESAs should be set up to reinforce mutual understanding, cooperation and consistent supervisory approaches, in particular in relation to financial conglomerates, and to coordinate the necessary information sharing between the ESAs and the ESRB.

9. The Council STRESSES that, without prejudice to the application of Community law and recognising the potential or contingent liabilities that may be involved for Member States, decisions under the mechanisms set out below should not impinge on the fiscal responsibilities of the Member States. The framework for the exercise of the above competences should be specified exhaustively and in precise detail in the relevant sectoral legislation in parallel with the creation of the ESAs. Moreover, any binding decision by the European Supervisory Authorities or the Commission must be subject to review by the

107 See doc. 9056/08 EF 27 ECOFIN 158 & COR1

Community Courts. Subject to these considerations, the Council FINDS that the ESAs should be entrusted with the following tasks and powers:

i. Ensuring that a single set of harmonised rules and consistent supervisory practices is applied by national supervisors, by two means:

a) Developing binding harmonised technical standards in the areas to be specified in Community legislation. Such standards should apply from a fixed date, provided the Commission endorses them;

b) Drawing up non-binding standards, recommendations and interpretative guidelines, which the competent national authorities would apply in taking individual decisions.

ii. Ensuring a common supervisory culture and consistent supervisory practices:

The ESAs should be responsible for building a common European supervisory culture and consistent supervisory practices, and ensuring uniform procedures and consistent approaches across groups by i.a.:

– issuing guidelines on practical supervisory issues with a view to a common framework for supervision;

– coordinating ex ante the supervisory analyses of the risks and behaviours of financial institutions and groups;

– conducting peer analysis across financial institutions and groups, to ensure consistency in supervisory outcomes;

– participating as appropriate as observers in supervisory colleges, so as to identify and address possible inconsistencies;

– collecting practical issues emerging in the implementation of Community legislation and ESAs' standards and ensuring that there is consistent interpretation across the Single Market;

– developing on a much broader scale common training for supervisors and staff exchanges.

– without prejudice to the role of European institutions, the ESAs should be given a certain role as regards international issues, including technical arrangements and preparation of equivalence assessments.

iii. Collecting micro-prudential information:

The ESAs should be responsible for the definition, collection and aggregation of all relevant micro-prudential information emanating from national supervisors.

To this end, a central European database should be established and managed by the ESAs. The information would be available for the relevant authorities in colleges of supervisors and should be shared with the ESRB subject to specific confidentiality agreements. The Commission is invited to examine the extent to which existing sectora1 1egislation would need to be amended.

iv. Ensuring consistent application of EU rules, in cases to be further clearly specified in Community legislation such as:

a) Manifest breach of EU law or ESAs' standards:

Without prejudice to the procedures laid down by the EC Treaty to ensure compliance with Community law, a mechanism should also be put in place to address non compliance by a national supervisory authority which is considered to be manifestly diverging from the existing Community legislation and ESAs' binding harmonised technical standards.

This mechanism should allow the ESAs to address recommendations to the relevant national supervisor. In the event that the non-compliance with Community law would persist, the Commission could require the national supervisory authority to either take specific action or to refrain from action in order to restore compliance with Community law.

b) Disagreement between national supervisors or within a college of supervisors:

In the case of diverging opinions between national supervisory authorities over the proper enforcement of EU legislation, or in the case of diverging opinions between national supervisory authorities within a college of supervisors, the ESAs should facilitate a dialogue and assist the supervisors in reaching a joint agreement. An overwhelming majority supports that, if, after a phase of conciliation, national supervisors or colleges of supervisors have not been able to reach an agreement, the ESAs should, through a binding decision, settle the matter. The other Member States do not agree with this approach, since they believe that it could impinge on Member States' fiscal responsibilities. The Commission's forthcoming legal text should define precisely the scope and modalities of this mechanism and ensure that such powers should not impinge in any way on Member States' fiscal responsibilities.

v. Using full supervisory powers for some specific pan-European entities:

An overwhelming majority supports the Commission to propose EU legislation giving the ESAs the responsibility for the authorisation and supervision of certain specific entities with pan-European reach, e.g. credit rating agencies and EU central counterparty clearing houses. The other Member States do not agree with this approach, since they believe that it could impinge on Member States' fiscal responsibilities. All Member States agree that these full supervisory powers should not be extended to financial conglomerates, banks, insurance companies or investment firms and other financial institutions whose failure could result in fiscal burden for Member States. The Commission's forthcoming legal text should define precisely the scope and modalities of this mechanism and ensure that such powers would not impinge in any way on Member States' fiscal responsibilities.

vi. Ensuring a coordinated response in crisis situations:

The Commission is invited to explore how ESAs could play a strong coordinating role amongst supervisors in crisis situations, i.a. by facilitating cooperation and exchange of information between the competent authorities and acting as mediator when needed, while fully respecting the responsibilities of national authorities in preserving financial stability of and in crisis management in relation to potential fiscal consequences and fully respecting central banks' responsibilities, in particular with regard to the provision of emergency liquidity assistance. An overwhelming majority supports the Commission to examine whether the ESAs should have, in crisis situations, the power to adopt specific emergency decisions, as e.g. short selling restrictions, which should be defined in Community legislation. The other Member States do not agree with this approach, since they believe that it could impinge on Member States' fiscal responsibilities. The Commission's forthcoming examination should address precisely the scope and modalities of this mechanism and ensure that such power should not impinge in any way on Member States' fiscal responsibilities.

10. The Council STRESSES that ensuring the ESAs independence vis-a-vis national authorities other than supervisors and vis-a-vis the European Institutions will be crucial. The ESAs should have their own autonomous budget, commensurate with their responsibilities, and be governed by rules which ensure their efficiency, independence, and accountability towards the Council, the Parliament and the Commission. Building on the existing EU Committees of supervisors, they should comprise high-level representatives of all the relevant national supervisory authorities. Their precise management, organisation and funding should be specified in appropriate Community legislation. Furthermore, they should have full-time Chairs.

11. The Council SUPPORTS the acceleration of work to build a comprehensive cross-border framework to strengthen the EU financial crisis management systems and calls on the Commission to bring forward appropriate proposals in this regard, including on guarantee schemes and winding up of financial institutions and the EFC to pursue its activities in this area based on experiences from the MoU on Cross-border financial stability.

NEXT STEPS:

The Council CONSIDERS that the Commission should present all necessary proposals by early autumn 2009 at the latest. The draft legislation for the setting up of the ESRB and the ESAs should specify i.a. the above-mentioned organisational and structural aspects, and the mechanism through which the ERSB and the ESAs should work in close cooperation. The aim should be to have the new European Financial Supervision system, comprising both macro-prudential and microprudential components, fully in place in the course of 2010. The present conclusions do not prejudge the choice of legal basis for the establishment of the financial supervisory structures, which can only be determined in the light of the content and objectives of the legislative proposals. The Council AGREES that the functioning of the ESRB and ESFS should be reviewed no later than three years after their establishment.

Suggested composition of the ESRB and its steering committee:

The Steering Committee shall be composed as follows:

– the ESRB chair and vice-chair;

– two additional Central bank members of the ESRB (one from a euro area Member State and one from a non-euro area Member State);

– the Chairs of the three new European Supervisory Authorities;

– the Commission member;

– the EFC President.

The General Board shall be composed as follows:

– Chair: President of the ECB (or alternatively a Governor (elected by ESRB members);

– Vice-Chair: elected by ESRB members;

– Governors of the 27 national Central banks;

– President of the ECB (if the latter is the chairperson of the ESRB, the ECB would be represented by its Vice-President);

– Chairs of the three European Supervisory Authorities;

– Member of the European Commission;

– EFC President*;

– A representative of the national supervisory authorities*, accompanying the Central bank Governor in a 1 +1 formula. The Steering committee shall also be chaired by the ESRB Chair, or the vice-Chair in the absence of the ESRB Chair.

* Members without voting right

*Source: The Council of the European Union, Press Release, 2948th Council Meeting, Economic and Financial Affairs, Luxembourg, 9 June 2009, 10737/09 (Presse 168)*

# Formal Minutes

## Wednesday 11 November 2009

Members present:

John McFall, in the Chair

| | |
|---|---|
| Nick Ainger | Mr James Plaskitt |
| Mr Colin Breed | John Thurso |
| Mr Michael Fallon | Mr Mark Todd |
| Sally Keeble | Sir Peter Viggers |
| Mr Andrew Love | |

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**The Committee's Opinion on proposals for European financial supervision**

Draft Report (*The Committee's Opinion on proposals for European financial supervision*), proposed by the Chairman, brought up and read.

*Ordered,* that the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 88 read and agreed to.

Summary read and agreed to.

A Paper was appended to the Report as Appendix 1.

*Resolved*, That the Report be the Sixteenth Report from the Committee to the House.

Written evidence was ordered to be reported to the House for printing with the Report, together with written evidence reported and ordered to be published on 3 November.

*Ordered*, that embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134 (Select commmittee (reports)).

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[Adjourned till Tuesday 24 November at 9.30 am.

# Witnesses


## Tuesday 3 November 2009

*Page*

**Dr Kern Alexander**, Senior Research Fellow, Centre for Financial Analysis & Policy, Cambridge University, **Dr Jon Danielsson**, Department of Finance, London School of Economics and **Professor Richard Portes** CBE, Professor of Finance, London Business School — Ev 1

**Mr Stuart Popham**, Senior Partner, and **Mr Simon Gleeson**, Financial Regulatory Partner, Clifford Chance LLP, **Ms Barbara Ridpath**, Chief Executive of the International Centre for Financial Regulation and **Mr André Villeneuve**, Chairman, City of London's EU Advisory Group — Ev 8

## Wednesday 4 November 2009

**Lord Myners,** CBE, Financial Services Secretary, HM Treasury, **Mr Gary Roberts,** Head of Financial Services Strategy, and **Mr Stephen Pickford,** Managing Director, International and Europe, HM Treasury — Ev 15


# List of written evidence


| | | |
|---|---|---|
| 1 | Professor Willem H Buiter | Ev 23 |
| 2 | Clifford Chance LLP | Ev 27 |
| 3 | Dr Kern Alexander | Ev 29, 46 |
| 4 | British Bankers' Association | Ev 34 |
| 5 | Association of British Insurers | Ev 36 |
| 6 | Investment Management Association | Ev 39 |
| 7 | European Commission | Ev 41 |
| 8 | The Takeover Panel | Ev 51 |


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# Reports from the Treasury Committee during the current Parliament

## Session 2008–09

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| First Report | Administration and expenditure of the Chancellor's departments, 2007–08 | HC 35 |
| Second Report | Pre-Budget Report 2008 | HC 27 |
| Third Report | Work of the Committee, 2007-08 | HC 173 |
| Fourth Report | Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability | HC 34-I |
| Fifth Report | Banking Crisis: The impact of the failure of the Icelandic banks | HC 402 |
| Sixth Report | Appointment of Paul Fisher to the Monetary Policy Committee of the Bank of England | HC 419 |
| Seventh Report | Banking Crisis: dealing with the failure of the UK banks | HC 416 |
| Eighth Report | Budget 2009 | HC 438 |
| Ninth Report | Banking Crisis: reforming corporate governance and pay in the City | HC 519 |
| Tenth Report | Appointment of Professor David Miles to the Monetary Policy Committee of the Bank of England | HC 765 |
| Eleventh Report | Appointment of Dr Adam Posen to the Monetary Policy Committee | HC 764 |
| Twelfth Report | Banking Crisis: International Dimensions | HC 615 |
| Thirteenth Report | Evaluating the efficiency programme | HC 520 |
| Fourteenth Report | Banking Crisis: Regulation and supervision | HC 767 |
| Fifteenth Report | Mortgage arrears and access to mortgage finance | HC 766 |

## Session 2007–08

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| First Report | The 2007 Comprehensive Spending Review | HC 55 |
| Second Report | The 2007 Pre-Budget Report | HC 54 |
| Third Report | The Work of the Committee in 2007 | HC 230 |
| Fourth Report | Climate change and the Stern Review: the implications for Treasury policy | HC 231 |
| Fifth Report | The run on the Rock | HC 56 |
| Sixth Report | Financial Stability and Transparency | HC 371 |
| Seventh Report | Administration and expenditure of the Chancellor's departments, 2006–07 | HC 57 |
| Eighth Report | Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee | HC 454 |
| Ninth Report | The 2008 Budget | HC 430 |
| Tenth Report | Re-appointment of Mervyn King as the Governor of the Bank of England | HC 524 |
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# Oral evidence

## Taken before the Treasury Committee

## on Tuesday 3 November 2009

Members present

John McFall, in the Chair

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| Nick Ainger | Mr James Plaskitt |
| Mr Colin Breed | John Thurso |
| Mr Michael Fallon | Mr Mark Todd |
| Ms Sally Keeble | Mr Andrew Tyrie |
| Mr Andrew Love | Sir Peter Viggers |

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*Witnesses:* **Dr Kern Alexander**, Senior Research Fellow, Centre for Financial Analysis and Policy, Cambridge University, **Dr Jon Danielsson**, Department of Finance, London School of Economics and **Professor Richard Portes CBE**, Professor of Finance, London Business School, gave evidence.

**Q1 Chairman:** Welcome to this inquiry into proposals for the European macro and micro prudential financial regulation; it is an issue which we wish to treat with urgency given the decision that will be made on 2 December, so it is important that we get our report before Parliament to try and inform as much as possible this decision-making. Would you introduce yourselves, please, for the record.
***Dr Alexander:*** I am Kern Alexander from the University of Cambridge.
***Dr Danielsson:*** Jon Danielsson from the London School of Economics.

**Q2 Chairman:** I will introduce the absent Professor Richard Portes from the LBS. He is on his way, running, I am told, so we look forward to him coming in breathless! The Swedish Presidency is eager to get the proposals for the Systemic Risk Board in the sectoral supervisors agreed by ECOFIN on 2 December and the European Council shortly thereafter. I presume that is not a reasonable timetable for you, is it? We are all agreed on that.
***Dr Alexander:*** It is quick but the proposals have been debated since last spring when the de Larosière Committee made the report, and there was a consultation by the Commission issued in March and then another one again in May; but this is a fairly condensed time period, yes.

**Q3 Chairman:** The Directive on Alternative Investment Fund Managers has been extensively redrafted, and the European Central Bank has recently expressed concerns that the proposals would put the industry at a significant competitive disadvantage. Should the Presidency learn from this and give European governments more time to consider these proposals?
***Dr Alexander:*** I think that now is the time to consider these issues. We have been in the midst of a financial crisis and the political urgency of re-regulating the financial markets is a current issue. I think the debate should be held now.

**Q4 Chairman:** If these proposals had been in place do you think Europe would have dealt with the financial crisis better?
***Dr Danielsson:*** I would say, no. The problem really with these proposals is expressed in the first place where it says there has been a weakness in the existing macro prudential oversight, and then immediately followed by saying "given its expertise in macro prudential issues, the European Central Bank can make a significant contribution". I did see a contradiction in those two statements. The problem is, prior to the crisis we had very little understanding of what constitutes systemic risk in general, and most central banks viewed systemic risk as a secondary activity. Now coming into the crisis of course systemic risk has become hugely important, but we have an understanding of what systemic risk is but we do not really know what it means; we do not really know how to measure it; we do not really know how to react to it properly. This is why I think these proposals, on the one hand, they are important; we do need a mechanism for understanding systemic risk; however, the specific proposals I do think they are misguided.

**Q5 Chairman:** As we know, the proposals for monitoring risk and better supervision have been negotiated through the G20, and other forums. Is it sensible for the EU to take the lead in these proposals without more knowledge of what is happening at a global level?
***Dr Danielsson:*** I would say, no. The problem really is—and I think this is where I find this proposal problematic—there is a very heavy emphasis on the structure of the institutions. It is a long discussion on who sits on the various boards, the 62 members; the sub-board, the 32 members; the various sub-boards; the President and the Vice President of the European Central Bank are apparently in charge. Of course, I would like to see an explicit mention of the governor of the most important central bank outside the Euro area being a vice president of this board; that is the Bank of England. I think that he should be there. However, it is very light on what the board is supposed to be doing. The emphasis is all on the

institutional structure and not on activities. I think that reflects our uncertainty in what the target means. They are explicit in one place where they start talking about compensation. They make the statement that compensation contributed to the crisis, which of course is agreed by most people; but then they start going into the issue of, we might need to regulate compensation in some sense; and that is not something people universally agree with. Then they continue by saying, "In extreme cases if such policies are the result of a non-application of legal requirements, the Authority may be able to take action to require national supervisors to apply the requirements effectively". They are talking about compensation here. They appear to assume the board will have a power to force the national authority to take action on compensation. While we do not understand systemic risk properly, and on the list of systemic risk issues, compensation is the highest.
**Chairman:** We are finishing at ten minutes to eleven and we have a lot of questions. We are grateful to you for coming, so we will try and be crisp all round.

**Q6 Mr Fallon:** Dr Alexander, could you just clarify the extent to which these draft Directives have moved further from the original agreement in June at European Council, which I understand from paragraph 20 was to give the European supervisors decision-making power as to whether national supervisors were meeting their requirements under a single rulebook, and power also to resolve disagreements. Is it not now the case that what is being proposed gives these European authorities direct supervisory power over individual institutions?
***Dr Alexander:*** It primarily gives the ESAs, the Supervisory Authorities, oversight in coordinating and promoting more consistency of supervisory practices over Member State supervisors. There are certain situations—if a supervisor does not comply with a determination made by the Supervisory Authority—that the Supervisory Authority can then apply a rule or a decision directly to the financial institution, and then it can be appealed to a board of appeal. That was not fleshed out in the earlier proposal, yes, you are correct. That is part of making this institutional proposal more detailed.

**Q7 Mr Fallon:** I understand that, but I just want to be absolutely clear: the European Banking Authority, for example, can under certain circumstances directly regulate an individual bank?
***Dr Alexander:*** When you say "regulate", I am thinking in terms of supervision like oversight. They can make decisions, determinations, and issue an order in a crisis situation; but they do not exercise the ongoing regulatory oversight of the banks; that is still done by the Member State supervisors.

**Q8 Mr Fallon:** It is left to the Commission, as I understand it, to determine what an emergency situation should be under the draft legislation. Why is that?
***Dr Alexander:*** The Commission has an EU surveillance authority that has been delegated to it by the Council of Ministers under Article 99 of the Treaty of Rome; so the Commission is involved in surveillance. It has the power to do that already.

**Q9 Mr Fallon:** The Commission therefore under certain circumstances could declare an emergency situation against the wishes of a Member State?
***Dr Alexander:*** Yes, it could.

**Q10 Mr Fallon:** What has happened to the safeguard in the European Council communiqué of June that none of this should impinge in any way on the fiscal responsibilities of Member States? How is that safeguard promulgated in the drafts?
***Dr Alexander:*** This safeguard is there. In each of the regulatory rules for each European Supervisory Authority it is clear that they may not make a decision or a determination that will infringe or impinge on the fiscal responsibilities, or fiscal requirements of a Member State.

**Q11 Mr Fallon:** Does that apply to the Commission itself when it decides: what is an emergency situation?
***Dr Alexander:*** It does apply to the Commission certainly. Just because the Commission declares an emergency does not mean that the UK has to raise taxpayer money to bail out a bank; so there is a safeguard there. The statement also says in the future there should be an evolution and greater burden-sharing, and rules ought to be designed to promote better fiscal management by the Member State authorities: but right now there is no compulsion of a Member State to use taxpayer money to bail out a bank.
**Chairman:** Professor Portes, welcome. Your spirit has been with us since we started earlier. We are concerned about the timescale for this and the legal implications and I know you are an expert in that area. We are hoping to finish for ten minutes to eleven and would like to get through as much as possible by that time.

**Q12 Nick Ainger:** Can we move on to the composition of the European Systemic Risk Board. The general board is made up of 33 members, 29 of whom are bankers; is that balance right?
***Dr Danielsson:*** I would think the balance is broadly wrong, because one thing we learnt in the crisis is that the most important institution perhaps is the Treasury. Prior to the crisis we thought we could leave these issues to the Central Bank and to the supervisor. Now of course we have learned that the taxpayer is called upon in almost all systemic crisis events to provide vast sums; and therefore I would think in a Systemic Risk Board like proposed here at least the treasuries of the most important countries should be represented because they will be called upon to provide the funds if something happens.
***Dr Alexander:*** I agree that in crisis management it is essential to have the Treasury involved, because the Treasury raises the money to fund any type of bail-out or crisis and they should have a seat somehow on

a Systemic Risk Board. The issue would be: do they have a voting right, as opposed to a non-voting right?

***Professor Portes:*** I am afraid I am in disagreement with both my colleagues here. This Board is already, by my count, 57 members. We are talking about action in crisis situations—let us get serious. Having yet another set—and you could not have just the most important countries around the table; you would have to have the treasuries of all the Member States represented—add another 25—absurd. You cannot possibly deal with crises and any recommendations, because of course the SRB will have no authority under this proposal to issue any binding requirements; so we are talking about proposals. As I say, you cannot imagine this body acting efficaciously, should a crisis arise.

**Q13 Nick Ainger:** Is not your two colleagues' view correct that you need more input than just the central bankers; because basically that is what the general board is, with voting rights?

***Professor Portes:*** The SRB, no more than the supervisory bodies, will not have any power to make commitments that entail fiscal obligations. Certainly you would expect some degree of consultation if the ESRB judges that a problem is not really a problem of liquidity but potentially a problem of solvency, therefore potentially needs taxpayer funds as a back-up; but having the representatives of the treasuries in there, I find the scale of this thing completely out of control.

**Q14 Nick Ainger:** Is that not the problem, that rather than looking at what this Committee is supposed to be doing and the input of information into it and the experience of people on it, it has to—because it is a European body—take into account all the 20-odd members of the European Union; and so automatically you come out with this huge body rather than an organisation which is effective, a committee which actually has the information on which to make informed decisions? Should we not be turning it round and looking at it from that perspective?

***Professor Portes:*** It is possible that it might develop an executive committee which would in effect have powers and responsibilities that could commit or at least very much obligate other members to follow it. Take the existing European Central Bank, it has a broad council, all the governors, plus the executive board. The executive board is only six people. With six people who can do business—you can make decisions—and then communicate to other members of the Council should the need arise. There is no provision for any such executive, as far as I can see.

**Q15 Nick Ainger:** The Steering Committee of the Systemic Risk Board, could that be seen as the executive committee and you actually have a wider range of members there?

***Professor Portes:*** Potentially, but there is no explicit detail as far as I can see of the functions of that committee, and how far it would be able to act expeditiously in a crisis.

***Dr Alexander:*** I would like to comment on that. The Steering Committee is designed to support the decision-making of the 61 member general board. It says that in the explanatory note. The Steering Committee could perform a more effective executive function in discharging the responsibilities of the Systemic Risk Board. I think there is potential for the Steering Committee to grow into a more effective smaller, more cohesive decision-making unit.

**Q16 Sir Peter Viggers:** Do you think that members of the European Economic Area will be content to be subject to bodies on which they have no representation?

***Dr Danielsson:*** I do not think this institution will have much to say about institutions in the European Economic Area to begin with, so I do not see why they should be concerned either way.

***Dr Alexander:*** Whether this body will have an impact on EEA states?

**Q17 Sir Peter Viggers:** Yes.

***Dr Alexander:*** I think there are points of contact with the other three EEA states outside the EU that have been involved in the Systemic Risk Board as non-voting members, and also the Swiss National Bank as well, the EFTA country. So there is an effort to include all European countries, not just the EU countries, regarding oversight surveillance; not really making decisions in a crisis, but in gathering information and exchanging data on cross-border banks that are operating in Europe; and monitoring macro prudential risk in the financial system. It does create I think an important channel for a flow of information which we do not have right now.

**Q18 Sir Peter Viggers:** There is nothing in the draft regulations to ensure representation of the non-Eurozone countries on key committees like the Steering Committee. If the Steering Committee were to evolve as you have indicated should not the non-Eurozone countries be represented?

***Dr Alexander:*** I think that the chair and the vice chair of the general board will be elected by the general board; and all Central Bank governors will have a position on the general board so they can vote for a non-Eurozone Central Bank governor to be a vice chair, for instance, of the Committee. That is not included in the current proposal.

**Q19 Sir Peter Viggers:** You are speculating about the way the situation may evolve; but should it not be written in the regulations to make it clearer at this point?

***Dr Alexander:*** I think it is written in the regulation that they can vote amongst the Central Bank governors who will be the chair and who will be the vice chair of all the European Union Central Banks.

**Q20 John Thurso:** Some organisations have told our staff that they fear the new structure will not respect the better regulation principles, and measures will be imposed without proper consideration of their effect on competitiveness. Do you agree with that and, if you do, how would you want to see them change?
***Dr Alexander:*** First of all, the European system of financial supervisors is decentralised; it relies on Member State supervisors to discharge most responsibilities and financial supervision. One of the key roles it is playing is, each ESA publishes a rule book or a code to help provide more harmonised and uniform practice of prudential supervision across the European Union. I agree with the earlier comments: this is very detailed; a lot of specifics regarding who does what in these proposals; but that is precisely to promote accountability and to show that the decision-making structure is accountable and that it is transparent, regarding ESAs and their relationship with the Member State Supervisors. I do not really think that it deviates from any type of good practice principle.

**Q21 John Thurso:** Any dissent? No. Members of the Board of Supervisors are meant to act independently, yet decisions on technical standards and guidelines and recommendations are being taken by qualified majority vote. Is there a contradiction in that? Professor Portes?
***Professor Portes:*** No, this is absolutely standard in European Union practice. We have lived with it for many years, and to see it extended in this way at least there is a possibility that you might get some outcomes. As it stands, if you go to a meeting of CESR or CEBS you say, "What am I here for? What are *they* here for?" That is one of the few new promising possibilities here, that you might actually get these fiercely independent—jealous of their authority—regulatory agencies to come to some common principles that would actually be imposed on the recalcitrant ones.

**Q22 John Thurso:** Given London's position as the clear major financial centre in Europe and one of the world leaders, is there any threat in the possibility of regulatory decisions being taken by QMV, particularly for London and its competitiveness?
***Professor Portes:*** Of course, there is always that possibility but we live with that possibility in many areas. Again, take the Alternative Investment Funds Management draft Directive, the original proposals are completely unacceptable and you can see I think that we are going down the right road that is not in the end going to be unacceptable to the City of London, and it could not be; that is just a practical matter. Qualified majority voting could not, in practice and in political practice, override a really strong objection, backed up by substance, from the most important financial centre in the European Union.
***Dr Danielsson:*** I do worry about that because I am looking, as I say, at the one specific area mentioned, which is the compensation area. Clearly one gets a sense of where they are heading, that they are looking to set European-wide rules on systemic risk; and those rules might be correct for European countries with small financial systems but they might not be appropriate for London; because what constitutes systemic risk in London may be different than in other European countries. I could see a possible conflict between the objects of London on the one hand and the objects of Europe on the other. Given the fact that these proposals are so light on any detail as to what is systemic risk or what the mandate of the report is, it is something that does give me a worry.

**Q23 John Thurso:** The devil is obviously always in the detail. Is there anything in the process? I get the sense people agree with the principle; at what point should we be concerned with the detail?
***Dr Danielsson:*** I do worry about the fact that they do already say, as I said earlier, that the Authority may be able to take actions that require national supervisors to apply requirements effectively. They are already assuming some power even at this early stage. This is contradictory to some of the statements in the document. At least those things I would like to see clarified.
***Professor Portes:*** How can you clarify that further? It is a straightforward statement. Finally somebody might be able to tell a national regulator what to do. Again, it is very hard to see, even by a qualified majority vote, telling our national regulator what to do—especially if you take the matter, which seems to concern you, Jon, compensation. We are out front in this for good or for ill. We are actually being tougher than other jurisdictions—or going to be tougher as things seem to be going.
***Dr Alexander:*** The UK plays a very important role presently in the three level three committees; and they will continue to play a very important role in influencing the decision-making of the European Supervisory Agencies. I cannot imagine that they would make decisions that are directly contrary to the views of the FSA, unless what the FSA want to do is in direct breach of EU law of an EU Directive. Let me briefly mention also, regarding the Systemic Risk Board it does not have legal personality; it has got no binding power. It meets simply in a pre-crisis situation to be involved in surveillance information and assessment; and if there is a crisis they cannot make decisions in a crisis because they have no legal power; but they are meant to try to raise red flags to issue warnings and recommendations and that is key; because in Europe the focus has always been on Member States, by Member State Central Banks, so we have not had enough focus on the broader European system. The ECBs played a role recently in that; but this is an incremental step regarding the Systemic Risk Board; and what we see on the supervisory agencies is simply a continuation of what we had with the Lamfalussy process, where we have got the supervisors already negotiating setting standards, overseeing each other's implementation through peer review, and this will be continued one step further in this framework.

**Q24 Mr Plaskitt:** Can I come back to this question of emergency powers and looking at Article 10, which is in the draft. It says that what can trigger an emergency situation and the powers that go with it are "adverse developments". Is it enough to rely on that?
***Professor Portes:*** We rely on the judgments of central bankers in these matters all the time. It is very hard to specify in advance what the nature of any given crisis is going to be. All crises are somewhat different. They may have common roots in many cases but their manifestations are always different: if it is an individual distressed financial institution that can differ quite considerably. I think it would be very difficult, if not impossible, to draw up any specific guidelines for intervention. As I say, central bankers for good or for ill have functioned in that way now since time immemorial.

**Q25 Mr Plaskitt:** The envisaged consequence of triggering this is that the Commission, according to the draft wording, can "upon its own initiative" immediately intervene. That is a huge power. In your view, does there not need to be some more definition about what constitutes an adverse development? Lots of things can be an adverse development, but if that is enough to trigger the Commission on its own initiative to make an intervention, is that alright, in your view?
***Professor Portes:*** What exactly do you mean by "intervention"? You mean declaring that there is a crisis?

**Q26 Mr Plaskitt:** No. What Article 10 says is the Commission can on its own initiative adopt a decision, and the next section says that will give it the power to require the competent authority to take a necessary action. It becomes quite direct and quite specific as I read it; and yet it all rests on the development of an "adverse development". Is it not a sweeping opportunity to exercise that power?
***Professor Portes:*** As I say, I cannot see how you can draw more specific requirements because of the immense diversity. If we look even at the nature of the financial institutions that have gotten into trouble and the things that have gotten them into trouble over the past couple of years the range of possibilities is enormous. I could sit here as an academic—and we academics are known for going into all sorts of "I couldn't possibly speculate"!

**Q27 Mr Plaskitt:** How about there being some indication of the potential extent of risk?
***Dr Danielsson:*** Could I add a little bit to this. I would agree very much with Richard. One problem with financial regulations in general is that they tend to guard against the previous crisis and not against the next one. There is always a danger, if you specify a regulatory structure for monitoring, that a reaction to whatever happened in the past creates inflexibility in dealing with the future. Therefore I think we do need to rely on the judgment of the central bankers to define the sequence and therefore writing them down is not the right way to do it.
***Dr Alexander:*** I would say that discretion is very important. We do not know what the source of the next financial crisis will be. I think also there is protection in Article 10 because the European Supervisory Authority may take measures to require a competent authority to do something but they have to do that on a qualified majority vote; and then the competent authority, say it is the UK FSA, they can appeal to a board of appeal, so there is a procedure in place. For an emergency there is an expedited procedure for appeal. I do not think it will get to that point. This would be unusually exceptional circumstances. The UK FSA, in their role in influencing the European Supervisory Authority, they are going to be right at the table and I doubt there would be a compulsory determination made against the UK FSA or the regulator.

**Q28 Mr Plaskitt:** Do you think there is enough in the draft as it is currently constituted to put in place early warning intervention, so there is intervention before you start hitting emergencies?
***Dr Danielsson:*** I worry about all these early warning mechanisms. We have been talking about early warning mechanisms in the global financial system for the past 30–40 years and these proposals have been made and none of them seem to work properly. With so many of the systemic events they seem to come out of the blue. After the facts we know what happened, but before the event we cannot identify any specific things that might lead to a future crisis. There is also a danger in having an early warning system like that might lead us to make a decision which is wrong.

**Q29 Mr Plaskitt:** Have we been looking for them? One of the arguments is that they were not spotted because no-one was bothering to ask penetrating questions; everyone was just gliding along. Have we not learnt from what has just happened that there ought to be some questions that are periodically being asked? Some stress testing that should be being done on a regular basis, could that not be part of a trigger mechanism for an early warning system?
***Professor Portes:*** It is not that warnings were not issued by competent international bodies—and that is why I smile when I read paragraph 6.2 in the Impact Statement about the tasks and powers of the SRB; it sounds exactly like the tasks and powers of the IMF or the BIS. We have the Global Financial Stability Report of the IMF every six months, and the BIS Annual Report every year for quite some time was warning of the dangers that were being created in the system, the search for a yield, the excessive risk-taking and so on and so on; but as Dr Danielsson said quite rightly in the event you did not know how that was going to manifest itself. Some of us, myself included, were wrong about the way in which those imbalances would manifest themselves. I wrote that there were serious difficulties but I got it wrong like most of my colleagues in how they would come out. I think that is where with specific early warning—

**Q30 Mr Plaskitt:** You are saying there is nothing in here to strengthen early warning systems in the future?
***Professor Portes:*** As I say, you could write this paragraph 6.2 here and it would apply absolutely to the IMF and the Bank for International Settlements, and they are a reputational body with a high level composition that will point out potential imbalances in the financial system which are likely to increase systemic risk and so on and so forth. That is exactly what the major international organisations did.

**Q31 Mr Plaskitt:** Do the other two of you share the same view?
***Dr Alexander:*** I would say that there is an incremental improvement here. The European Systemic Risk Board will be entitled to obtain information that would have been considered confidential before from national supervisors and that will enable it to conduct, I think, more effective surveillance. Many Member State national supervisors would not disclose information either for proprietary reasons or for other reasons, including embarrassment, to the ECB, and so now we have a framework set up where any national legal restriction on the disclosure of information is going to be amended and Member State supervisors shall share information with the Systemic Risk Board and also the European Supervisory Authorities. I am not going to say that is foolproof prevention for a future crisis but I think that is an important step, to link up macro-prudential oversight with micro-prudential supervision.

**Q32 Mr Love:** Dr Alexander, earlier on in an answer to Mr Fallon you indicated that in your view the regulations ensured that the decisions made do not impinge on the fiscal responsibility of Member States. Would you accept that that is not a confidence that others share?
***Dr Alexander:*** Right now there is no legal requirement that a state bail out a bank because of a decision made by the European Systemic Risk Board. There is no legal obligation to do that in the current proposal, if we are in a crisis, for instance. That would have to be a decision made at ECOFIN and the Council of Ministers as a finance ministry decision, so I just do not share that concern. I think there are other concerns that we might talk about regarding these proposals. Out in the future there could be burden sharing arrangements introduced and agreed to by all Member States regarding how we might respond in a crisis, and that is something that needs to be addressed in the future. Also, how do we bail out cross-border banks that are viewed to be too big to fail? The Commission has now got a consultation paper; last month they proposed on that, so I think these are discussions that we need to keep having in the future but presently there is no legal obligation for a state to use taxpayer money for that.

**Q33 Mr Love:** What has been said to us is that there is a safeguard clause related to Articles 10 and 11 but not in relation to Article 21 and therefore it is open that a decision made by the Systemic Risk Board could trigger the need for fiscal intervention in a Member State. Do you not accept that?
***Dr Alexander:*** The Systemic Risk Board cannot make that decision. They can make a recommendation to ECOFIN and the Council of Ministers, so it goes up the political chain.

**Q34 Mr Love:** Let me pose it to you another way. They may make a judgment. That judgment is then leaked. There is then a run on a financial institution that triggers a fiscal intervention. Is that not a possibility, what could happen in any of the circumstances that we are talking about?
***Dr Alexander:*** The European Systemic Risk Board can issue warnings, recommendations, and these all have to be acted on. They are not legally binding decisions, and that is their role, to point out problems, red flags, certain developments in the financial system. It has no power to compel a Member State to use taxpayer money to bail a bank out or subsidise it directly. It might say that the European supervisory agencies can make decisions that are legally binding by qualified majority voting which may have indirectly a fiscal impact. It might require that supervisors perform more active supervision at the local level which is going to involve taxpayer money probably, certainly indirectly, but regarding a bank bail-out during a crisis, there is nothing legally binding in that area.
***Professor Portes:*** If you go down that road you might as well try to muzzle Robert Peston, that is to say, yes, anybody saying an institution is in trouble, better do something about it, can provoke a run; that is absolutely standard. There is not much you can do about that. There is no authority here, however. Dr Alexander is perfectly right—there is no authority here and I do not know who is maintaining that there might be some hidden authority. If so, it is hidden awfully well. I just do not believe this. It is quite explicit that there shall be no such powers.

**Q35 Mr Love:** Is it appropriate for the Council of Ministers to rule on this issue by qualified majority voting, considering the sensitivities of this as an issue?
***Professor Portes:*** To rule on what? To rule on imposing fiscal obligations? Again, if we did not like what was being proposed we would invoke the standard safeguard, which is that no external instance by qualified majority voting or any other way can impose a fiscal obligation on the UK Treasury, full stop.

**Q36 Mr Fallon:** I just want to come back on this, Professor Portes. Article 23 does not say that. It says that the Council considers an appeal from a Member State and can uphold the Authority's original decision, so the safeguard you are referring to is not in the draft.
***Professor Portes:*** Not on fiscal obligations. I am sorry, I do not agree; I certainly do not read it that way, and there are enough explicit provisions in there that say that none of these new instances can impose fiscal obligations on Member States.

**Q37 Mr Fallon:** But Article 23(2) says, "Where the Council by majority voting decides to maintain the Authority's decision . . . the suspension of that decision shall be immediately terminated".
***Professor Portes:*** Decision on what?

**Q38 Mr Fallon:** A decision that a Member State appeals as in terms of its fiscal responsibilities.
***Professor Portes:*** No, I am sorry. I do not have that passage in front of me.

**Q39 Mr Fallon:** Have you read Article 23?
***Professor Portes:*** Closely, and I cannot see any room for that interpretation.

**Q40 Mr Fallon:** Have you read Article 23?
***Professor Portes:*** Yes.

**Q41 Mr Fallon:** It seems pretty clear to me that a Member State can appeal and then the Council acts by qualified majority as to whether to uphold the appeal or not. Is that not the position?
***Dr Alexander:*** I think the dispute here that Article 23 refers to is if a Member State says, "We think this decision by the European supervisory agency is impinging on our fiscal position in some way and therefore we contest that", and the ESA says, "No, it does not. We are simply adopting a rule. In the code book it says you have got to regulate your banks in this way", and so they can appeal and they can appeal to the Commission, to the Council of Ministers ultimately.

**Q42 Mr Fallon:** But they could lose the appeal. The Council can decide by qualified majority to reject a Member State's appeal.
***Dr Alexander:*** Because the determination was that it does not impinge on the fiscal requirement for that Member State. I would say as a lawyer looking at this—

**Q43 Mr Fallon:** I just want to be clear. The final say is for the Council, not for the aggrieved Member State that thinks it does impinge on its fiscal responsibility. The final decision is for the Council.
***Professor Portes:*** To impose any specific fiscal burden on any specific Member State. It is a decision about a regulation and, in the end, if that regulation were ultimately to be interpreted as imposing a specific fiscal burden on a specific Member State it would not apply; it could not apply in the rest of the legislation. I am sorry; we are not here talking in that Article to which you refer about the power to impose a fiscal responsibility on a Member State.

**Q44 Mr Fallon:** I think you ought to look at it again. Let us come back to Article 21 that Mr Love referred to. You rather dismissed this but the European Banking Authority, once it has had the warning from the Systemic Risk Board, it says, "shall decide on the actions to be taken". There is no Article 23 safeguard for the exercise of the European Banking Authority's powers under Article 21, is there? Have you read Article 21?
***Dr Alexander:*** Yes; I have got it right here. What provision are you referring to, "The authority shall co-operate closely with the SRB"? Yes. "They shall provide the SRB with regular up-to-date information".

**Q45 Mr Fallon:** The second paragraph of number 4, "It shall decide on the actions to be taken".
***Dr Alexander:*** Article 21, paragraph 2 or 4?

**Q46 Mr Fallon:** Four.
***Dr Alexander:*** "On receipt of a warning or recommendation from the SRB addressed to the Authority, it shall convene a meeting of the Board supervisors and assess the implications of such a warning or recommendation. It shall decide by the relevant decision-making procedure the actions to be taken in accordance with the powers conferred upon it by this Regulation".

**Q47 Mr Fallon:** Yes, I have just read that to you—"It shall decide on the actions to be taken". That power is not subject to the safeguards clause in Article 23.
***Dr Alexander:*** Why do you say that?

**Q48 Mr Fallon:** Because 23 only refers to the power under Articles 10 or 11.
***Dr Alexander:*** Yes, and your concern is that there may be a decision here regarding fiscal responsibilities.

**Q49 Mr Fallon:** It is not a question of concern. I am just asking you whether that is legally the position. As drafted at the moment the safeguards clause does not apply to an action taken under Article 21. Is that correct or not?
***Dr Alexander:*** I think that Article 23 safeguards can be applied to Article 21 too.

**Q50 Mr Fallon:** But it does not say so.
***Dr Alexander:*** No, not expressly. It should be clarified. I would say that safeguards are regarding fundamental powers of Member States in the European Union regarding fiscal powers and you cannot derogate from that unless it is expressly derogated from in the EU law or in the provisions, and so this would not be interpreted to impinge on the fiscal authority of the Member State, but I think you are right for pointing it out. It should be clarified.

**Q51 Mr Fallon:** There does not seem to be an appeal power at all for Article 21 decisions.
***Dr Alexander:*** There is an appeal power regarding all decisions made by the European Supervisory Authority to the Board of Appeal. Any Member State or a financial institution that is affected by a decision by the ESA may appeal to the Board of Appeal and then on to the Council of Ministers. In the explanatory note that is stated.

**Q52 Mr Fallon:** We were talking about the Banking Authority, not the Systemic Risk Board.

***Dr Alexander:*** No, I am talking about the European Supervisory Authority. Every decision they make by qualified majority voting that affects either a Member State authority or a financial institution directly they can appeal to a Board of Appeal and on to the Council of Ministers. The explanatory note says that, but that is a good point.

**Q53 Mr Fallon:** It might be clearer if Article 23 specifically covered Article 21.
***Dr Alexander:*** Yes, I agree.

**Q54 Mr Fallon:** And 10 and 11.
***Dr Alexander:*** It should be clearer, exactly.
**Chairman:** The search for clarity continues. Thank you very much.

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*Witnesses:* **Mr Stuart Popham**, Senior Partner, **Mr Simon Gleeson**, Financial Regulatory Partner, Clifford Chance LLP, **Ms Barbara Ridpath**, Chief Executive of the International Centre for Financial Regulation and **Mr André Villeneuve**, Chairman, City of London's EU Advisory Group, gave evidence.

**Q55 Chairman:** Welcome to the Committee and its second evidence session. Can you introduce yourselves for the shorthand writer, starting with André?
***Mr Villeneuve:*** I am André Villeneuve. I am Chairman of the City of London's EU Advisory Group, which has about 26 or 27 members from different firms practising in the City and we have as observers senior officials from the Treasury, the FSA and the Bank of England.
***Ms Ridpath:*** Barbara Ridpath. I am Chief Executive of the International Centre for Financial Regulation, a recently established research institute with public and private stakeholders.
***Mr Popham:*** Stuart Popham, Senior Partner of Clifford Chance and Chairman of the shortly to be launched City UK, a body to promote financial services throughout the UK.
***Mr Gleeson:*** Simon Gleeson, Financial Regulatory Partner from Clifford Chance.

**Q56 Chairman:** Welcome to this session. We have 45 minutes for this session, finishing about 11.35, so we have a lot to go through. The Commission says "deeper and more integrated financial markets offer better opportunities for financing and risk diversification, and thus help to improve the capacity of the economies to absorb shocks. Financial integration and stability are therefore mutually reinforcing." Do you agree?
***Ms Ridpath:*** Sadly, I think there is a false premise there. Financial integration and financial stability are sadly not mutually reinforcing. They are important. Financial integration and capital flows are critical but unfortunately financial integration permits more rapid transmission of crisis and contagion, not less, and what you need is effective circuit breakers to contain that contagion.

**Q57 Chairman:** How will the new system of a Systemic Risk Board and European Supervisory Authorities affect EU competitiveness? Is there going to be a trade-off between its effectiveness and national independence?
***Mr Villeneuve:*** I think there is good and bad here. It should be helpful if it puts us on a level playing field with a single rule book and single application of these rules. It will not be good if the EU forges ahead of international standard setters such as the FSB or the Basel Committee on Banking Supervision.

**Q58 Chairman:** Are there some countries that are going to win out of this and some that are going to lose, potentially?
***Mr Popham:*** Unfortunately, the answer has to be that it all depends on how it works in practice. The potential certainly exists for that. If it achieves a uniformly enhanced supervisory regime over financial systems throughout the EU that can only be good for everybody, but it depends on how it is achieved and by whom and therein lies the difficulty of this. Because of its lack of specificity and preciseness it is something of—I was going to say "a lottery" but I think it is just unknown. Let us call it that.

**Q59 Chairman:** If these proposals had been implemented would the financial crisis have been better dealt with?
***Ms Ridpath:*** Possibly at the margin, because you would have had someone blowing the whistle a little sooner, but it would not have made a substantial difference.

**Q60 Chairman:** Actually, we did. In this Committee we were told by witnesses that they did blow the whistle. Maybe it was not a loud enough whistle, so maybe the volume was down in Europe just as it was here.
***Ms Ridpath:*** Yes. Without the tools to action it it does not make a dramatic difference.

**Q61 Mr Fallon:** Could you clarify an issue on appeals? Perhaps I could ask Clifford Chance for some cost-free advice on this. Article 46, as drafted, of the Banking Regulation, specifies that the appeals only apply to Articles 9, 10, 11 and under Article 1, so they do not actually cover Article 23. Is that right?
***Mr Gleeson:*** That is correct.

**Q62 Mr Fallon:** Is that a serious gap?
***Mr Gleeson:*** That depends on how useful you think the appeal power is likely to be.

**Q63 Mr Fallon:** What do you think?
***Mr Gleeson:*** This system was in existence, at least its bare bones were in existence, during the previous crisis and the actions that were taken at the Brussels level were completed well after the crisis had concluded. The appeal process is a long-drawn out process.

*Mr Popham:* The simple answer must be that there does not seem to be any particular reason why it is excluded from the appeals process so it should be included. Whether it would make a great deal of difference in practice is a debatable point.

**Q64 Mr Fallon:** But the European Banking Authority could take a decision that directly impinged on the fiscal responsibilities of a British Chancellor without appeal under Article 23. That is the position, is it not?
*Mr Popham:* It does look that way, yes.

**Q65 Mr Fallon:** Is it also the case that the European Banking Authority's decisions can apply directly to individual financial institutions in this country?
*Mr Popham:* Again, potentially so. Through a direction to the applicable national regulator, which then does not implement it, it is possible in certain circumstances, and Simon will give you the specifics, to address an individual institution in a national country.
*Mr Gleeson:* What is strange about this is that there is a power to address requests directly to individual financial institutions but what the request is to do is to comply with the directives that already exist, so in theory, although the power exists, it is a power to do nothing more than to say, "Comply with the law as it already stands". It is mysterious as to what use that power could be.

**Q66 Mr Fallon:** But the power could be addressed to a British bank?
*Mr Gleeson:* It could, yes.

**Q67 Mr Fallon:** And the British bank would then have to comply?
*Mr Popham:* Yes.

**Q68 Chairman:** Are you determined not to give us free advice, Mr Gleeson?
*Mr Popham:* It is just the normal advice you are getting.

**Q69 Peter Viggers:** Do you have any concerns about the Commission's powers to delegate authority to the Supervisory Authorities?
*Mr Gleeson:* Yes. The technical issue here is that the Commission has no such power. It is clear as a matter of European law that the European Court of Justice will not permit the Commission, or, for that matter, the Council, to grant to any subsidiary body the power to exercise its discretion. Consequently, what this draft does is attempt to draft around that to create a regulator without the power to make rules or the power to exercise discretion. This is why we find it so hard to work out what a regulator thus constituted can actually do.

**Q70 Peter Viggers:** So what are the risks in agreeing to these proposals if there are doubts about their legal validity?
*Mr Gleeson:* What the proposals do is create a framework which will enable the secretariat thus created to decide what it is going to do, subject to a European law constraint that it will not be allowed to do very much. It is arguable that these proposals create no risk because actually the institutions thus created cannot legally do anything, but that takes us to the point mentioned earlier, which is that they will have strong persuasive power just by reason of their existence.

**Q71 Peter Viggers:** Moving to more general issues, do you think that members of the European Economic Area will be content to be subject to bodies on which they have no representation, Mr Villeneuve?
*Mr Villeneuve:* I think it is important that it embraces the whole of the European Union members. You are talking about EU members or EEA members?

**Q72 Peter Viggers:** Members of the European Economic Area.
*Mr Villeneuve:* The proposals address the EU at the moment and I think it is important that certainly all EU members, whether in or out of the Eurozone, should be represented. On the EEA, I do not have a strong view on that. Could I add one thing to that? It is very important that the views taken by the ESRB, among other things, take also a global perspective so it is not just an EU-centric perspective. It must take a global perspective. There are lots of non-EU banks in the EU, and anyway we are talking about a global economy here, so it is important that they take into account what the US might be thinking, what Switzerland might be thinking and other areas such as those. I would just clarify that.

**Q73 Peter Viggers:** Referring back to earlier evidence we received, the role of the Steering Committee may evolve, but as it is currently constituted there is nothing in the draft regulations to ensure representation of the non-Eurozone countries on that committee. Should that be rectified?
*Mr Villeneuve:* Given the importance of the City of London, it would be crazy not to have the Bank of England playing a very strong role in that committee in my view. I cannot imagine that they would want the Bank of England not to play a strong role.
*Ms Ridpath:* There is a three-year review period which gives you some time to consider how it has worked in the original set-up and whether it needs to be legislated to improve the workings after the first three-year period.
*Mr Popham:* The balance is between trying to include everybody making it an unmanageable or unworkable group or so trimming it down that you exclude the very people you should be including, and that is the risk.

**Q74 Peter Viggers:** How concerned should we be? Should we try to legislate at this point to try to cover the point or do you think the situation will evolve satisfactorily?
*Mr Popham:* I think it would certainly be worth trying to ensure that there is recognition of the necessity of appointing appropriate people and to

keep that more perpetually under review than three years. The real test of this organisation is going to come when there is a crisis and unfortunately it is going to be rather late in the day then to discover that it is not the right body. If I can pick up André's point, it does seem to me that the critical point here is that it is part of a process of joining up the global array of financial regulators so that in a future crisis there is some capability of communicating. If, alternatively, this is seen as some kind of hurdle over which you have to climb in order to co-ordinate then it is not going to serve good purpose at all.

**Q75 Mr Todd:** You have referred to the fact that this is a global market place. I have some difficulty in defining what specific value an EU level engagement adds to this framework of regulation and risk management. Can you help me to fill that space in my mind?
***Mr Villeneuve:*** The EU is 27 different countries and it would be helpful as a process, I would imagine, to get more global agreement on what the issues are and how they need to be addressed if there were some co-ordination amongst at least the 27 European countries as to what the problem is.

**Q76 Mr Todd:** There already are a number of committees on which knowledge is exchanged, best practice is discussed, information is shared. That would appear a valuable function. I just wonder what value is brought by having a regulatory framework which brings together nations of very different scale in terms of financial sector engagement to provide an attempt at what appears to be second-guessing the regulatory activities of individual states.
***Mr Villeneuve:*** It is clear that these proposals have grown out of the fact that the current structure did not help prevent this crisis.

**Q77 Mr Todd:** Indeed, but that does not mean that another one developed from it is going to be better.
***Mr Villeneuve:*** All the people who have studied this, including Lord Turner, would suggest that we needed more attention on the macro issues that were arising out of this and this is one mechanism that the European Union can put forward on this. You raise a very important question about the relative size of financial services. I would link that to the question about qualified majority voting. I know you will probably come on to that but I would imagine that the system of qualified majority voting should also recognise the size and importance of financial services relative to each country's GDP, and certainly from a practitioner point of view I would like to see that. It does not at the moment.

**Q78 Mr Todd:** Indeed it does not, but do you think that is at all likely to be an outcome?
***Mr Villeneuve:*** Unfortunately not.

**Q79 Mr Todd:** It is an intriguing suggestion, though not obviously realisable.
***Mr Villeneuve:*** In the interests of compromise, unfortunately not, but that would be a desirable outcome.

**Q80 Mr Todd:** So what should be the British Government's strategy in this matter, because what we appear to be doing is engaging in quite detailed negotiation about the mechanics of this and there has been some useful questioning on some of the clauses within this? I am more questioning whether this is strategically the right place for the European Union to be engaged and how it should deploy its resources.
***Ms Ridpath:*** It is an awkward thing to answer as a foreigner, I realise, but I think you would do best—

**Q81 Mr Todd:** We have had quite a lot of them in front of us.
***Ms Ridpath:—*** by engaging actively in these new supervisory bodies, as actively as you can as proponents of your system of supervision that has proved quite worthy, rather than try and throw stones at the legislation and get it put out. I think you would do very well by taking a leadership role in these organisations and showing that they are so important that you are going to make them work and make them work to your interest.

**Q82 Mr Todd:** That is one strategy.
***Mr Popham:*** Could I just embellish that if I might, which is that, in pursuing that, what would be particularly useful would be the development of the details of the rules and the application so that one had a much clearer understanding of how and when it would apply and only then can you make the decision whether it is the appropriate—

**Q83 Mr Todd:** The very last thing we need is to have some cloudy entity in Europe which will obstruct rapid decision-making and also introduce some intriguing potential moral hazard issues of quite where regulation applies and whether a national regulator, not necessarily thinking of our own but somewhere else, need do its job if there is some second-guessing being done as well.
***Mr Popham:*** I think we are saying precisely that because there is the obvious likelihood of an interregnum whilst these bodies come into existence but cannot actually do anything. Meanwhile, what happens if a crisis arises? It does not seem to me the best way of launching this ship.

**Q84 Mr Tyrie:** Barbara Ridpath was giving the British Government tactical advice, that is, suggesting engagement and leadership rather than throwing stones from the outside, but I think Mark Todd's question was one of principle. At the end of all this does the EU have very much, in an objective sense, that can contribute to the welfare of its citizens by engaging in legislation of this type?
***Mr Gleeson:*** Can I make a point in relation to that, and that is that from the UK perspective the answer is probably not, because from the UK perspective controlling a crisis means being able to deal closely with the US, potentially with China, India, the

major financial centres. If you look at life from a continental European perspective this structure would potentially have been useful in the collapse of an institution like Dexia. Remember that cross-border deposit-taking is much more common across continental Europe than it is between continental Europe and the UK. The answer to the question "what good is this?", is, (a) possibly more good to continental Europe than to us, and, (b) important to ensure that it does work there—because we have an interest in it working there—without obscuring the UK's ability to deal easily and quickly with non-EU global regulators.

**Q85 Mr Tyrie:** The second broad question has to be do we need to get this done in a rush or is this something that we should be thinking about very carefully over a longer time frame, bearing in mind that we have just had the crash; the horse has bolted.
***Mr Popham:*** Assuming there is not another one coming along close behind, the answer must be that it would be better to consider this at some leisure; otherwise the likelihood is we will get it wrong and a statement was made by the previous witnesses to the effect that it would likely address the previous crisis, not the next one.

**Q86 Mr Tyrie:** And therefore what explanation do any of you give to what appears to be an extraordinary rush to legislate?
***Mr Villeneuve:*** The members of my committee are very unhappy about that, of course. That is all I can say.

**Q87 Mr Tyrie:** We know that, but I am asking you for an explanation about the foot being on the accelerator.
***Mr Villeneuve:*** There are many explanations. The Swedish Presidency is obviously anxious to get something wrapped up at the Council by December which is when they leave. Is that a good enough reason to rush it? No, but that is one element. Another element is that there are people, certainly in France and maybe other countries, that feel that while the crisis is still burning in our minds you are more likely to get this sort of movement than before, and you have to recognise that the UK has come a long way in this crisis from where it was before. We have engaged with the other European countries a lot more now as a result of this crisis than we have ever done before. That has been noticed and people feel that striking while the iron is hot may be good.

**Q88 Mr Tyrie:** Just to clarify, what you mean by that presumably is that the British are in a weak position because the Anglo-Saxon model is being challenged, so get them while they are down; that is the continental view, or have I been a little pejorative there in describing the continental position?
***Mr Villeneuve:*** I think it is more that the British realise that we cannot go on the way we are, and other countries, by the way, have realised this too and this is a good moment to get changes made. I am a great supporter of the Anglo-Saxon model. By the way, I do not think there is an Anglo-Saxon model. There is a British model and an American model, if that is what you mean. There is also a German model, but that is something else.
***Mr Popham:*** It seems to me the only other possibility it might offer is to draw a line under the current crisis and perhaps to allow financial services to return to some element of normality rather than for ever being in the headlines as to continuous crisis.

**Q89 Mr Tyrie:** I saw Mr Gleeson trying to get in, so could we have a review on the same question?
***Mr Gleeson:*** I was just going to make the point that the real issue is, I think, about resources. If these resources are to be devoted to international agreements, is it best for that to be done within the European Union or at the global level? The answer to that seems to me to be clearly at the global level, so this to some extent seems like a second-best option.

**Q90 Chairman:** André, so you were roundly rejecting Andrew's scurrilous suggestions in your answer there? I thought you were.
***Mr Villeneuve:*** I would not have characterised it that way, Chairman. I am for less haste and more careful consideration, just to be quite clear on my answer there. I was just trying to attempt to answer Mr Tyrie's question about why there is— haste.

**Q91 Chairman:** Now another attempt for free advice, Simon. Under Article 11 the ESA appears to have considerable arbitration power between two financial institutions. Why do you say it is unclear what power the ESA will be able to exercise? I am thinking of section three in particular here.
***Mr Gleeson:*** It is the same basic issue, that they may adopt an individual decision addressed to a financial institution, that is certainly true, but the substance of the decision they can make is to require the institution to comply with its obligations under existing law.

**Q92 Chairman:** Yes, but it says here, "The Authority may take a decision requiring them to take specific action or to refrain from action in order to settle the matter".
***Mr Gleeson:*** Yes, in compliance with Community law.

**Q93 Chairman:** Yes, but it is going to arbitration because there is a doubt and they are suggesting that there is specific action required.
***Mr Gleeson:*** Yes.
**Chairman:** That seems simple enough to me as a non-lawyer.
**Nick Ainger:** That is your first mistake!
**John Thurso:** That is why you are not paid as much!

**Q94 Chairman:** I am too diplomatic to say that. Come on.
***Mr Gleeson:*** The issue is that you start by creating a disagreement between competent authorities. Now, assume that that disagreement is wholly synthetic and constructed for the purpose of enabling an order like this to be made. I agree that you can do that, but what that involves is something which is close to a

conspiracy between the authorities and the Member State to agree that the law says something which either it does not say—the situation where the FSA says, "This directive means X" in such a fashion that the rest of Europe can say, "It is clear beyond doubt that the FSA is just making this up and it does not say that at all", is a very hard set of facts to imagine.
**Chairman:** Oh, forget it! I am going back to bed!

**Q95 Nick Ainger:** I do not know if you heard the evidence that our previous academics gave in relation to the ESRB and its construction. Professor Willem Buiter has given us a memorandum and he describes the construction of the design as a shambles. He says it is ludicrously lob-sided in favour of central banks in general and the ECB in particular, and it is high time to have a re-think before the EU adopts and implements a financial and political disaster. Would you agree with the eminent professor?
***Ms Ridpath:*** I would not entirely. I think the ECB has done a fairly remarkable job in only ten years of demonstrating its independence and its integrity, so I think that, even though there are some who are quite angry at the things the central bankers did not do, having now the banks in large part at the helm of this I think is a good thing.
***Mr Villeneuve:*** I also agree with the point that one of the academics made, and I cannot remember which, that you have got to have a trade-off between having everybody you would want there and the viable size of a committee. In my view you run a good size committee here but I cannot imagine, on something as important as a financial crisis, having 100 people in the room, albeit desirable participants, and getting a reasonable quick answer. I think there has to be a trade-off, and if it revolves around central bankers so be it.
***Mr Popham:*** I think particularly if we are looking at macro-prudential activity then central banks are most likely to be the focal point for national representation and for national implementation. Once it goes a little bit broader than that they may not be, but one assumes that it should be possible for the Governor of the Central Bank to take account of other people's views before he comes to the table. As you say, however, trying to construct what I have described before as half an ark where you have got one of everything is a recipe for a very slow-moving exercise, and 27 countries are 27 countries.

**Q96 Nick Ainger:** All I would do is paraphrase what Professor Buiter says, that the central banks have not got a very good record of identifying systemic risk, have they, or else we would not be in the position we are now?
***Ms Ridpath:*** They have not had a very good track record of acting on it. Actually, the financial stability report of the Bank of England was very good at identifying it. They just did not do anything about it and that was true of several people at the BIS as well. The question is the tools to act on it, not identifying it, I think.

**Q97 Nick Ainger:** Do you see the difference being, as the Chairman referred to earlier, that people were blowing whistles but nobody was listening and that the ESRB will be able to blow the whistle and presumably people will listen this time? That is the theory, is it not?
***Ms Ridpath:*** I remain concerned whether people will listen.
***Mr Popham:*** I think as an observation it will rather depend on who it is that is blowing the whistle, not which organisation is blowing the whistle. If these organisations are staffed with people who are well respected across the financial communities then they will be heard. I do not know what the opposite extreme is but ultimately if they are nothing more than bureaucrats who nobody recognises they will not be heard.

**Q98 Nick Ainger:** The ESRB will have these powers—its only powers—to issue warnings and recommendations, and everyone is concerned that those warnings and recommendations will be adhered to, but in your memorandum to us, Stuart and Simon, you say you raise concern about its effects on Member States' governments. First of all, should we not want that to happen because what is the point in issuing these warnings and recommendations otherwise?
***Mr Popham:*** I suppose it depends whether you agree with that. If you think it is all designed to and will achieve a better degree of supervision, yes, good thing. If you think otherwise, it is an undue interference, bad thing. The question is to what extent they should overrule national regulators in that sense or, more to the point, not so much overrule as just undermine and question and slow down the process.

**Q99 Nick Ainger:** But if they are right then should it not have that effect? What is the point otherwise of this body?
***Mr Popham:*** If we might go back one step to what André said at the beginning, which is that this needs to look at things on a global basis, there should be other people presumably observing and discussing and communicating at this stage. We are talking about a crisis and a crisis not just of an individual financial institution presumably but a country-wide or a regional-wide or a global-wide crisis, and therefore one is hoping that you are going to get the most effective way of getting a co-ordinated whistle being blown rather than some itinerant one that you have not really seen coming and does not seem to be in any sense co-ordinated with the overall markets. That is the risk. The structure being put in place sounds good. The question is how well it will operate in practice. I come back to my earlier point, which is, if there are at the moment no rules, no real definition of its ambit, no definition of what the financial crisis might be, it is very difficult to assess in advance how well it is going to work. We would all want one if it is going to work well.
***Mr Gleeson:*** There is one other small point there, which is that it is very easy to misunderstand macroeconomic regulation by assuming the market

is even. If you imagine, for example, that this body decides that there is too much credit in Europe and bank capital adequacy requirements should go up, if at that time the UK, for example, is in the middle of a deep recession and increasing capital adequacy requirements for UK banks would have the effect of making that recession much worse, then it probably should not be the case that that determination by this body should effectively determine the action of UK economic and monetary policy.

**Q100 Nick Ainger:** But is there not a judgment to be made about what is a great risk?
***Mr Gleeson:*** Yes.

**Q101 Nick Ainger:** An individual state may well find it difficult for a given period but, if you like, in terms of the overall global economy being in depression as an alternative to an individual country being in recession, presumably the judgment will be best stay out of a global depression?
***Ms Ridpath:*** In the UK over half the banking assets are not by UK institutions so there is only so much effect that changing FSA capital requirements would have on lending in the United Kingdom.

**Q102 Mr Plaskitt:** Mr Gleeson, you have given the impression so far that you think there is not a lot in these proposals that fundamentally changes from the status quo, but in your view are there any meaningful new emergency powers being proposed here?
***Mr Gleeson:*** That comes to the issue that the Chairman was raising a little earlier. We have this power to give individual decisions to individual financial institutions but it is immensely unclear how that would work and what the consequences would be either for that institution or for the government concerned. What we have here is a hook on which the appropriate procedures could be used to build a meaningful sanction, but at the moment in the draft we have nothing more than a hook.

**Q103 Mr Plaskitt:** Do you think it is satisfactory to proceed with a draft that has only that?
***Mr Gleeson:*** I certainly do not.

**Q104 Mr Plaskitt:** What would you like to see it have instead?
***Mr Gleeson:*** It seems to me that what this draft seeks to do is complete the establishment of these bodies and then to leave it to themselves to decide what they will do and how. My personal view is that that determination should be made by the Member States and not by the bodies once they have been established, and I think that that discussion should precede the finalisation of these documents.

**Q105 Mr Plaskitt:** In the case of identifying emergency circumstances or, as the current draft says, "adverse developments", is it safe to leave that to a bunch of Member States who might all disagree whether it is adverse or not, whereas this envisages one power determining that? I think that this discussion illustrates that there should at least be dialogue, if not agreement, on what we mean by "adverse developments" before we put it into the directive and then proceed.

**Q106 Mr Plaskitt:** You will have heard the previous witnesses suggest that there was not a lot of improvement in these proposals in respect of having effective early warning mechanisms. Do all of you share that view or do any of you dissent from that view?
***Ms Ridpath:*** I do not know if we share so much the early warning mechanisms which are in here rather than whether they have the teeth to take any actions about those mechanisms. There are recommendations to go to the national level but where the teeth lie to apply changes in interest rates, quantitative credit restrictions, things like that, is not clear at all.

**Q107 Mr Plaskitt:** I am getting the impression that some of you think all of this is saying what the Union thinks needs to be said rather than changing things in fundamental ways. Is that what you are telling us?
***Mr Gleeson:*** It is fair to say that to make any significant fundamental change in the way that this is done you would need a change in the treaty. Since that is completely out of court then you can see very clearly on the drafting that what is happening here is an attempt to work within the constraints of what can be done under the existing arrangements.

**Q108 Mr Plaskitt:** So is this a window-dressing exercise?
***Mr Gleeson:*** I can see how it could be called that.
***Mr Popham:*** We normally charge a lot for that!

**Q109 Chairman:** What do you change in the treaty? You said you need to change something.
***Mr Gleeson:*** It is not possible to give these entities under the current institutional arrangement the power either to make rules or to exercise discretion, and in order to achieve the European regulatory bodies which were the original objective of this exercise that would need to change.

**Q110 Chairman:** But that is what the draft before us proposed to do, to give them the powers.
***Mr Gleeson:*** If that is the case then there is a risk.

**Q111 Chairman:** The regulations say they can.
***Mr Gleeson:*** If that is the case then the risk is that the European Court of Justice will take the view that these directives are effectively *ultra vires* to the treaty.
***Mr Popham:*** And at that stage they will cease to exist.

**Q112 Mr Plaskitt:** If that were the case then all we would have done here was a piece of window-dressing in your view, because it is still subject to a potential ECJ test; is that right?
***Mr Gleeson:*** Absolutely.

**Q113 Mr Plaskitt:** Is that not true of any development that takes place within existing treaties, so there is nothing novel about this, is there?

***Mr Gleeson:*** What is novel about this is that analytically it exists on the outer edge of the possible. The vast majority of what the Commission does is so clearly within the treaty that these issues do not arise.

**Q114 Mr Plaskitt:** All right. I am not sure we are going to get much further with this.
***Mr Popham:*** Can I come back with an alternative for you, which is that if the intention is to ensure an easier means of co-ordinating a forum in which people can get together and decide whether a whistle should be blown, a mechanism by which best standards can be adopted and encouraged, then all of that is well within the treaty power, all of that is desirable. If, however, you think it is going to go further and the intention is to go further, to issue a central diktat or to overrule continuously national rights, that is where there probably is not the treaty authority and it runs the risk of going astray, and then you are into the conspiracy theory.

**Q115 Mr Plaskitt:** I think it is very important to establish that. Can I finally come back to this global question? Given the discussion we are having, would you say that, as currently constituted and, given what we established about whether this alters powers within existing treaties, adoption of this poses no risk to the European Union losing out as a result of regulatory arbitrage?
***Mr Villeneuve:*** It is extremely important that anything that is done in the EU is synchronised with what the US in particular does but also Asian countries do. If we front-run the US, that is very bad for the EU and for London. In this particular instance there are a lot of discussions going on with the US and I am more encouraged than I was a few months ago that there is a serious attempt being made to engage with the US authorities on how we might not have exactly the same system but we might have similar systems but at least work together. There are other aspects of EU legislation for financial services where I cannot be so positive, but we are talking about this now.

**Q116 Mr Plaskitt:** Do you think any of this is running ahead of where the US is and therefore posing a risk?
***Mr Villeneuve:*** I think it risked looking like that at one time but I think now there is a serious attempt to synchronise with the US. It would be very bad indeed if, as I said earlier, we forged ahead of the international standard setters as well. Very important in this is Basel, so if we try and front-run Basel that is bad news. There are some people in Europe who might want us to take a more aggressive view and show the lead to the rest of the world, but that is just nonsense.
**Mr Plaskitt:** And there is a whole separate question on whether Basel itself is adequate, but we have not got time to go into that, I suspect.

**Q117 Chairman:** Thank you. Richard Portes told us that it was politically inconceivable that the FSA would be overruled in the Supervisory Authorities. Are you confident that that is the case?
***Mr Gleeson:*** We have seen at least one case of the FSA being effectively overruled, albeit on a technical matter, in CESR, the committee which is the predecessor of one of these, so not only is it not inconceivable; there is at least one precedent.

**Q118 Chairman:** Any supporters of Portes?
***Mr Villeneuve:*** I would say yes, it is conceivable, and I would also say that the FSA needs to play a very active role, and as a committee I would also be concerned to make sure that they have enough people ready to play that active role.

**Q119 Chairman:** You say here the Supervisory Authorities have no powers or, if they do have powers, they will be operating at the far edge of legality. Do you agree with that?
***Mr Gleeson:*** Yes.

**Q120 Chairman:** Stuart?
***Mr Popham:*** Yes.

**Q121 Chairman:** Barbara?
***Ms Ridpath:*** I cannot really speak to the legals. I am not going to touch that one, I am afraid.

**Q122 Chairman:** André?
***Mr Villeneuve:*** I have my legal counsel. I will bow to him.
**Chairman:** I can say, Simon, I hope you give more clear advice when it is paid for. Can we thank you for the advice that you have given this morning and hopefully it will help us produce a report before 2 December.

## Wednesday 4 November 2009

Members present

John McFall, in the Chair

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|---|---|
| Nick Ainger | Mr Andrew Love |
| Mr Colin Breed | John Thurso |
| Jim Cousins | Mr Andrew Tyrie |
| Mr Michael Fallon | Mr Mark Todd |
| Ms Sally Keeble | Sir Peter Viggers |

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*Witnesses:* **Lord Myners CBE**, a Member of the House of Lords, Financial Services Secretary, **Mr Gary Roberts**, Head of Financial Services Strategy and **Mr Stephen Pickford**, Managing Director International and Europe, HM Treasury, gave evidence.

**Q123 Chairman:** Lord Myners, welcome to the Committee. We are perhaps going to have a vote shortly so we will try and speed on with it, so over to you to identify yourselves for the Committee.
***Lord Myners:*** I am Paul Myners and I am Financial Services Secretary in HM Treasury and with me I have two colleagues from the Treasury, Steve Pickford and Gary Roberts.

**Q124 Chairman:** We are here today to talk about macro and micro regulation regarding Europe, not the usual things we talk to you about, so we can probably afford to be more chummy as a result of that. The European Commission's proposals to establish a new framework for financial regulation across Europe are designed to enhance financial stability and prevent future crises. Can you explain why these proposals are necessary and how they will promote financial stability across the EU?
***Lord Myners:*** I think the European Systemic Risk Board in particular will play an important role in co-ordinating the views of central banks across Europe and bring together the major central banks in developing a consensus around areas where there is a risk of systemic danger. I think the ESAs will play a very important role in raising standards, in developing a single rule book and in securing more effective enforcement.

**Q125 Chairman:** Do you acknowledge though that there is a real danger that the proposals as they stand mean that the UK could end up without a seat on the Steering Committee of the ESRB?
***Lord Myners:*** We are making representations that the Steering Committee should include representatives of central banks that are in the euro and central banks that are not in the euro, and in particular of course London as the largest financial centre in the European Area quite naturally expects to have a voice in that forum, and I am confident that we will be successful in securing that.

**Q126 Chairman:** Do you want that written in the regulations?
***Lord Myners:*** I do not think these things need to be written in the regulations. I think they are a goal to which we will work and I am confident through our engagement with other Member States that we will secure a satisfactory outcome.

**Q127 Mr Fallon:** Lord Myners, it has been reported that there is broad agreement about these proposals. Has the United Kingdom broadly agreed with those proposals?
***Lord Myners:*** The UK, Mr Fallon, is broadly in support of the creation of the European Systemic Risk Board and also of the three European Supervisory Committees. There are issues of detail, particularly around legality and around fiscal consequences, on which we are not in agreement with the Commission's proposal. We are however much more sympathetic and supportive of the conclusions reached at the June meeting of the European Council. The Commission seems to have gone rather further than the Council envisaged in one or two areas and will have to come back into line with the Council's agreed position.

**Q128 Mr Fallon:** Dr Alexander from Cambridge told us yesterday there are certain situations under the European Banking Authority Directive where the supervisory authority can apply a rule or decision directly to the financial institution. A few hours later the Chancellor told the House: "We have made it absolutely clear that we believe domestic regulation ought to be a matter for our regulators". Can you reconcile those two statements?
***Lord Myners:*** I cannot reconcile the two. What I can say is that the Chancellor's statement reflects the position of the Government which is that the European supervisory authorities should have certain powers over the rating agencies but not over directly regulated entities within nations and that is a position on which we have been very consistent, and indeed as reflected in the Chancellor's communication, I believe, with the Czech Presidency in the early part of March this year.

**Q129 Mr Fallon:** So as the draft is worded at the moment you are not supporting it?
***Lord Myners:*** That is one of the elements of the draft with which we are not in agreement.

**Q130 Mr Fallon:** Could you clarify the appeals procedure where a Member State believes that its fiscal responsibilities are being impinged on. As I understand it, a Member State who feels that is able to appeal but that appeal can still be dismissed on a two-thirds majority.

**4 November 2009 Lord Myners CBE, Mr Gary Roberts and Mr Stephen Pickford**

***Lord Myners:*** Mr Fallon, that is why we are objecting to the current proposal from the Commission and want to hold to the line agreed by the European heads of state in the European Council in June that there can be no interventions that have fiscal consequences for individual national governments. We have consistently held that view and will continue to do so.

**Q131 Mr Fallon:** So what is described in the draft Directive as a safeguard you want to convert into a veto?
***Lord Myners:*** What is a safeguard is a safeguard against a procedure with which we do not agree and therefore that safeguard would not be required if the proposal is aligned with that established by the European Council in June.

**Q132 Mr Fallon:** Because we also established yesterday that the Article 23 safeguards do not apply to decisions taken under Article 21. They only cover decisions taken under Articles 10 and 11 so it is deficient in that respect as well, is it not?
***Lord Myners:*** I am going to ask Mr Pickford or Mr Roberts to make an observation on that.
***Mr Pickford:*** I think it is fair to say that we are unhappy with the coverage of Article 23. We think the safeguard should extend over all of the Regulation rather than part.

**Q133 Mr Fallon:** Lord Myners, how did we get into this position when the Prime Minister reported back to the House, in fact I asked him the question on his statement on the June Summit, where he assured us that there would be no impingement on the fiscal responsibility of Member States and now you are fighting a rearguard action to try to defend the position of a Member State whose fiscal responsibilities might be put at risk?
***Lord Myners:*** I remember well the question you asked the Prime Minister. I would not characterise it as a rearguard action. I think we are just going to remind the Commission, and have indeed done so already at the October ECOFIN meeting, of the agreement reached by the European heads of state at the European Council in June. Maybe we will touch later on the Alternative Investment Fund Managers Directive. The Commission has gone rather further than the Council contemplated.

**Q134 Mr Fallon:** But why have you allowed that to happen? We are represented in Brussels. Why have we got a draft that is so unsatisfactory?
***Lord Myners:*** I do not think as one Member State we are in a position to stop the Commission putting forward proposals. What we are in a position to do through ECOFIN and the European Council, and in due course through Parliament, is to oppose those proposals.

**Q135 Mr Fallon:** You are representing the Member State with the biggest banking industry in Europe. How have we ended up with a draft Directive that is so opposed to our own particular interests? Who has been on the case here?
***Lord Myners:*** I think what really matters in the end is where we end up in terms of the final rules and agreements, and I am confident that the agreement reached by the European Council in June, which was debated in some depth and involvement, will reflect the final outcome.

**Q136 Mr Fallon:** So you are going to win all these battles?
***Lord Myners:*** Personally I like to go into battles with the intention of winning, including with the Treasury Select Committee. I do not always do so but we will do our best. I suspect, Mr Fallon, that you and I have very similar views on this issue and I share your concern that the Commission seems to have gone so much further than the Council, and that is why I keep saying we must come back to the position agreed by the Council in June.

**Q137 Mr Todd:** The sector that we are talking about is a global industry. The European Union contains a collection of countries some of which like ourselves have major financial services industries and some where they are trivial. What added value does a European Union framework bring?
***Lord Myners:*** Well, there are considerable advantages from having a single market of 27 member countries.

**Q138 Mr Todd:** I take that as read. I am looking more at the intervention.
***Lord Myners:*** It is above my pay level to contemplate a construct in which the EU operated in a different way in respect of a particular industry. I think the point to emphasise here is that the setting of common standards, a common rule book, peer review and strong enforcement must be to the benefit of all banking institutions in Europe and their customers.

**Q139 Mr Todd:** But surely while peer review and best practice exchange is sensible and information flow between regulators is obviously utterly desirable, it is hard to see why having an international body with such a mixed agenda can greatly add value to the regulation of our own financial services sector. Would it not be a better thing to focus on a more limited role within the EU and a global construct which brought us together with other major financial services providers in the world?
***Lord Myners:*** I understand the point you make, Mr Todd, but the representations made to us by the City of London and other major banking institutions in the UK are that they have a very strong preference for a single rule book which covers the totality of the European Union.

**Q140 Mr Todd:** Albeit determined by a collection of nations often of rather less significance than ourselves in this sector?
***Lord Myners:*** I think we would expect our voice and credibility to be reflective of the significance of the financial services industry. Of course it is also worth remembering that we have consistently made the case that European legislation and proposals must

be evidence-based and must be the consequence of proper consultation with an impact assessment. We have seen things come out of the Commission which do not meet those criteria and of course they have often been found to be badly deficient as a consequence.

**Q141 Mr Todd:** We have appeared together at a discussion on hedge fund issues as an example of perhaps exactly that kind of thing.
***Lord Myners:*** Absolutely.

**Q142 Mr Todd:** Does that not exemplify the difficulty of constructing a European entity in which the experience and value of many of these sectors differs so dramatically between nation states?
***Lord Myners:*** One would expect those nation states which have the greatest economic interest in this area to be the leaders of debate and discussion, as indeed you would over aspects of European policy such as fisheries or agriculture.

**Q143 Mr Todd:** One might expect it but that was not what happened in that particular example.
***Lord Myners:*** I think that particular example, the Alternative Investment Fund Managers Directive, was the consequence of Brussels politics and a need to produce a draft Directive in a hurry and we have seen all the bad outcomes that you would expect with such a rushed and hasty process.
**Mr Todd:** Okay, thank you, Chairman.

**Q144 Sir Peter Viggers:** I would like to probe the legal framework of these proposals. The Commission cannot delegate powers it does not itself possess or delegate powers which require the exercise of discretion. That is the *Meroni* judgment of 1958. The powers given to the European supervisory authorities are extensive. Under Article 9 they can take enforcement action against individual financial institutions and under Article 11 they can arbitrate between them. Is this not exactly the so-called wide margin of discretion that the European Court of Justice said would amount to an illegal delegation of power? How content are you with the Articles as drafted?
***Lord Myners:*** There are complex issues of a legal nature here. The current proposals use Article 95 to set up the three ESAs and the ESRB and Article 105 to ask the ECB to provide the secretariat for the ESRB. You are absolutely right to remind the Committee and myself of the *Meroni* principle. There are complex issues of case law about how European agencies should operate. We are working closely with other Member States and the Council Legal Service to ensure the bodies are on a sound legal footing. The main issues that still need to be resolved are whether the supervisory authorities may be exercising discretion which goes beyond that contemplated by *Meroni* and whether the Commission is seemingly playing the role of the courts where we must not transgress the authority of the courts. The Council Legal Service has expressed some opinions here which in themselves indicate some uncertainty that they have about some of these issues, but even there we do not totally agree in an unreserved way with everything that the Council Legal Service has said, which is why we continue to engage with them, but the legal framework of the proposed structures is one which needs to be robust and able to withstand challenge because creating a new superstructure (which we support) of European regulation and supervision must be one that stands the test of compliance with legal principles.

**Q145 Sir Peter Viggers:** Can you point to any other existing Community agency which has the same powers as the proposed European supervisory authorities?
***Lord Myners:*** I think that is a question I might hand to Mr Pickford.
***Mr Pickford:*** I personally am not aware. We will give you a note if you would like. I think the point of your question, Sir Peter, is precisely to establish that there is uncertainty as to whether the Commission proposals are consistent with the *Meroni* principle. The Financial Services Secretary was making precisely that point, that we are uncertain about that and it needs to be clarified.

**Q146 Sir Peter Viggers:** Are you studying how a concerned party could challenge the decision of an ESA under Articles 9 and 11?
***Mr Pickford:*** The whole question of appeals is again something that we are actively engaged with and we do need to make all of these legal questions clear before the Regulations can have formal agreement.

**Q147 Sir Peter Viggers:** Indeed and what would happen if there was a successful legal challenge to a European supervisory authority?
***Lord Myners:*** I understand why you would be interested to ask that question, Sir Peter, but the question could be open to so much interpretation as to the nature of the challenge. I think I would come back to my contention that we must have a robust framework which clearly complies with law and legal principle and reduces the areas at risk of challenge. As currently proposed, we can see that it could give rise to numerous ways in which a judgment by any ESA could be challenged and that clearly would not be consistent with the overall objective of the structure that Jacques de Larosière has encouraged us to address here.

**Q148 Nick Ainger:** We have received a memorandum from Professor Buiter about his views on the European Systemic Risk Board. I will quote you a couple of things from it. He says the design of the proposed ESRB is a "shambles". "The membership and the nature of the Secretariat are ludicrously lopsided in favour of central banks in general and of the ECB in particular. It is high time to have a re-think, before the EU adopts and implements a financial and political disaster." How do you respond to that criticism which was also supported in evidence that we had from Dr Danielsson and Dr Alexander yesterday as well?

***Lord Myners:*** Professor Willem Buiter is a past master of under-statement! However much I read in this job, and one of the things I have come to learn as a minister is that I probably have to read for at least 20 hours a week, one never seems to read everything you intended to. This morning I printed off Professor Buiter's comments on his *FT* Maverecon site in order to read it before this afternoon's meeting but I was so interested in hearing what you were asking UKFI that I did not get round to reading it, so you have the edge over me again there, Mr Ainger. It is right that central banks play a key role in the ESRB and we expect the Bank of England to be there and to play a very significant role. National central banks have the expertise in assessing risks domestically and clearly that engagement will be invaluable at a European level, as I said earlier. National supervisors will also be involved as observers in the ESRB and there are opportunities for them to bring their significant expertise to ESRB discussions and subsequent warnings and recommendations through the advisory technical committees that will be set up in the legislation and I do not think that Professor Buiter provides much focus on the role of the advisory technical committees.

**Q149 Nick Ainger:** But is not the problem this: that it is the usual suspects and they did not spot the big one coming last time and yet we are now asking them to take on this role and hopefully they will spot the next one coming? Someone has to pick up the bill and it is not central banks; it is actually the fiscal authorities, so should they not be part of the ESRB?
***Lord Myners:*** I think some of this picks up some of the themes of your earlier engagement with John Kingman and his colleagues at UKFI because the people who failed in the past were still the people, or the type of people as Ms Keeble was saying, who were in position earlier on. I would hope that the painful experience across Europe of the financial crisis, not just here but in the Netherlands, in Belgium, in Switzerland and in Germany means that people are now much more alert to risk. I think we also need to ensure that the ESRB is manageable in terms of size. I think if you had central banks, financial regulators and treasuries involved from 27 member countries it is going to become wholly unmanageable. I have attended ECOFIN meetings where you walk into the room and ask how can a group this large possibly be an effective decision maker. My own inclination from my business experience is that a smaller ESRB would be better than a larger one but we do need to ensure appropriate national representation.
**Nick Ainger:** Is that not the problem—that because this is a European Union body every Member State has to be represented and immediately you have got an unwieldy body? Surely, if the aim of it is to genuinely provide early warnings and make recommendations that perhaps it should be trimmed down significantly? Estonia is not going to cause a major run on any banks other than its own. It does not on its own pose a systemic risk to the global economy.

**Q150 Chairman:** We actually visited Sweden a couple of years ago and we know that Sweden has heavily invested in the Baltic States and that is a big issue there.
***Lord Myners:*** Not Estonia, it was Latvia from recollection.

**Q151 Nick Ainger:** But do you see the point?
***Lord Myners:*** Yes I do. I think the architecture, Mr Ainger, needs to place much more emphasis on smaller working groups within the ESRB, so the constitution of the ESRB will have this group at the top with 27 member nation representation but the technical advisory committees and the Steering Committee and the Secretariat is where much of the day-to-day work will be done to take recommendations to the board, and I think that is the way you square the circle of having accountability and representation whilst at the same time also being effective.

**Q152 Nick Ainger:** Could we move on then to its powers because the ESRB does not have any powers, strictly speaking; its role is to provide warnings and make recommendations.
***Lord Myners:*** Yes.

**Q153 Nick Ainger:** Is it just going to be a talking shop? Is it going to be the same again as happened before when we had the Governor here when we have been looking at the banking crisis and he has pointed out various paragraphs in certain reports to say that, "Yes, I did issue warnings but nobody listened, nobody took them seriously." What is going to be different about the ESRB that these warnings and recommendations are going to be effective?
***Lord Myners:*** I think it is not sufficient to simply write in reports and leave it at that. I think if you have serious concerns about the potential for risk then those need to be escalated and pursued in a persistent way. What went wrong in a number of jurisdictions with a number of organisations which had a responsibility for financial stability is that they either confined their observations to semi-academic tomes or made their point and left it at that. So I think there is a case here for the ESRB, if it is seriously concerned about the risks, to ensure that those are listened to and to make recommendations. The ESRB may not have powers to make decisions but it can certainly make recommendations including, importantly, to ECOFIN.

**Q154 Nick Ainger:** But it can also make recommendations to the European supervisory authority, can it not?
***Lord Myners:*** Yes.

**Q155 Nick Ainger:** And the ESA can then implement those recommendations, so it does have powers which are actually greater than set out in the draft legislation because it uses the conduit through to the ESA to actually get the recommendations implemented.

***Lord Myners:*** It does not have the powers itself. It has the capacity to influence those who do have the powers.

**Q156 Jim Cousins:** Lord Myners, under the existing Directives that we have now governing investment it has already happened that the European Commission, for example, did away with over-the-counter selling of hedge fund products and that overruled the decision of the FSA and a number of London-based funds had to be wound up. That has already happened under the existing Directives. Are you not concerned that the introduction of a European supervisory authority may mean that that kind of thing happens far more often?
***Lord Myners:*** I am not familiar with the particular case you make in connection with over-the-counter hedge funds and I will refresh my mind on that and if necessary write a letter to the Committee. I think it is back again to having to have absolute clarity about the roles and responsibilities of the ESAs. It is not envisaged that the ESAs will have any power to direct or regulate individual entities. They will work to achieve a common rule book and common standards of supervision and enforcement but not to overreach national regulatory bodies when it comes to individual organisations.

**Q157 Jim Cousins:** Lord Myners, what the example I have already given illustrates is they do not have to have the power to regulate individual entities. By regulating classes of product that has much the same effect, if not to an even more dramatic degree.
***Mr Roberts:*** The law and the regulations will still be made under co-decision by the Council and the Parliament. I am not familiar with the example you give whether that was something that happened in MiFID.

**Q158 Jim Cousins:** UCITS.
***Mr Roberts:*** UCITS, right, but that was where the decision was taken under co-decision in order to set those rules. What the ESAs are going to do is make sure that the competent authorities are applying those rules and make sure that the competent authorities have the correct supervisory standard in order to enforce those rules. They will also, in areas delegated to them over time by the Council and the European Parliament, establish technical standards which would then be applied by the national competent authorities, so there are a number of checks and balances in place in order for us to be able to ensure that the standards and the rules are evidence-based and the concerns of industry and other stakeholders are taken into account. It will not be that the supervisory authorities will just be able to sit in a room and suddenly decide let us go and close down this market in the UK; they will have to go through a number of hoops before they could get to that stage.

**Q159 Jim Cousins:** Of course this issue is not just about closing down markets in the UK, although that is an instance where that happened. That is not the issue; it is the fact that it will inhibit British-based institutions from operating cross-border to create a Europe-wide market for their products. That is the point at issue. Are you not concerned that this new box of tricks will have an effect on that?
***Mr Roberts:*** Am I concerned? If we and the industry do not keep our eye on the ball when technical standards are being proposed and consulted on and bring that evidence base to those that are making those decisions, then there is a possibility that things get through but, as we have seen with the AIFM Directive, when proposals are made which clearly would harm normal business practices that evidence is brought forward and provisions are made so there is a process of checks and balances that ensures that when bad proposals are put on the table that the evidence is gathered and they can then be corrected and a more proportionate and acceptable regime put in place.

**Q160 Jim Cousins:** There is a big difference in the European frameworks that we are working to between home and host country regulation and of course that affects whether business is operated through branches, which are governed by home country regulation, or through subsidiaries, which are governed by host country regulation, and obviously sovereignties trying to defend their jurisdictions can give a big steer towards the use of subsidiaries in order to bring about home country regulation. This could be a big distortion in the way that cross-border financial institutions actually work. Are you not concerned that these new frameworks will reinforce the pressures towards having business operated through subsidiaries so that they can then be subject to home country regulation?
***Lord Myners:*** I think, Mr Cousins, we are going to see a move towards more use of subsidiaries in financial services as a consequence of the importance that we and others are placing on the concept known as the living will. The living will will oblige companies to conduct themselves through a structure of subsidiaries with less use of branching and agglomeration. I think that will have a number of other beneficial consequences including greater transparency over tax matters and regulatory arbitrage.

**Q161 Jim Cousins:** And you are aware that a lot of big British financial services and institutions are extremely concerned about being forced to put their business through a framework of subsidiaries which is much less flexible in terms of their use of capital than through branches?
***Lord Myners:*** Ms Keeble asked earlier on about HSBC. HSBC is a model for a group which is built around a subsidiary structure. It does so effectively. I am sure there will be banks which make representations against this and I am sure they will argue that it reduces their flexibility, but if it increases their strength and their ability and the regulators' ability to cope with stress then there are very strong compensating arguments.

**Q162 Jim Cousins:** So over this home/host country issue, which is of fundamental importance to cross-border financial institutions, you are not going to fight the battle, you are already sending the telegram of surrender; we will accept subsidiaries?
***Lord Myners:*** No, I will not surrender at all, quite the reverse; I am saying that I believe that over the next five to ten years we will see increased emphasis as a consequence of living wills on the use of subsidiaries in the financial sector compared with the current approach to branching. The deficiencies of the home/host structure were writ large over the problems we had with the Icelandic banks and indeed again that is something the Chancellor emphasised in his communication with the Czech Presidency at the beginning of March.
**Ms Keeble:** I wanted to ask a bit more about this and then move on to some other things. Lord Myners, you did refer to the issue of the composition of the decision-making bodies.
*The Committee suspended from 4.17 pm to 4.28 pm for a division in the House.*
**Chairman:** You are actually one minute late. We were on the verge of a collective decision to get you to the Tower! Sally?

**Q163 Ms Keeble:** You mentioned just before we went off to vote that you were concerned about the composition of the bodies that would be making the decisions. Are you also concerned about the fact that it can be possible for regulatory decisions that affect the City to be taken by qualified majority voting?
***Lord Myners:*** No, not as long as those regulations are based upon the best principles of regulation with proper research, evidence-based, and with proper impact assessment.

**Q164 Ms Keeble:** In looking at that are you satisfied that the new structures will have respect for the better regulation principles and that those are all being taken into account in drafting the new regulations?
***Lord Myners:*** We will do everything we can, Ms Keeble, to ensure that is the case, but we all know from our experience of working with Brussels that those principles are not always applied and we have to be vigilant and insistent upon it.

**Q165 Ms Keeble:** There are two things about that. I agree that we always work towards that end but in this particular instance it is affecting the most critical sector of our economy.
***Lord Myners:*** Yes.

**Q166 Ms Keeble:** Are you satisfied that you have actually got the measures in place because trying to get hold of European legislation can be like trying to grasp a jelly sometimes, can it not?
***Lord Myners:*** Many of the issues of greatest concern here are of a highly technical nature and the decision-making on technical matters in Europe does tend to be based upon evidence and proper analysis. Of course it is up to Government, Parliament and indeed the industry to be vigilant in its representations.

**Q167 Ms Keeble:** I know that there are issues about the composition of the Systemic Risk Board—and I am not sure if the same applies to the ESA—that it is dominated by central bankers who are different usually from retail bankers or industry reps, if you know what I mean.
***Lord Myners:*** The ESRB will be—

**Q168 Ms Keeble:** I am asking more about the ESAs?
***Lord Myners:*** I do not think the ESAs will be dominated by central banks. I think there will be an important role there for regulators and for technical specialists.

**Q169 Ms Keeble:** Can you just say who will be on those? If they are not central bankers, will they be national regulators or will they be eurocrats?
***Lord Myners:*** They will be national regulators so that is where we would expect the FSA to be represented for instance.

**Q170 Ms Keeble:** Do you think our FSA will be able to hold its own on its new principles of regulation?
***Lord Myners:*** I have been very impressed by the extent to which the FSA has been able to influence the thinking of many international fora. I think for instance around Basel and around the Financial Stability Board where it is quite clear that people like Paul Tucker and Adair Turner are major thought leaders. I think we have a good basis here and I also think the current level three committees work fairly well in terms of technical involvement so I think there are grounds here for some confidence rather than hopeless optimism.

**Q171 Ms Keeble:** I can see the point about the decisions at technical level where there is an issue of chasing them through. You talked about going to the ECOFIN meetings and seeing too many people around the table. There are also some very different views about what is acceptable in terms of financial products and so on. Are you concerned, even allowing for competence at the technical level, that there might still be decisions that go against our own financial services industry in terms of the balance of risk and innovation?
***Lord Myners:*** I think we are always going to have to ensure that decisions are good for the consumer across Europe and hopefully that will be equally good for the consumer in the UK. In some ways that is an unsatisfactory answer but it is a very honest answer, that we have to continue to work at this.

**Q172 Ms Keeble:** Continual vigilance. I wanted to ask about the Commission's emergency powers because there have been some concerns expressed about them and the fact that they can decide whether there is an emergency situation which may seriously jeopardise the orderly functioning integrity in financial markets or the stability of the whole or part of the financial system in the community." Those are very sweeping powers. Are you concerned about them?

***Lord Myners:*** Yes I am and we are looking very closely and carefully at the roles of the Commission in the proposed legislation. Alongside other Member States, the UK has questioned the Commission's role in some of these areas. For example, the Commission's ability to decide unilaterally when there is an emergency situation. The draft proposal has already been amended along these lines following the first discussions at the Council but I cannot conceive of a situation in which the Commission would be the natural body to be able to formulate a view on what constituted an emergency situation.

**Q173 Ms Keeble:** Are you concerned about Europe's attitude towards state aid in relation to the support that we have provided to the banking industry?
***Lord Myners:*** No, not at all. I have been dealing very closely, and officials, with Neelie Kroes on state aid and I think she has done a remarkably good job in the outcomes that she secured in Germany, Belgium, France, the Netherlands and here in the UK. Of course we have built on her work in ensuring that we have gone even further in fostering competition.

**Q174 Ms Keeble:** I just want to ask one more question about something different. You are the one person who has come here and volunteered remarks about women in the City which is obviously the financial services industry. What are your concerns about diversity and risk and what do you think the Government should be doing to deal with this issue?
***Lord Myners:*** I think one of the greatest risks in decision-making in any forum, but particularly in corporate boards and in risk, is the mutual reinforcement of prejudice and a desire to achieve early consensus in a comfortable way. The responsibility for challenging this lies in the hands of the chairman, so for instance I think a significant part of the responsibility for the failure of a number of UK banks must rest with the chairmen who did not create a challenging enough environment. Then you need people around the table with diverse perspectives and backgrounds. I do not think it is just a matter of gender. Put quite simply: if we appoint more females to the board (and I would say when I was Chairman of Marks and Spencer we had more women on that board than any FTSE 100 company has ever had on its board as a proportion of the total board so I think I am in the right place in terms of my own behaviours as far as gender is concerned) but if the women on the board went to the same sort of schools, read the same newspapers and belonged to the same clubs as the men on the board you may not necessarily have added more diversity.
**Ms Keeble:** Hence Nichola Pease's comments.
***Lord Myners:*** Yes.

**Q175 Mr Love:** I was struck earlier on by your confidence that you can win through the argument at the European level on the issues that you remain concerned about, and so I looked up in what we have been given as a rough guide to the European legislative process which states, as item three: "Political agreement is reached in the Council," which I think is where you rest your case. It then goes on to say: "The European Parliament examines and revises the Council's proposals. The Council considers and approves the revised text. The Council and the European Parliament negotiate and the Commission as a sort of *deus ex machina* is a party to all stages of negotiation." That sounds very much to me like compromise is the order of the day. Just reassure us that you can wend your way through all of this and come out the other end with the decisions that you are looking for.
***Lord Myners:*** Mr Love, I am afraid I cannot give you cast iron guarantees. I certainly would never do that only to then break the guarantees or disregard them. Europe is based on, I think the politest spin is, less compromise than consensus and Europe works towards conclusions through co-determination, going back to Mr Fallon's earlier observation about the Commission. The Commission is perfectly entitled to take initiatives and put forward proposals but those have to be debated and agreed through Council and Parliament, so it is consensus building. Am I optimistic about these things? I go into life trying my best. I frequently fail but I always think it is better to go in with an optimistic view and a determined view to try to secure good outcomes.

**Q176 Chairman:** Would you be prepared to use the veto to protect the fiscal position of Member States?
***Lord Myners:*** Yes.

**Q177 Mr Fallon:** Just coming back to this proposal that the Commission should decide what an emergency situation is, what is the revision to Article 10 that gives you such comfort? What is the amendment to which you referred?
***Lord Myners:*** I am not sure I referred to an amendment.

**Q178 Mr Fallon:** You said Article 10 had been revised.
***Lord Myners:*** I do not think I did.

**Q179 Mr Fallon:** You said improved or something like that.
***Lord Myners:*** I think what I said was other Member States and the UK are questioning the Commission's role in this area, for example the ability of the Commission to decide unilaterally when there is an emergency situation. I think it is still a matter that is subject to review, Mr Fallon, but I think it is very clear to us that the Commission is simply not the appropriate body to reach a determination on what constitutes an emergency situation. Having lived through some emergency situations myself in the last 13 months, I cannot see how the Commission can do this, but there certainly needs to be a role for the Council and there certainly needs to be a role for the ESRB to give advice on whether an emergency situation exists.

**Q180 Mr Fallon:** Because at the moment as the drafting stands it is the other way round, the Commission can enable a banking authority, the FSA for example, to take a decision here in the UK which might not be in our national interest. That is how the draft reads at the moment.
***Lord Myners:*** And that is why we are objecting to the draft of the Commission. The Commission can take an initiative but we hold to the line that the decision taken by the leaders of the 27 European countries in the June Council, as reiterated in the October Council as supported by ECOFIN and as to be determined in the final December ECOFIN and Council meetings, will be the right one; that there cannot be any compromising of national fiscal integrity.

**Q181 Mr Fallon:** But this is not just fiscal integrity. Clifford Chance gave us evidence yesterday and said that there is a real risk that this power may have a "chilling effect" on national regulators considering action to address financial turbulence. It is nothing to do with fiscal responsibility. This is simply where the Commission off its own bat decides there is an emergency because of some adverse development.
***Lord Myners:*** Yes, and I agree with the description that that could have a chilling consequence, and that is why we need to ensure that that is not where we end up in terms of the responsibilities of the Commission.

**Q182 Mr Fallon:** You told Mr Love that you frequently fail. You are not, I hope, going to fail on this stuff, are you?
***Lord Myners:*** Well, I am not going to sit here, Mr Fallon, and claim that everything in my life has been a complete success and I have achieved everything that I want to do. I am just a very optimistic, determined, energetic person who does one's best and I will use every effort to secure a good outcome here for the City of London, for the UK and for Europe, and I do not think we are in any way in conflict as in what is good for Europe will be good for the City and good for UK consumers.

**Q183 Chairman:** We do not want you to display such modesty in your negotiations. Can you clarify the proposed timetable for ministers to agree the ESRB and ESA proposals?
***Mr Pickford:*** The Council was clear that it wanted to have agreement in ECOFIN in December.

**Q184 Chairman:** Maybe I could clarify my remarks about us being chummy today, Lord Myners. It is because we feel that we are on the same side. We have been quite alarmed by some of the evidence that we have received in terms of the interpretation. A Clifford Chance lawyer, when I asked him about the supervisory authorities I said they have no powers or if they do have powers they will be operating at the far edge of legality, agreed with me on that and in evidence from Richard Portes and others talking about the ESRB and the size of that committee, to which you alluded, being too big, there seems to be an awful lot of muddle here and an awful lot of dangers lurking on this issue.
***Lord Myners:*** It is nice of you to say that there is a chummy atmosphere. I have been a considerable admirer of the work of the Treasury Select Committee over many years. I have at times sat on the public benches and looked at the work you have been doing on private equity and other areas before I became a government minister. It is absolutely right that you are looking at this area; I am pleased that you are. I am sure your wise conclusions will help formulate our position on these issues. That is why the Chancellor did not support an early general agreement because it has to go through proper parliamentary review and process and it is because of your focus on this and the wide range of people that you have taken evidence from that you will greatly inform the UK Government's position and negotiating strategy on these issues.

**Q185 Chairman:** We hope to come out with a report within two weeks and hopefully that will be helpful to you and to Parliament as well.
***Lord Myners:*** If on reflection, Chairman, we feel we could improve on any of our replies, or indeed after having read the transcript of others who have given evidence, we will volunteer a note to the Committee if we think that might possibly be helpful to you.
**Chairman:** Thank you very much for your time.

# Written evidence

**Written evidence submitted by Willem H Buiter, Professor of Political Economy, Centre for Economic Performance, London School of Economics and Political Science**

## THE PROPOSED ESRB IS OVERWEIGHT CENTRAL BANKERS[1]

### INTRODUCTION

On 25 September 2009, the Commission of the European Communities produced a proposal for EU-level macro-prudential regulation and supervision, "*Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board*". It looks as though the EU Presidency (Sweden) and the Commission are trying to get this proposal adopted in a hurry.

I recognise the need for EU level regulation and supervision of macro-prudential risk and support EU-level Colleges or Agencies to supervise systemically important cross-border banks, other financial institutions, markets and instruments. Unfortunately, the design of the proposed European Systemic Risk Board (ESRB) is a shambles. The composition of the General Board, the Steering Committee and the Advisory Technical Committee, the selection of the Chair of the General Board and the Steering Committee (the same person), the selection of the Chair of the Advisory Technical Committee (appointed by the General Board on a proposal from its Chair) and the nature of the Secretariat are ludicrously lopsided in favour of central banks in general and of the ECB in particular. It is high time to have a re-think, before the EU adopts and implements a financial and political disaster.

### (1) THIS IS IT

The European Commission's proposal is worth quoting at length. In this Section, all quotes are in italics. My own comments are in regular characters.

#### 6.1 *Establishment of the ESRB*

*The ESRB is an entirely new European body with no precedent, which shall be responsible for macro-prudential oversight. The objective of the ESRB shall be threefold:*

- *It shall develop a European macro-prudential perspective to address the problem of fragmented individual risk analysis at national level.*
- *It shall enhance the effectiveness of early warning mechanisms by improving the interaction between micro-and macro-prudential analysis. The soundness of individual firms was too often supervised in isolation with little focus on the degree of interdependence within the financial system.*
- *It shall allow for risk assessments to be translated into action by the relevant authorities.*

#### 6.2 *Tasks and powers of the ESRB*

*The ESRB will not have any binding powers to impose measures on Member States or national authorities. It has been conceived as a "reputational" body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority.*

#### 6.2.1 *Warnings and recommendations*

*An essential role of the ESRB is to identify risks with a systemic dimension and prevent or mitigate their impact on the financial system within the EU. To this end, the ESRB may issue risk warnings. These warnings should prompt early responses to avoid the build-up of wider problems and eventually a future crisis. If necessary, the ESRB may also recommend specific actions to address any identified risks.*

*ESRB recommendations will not be legally binding. However, the addressees of recommendations cannot remain passive towards a risk which has been identified and are expected to react in some way. If the addressee agrees with a recommendation, it must communicate all the actions undertaken to follow what is prescribed in the recommendation.*

*If the addressee does not agree with a recommendation and chooses not to act, the reasons for inaction must be properly explained. Hence, recommendations issued by the ESRB cannot be simply ignored.*

[1] © Willem H Buiter 2009.

*The ESRB shall decide on a case by case basis whether warnings and recommendations should be made public.*

Comply or explain, in short.

6.5 *The internal organisation of the ESRB*

*The ESRB shall be composed of: (i) a General Board; (ii) a Steering Committee and (iii) a Secretariat.*

6.5.1 *The General Board*

*The General Board is the decision making body of the ESRB and as such, will be responsible for the adoption of the warnings and recommendations described in section 6.2.1 of this explanatory memorandum.*

*The members of the General Board with voting rights are:*

- *the Governors of national central banks;* (currently 27)
- *the President and the vice-President of the ECB;* (2)
- *a Member of the European Commission;* (1)
- *the Chairpersons of the three European Supervisory Authorities;* (3).

*The members of the General Board without voting rights are:*

- *one high level representative per Member State of the competent national supervisory authorities;* (currently 27, assuming there can be no more than one competent national supervisory authorities; we already know there can be at least one incompetent national supervisory authority; if the competent national supervisory authority is the central bank, that central bank gets a non-voting member of its own as well as its voting Governor member); and
- *the President of the Economic and Financial Committee;* (1). This is the committee established pursuant to Article 114 of the Treaty establishing the European Community.[2]

Until the EU expands its membership, the membership of the General Board would therefore be 61, enough to run a small football league. This is not a body that will do anything useful.

6.5.2 *Chairperson*

*The Chair will be elected for five years from among the Members of the General Board of the ESRB which are also Members of the General Council of the ECB. The Chair will preside the General Board as well as the Steering Committee and instruct the Secretariat of the ESRB on behalf of the General Board. The Chair shall be able to convene extraordinary meetings of the General Board on its own initiative. As regards voting modalities within the General Board, the Chair will have a casting vote in the event of a tie. The Chair shall represent the ESRB externally.*

What is interesting here is that, because the General Council of the ECB includes the six-member Executive Board and the 27 Governors of the national central banks (NCBs), it could, in principle and in theory be possible for someone other than the President of the ECB to be the Chair of the ESRB, including a Governor of an NCB that is not part of the Eurosystem. In practice, because the Governing Council of the ECB (the six Executive Board members plus the Governors of the 16 NCBs that are also members of the Eurosystem), which is a subset of the General Council, has 18 voting members on the ECB General Board (the President and the Vice-President of the ECB and the Governors of the 16 Eurosystem NCBs), it will always be able to have its way, as the total number of voting members is 33.

6.5.3 *The Steering Committee*

*Given the size of the General Board—which will comprise a total of 61 members—a Steering Committee will assist the decision-making process of the General Board. The Steering Committee will prepare the meetings of the General Board, review the documents to be discussed and monitor the progress of the ESRB's on-going work.*

*The Steering Committee will comprise the Chair and Vice-Chair of the General Board, the Chairpersons of the three ESAs, the President of the EFC, the Member of the Commission and five members of the General Board which are also members of the General Council of the ECB (12 members).*

Note that central bankers will dominate the Steering Committee, with seven out of 12 members. The Chair of the Steering Committee is the same person as the Chair of the General Board, all but certain to be the President of the ECB.

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[2] Contrary to what I asserted in the first version of this note, the EFC is not a committee of the European Parliament. Rather, it gathers senior civil servants from national Ministries of Finance. It is de facto a preparatory forum for the ECOFIN Council. The relevant committee of the European Parliament is called the Economic and Monetary Affairs Committee. I am indebted to Carlomagno (carlomagno07@gmail.com) for correcting my error.

6.5.4 *The Secretariat*

*The ECB will ensure the Secretariat to the ESRB. The Secretariat will receive instructions directly from the Chair of the General Board.*

Who was surprised that the ECB will "ensure" the Secretariat to the ESRB?

6.5.5 *The Advisory Technical Committee and other sources of advice*

*The role of the Advisory Technical Committee (hereinafter, referred to as the "ATC") is to provide advice and assistance to the General Board on the issues that are within the scope of the ESRB, on request from the latter.*

*The members of the ATC are:*

— *one representative of each national central bank;*

— *one representative from the ECB;*

— *one representative of the national supervisory authority per Member State;*

— *one representative of each European Supervisory Authority;*

— *two representatives of the European Commission; and*

— *one representative of the EFC.*

*The Chair of the ATC shall be appointed by the General Board on a proposal from its Chair.*

Note that, because for quite a few member states the representative of the national supervisory authority will come from the central bank, it is quite likely that the ATC will have a majority of central bankers on it. Its chair is effectively in the gift of the President of the ECB.

(2) Central Banks are Wildly Over-represented on the Proposed ESRB

Six arguments support the view that central banks are greatly over-represented on the proposed ESRB.

(1) The ECB, the Eurosystem NCBs and the rest of the EU NCBs have not exactly covered themselves with glory in the area of macro-prudential supervision and regulation during the past decade. Like the Fed, they failed to foresee the financial crisis let alone to prevent it. Like the Fed, the ECB and most other EU central banks contributed over a period of many years to the unsustainable credit and asset market boom and bubble that turned to bust starting in August 2007. They did so by keeping interest rates too low for too long, by failing to control the excessive growth of credit and the broad monetary aggregates, and by failing to diagnose the excessive leverage, and the maturity and liquidity mismatch that was building up in the banking sector and shadow banking sector balance sheets.

In Germany, the Bundesbank failed to diagnose the deep rot in most of the Landesbanken, and the excessive leverage of its main cross-border banks; in Spain, the Banco de España, despite being widely admired for its pioneering of dynamic provisioning, failed to recognise the wildly excessive exposure of its regional Cajas to the construction industry, developers and the housing market generally. The Banque de France missed an epochal fraud at Société Generale. The Dutch central bank missed the ball completely with the ABN-Amro take-over and the subsequent collapse of Fortis. The litany of central bank failure is endless.

It makes no sense to turn over control of the task of macro-prudential supervision to a set of institutions that have manifestly failed to do the job properly at the latest time of asking. They have no track record of competence in macro-prudential supervision.

Clearly, as the ultimate providers of domestic-currency-liquidity of the highest quality, central banks have to be actively involved in maintaining financial stability and in restoring it should it become impaired. They should not be put in charge of the activity, however. Arguments to the contrary, including those made by the Fed (in its opposition to proposals for a new council of financial regulators who would collectively rule the financial stability roost, rather than conceding supremacy to the Fed or a to body dominated by the Fed,) have no intellectual merit and are best explained as manifestations of the very human and institutional desire for more turf.

(2) The central banks in control of the ESRB would be conflicted in the use of their instruments, especially in the setting of the short-term interest rates under their control, by the potentially clashing demands of price stability and financial stability. This point has been made many times, but does not get any less convincing because of its frequent invocation.

(3) Macro-prudential regulation and supervision inevitably involves guiding and direction the actions of, and even determining the fate of, large systemically important individual financial institutions. Such institutional life-or-death decisions involve property rights and other important distributional and wider political dimensions, as well as technical issues. They are inherently political, even party-political. The independence of the ECB in the area of price stability could be undermined if it were to play a dominant role in macro-prudential regulation and supervision.

(4) The proposed construction ignores the central fiscal dimension of financial stability. Although there was much that was flawed about the UK model of financial stability management, its tripartite nature has to be a feature of any viable system for macro-prudential management. The key financial stability related competencies are (1) liquidity provision; (2) prescribing and proscribing behaviour of financial actors and (3); solvency support. These three functions or competencies can be performed by three different institutions, with the central bank engaged in liquidity provision, the Treasury providing tax payer support for under-capitalised systemically important institutions and a regulator/supervisor telling financial institutions what they must do and/or cannot do. These three functions or competencies can also be bundled in just two organisations (typically the Treasury for the solvency support and the central bank for liquidity support and regulatory and supervisory authority), or even by just one: the Treasury taking over the functions of the central bank and the regulator/supervisor.

Regardless of how these tasks are structured institutionally, the recent crisis has made it clear that without the ultimate support of current and future tax payers (managed through the Treasury), either there is no such thing as a safe bank (or a safe highly leveraged institution with serious asset-liability mismatch as regards maturity, liquidity and currency mix), or safety for the banks can only be assured by abandoning the goal of price stability.

When central banks act on their own to recapitalise under-capitalised banks, as has been done on a large scale in the US and on a smaller but still significant scale in the Euro Area, the UK and Japan, they act in a quasi-fiscal capacity, that undermines important constitutional and legal prerogatives of the legislature. These quasi-fiscal operations of the central banks (through artificially low borrowing rates for banks, overvalued collateral and outright purchases of private securities at prices above fair value etc.) are in addition often opaque and non-transparent. They represent an abuse of seigniorage by an appointed, unaccountable authority. In the interest of good government, quasi-fiscal actions should be rooted out and replaced by explicit, transparent fiscal actions, including fiscal bail-outs.

Before banks are supplied with additional capital by the tax payer, however, the unsecured and secured creditors and other counterparties of the undercapitalised or borderline-insolvent banks should be asked to donate blood. In inverse order of seniority, haircuts should be applied to unsecured creditors and to secured creditors and other counterparties, or their (contingent) claims on the bank should be converted into common equity.

It is astonishing to have a proposal for a European Systemic Risk Board that does not find a place in the key decision-making bodies for the fiscal authorities—a place that ought to be at least as significant as that of the central banks. Indeed, a proper tripartite representation, with equal voting rights for central banks, fiscal authorities and regulators/supervisors, has much to recommend it.

(5) The proposed construction does not allow for the proper representation of the financial industry. Obviously, we don't want turkeys to turn up in large numbers to vote against Christmas. Industry representatives should, however, be present as a matter of course in a non-voting capacity. The expertise in the central banks, the regulators/supervisors and the ministries of finance concerning complex systems and convoluted financial instruments is quite inadequate as a foundation for effective macro-prudential management. We must get the banks, hedge funds and other financial institutions inside the tent.

(6) The proposed construction does not permit external, independent talent, knowledge and expertise to be brought to bear on the decision making process. There are independent experts outside the central banks, regulators/supervisors, ministries of finance and the (private) financial sector who would have much to contribute to a systemic risk board. Time to get such experts, be they at universities, think tanks or other research institutes on board.

(3) No Substantive Accountability

The proposal repeats a feature of the design of the ECB that is most unwelcome: the absence of any substantive accountability. To the ECB (and to its architects), accountability means reporting obligations—nothing more. And indeed in the Commission's proposal it states:

6.6 *Reporting obligations*

*"The ESRB shall be accountable to the European Parliament and to the Council and shall therefore report to them at least annually. The European Parliament and the Council may also require the ESRB to report more often."*

Reporting obligations are part of what is sometimes called formal accountability. It means that the Agent or Trustee (the ESRB) is required to provide the Principal or Beneficiary (the Council, the European Parliament, the citizens of the EU) with the information necessary to assess how well the Agent/Trustee has performed with respect to its mandate. Substantive accountability means that the Principal(s) can impose sanctions on the Agent/Trustee if the performance of the Agent/Trustee is unsatisfactory in the eyes of the Principal(s).

Substantive accountability is lacking for the ECB, because it is logically incompatible with the extreme degree of independence accorded by the Treaty to the ECB in the conduct of monetary policy. That same extreme degree of independence the ECB enjoys in the pursuit of price stability, the Commission apparently

also wishes to bestow on the ESRB in the pursuit of financial stability. This is implied by its proposal for two reasons. First, because accountability is, as with the ECB, defined purely in terms of reporting obligations, with no sanctions or punishment available to be imposed on the ESRB and its members should their performance not be up to snuff. Second, because the majority of the voting members of the General Board and the Steering Committee are members of the Governing Council of the ECB. The Executive Board members of the ECB and the 16 NCB Governors of the Eurosystem are inviolable and untouchable as monetary policy makers. How could they be fired, demoted, reprimanded, subjected to a pay cut or tarred and feathered and run out of town in their new capacity as members of the General Board and Steering Committee of the ESRB?

The lack of substantive accountability of the ECB as regards monetary policy should not be extended to the domain of financial stability, which is an inherently political rather than just a technical issue.

## Conclusion

We need an EU level macro-prudential stability board. The current proposals for the ESRB are, however, deeply misguided, as they make the central banks the dominant players in the systemic risk game. Central banks have neither the technical knowledge, nor the tools and instruments nor the legitimacy to dominate the macro-prudential financial stability framework. Back to the drawing board.

*28 October 2009*

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## Written evidence submitted by Clifford Chance LLP

### The Establishment of the Proposed EU Financial Authorities

You have asked for our views as to the current state of the proposed EU legislation to establish the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Markets Authority (together the European Supervisory Authorities, or ESAs) which will together comprise the European System of Financial Supervisors, along with the European Systemic Risk Board.

The ESAs effectively already exist in the form of the Lamfalussy level 3 committees. The existing role of these committees is to co-ordinate policy development work amongst European national financial regulators. Their track-record in this regard has been steady but unspectacular. In practical terms the effect of these reforms is to endow these committees with a budget, a permanent secretariat and some slightly extended responsibilities.

The proposal is that the ESAs will be established with budgets, staff and legislative powers, and will then determine for themselves the scope of their remit and the procedures which they will follow. This is not objectionable per se—all agencies are to some extent necessarily incomplete when they are established. However given the breadth of the mandate to be given to the ESAs, the period after the establishment of these entities but before they have completed the process of determining their mandate may increase systematic and regulatory uncertainty. For this reason it is arguable that it would have been a better approach to establish and empower the ESAs progressively; conferring on them each specific power once they had decided and published the mechanisms by which that power would be implemented.

There are, however, some specific concerns which arise from the proposals. In general terms they relate to the very high level of uncertainty as to how these entities will operate and be organised which may be inevitable at this stage. However since they raise significant issues relating to sovereignty, effective regulation and market efficiency they should be at least addressed at this stage.

#### *The Co-ordination Role of the ESAs*

The success of the London markets is driven in good part by the excellence of its regulation, and in particular from the FSAs status as a global thought leader in regulating complex and international markets which operate in different legal and cultural environments. The maintenance by the FSA of this position requires it to be able to develop and implement regulatory policy at a pace which broadly replicates the rate of change in the markets. The proposed mechanisms are potentially beneficial if they enable successful regulatory policies to be disseminated across the EU. They will be damaging if they significantly inhibit the FSAs ability to develop policy to respond to (or to lead) market developments.

It is proposed that these committees should have a greater role in international communication between regulators. It is not clear to us that this is desirable. Effective regulation of the global financial system requires close and immediate communication between regulators. Put simply, it would be highly damaging if at a time of crisis the FSA and the federal reserve or the SEC were constrained in their dealings with each other by the necessity to involve a semi-structured Brussels bureaucracy.

The proposed role for the ESAs in "crisis management" is very unclear. The current proposal is that the commission will "declare an emergency", and thereafter the relevant ESR will have the power to require national regulators to take action in accordance with relevant EU legislation (subject to a fiscal safeguard). However there is no public material which indicates how an ESA would use this power, in what cases or to

what end. It is also unclear whether and to what extent such a "declaration of emergency" could inhibit national regulators from taking immediate steps. Given that it is very unlikely that an ESA will be able to act promptly or without notice (this is not a criticism, but a necessary consequence of the EU-wide composition of these agencies), there is a real risk that this power may have a chilling effect on national regulators considering action to address financial turbulence.

These issues are aspects of a wider concern, which is that the markets are global and not European, and international action to address market failure therefore needs to be primarily international. European action may be part of the solution, but it may also be part of the problem. Our view is that what is required is an international convention which addresses at least the following broad issues so as to:

(a) Provide a legal basis for colleges of supervisors.

(b) Create a principle of optimal recovery for all clients in cross-border insolvencies of financial sector companies.

(c) Provide a basis for mutual development of client protection measures and for mutual recognition of those measures.

(d) Mandate information-sharing and co-operation amongst supervisors and economic stability regulators, designate a lead supervisor and enable them to co-operate in multinational work-outs.

(e) Provide for multilateral co-operation in the supervision of markets which do not have a single identifiable seat (such as derivatives, syndicated loans and foreign exchange markets).

*Technical Standards*

It is suggested that in a number of areas where the Commission has the right to make determinations under the existing directives, these committees should compile draft technical standards to be approved. This might be an improvement on the current position where the Commission is required to send a request to the existing committee for advice, and the committee then makes a recommendation to the Commission.

*Decision-Taking and Rulemaking*

The ESAs will not have power to take decisions or to make rules—European law requires that these powers are reserved to the Commission, and we believe that this could not be changed without an amendment to the EU treaty. The attempt to give the committees the power to review the issue of whether individual national regulators have correctly implemented EU legislation appears to be an attempt to stretch this point. This is done by:

(a) conferring on the ESA the power to issue "guidelines" and imposing on competent authorities an obligation "to make every effort to comply with those guidelines"; and

(b) conferring on the ESAs a power to take action against a particular national regulator where it has not "correctly applied " the relevant EU legislation." By issuing a recommendation to that national regulator to change its policy.

The power to "settle disagreements" is also troublesome. What is proposed here is that where there is a dispute between national regulators as to practices, an ESA should have the right to make a determination as to which is right and, if its decision is not accepted by a national regulator, to adopt an individual decision addressed to an individual market participant. This comes very close to giving the ESA the power to regulate individual market participants directly. Thus from the day that the regulation is enacted it will potentially have significance for individual firms.

There is nothing inherently objectionable from a practical perspective in these policies. However the legislative approach which has been adopted runs the risk of creating significant legal uncertainty during the hiatus period after these entities have been created but before they have determined their powers, practices and procedures.

*Interaction of Macro-prudential Supervision and Regulation*

There is a particular concern as regards the ESRB. It is generally accepted that the systemic risk issues which the ESRB is charged with addressing are interconnected with economic and monetary policy. The ESRB has the power to make recommendations to national supervisory authorities as well as to member states and the ESAs on any issue relating to systemic risks. The ESRB will have the power to "name and shame" regulators which do not act in accordance with its determinations. This gives rise to two concerns:

(a) the interposition of the ESRB between national regulators and national governments may not be desirable or efficient; and

(b) this power of the ESRB is not subject to an explicit carve-out in respect of sovereignty and imitation. Its use could therefore have the effect of enabling the ESRB to bring pressure on member state governments to alter their economic or fiscal policies in accordance with ESRB policy.

*28 October 2009*

**Written evidence submitted by Dr Kern Alexander**[3]

## PROPOSALS FOR EUROPEAN MACRO AND MICRO PRUDENTIAL FINANCIAL REGULATION

### Introduction

The Europe Commission has proposed a major institutional restructuring of EU financial regulation that involves the creation of a European Systemic Risk Board to monitor macro-prudential risks and three EU supervisory agencies to adopt a regulatory code and to oversee member states micro-prudential supervision. The Commission proposals, if approved by Council, will lead to significant institutional consolidation at the EU level. This will bring important changes to the existing EU framework of financial supervision that is based on home country control and mutual recognition based on minimum standards. It also has important implications for international supervisory and regulatory arrangements because the proposed EU financial supervisory agencies and ESRB are likely to play a significant role in setting the international regulatory agenda. This memorandum examines how the Commission's proposals will change the institutional structure of financial supervision and regulation in Europe and discusses some of the institutional and legal issues regarding the operations of the proposed framework.

### 1. European Financial Regulation and Supervision

The challenge arising from the increasing integration of European and global financial markets and the recurrence of financial crises, such as the 2007–08 financial crisis, is how to strike the right institutional balance between EU institutions and member states in the regulation and supervision of financial markets. In the EU, most financial regulation is based in the member state where the financial firm is incorporated or has a headquarters. Supervision is based on the principle of home country control in which the supervisor of the jurisdiction where the bank is chartered or incorporated exercises extraterritorial regulatory responsibility over the bank's EU branch operations. However, when an EU-based banking group has subsidiaries operating in other EU states, the supervision of those subsidiaries is exercised by the host state supervisor of the jurisdictions where the subsidiaries are incorporated.

The regulatory policy incentives of home country regulators are to protect the depositors and creditors of banks based in their home jurisdictions. This works as long as banking activities are largely confined to one country—normally the country where the bank is incorporated and has its home license. It has also worked well for banking groups which have fragmented management structures in which the management of foreign subsidiaries is largely autonomous from the day-to-day management of the parent group, hence allowing the foreign subsidiaries' management to deal independently with host state supervisors can result in satisfactory regulatory objectives.

However, as global financial markets have become increasingly integrated, the structure of banking markets and their management have changed significantly. Large banking groups have been created from a growing number of cross-border bank mergers. As a result, many banking groups today have major operations in multiple jurisdictions where they can pose systemic risk to a host state banking system. In addition, large banks are increasingly dependent on international capital markets for much of their funding. Banking groups are also progressively centralising a number of key functions at the group level. For instance, risk management, liquidity management, funding operations and credit control, are typically exercised at the group level or in specialised affiliates in order to gain economies of scale and synergies in specialist operations. This also has led to the distinction between branches and subsidiaries becoming blurred. For instance, it is no longer the case that a large subsidiary bank operating in one jurisdiction will be allowed to stay in business if its parent company bank defaults or fails in another jurisdiction (at least not for the short-run).

These market changes pose a number of challenges for the existing EU regulatory framework. The recent financial crisis in Europe had substantial cross-border effects because of counterparty exposures through the money markets and the disruptions to trade and finance caused by the cross-border operations of many large banking groups and financial conglomerates.

The EU legislative and regulatory framework of home country control based on mutual recognition and minimum standards has accomplished a great deal in promoting the objectives of the EU internal market but has recently come under strain because of growing integration in key areas of European banking and capital markets and increased risk exposures of counterparties located in multiple member states. The financial crisis demonstrated that the EU's home country control supervisory framework was inadequate to deal with the cross-border dimension of risk-taking in European financial markets. An important reason for this is that the legal competence of EU state supervisors has primarily focused on home markets, with little attention given to the impact of their actions on the broader European market or other EU host states.

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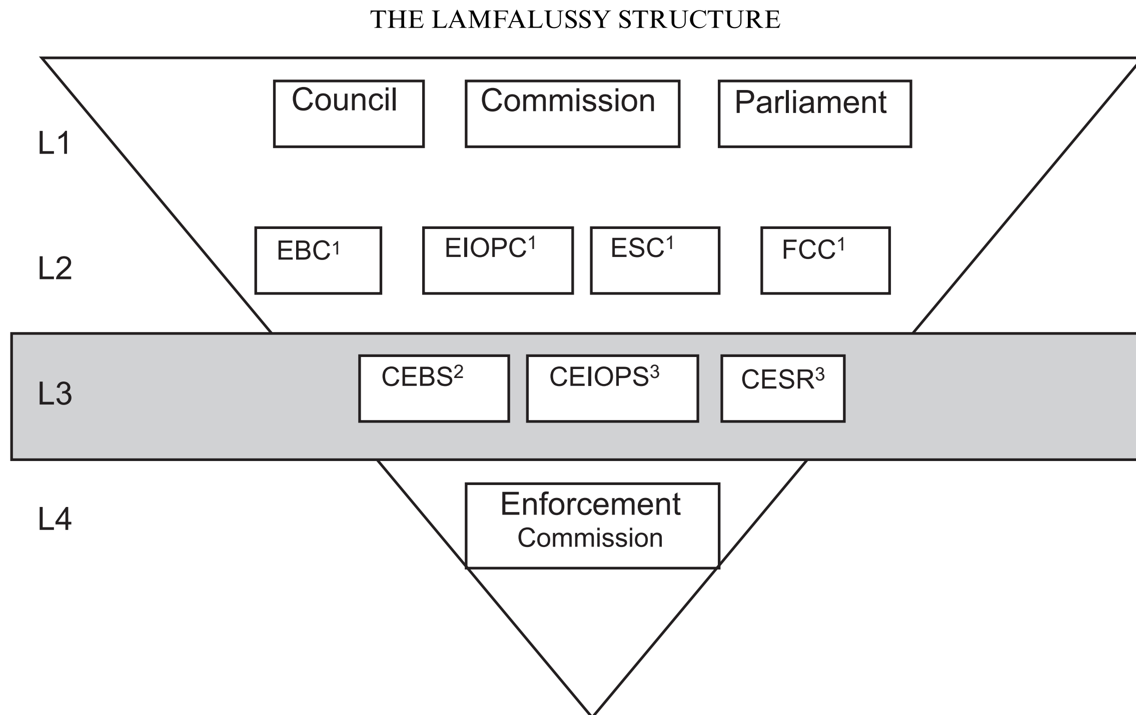
2. The Lamfalussy Process and Institutional Consolidation

The evolution of EU markets to more integrated structures based on liberalisation of capital restrictions and trade in financial services has been facilitated by the growing importance of the euro as a reserve currency and advances in technology that enable market participants to operate more easily in a cross-border environment. The role of EU member state institutions in regulating financial markets has undergone significant changes as well. The EU Financial Services Action Plan (FSAP) has recognised the Lamfalussy four-level framework as essential in achieving the EU Treaty objectives of an open internal market for capital movement and trade in financial services. The Lamfalussy four-level legislative decision-making process now applies to all major financial sectors, including banking, securities, insurance and pension fund management.[4]

THE LAMFALUSSY STRUCTURE




EBC = European Banking Committee
EIOPC = European Insurance and Occupational Pensions Committee
ESC = European Securities Committee
FCC = Financial Conglomerates Committee
CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors
CESR = Committee of European Securities Regulators

[1] Finance ministries
[2] Supervisors and Central Banks
[3] Supervisors

The three so-called Lamfalussy Level 3 networks presently consist of 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 have been acting in a regulatory capacity and prior to the crisis were successful in expediting the regulatory standard-setting process by making it more flexible and efficient. The successful operation of the regulatory networks depends on cooperation and frequent contacts between member state supervisors. To this end, the Committees have begun a number of initiatives to increase cooperation and convergence; but the changing structures of financial markets necessitates further institutional coordination in the Level 3 committees to address the growing cross-border effects of financial crises and the cross-border activities of large financial groups.

The Lamfalussy programme does not create a legislative competence to supervise financial markets at the European level. Indeed, the original Report of the Committee of Wise Men in 2000 envisioned only two principal functions for the Level 3 committees: (1) technical advice regarding the development of implementing measures, and (2) promotion of consistent implementation of Community legislation and

[4] Commission Decision 2001/527/EC (6 Jan 2001) (establishing Committee of European Securities Regulators); Commission Decision 2004/5/EC (5 Nov 2003)(establishing Committee of European Banking Supervisors); and Commission Decision 2004/6EC (establishing Committee of European Insurance and Operational Pensions Supervisors (CEIOPs). The four levels consist of (1) legislative proposals of high level principles through the traditional EU co-decision process; (2) based on the legislative proposals, EU finance ministers agree to implementing measures for member states; (3) member state regulators make proposals to Level 2 finance ministers regarding the implementing measures and then consult with each other regarding implementation; and (4) national compliance and enforcement. See Lamfalussy Committee, "The Final Report of the Committee of Wise Men on the Regulation of European Securities Markets" (15 February 2001)(Brussels).

enhancement of convergence in EU supervisory practices. It is essentially a regulatory process that relies on existing comitology procedures as set forth in Article 202 of the Treaty of Rome to develop EU financial legislation based on proposals from national finance ministers and regulators, in consultation with industry. Although the early stages of implementation of the Lamfalussy programme ignited some controversy concerning the scope of legislative authority for EU institutions, it has resulted in streamlined decision-making, promoted a wide ranging dialogue with industry and consumer groups and has disseminated its work and proposals to all relevant stakeholders. The Council and Parliament have recognised the early success of the Lamfalussy programmes and the ongoing work of the networks of the three regulatory committees.

The Lamfalussy framework has, however, been criticised as being too slow and lacking the institutional capacity to respond effectively to a cross-border financial crisis within the European Union. Prior to the crisis, EU authorities had recognised that the changing structure of European financial markets and the cross-border operations of large banking groups necessitated further institutional consolidation at the EU level and in particular raised important issues regarding how much authority the Level 3 committees should be given in overseeing national supervisors and cross-border firms and wholesale capital markets.[5] Moreover, the International Monetary Fund's 2004 surveillance report identified the weak link in EU supervisory arrangements to be the absence of a clear framework of coordination between EU national supervisors with respect to the oversight of the cross-border operations of financial groups in EU states.[6] The recognised weaknesses in the EU institutional framework of financial supervision became even more apparent in 2007 and 2008 when the credit crisis incapacitated wholesale financial markets and EU supervisory authorities were unable to respond in a coherent or effective manner.

### 3. European Union's Regulatory Response to the Crisis

The Commission's proposals are premised on the notion that current supervisory arrangements proved incapable of preventing, managing and resolving the recent financial crisis. Although the EU regulatory response lacked coherence in the early stages of the crisis in 2007 and early 2008, the European Commission has now proposed specific and meaningful proposals for EU regulatory reform. The catalyst for EU reforms was the publication of the Report of the Committee chaired by Jacques De Larosière in February 2009. The De Larosière Report was commissioned by the European Commission and it contains substantial proposals for the reform of European financial regulation.

The De Larosière Report proposed the creation of a European Systemic Risk Board (ESRB) that would have responsibility for macro-prudential oversight throughout the European Union.[7] The ESRB would consist of EU central bank governors, including the ECB President, the chairpersons of the three EU Supervisory Authorities[8] (the former Chairmen of the Lamfalussy Committee level 3 committees), and representatives from the EU national supervisory authorities, as well as the Chair of the European Financial Committee and the President of the European Commission.[9] The De Larosière Report also proposed the creation of a European System of Financial Supervision that would consist of a more institutionally consolidated version of the existing 3 Level 3 Lamfalussy Committees working in tandem with the EEA member state supervisory authorities.

On 23 September 2009, the Commission adopted several Regulations that incorporated most of the De Larosière recommendations including establishing the ESRB and ESFS along with the three new EU financial supervisory agencies.[10] Under the Regulation, the ESRB would consist of the representatives and officials of over 60 EU agencies and member state regulatory authorities. Under the proposal, the ESRB would monitor and assess systemic risks—individual banks and the whole European financial system. The ESRB would also issue recommendations and warnings to countries or financial groups or other concerned entities and would report all recommendations and warnings to the European Council of Ministers. The ESRB would devise specific follow-up procedures and "moral incentives" to follow recommendations or explain why not. The ESRB can inform the Council if unsatisfied with a member state or entity's explanation and can conduct "name and shame" publicity if necessary.

[5] See CEBS and the European System of Central Bank's Banking Supervisory Committee (BSC) Joint Guidance (2006) (extending the guidance role of the Level 3 Committees from "going-concern" activities to crisis management cooperation). Moreover, CEBS and the Banking Supervisory Committee (BSC) created a Joint Task Force on Crisis Management in order to enhance cooperative arrangements in a financial crisis and which has issued guidance for supervisors to follow in the event of a systemic financial crisis.(IIMG, 2007, p 19).

[6] IMF Article IV Surveillance Report, (2007) p 27; see also IMF Article IV Surveillance Report (2006) para 12.

[7] The European Commission welcomed the proposal in its Communication entitled "Driving European Recovery" (4 Mar. 2009) COM(2009) 114. Later, the Commission in its Communication entitled "European Financial Supervision 2" (27 May 2009) proposed a series of reforms to the current Lamfalussy institutional arrangements for safeguarding EU financial stability which included the creation of a European Systemic Risk Board responsible for macro-prudential oversight, and a European System of Financial Supervision (ESFS) responsible for overseeing micro-prudential supervision of firms operating in Europe.

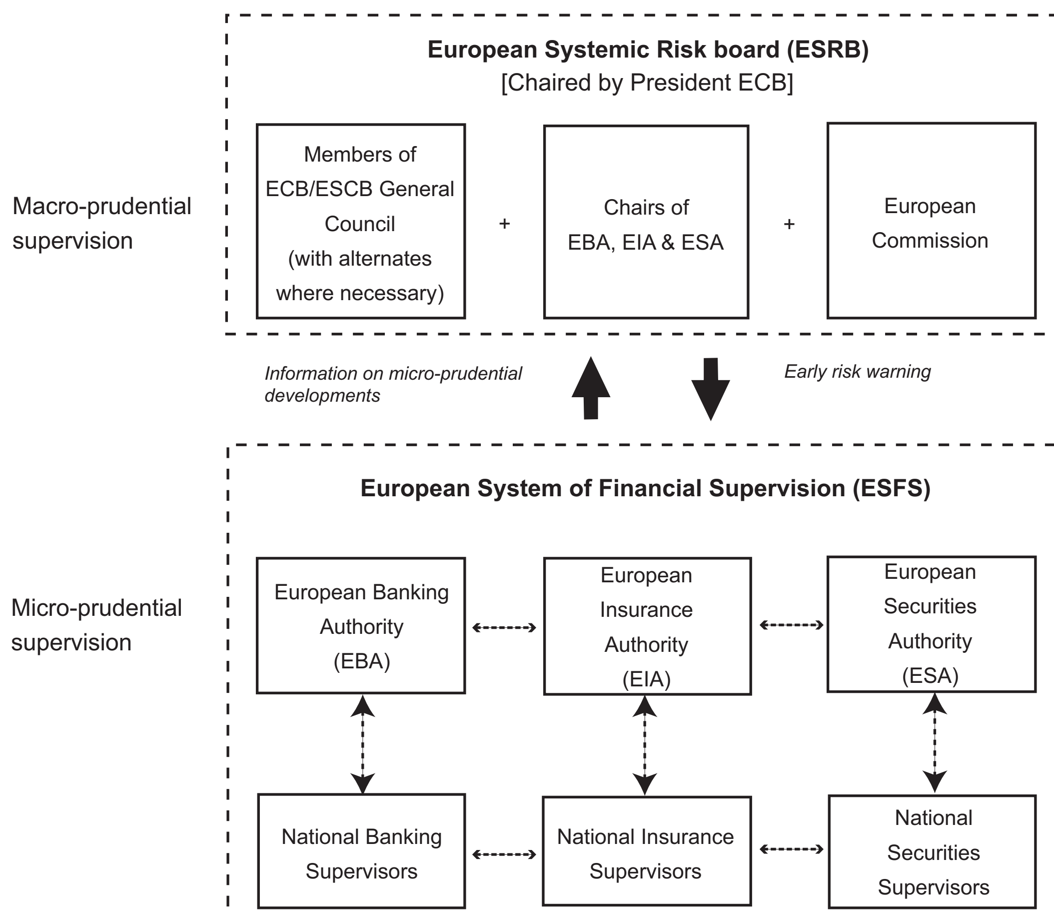
[8] The three authorities would be a European Banking Authority, European Securities and Markets Authority, and the European Insurance and Occupational Pension Authority.

[9] The Presidents of the EFC and Commission would be observers and not have voting rights.

[10] The ESRB secretariat would be entrusted to the European Central Bank. The legal basis of the Regulation is Article 95 of the Treaty on European Union (as amended), which requires co-decision by the Council of Ministers and the European Parliament.

Regarding micro-prudential regulation, the Commission adopted three regulations[11] that would create a European System of Financial Supervisors (ESFS) consisting of a network of national supervisors along with three new European Supervisory Authorities (ESAs), created from the existing Lamfalussy Level 3 Committees of supervisors, with responsibility for banking, insurance and pensions and securities markets regulation respectively.[12] The ESFS would oversee the exercise of shared and mutually reinforcing responsibilities between member state supervisors and the ESAs with the ESAs performing specifically delegated tasks.

The Commission's Regulations would restructure and consolidate the EU regulatory and supervisory framework in order to enhance its effectiveness, coherence and accountability to Parliament and Council. The institutional framework would look like the following:




The above institutional framework recognises the interdependence between micro- and macro-prudential risks across EU financial markets and the need to be accountable to the views of market participants and all EU stakeholders, including financial institutions, investors and consumers. It provides a more consolidated and rational institutional design for linking micro-prudential supervision of individual firms with the supervision of the linkages between institutions and between institutions and the broader financial system. The ESRB is expected to provide a broader perspective of the financial system and to interact with supervisors in monitoring and assessing system-wide risks. In this capacity, the ESRB would serve as the basis for developing a more integrated EU supervisory structure that would improve consistency in regulatory and supervisory practices and approaches across EU/EEA states, thus creating a level playing field and a more efficient regulatory framework for controlling systemic risk and preventing market failure.

The ESRB was created as a body without legal personality pursuant to article 95 of the EC Treaty. The absence of legal personality provides it with more institutional flexibility and scope to fulfil its core functions and broader mandate to monitor the whole European financial system. It also allows the ESRB to interact flexibly with the ESFS and member state supervisors to form a common framework of regulation that allows for regulatory innovation to address evolving market risks.

[11] Regulation of the European Parliament and of the Council COM(2009) 503 (establishing a European Securities and Markets Authority), COM(2009) 502 (establishing a European Insurance and Occupational Pensions Authority), and COM(2009) 501 (establishing a European Banking Authority).

[12] The three ESAs would be known respectively as the European Banking Authority (EBA), European Securities and Markets Authority, and a European Insurance and Occupational Pension Authority (EIOPA).

The Regulation confers a specific role for the European Central Bank in the ESRB's operation: the ECB's President and Vice President serve on the ESRB Board. The ECB would provide the ESRB secretariat that provides administrative, logistical and analytical support. The ECB's integral role in overseeing and effectively discharging the operations of the ESRB means that under Article 105 (6) of the Treaty the Council is required by unanimous to adopt this Regulation in order for the ECB to have the authority to carry out certain tasks indirectly through the ESRB that would constitute prudential supervision.

4. The ESFS and Colleges of Supervisors

The ESFS would place greater emphasis on using colleges of supervisors from EEA states to supervise the operations of Europe's largest cross-border banks and financial institutions. The proposed European Banking Authority (formerly the Lamfalussy Level 3 Committee of European Bank Supervisors (CEBS)) would have responsibility for overseeing the implementation of guidelines and decision-making procedures for the colleges. Membership of the colleges would include: All EEA supervisors of subsidiaries; EEA supervisors of branches recognized as significant; third country supervisors with equivalent confidentiality provisions; and central banks as appropriate.[13]

The main function of colleges will be to exchange information between supervisors, coordinate communication between supervisors of the financial group, voluntary sharing and/or delegation of tasks, joint decision on model validation (eg Basel II). The colleges will also be involved in joint risk assessment and joint decision on the adequacy of risk-based capital requirements. The planning and coordination of supervisory activities for the financial group and in preparation of and during emergency situations (ie crisis management).

The overarching philosophical rationale for designing the college system and the ESRB/ESA institutional structure is that systemic risk and financial instability create negative externalities in European financial markets and it is a necessary policy objective of the European Union institutions to control financial risks that can threaten the efficient operations of the internal EU market.

5. EU Proposals and International Regulatory Developments

Most policymakers and regulators in Europe, the United States and in other major jurisdictions are now in agreement that the micro-prudential regulation of individual banks, firms and investors should be expanded to include a macro-prudential dimension that links the regulation of individual firms (at the micro-prudential level) to developments in the broader financial system and macro-economy. An important regulatory challenge will be how regulators and central banks can strike the right balance between micro-prudential regulation and macro-prudential regulatory and supervisory controls that are determined by factors in the broader financial system and economy. Recent international initiatives (eg the G20 and Financial Stability Board and Basel Committee) have recognised the importance of macro-prudential supervision and regulation and are examining some of the main issues regarding how to link micro-prudential supervision with broader macro-prudential systemic concerns. Indeed, many national policymakers and regulators (eg US and UK) are debating which regulatory measures would be most effective in enhancing financial regulation by incorporating macro-prudential objectives.

The Commission's proposals for an ESRB and ESFS could potentially change the role that the UK plays in international standard setting bodies. Under the Commission regulations, the ESRB would interact with global macro-prudential risk bodies, such as the Committee on Payment and Settlement Systems and the Committee on the Global Financial System. It would also contribute to the surveillance operations of the International Monetary Fund. Similarly, although not formally recognised yet, the ESFS's three financial authorities would participate in the international standard setting bodies, such as the Basel Committee, IOSCO and the IAIS. The involvement of European institutions in these international bodies would enhance the effectiveness of Europe's role and influence in the global financial architecture.

6. UK Regulation and London's International Position

This Committee has published several reports analysing the causes of the credit crisis and its impact on the UK economy. The causes of the crisis have been attributed to macroeconomic factors, major weaknesses in corporate governance in financial institutions, and serious regulatory failings. The costs of the crisis for the UK economy have been enormous, with recent estimates of more than 19% of UK GDP. It is evident that poorly regulated financial markets can lead to huge social costs for the broader economy and that these social costs in regional and globalised markets can be exported to other economies. The UK is a member of the European Union's internal market with free capital flows and cross-border trade in financial services. The crisis demonstrates that London's important position as an international financial centre brings both economic benefits and social costs to the European economy.[14] It is essential therefore that Europe have a more comprehensive framework for regulating and controlling the social costs of financial risk-taking, especially those social costs that arise from poorly supervised and managed risks in the City of London.

[13] Moreover, the Capital Requirements Directive (CRD) (Art 131a) provides the legal basis for a single college for global EEA-based banks.

[14] For example, the collapse of the Royal Bank of Scotland demonstrated how the risk-taking of UK banks can generate cross-border externalities to other countries and financial systems.

Macro-prudential risks are evident in the European financial system. Banks have exposure to each other throughout Europe in the money markets through a variety of risk exposures, and European policy-making needs to have better surveillance of the systemic risks posed by certain banking groups and financial institutions that operate in Europe and the inter-connected nature of wholesale capital markets. It does not mean that EU regulation and oversight should displace national regulators; it simply means that member state regulators, at the national level, must have more accountability to committees of supervisors at the EU level in order to carry out more efficiently cross-border supervision of the largest forty or so of Europe's banks and to monitor systemic and liquidity risks that arise in the capital markets.

UK financial regulation is already undergoing major changes that will lead to increased costs for the financial sector. More intrusive regulation, if applied effectively, can result in more effective control of the social costs of financial risk-taking. The Commission's adoption of the Regulations creating the ESRB abd ESFS have this objective in mind: the monitoring and control of systemic risks in the European financial system. It is for this reason that UK policymakers should support these important regulatory initiatives.

*3 November 2009*

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**Written evidence submitted by the British Bankers' Association**

Introduction

1. The British Bankers' Association[15] (BBA) believes macro and microprudential financial regulation should be reformed and therefore we welcome the European Commission's proposals, and the desire to make cross-border supervisory arrangements more efficient. We particularly welcome the creation of a single rulebook which should help cross-border financial institutions in the EU single market. However, there are a number of areas where we believe the proposals go further than what is necessary to achieve improved supervisory convergence and cooperation between national supervisors. We finally believe the Commission's proposals depart substantially from what was agreed in June by the European Council.

2. We believe the key objectives this package should deliver for cross-border financial institutions are: a high level of legal certainty, avoiding unnecessary and conflicting reporting requirements, confidentiality of sensitive firm-specific information and the ability of supervisors to take decisions based on knowledge of the business models of firms, and finally the need for the supervisory architecture to work for London as an international financial centre. In this respect, there is therefore a need to assess the proposals both in relation to their impact on the competitiveness of the UK's financial services industry, as well as ensuring that they are consistent with the, inter alia, regulatory agenda being set by the G-20 and the Basel Committee on Banking Supervision. This is particularly the case in relation to the conduct of supervisory colleges at the EU and global level.

3. We have been closely engaged with the earlier High Level Group Report by Jacques de Larosière and the European Commission's consultation on improving regulatory cooperation and supervision across the EU.

4. We have supported the development of the review of the supervisory framework and we support the need for some centralisation of power in the new European Supervisory Authorities, but have emphasised at all times that this should be targeted at deepening supervisory convergence and co-operation, while developing a single rulebook, and accepting that some binding powers may be necessary in the interpretation of the rules. We also draw the Committee's attention to the fact that regulatory structures are currently evolving not just potentially in the UK, but also in a number of Member States, most notably in France and Germany, so this has a bearing on how the EU system should function going forward.

5. With regard to the proposals for a Regulation and Council Decision on the setting up of a European Systemic Risk Board (ESRB), we have concerns about information gathering powers of the body and the possibility the monetary policy tools be inappropriately used for supervisory purposes.

6. With regard to the Regulations setting up European Supervisory Authorities (ESAs), we have concerns over the ability of the ESAs to take directly binding decisions on individual institutions, the role of ESAs in colleges of supervisors and again the ability to collect information directly from individual institutions.

7. With regard to process and timescale, we urge the Council and European Parliament not to rush through an agreement, but to take their due time to examine the proposals in detail. It is important to get these questions right rather than achieving a quick result that does not meet the objectives set out. We also note that care is needed to ensure that consistency is achieved between the EU supervisory package, the many proposed changes to the EU regulatory framework (for instance through changes to the Capital Requirements Directive), and also, from a UK perspective, the potential re-shaping of the domestic regulatory architecture.

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[15] The BBA is the leading association for the UK banking and financial services sector, speaking for 220 banking members from 60 countries on the full range of UK or international banking issues and engaging with 40 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

Macroprudential

8. The macro-prudential proposal to create an ESRB is broadly to be welcomed as it should help early warning of systemic risk at the cross-border level.

9. Our main concern lies in Article 15, Paragraph 4. The ESRB is empowered to make reasoned requests for information from the ESAs for data "not in summary or collective form" from individual institutions. The ESAs will of course, under Article 20 Paragraph 2 of the ESA Regulations, have the power to request confidential information directly from firms. In our view, individual institutions should only have to deal directly with their national supervisor in relation to information requests, and not with the supra-national entity. So, we believe that if the ESAs or the ESRB consider that some individual institutional data is missing, then they should only be allowed to address information requests directly to national supervisors.

10. We understand the need for the ESRB to have access to data, but are concerned at the very broad power for the ESRB to access data only following a "reasoned" request. A reasoned request provides no real safeguard for the use of confidential data as there are no objective criteria as to when such information can be used. We do not think that the subsequent Swedish Presidency compromise proposal, which proposes a couple of additional safeguards, goes far enough; the bottom line being that, as a macro-prudential supervisor, the ESRB should not routinely have access to individual—micro-prudential—institutional data.

11. We believe the ESRB should focus on trends and aggregated data analysis to spot macro-systemic risks. This does not require individual firm data unless exceptional circumstances require it. We would like more and sounder safeguards around the request and use of disaggregated data where individual firms are identified.

12. Another way to potentially improve the ESRB proposal is to consider formalising the seeking of advice from the private sector in Article 13. We believe a more formalised body such as a Banking Stakeholder Group, as has been proposed in the European Banking Authority (EBA) Regulation (Article 22), might facilitate greater dialogue with industry which in turn should help the ESRB spot emerging trends and systemic risks.

13. We do not have any specific comments on the Council Decision entrusting the European Central Bank (ECB) to run the ESRB.

Microprudential

14. With regard to the micro-prudential proposals to create three new ESAs: European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), we accept the need for regulatory authorities to deliver a single rulebook in Europe and to improve cooperation among supervisors.

15. We noted and agreed with the European Council conclusions from 19 June 2009 that supervision of firms should remain with national supervisors on a day-to-day basis given the knowledge local supervisors have of local market conditions. With this in mind we are concerned with some of the powers that the European Commission has proposed to assign to the ESAs. In particular, we note that it is proposed that the European Commission will be present in all layers of the organisational structure of the ESAs, and there is a case for saying that this should be reduced, perhaps to just the Board of Supervisors and the Management Board.

16. The primary concern we have is the ability of the ESAs to take binding decisions addressed to individual institutions. This power is given in Article 6 Paragraph 2, Subparagraph e, and spelled out in three locations. We believe, in particular that this could give rise to legal uncertainty, if national supervisors can be second guessed and subject to override. This could have a destabilising effect in the market. As noted above, we are in favour of a deepening of cooperation between national supervisors and the new body. But this should not be at the cost of undermining national powers and creating friction within the European System of Financial Supervision.

17. In Article 9 Paragraph 6 the ESAs can override national supervisors and take decisions on individual firms to "act accordance with Community Law". In Article 10 Paragraph 3 the ESAs can adopt decisions directly on individual institutions. In Article 11 Paragraph 4 the ESAs are given the power to override national supervisors in cases where they disagree. We do not agree with the need for these powers—for the ESAs to address decisions directly to individual institutions—given that day-to-day supervision is supposed to remain with national supervisors.

18. In Article 6 Paragraph 3 the ESAs are empowered to execute any "exclusive supervisory powers" over cross-border institutions. As the European Council noted in its conclusions, the only direct supervisory power is that of the ESMA over Credit Rating Agencies. There is therefore no need for this article in the EBA or EIOPA Regulations.

19. Although we agree with the ESAs ability to draft technical rules, we are concerned with the ability of the European Commission in Article 7 Paragraph 1 to amend the technical rules where "Community interest so requires". The Commission should have the power to endorse the technical rules or reject them, but not to amend them as that would prejudice the authorities in their role as drafters of a single rulebook. It is important that the European Commission is not able to amend ESA proposals to create rules without some effective check from other EU bodies, including the Council, the Parliament or the ESAs themselves.

20. We do not believe it is appropriate for the European Commission to declare an emergency situation, as is currently stipulated in Article 10 Paragraph 1. Given the implications to Member States, it should be the Council to agree on a state of emergency, perhaps on the recommendation of the Commission, ESAs or ESRB.

21. With regard to Article 12 and the role of ESAs in colleges of supervisors, we believe that these provisons for information sharing in Paragraph 2 are unclear. Our concern revolves around whether this may deter third country supervisors from participating in colleges and potentially undermine G20 colleges. The issue at stake is that confidential information from third country supervisors may be downstreamed—via the ESA college database—to supervisors with no, or relatively minor, interest in the supervision of that bank. In addition, this may also lead, in G20 colleges, to confidential information being disclosed to a third country supervisors that own banking sectors competing with the EU financial institution. There must be clear accountability of access to confidential information and regular review of the effectiveness of this Paragraph. To emphasise the point, the ESA should only have an advisory capacity in relation to the operation and information flows in any given college.

22. We do not believe it is appropriate for the ESAs to scrutinise mergers and acquisitions as is proposed in Article 19 Paragraph 2. It encroaches on the role of national supervisors and the European Commission's Directorate-General for Competition. A merger is, by definition, institution specific and market and commercially sensitive, and should remain primarily a matter for national and EU competition authorities.

23. We strongly disagree with the ability of the ESAs in Article 20 Paragraph 2 to request information directly from individual institutions. Such information should be disseminated by the national supervisors to the ESAs.

24. Article 21 Paragraph 2 gives the ESAs power to send individual firm data to the ESRB on the basis of a "reasoned request". There should be proper safeguards built in for this exchange to happen.

25. We welcome the creation of Stakeholder Groups in Article 22 and suggest that perhaps investors could be included as an important stakeholder in the financial sector across Europe.

26. With regard to the making public the decisions, as proposed in Article 24 Paragraph 5, the BBA is concerned over the naming of individual firms, and believe this is wholly inappropriate. The name of the firm should not be published if an ESA decision is rejected following use of the safeguard mechanism (Article 23).

27. We are concerned with the independence of the representatives to the proposed Board of Supervisors (Article 27), if they are supposed to act in the "Community interest". Members of the Board should not be obliged to act in the Community interest only. It should be enough that they act independently and objectively.

28. We are concerned with the voting procedures in Article 29 Paragraph 1. Under the proposal only votes concerning technical standards should be by Qualified Majority Voting (QMV), and all other votes should be by simple majority. This would not take into account the scale of the UK financial services market so we urge for more votes to be under QMV rather than simple majority.

29. With regard to the appeal mechanism in Article 46, we are concerned that in Paragraph 3 there is no automatic effect of suspension of a decision when an appeal is brought under these proposals.

30. It might also be useful for the ESAs to consult on its budget alongside its work programme, which could be added to the provisions currently in Article 49.

*5 November 2009*

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**Written evidence from the Association of British Insurers**

The ABI is the voice of the insurance and investment industry. Its members constitute over 90% of the insurance market in the UK and 20% across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. And through the ABI they come together to improve customers' experience of the industry, to raise standards of corporate governance in British business and to protect the public against crime. The ABI prides itself on thinking for tomorrow, providing solutions to policy challenges based on the industry's analysis and understanding of the risks we all face.

1. Summary

1.1 The European Union already plays a significant role in the regulation of financial services, and the European Commission's proposals for new regulatory bodies at EU level represent sensible evolutionary change from the current arrangements. Nevertheless, these proposals will set the ground rules for relations between Europe's regulatory bodies for several years, with significant implications for the competiveness of British providers of financial services. The proposals should therefore be considered with care.

1.2 The financial crisis demonstrated the dangers of imperfect communication between supervisory authorities. The Association of British Insurers has consistently supported strengthening the supervisory framework at EU level, which we believe will promote financial stability. Together with an implementation of Solvency II that remains true to the Framework Directive, these measures will make a significant contribution to the development of a Single Market for insurance. Broadly, we therefore support these legislative proposals by the European Commission, which are a reasonable reflection of the outcomes of the debate following the report by Jacques de Larosiere earlier this year.

1.3 We welcome the creation of the European Systemic Risk Board (ESRB) as a macro-prudential body at EU level. However, the ESRB will make recommendations for the totality of financial services, not just banks. It is therefore important that the membership and procedures of the Board should be revised to allow adequate access to insurance and asset management expertise.

1.4 CEIOPS' proposals for the implementation measures for Solvency II have underlined the risks associated with regulatory judgements taken by supervisory bodies alone, without the benefit of external experience and expert advice. We therefore hope to see introduced into the process further checks and balances on the decision-making powers of the European Insurance and Occupational Pensions Authority (EIOPA), and the other authorities.

1.5 We also have reservations about the cases where the Commission has proposed that EIOPA should take a regulatory decision that applies directly to individual insurers, bypassing national supervisors. This will disrupt the relationship between insurers and their supervisors, and generate regulatory complexity.

2. Detail

2.1 These proposals are important to ABI members not only in our capacity as insurers, but also as major institutional investors with a significant interest in the efficient functioning of the securities markets. We set out below a number of detailed comments on the European Commission's proposals. It should, however, be borne in mind that no regulatory structure can guarantee the prevention of another crisis. What really matters is the quality of regulators' judgement. In an inter-connected financial system, it is also crucial that regulators trust each other, and are genuinely willing to co-operate with each other. These proposals may go some way towards ensuring co-operation at EU level, but this level of co-operation needs to be reflected at international level also.

3. European Systemic Risk Board (ESRB)

3.1 The composition of the Board bears further examination on two counts.

3.2 First, the body will be dominated by banking interests. In view of the events of the financial crisis, the reasons for this can readily be understood. However, decisions taken in a banking context can have a significant impact on insurance. For example, regulatory action to reduce banks' reliance on hybrid and subordinated debt will have serious consequences on insurers as the main holders of these instruments. At present the EIOPA Chair, the single person on the Board with an exclusive insurance interest can easily be outvoted. The voting procedure needs a mechanism to ensure that the voice of insurance is heard.

3.3 Second, the Board is large and unwieldy, and dominated by people with regulatory and supervisory authority. Consideration should also be given to reducing substantially the number of executive members of the Board, and to appointing independent members. This model has worked very well for the Monetary Policy Committee of the Bank of England, and would be well suited to a senior advisory group such as this.

4. European Insurance and Occupational Pensions Authority (EIOPA)

4.1 The decision-making procedures envisaged in the EIOPA Regulation do not offer adequate checks and balances on the judgement of supervisory bodies. ABI has consistently supported stronger decision-making at EU level, but CEIOPS' consultation on the implementing measures for Solvency II has given us pause for thought about the wisdom of handing broad areas of decision-making to supervisory bodies acting collectively, without adequate provision for consultation or democratic oversight. CEIOPS' proposals on Solvency II are characterised by crude reliance on capital requirements, and by failure to acknowledge the basic differences between the business models of insurance and banking. Over-restrictive regulatory processes such as these will exclude the less well off consumers from the benefits of financial services, and add unnecessarily to costs. We are confident that neither the European Commission nor Europe's Governments will allow CEIOPS' proposals on Solvency II to go forward without substantive amendment. However, this experience must inevitably raise questions about the limits to supervisors as decision-makers. We should be quite clear that our reservations are not about having these decisions taken at European level, but about the lack of checks on the decision-making powers of supervisors. We believe that the quality of the new EU supervisory framework will be greatly improved by the judicious introduction into the decision-making process of opportunities for input by expert parties not directly involved in supervision. We welcome the opportunities for intervention by the Commission to continue its leadership role in the development of the supervisory framework at EU level.

4.2 The EIOPA Regulation envisages in a number of cases regulatory decisions direct from EIOPA at EU level to an insurance company. We have reservations about this, which risks damage to the supervisory relationship between an insurer and their lead regulator. Multiple sources of regulatory authority will add

unnecessarily to the complexity of regulation. This also runs counter to the key objective of Pillar II of Solvency II, which aims to develop an open and constructive relationship between insurers and their regulators. It will be very difficult in practice for EIOPA to craft a decision that fits neatly into this relationship, and the procedure creates the risk that insurers will face contradictory directions.

4.3 We agree that binding powers in the last resort are needed at EU level to deal with cases where national supervisors cannot reach agreement. Otherwise there is a real risk of regulatory fragmentation in the single European market. But we believe the decision should always be communicated through the national regulator, who will be able to place the decision into the context of the continuing supervisory relationship with the insurer in question. The objective is a common rule book implemented by national supervisors. The procedure proposed in the Regulation would create too many exceptions to the generally agreed principle that day to day supervision should be done at national level

4.4 The power for EIOPA to develop technical standards (Article 7) is rightly subject to endorsement by the Commission. We look to the Commission to supervise with care the early use of this new power. Its scope is exactly the same as that of Level II implementing measures, and we are concerned that this will lead to technical but commercially significant issues being downgraded from Level II (with input by both Council of Ministers and European Parliament) to technical standards.

4.5 Further thought is needed about the scope of EIOPA's actions in the field of occupational pensions. The debate about the EU supervisory framework has been carried out mainly in banking terms. The proposals map across reasonably well to insurance, and it is logical that they should apply to occupational pensions also. However, the regulation of pensions across member states is highly diverse. Great care needs to be taken to ensure that decisions taken at EU level do not undermine national systems for saving for retirement. EIOPA should exercise with particular restraint in the pensions field its powers to promote consistent application of EU law, to settle disputes between regulators, and to draw up technical standards. An obligation on EIOPA to take into account the implications for national systems of savings for retirement should therefore be introduced into the relevant Articles.

4.6 The powers (Article 20) for the collection of information from national authorities require further safeguards to prevent excessive burdens being placed on market participants. As a result of the wide audience in the ESRB and ESFS, there is also a significant risk of exposure of market-sensitive firm-specific material. Further safeguards are needed to prevent this. We recommend the introduction of a proportionality test, to ensure that all the information collected is genuinely needed.

4.7 The decisions of the EIOPA Board of Supervisors (Articles 25-29) are to be taken by qualified majority on technical standards and financial issues. Decisions in cases of inconsistent application of Community law or dispute between national supervisors are to be taken by simple majority. Decision-taking by simple majority creates the risk that supervisors responsible for large and complex markets will find themselves outvoted by less experienced colleagues. All decisions should be taken by qualified majority.

5. European Securities and Markets Authority

5.1 ABI members are major institutional investors as well as insurers, and all these points apply mutatis mutandis to the Regulation establishing ESMA. Three points are particularly important with regard to ESMA:

(i) That the power to regulate bodies with Community-wide reach should apply explicitly to Credit Rating Agencies alone. This is to prevent regulatory creep.

(ii) That ESMA should not be able to launch on its own initiative the procedure for inconsistent application of Community law. To avoid inconsistency of approach, the European Commission should take the initiative in all cases where the correct application of EU law is in question. If ESMA were to have the powers to take up cases of this nature on its own initiative, this would increase the risk of EU level intervention in individual cases, creating regulatory confusion in the wholesale securities markets.

(iii) That the ESMA Stakeholder Group should have balanced representation for the buy and sell sides of the wholesale securities markets. This is to prevent the recurrence of regulatory capture by the investment banks.

*6 November 2009*

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**Written evidence submitted by the Investment Management Association**

Summary

1. IMA believes that good regulation works in the interests of investors and the financial services industry (paragraph 2).

2. The establishment of better monitoring arrangements through the European Systemic Risk Board and the Financial Stability Board is welcome, but the new bodies need to co-ordinate their deliberations effectively (paragrpahs 3 and 6).

3. They will need to see views and input from all parties, but those of investors will be particularly important; they should not allow the debate to be dominated by bank interests and the broker/dealers (paragraphs 4–5).

4. The creation of the UCITS fund product has been an example of good EU regulation, and a success for the Single Market. But further harmonisation of EU regulation and less gold-plating here and in other areas would be beneficial (paragraphs 7–9).

5. The IMA therefore supports the proposed new European System of Financial Supervision, and the proposed new institutions (paragraphs 10–11).

6. But there is a need for a greater voice for asset management in the workings of the proposed European Insurance and Occupational Pensions Authority (paragraphs 12–13).

7. The new regulatory framework must be properly co-ordinated at the global level. There have been worrying signs of protectionism which must be avoided (paragraphs 14–16).

Introduction

1. The IMA[16] welcomes the opportunity to submit evidence to the Committee's Inquiry.

2. IMA strongly supports well regulated financial markets. They are to the benefit of investors and hence the asset management industry. Current regulation of the asset management industry has served the industry and its clients well. While the financial crisis has posed challenges for the asset management industry, as it has for other sectors, the IMA considers that fund structures and regulation have proved robust in the UK, with the overwhelming majority of authorised funds continuing to fulfil their obligations to investors. The long term challenge will be to develop equally robust regulatory structures and regimes for the financial sector as a whole.

Macro Prudential Oversight: the European Systemic Risk Board (ESRB)

3. IMA has welcomed the proposals made by the de Larosière Group. We support improved macro prudential supervision and effective early warning mechanisms. We therefore welcome the creation of a European Systemic Risk Board (ESRB) and also the G20 conclusion to reinforce the role of the Financial Stability Forum and reform it as the Financial Stability Board (FSB). Good co-ordination between FSB and ESRB will be essential because financial stability problems do not recognise borders.

4. It is however essential that, as the proposals are developed and as the new institutions begin to operate, the views of and input from investors is actively sought. Financial markets exist to serve the interests of investors and issuers of capital. Consultation and communication with the industry needs, therefore, to extend well beyond market intermediaries. For the moment the only reference to industry input is the proposed Article 13 on "Other sources of advice" which says simply: "In performing its tasks, the ESRB shall seek, where appropriate, the advice of relevant private sector stakeholders". The ESRB should seek open, transparent and structured dialogue with the industry.

5. We, therefore, share the de Larosière Group's view that "to be effective macro prudential supervision must encompass all sectors of finance and not be confined to banks, as well as the wider macro economic context."[17] Much analysis hitherto has paid insufficient attention to the systemic significance of the asset management industry. In part this is because asset management firms themselves are not of systemic significance, because the fact that they do no hold client assets themselves means that they do not need large balance sheets. But the European asset management industry has total assets under management in excess of €10 trillion. This makes it the single most important source of liquidity for European capital markets. As well as the role of pension funds and other long term investors, such as holders of equity, bonds, commercial property and other asset classes, insurance companies are major holders of fixed income stocks against annuity liabilities and money market funds provide demand for short term bank paper. This exposure to all markets gives asset managers a distinctive perspective on market developments, and one which needs to be factored in to macro prudential assessments.

6. An important point of detail is that duplication of reporting requirements should be avoided. Information flow should be encouraged between the ESRB and the new micro prudential authorities, so that market participants do not have to provide the same information to different bodies in different formats; existing information sources should be exploited in full before imposing new requirements. This implies that reporting requirements should be streamlined both in terms of format and content whilst being proportionate and tailored to the specific characteristics of the entities required to report. In particular, an obligation to report each and every transaction should be avoided.

[16] The Investment Management Association (IMA) represents the discretionary investment management industry operating in the UK. Members include independent investment managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3 trillion of assets, all of which are owned by underlying clients, including authorised investment funds, pension schemes and individual investors.

[17] De Larosière Report, page 39, paragraph 153.

### Micro Prudential Oversight: the European System of Financial Supervision

7. The successive UCITS[18] Directives have created an EU-wide framework for the management and distribution of retail funds. It has been a major success story for the Single Market, providing a good product for consumers and investors, and giving the European asset management industry a product and a brand which it has been able to exploit globally. As a result UCITS funds are sold in a wide range of non-EU markets and are the world's leading mutual fund brand.

8. This success is the result of effective regulation at the EU level. It has served the interests of both European consumers and the European industry. The UK asset management industry accounts for over a third of the European industry by assets under management and has therefore been a significant beneficiary of this process.

9. A harmonised regulatory and supervisory framework is therefore of great importance to the industry: it is very expensive and inefficient to operate under 27 different sets of rules, or 27 differing interpretations of the EU rules. In too many areas of financial markets regulation, and especially supervision, national differences remain strong beneath a veneer of European harmonisation. There has also been too much gold-plating of the EU rules, with national regulators adding requirements on top of the EU requirements as they see fit. Examples of this may be seen with both the Markets in Financial Instruments Directive (MiFID) and UCITS Directives.

10. Attempts have been made via legislation (for example, the provisions to simplify and facilitate cross-border marketing of investment funds in the UCITS IV Directive earlier this year) but ultimately strengthening the current 3L3 Committees (CEBS, CEIOPS and CESR) will be necessary if significant progress is to be made. The IMA therefore supports the proposals to transform them into European authorities (European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority) with greater powers, whilst leaving day-to-day supervision to national supervisors, thus making full use of their local knowledge.

11. We also support the Commission's proposed actions to introduce a far more consistent set of supervisory rules, including the ability for the future authorities to draft binding technical standards. This will help to limit future gold-plating of EU rules.

12. The IMA has one issue on the division of responsibility between the new Authorities. At present, pensions issues are seen as entirely a matter for CEIOPS, but we consider it is important that under the new arrangements the proposed ESMA should also have input. In addition, representatives of the asset management industry should be included to the Insurance, Reinsurance and Occupational Pensions Stakeholder Group to be set up by EIOPA.

13. This is because the asset management industry has an important role to play in retirement provision, notwithstanding the historic dominance of insurance products. Defined contribution pension schemes typically use fund products run by asset managers to provide the foundation for the accumulation phase of pension saving. As the DC market grows across Europe, so will the importance of these products. The approach to pensions policy and the regulation of pensions at EU level needs to recognise this.

### Global Crisis Calls for Global Solutions

14. Financial markets are global and their problems are global. But regulation and supervision remains of necessity largely national. It will be important for Europe to co-ordinate regulatory responses with the key non-EU jurisdictions, consistently with the process under way by the G20.

15. There have been some worrying signs of protectionism, which would be harmful in the long run to Europe's financial markets, its industry and its consumers. For example, the Commission's original proposals for regulating Credit Rating Agencies would have allowed European investors to invest only in European-rated issues, although this was subsequently modified. And the proposed Alternative Investment Fund Managers Directive risks protectionism by introducing a three year delay before third country funds can have a European passport, and by making the whole investment value chain subject to prescriptive rules, making it very difficult if not almost impossible for third countries to achieve equivalence.

16. We do not believe that only European regulation can protect investors. The position of third countries must be taken into account in a balanced manner. For example, the UK/European asset management industry is a major exporter of EU harmonised investment funds (UCITS) into Asia and Latin America. Closing Europe's borders is not an option in the globalised economy. We agree that the EU can and should take the lead, but it must act responsibly and in co-ordination with other jurisdictions.

*6 November 2009*

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[18] Undertakings for Collective Investment in Transferable Securities.

**Written evidence submitted by the European Commission**

The European Commission welcomes the Treasury Committee's inquiry into its proposals for European macro- and micro-prudential regulation. Experience of the financial crisis has exposed important failures in financial supervision, both in particular cases and in relation to the financial system as a whole. President Barroso therefore requested a group of high level experts, chaired by Mr Jacques de Larosière, to make proposals to strengthen European financial supervisory arrangements, with the objective of establishing a more efficient, integrated and sustainable European system of supervision. The Group presented its report on 25 February 2009. Building on its recommendations, the Commission set out proposals for a new European financial supervisory architecture in its Communication to the Spring European Council of March 2009. The Commission presented its ideas in more detail in its Communication of May 2009[19] which proposed:

— establishing a *European System of Financial Supervisors (ESFS)*, consisting of a network of national financial supervisors working in tandem with new European Supervisory Authorities (ESAs), created by transforming the existing European supervisory committees[20] into a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA), thereby combining the advantages of an overarching European framework for financial supervision with the expertise of local micro-prudential supervisory bodies that are closest to the institutions operating in their jurisdictions; and

— establishing a European Systemic Risk Board (ESRB), to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole. To this end, the ESRB would provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks.[21]

The rationale for the Commission's proposals have been set out in the following documents:[22]

— the explanatory memorandum accompanying the legislative proposals establishing the three European Supervisory Authorities and the European Systemic Risk Board;

— the Commission's impact assessment assessing the options related to the aforementioned proposals; and

— the Commission communication of 27 May 2009 on European Financial Supervision.[23]

This submission will focus on the specific questions posed by the Committee.

### 1. The Interaction between EU, National and International Regulatory and Supervisory Arrangements

There is significant regulatory and supervisory reform being undertaken in many countries internationally. Recently in Pittsburgh, G20 leaders reaffirmed their commitment to "reform the global architecture to meet the needs of the 21st century" including through the establishment of the Financial Stability Board (FSB).

Through these proposals, the Commission is clearly responding to the weaknesses identified during the crisis as well as to the G20 call to take action to build a stronger, more globally consistent, regulatory and supervisory system for financial services. The proposal for a European Systemic Risk Board responsible for macro-prudential oversight of the financial system within the Community in order to prevent or mitigate systemic risks, to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth, will help to strengthen the international macro-prudential risk monitoring architecture.

At the micro-prudential level, the ESAs could serve as helpful contact points for supervisory authorities from third countries. In this context, they may, without prejudice to the competences of the EU Institutions, enter into administrative arrangements with international organisations and the administrations of third countries.

The ESAs may also assist in preparing equivalence decisions pertaining to supervisory regimes in third countries. Moreover, the ESAs may, upon request or on their own initiative, provide advice to the European Parliament, the Council and the Commission or publish opinions, including with respect to the prudential assessments of cross-border mergers and acquisitions. The latter should provide for additional safeguards to ensure a sound and objective assessment of future cross-border mergers or acquisitions.

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[19] Commission Communication of 27 May 2009 on European Financial Supervision. COM(2009) 252 final.

[20] These are the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

[21] It should be noted that this explanatory memorandum focuses on the proposals to establish the ESFS by transforming the existing European supervisory committees into ESAs. The proposal to establish the ESRB is being discussed in a separate memorandum.

[22] All available at the following web address: http://ec.europa.eu/internal_market/finances/committees/index_en.htm#package

[23] Available at: http://ec.europa.eu/internal_market/finances/committees/index_en.htm#communication

At the national level, significant reforms are also being undertaken. The Commission's proposal establishes a network of national financial supervisors working in tandem with the new ESAs, thereby combining the advantages of an overarching European framework for financial supervision with the expertise of local micro-prudential supervisory bodies that are closest to the institutions operating in their jurisdictions. The proposal also, in line with the June European Council conclusions, leaves day-to-day supervision of financial institutions at the national level, and a central role in the supervision of cross-border groups to colleges of supervisors.

### 2. The Composition and Internal Structures of the Supervisory Authorities and the ESRB

The European Systemic Risk Board will consist of a General Board, which will act as the decision-making body of the ESRB, a Steering Committee to assist the General Board, and a technical advisory committee to provide advice and assistance on issues relevant to the work of the ESRB, when requested. Finally, the ESRB will be supported by a secretariat to provide analytical, statistical logistical and administrative support for the ESRB.

The composition of the General Board is a key issue for the effectiveness of the ESRB. The choice has been made to ensure a significant representation of central Banks. In most Member States, central banks have some degree of responsibility for macro-prudential oversight of the financial sector. Because of this responsibility and acquired expertise, central banks are well placed to contribute to the analysis of the impact on financial stability of the inter-linkages between the financial sector and the broader macroeconomic environment.

The analytical work and logistical support to the ESRB will be provided by a Secretariat, which will be ensured by the European Central Bank. Granting the secretariat function to the ECB will allow the ESRB to exploit the ECB's in-depth macro-prudential expertise and its central role in the EU monetary system. In co-operation with national central banks, the European Central Bank compiles and disseminates a wide range of monetary statistics and indicators regarding financial institutions. The European Central Bank and the Eurosystem monitor cyclical and structural developments in the euro area/EU banking sector as well as in other financial sectors to assess the possible vulnerabilities in the financial sector and its resilience to potential shocks.

Regarding the European Supervisory Authorities, each is envisaged to consist of a Board of Supervisors (the main decision-making body deciding on among other things the adoption of the draft technical standards, opinions, recommendations, and decisions), a Management Board (to run the administration of the authority) and a single Board of Appeal for all three ESAs.

The Board of Supervisors is proposed to comprise:

- — the Chairperson of the respective ESA, who will chair the meetings of the Board, but shall be non-voting;
- — the Head of the relevant national supervisory authority in each Member State;
- — one representative of the Commission, who shall be non-voting;
- — one representative of the ESRB, who shall be non-voting; and
- — one representative of each of the other two European Supervisory Authorities, who shall be non-voting.

Where relevant, the Board may also decide to admit observers.

The Management Board is proposed in particular to be responsible for preparing the Authority's work programme, adopting the rules of procedure, and to play a central role in the adoption of its budget. According to the Commission's proposal, it will be composed of the ESA's Chairperson, a representative of the Commission, and four members elected by the Board of Supervisors among its members, who shall act independently and objectively in the Community interest. The Authority's Executive Director may participate in meetings of the Management Board without the right to vote.

The Board of Supervisors may decide to set up further sub-committees as appropriate, for example to tackle specific regulatory issues.

### 3. Whether the Powers Proposed for these Bodies are Appropriate

The tasks/powers of the European Supervisory Authorities are described below. This section also covers two further but relevant issues: direct decisions addressed to individual institutions and the safeguards applied to the Authority's powers.

It should however be stressed that the powers of the authority are only exercised following decisions from the Board of Supervisors, which are essentially made up of the national supervisory authorities to which such decisions will be addressed (even decisions addressed to individual institutions can only be made following non-compliance with a decision initially addressed to a national supervisor).

*The development of technical standards*

To contribute to the development of a common rule book, the Authorities will, in areas specified in the relevant sectoral legislation, develop draft technical standards. These standards will constitute an effective instrument to strengthen Level 3 of the Lamfalussy structure, which currently is limited to the adoption of non-binding guidelines. The areas where the Authority may develop such draft standards—laid down in a draft Directive accompanying the Regulations creating the ESAs—concern issues of a highly technical nature where uniform conditions for the application of Community legislation are needed. These matters do not involve policy decisions and their content is tightly framed by the Community acts adopted at Level 1. Development of the standards by the ESAs ensures that they benefit in full from the specialised expertise of national supervisors.

The draft technical standards are proposed to be adopted by the Authority on the basis of qualified majority of the members of the Boards of Supervisors, as defined in Article 205 of the Treaty.

Areas where technical standards can be developed will be specified in the level 1 legislation and were previewed in a Commission staff working document and are contained in an draft Directive amending existing sectoral legislation.[24] The Commission has proposed that the draft technical standards will be developed by the Authority. However, the Authorities cannot have the power delegated to them to give such standards legal effect. According to Article 202 of the Treaty, the Council and the Parliament can only delegate such powers to the Commission. Therefore the Commission must subsequently endorse these draft standards in the form of regulations or decisions so as to give them direct legal effect.

This approach enables the system to react quickly to certain market developments and not lose precious time sending proposals back and forth between the Authorities and the Commission. The Commission will have the power to amend ESA proposals, but as a safeguard, the Commission may only amend the standards if the Community interest so requires. Situations where that would be the case include: if the draft technical standards were incompatible with Community Law, would not respect the principle of proportionality or would run counter to the fundamental principles of the internal market for financial services as reflected in the acquis of Community financial services legislation; for example, where a standard strays outside of the scope defined in the level 1 legislation, or where it conflicts with the level 1 or level 2 legislation. Since the Commission will be an observer in the Authority, it will have the opportunity to raise such issues upfront which should avoid any later need for amendments. Therefore, amendments will be very rare.

For the purpose of consultation with stakeholders, a Stakeholder Group is proposed to be established for each ESA, consisting of representatives of the industry, financial sector employees and users of financial services. The relative proportions of each should be balanced and no one group should dominate over the others. In those areas not covered by the technical standards, the ESAs shall, like the existing European supervisory committees, have the possibility to issue non binding guidelines and recommendations to national supervisory authorities and financial institutions and market participants. If in any specific case national supervisory authorities choose not to comply with the guidelines and recommendations they should explain their decision to the Authority.

*Powers to ensure consistent application of community rules*

National supervisors and financial institutions need confidence that the rules of the single market will be applied throughout the EU. Without prejudice to the initiation of infringement proceedings by the Commission against Member States, the ESAs are proposed to have a general power to contribute to ensuring coherent application of Community legislation. To this end, a mechanism should be put in place to address behaviour by national supervisory authorities who are considered to be diverging from the existing Community legislation. The proposed mechanism consists of three steps:

— First, the ESAs, on their own initiative or upon request from one or more national supervisors or from the Commission, would investigate such alleged divergences and, where necessary, adopt a recommendation for action addressed to the national supervisory authority concerned. Within the general duty of compliance with Community legislation, the supervisory authority would be called on to comply with the recommendation within one month.

— Secondly, if the recommendation is not complied with, the European Commission may, after being informed by the ESA or on its own initiative, take a decision, requiring the national supervisory authority to either take specific action or to refrain from an action. The latter shall, within 10 working days of receipt of the decision, inform the Commission and the ESA of the steps it has taken or intends to take to implement this decision.

— Thirdly, in the exceptional situation that the supervisory authority does not comply with the latter, and where there is directly-applicable Community law on the matter (ie Regulations) the ESAs may as a last resort adopt a decision addressed to financial institutions, bringing about compliance with Community law. This is without prejudice to the Commission's powers to enforce its own decision. The issue of direct decisions addressed to financial institutions is discussed later in this section.

[24] http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/sec2009_1233_en.pdf
http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20091026_576_en.pdf

*Action in emergency situations*

The ESAs are proposed to fulfil an active co-ordination role between national supervisory authorities, in particular in case of adverse developments which potentially jeopardise the orderly functioning and integrity of the financial system in the EU. However, in some emergency situations, co-ordination alone may not be sufficient, notably when national supervisors alone lack the tools to respond rapidly to an emerging cross-border crisis. The ESAs should therefore, in such exceptional circumstances, have the power to require national supervisors to jointly take specific actions. The determination of a cross-border emergency situation involves a degree of appreciation, and should therefore is proposed to be entrusted to the European Commission. This power is subject to the safeguard procedure (set out later in this section).

*Settlement of disagreements between supervisory authorities*

A mechanism is proposed to ensure that relevant national supervisory authorities take due account of the other national supervisors, including within colleges of supervisors. In certain areas of the legislation which require co-operation, co-ordination or joint decision making between national supervisors, if a supervisory authority disagrees on the procedure or content of an action or inaction by another supervisory authority in the context of that co-operation, the relevant ESA, at the request of the supervisory authority concerned, may assist the national authorities in reaching a common approach, or failing this it may settle the matter. This mechanism consists of three steps:

— Firstly, if one or more national supervisory authorities request the ESA to assist in resolving such disagreements, it may first set a phase of conciliation between the authorities concerned to try to reach agreement among themselves, with the involvement of the Authority as necessary in a mediatory capacity.

— Secondly, if, after a phase of conciliation, they have not been able to reach such an agreement, the ESAs may, through a decision, settle the matter. However, this would clearly be exceptional as in most cases the respective national authorities would be expected to come to an agreement in the preceding conciliation procedure.

— Finally, in case of non-compliance by a supervisory authority with the previous decision, and where there is directly-applicable Community law on the matter (ie Regulations), the ESAs may also decide to adopt decisions addressed to financial institutions specifying their obligations.

The dispute settlement mechanism should only address material issues, eg cases where action or inaction by a supervisory authority has a serious detrimental impact on the ability of a supervisory authority to protect the interest of depositors, policy holders, investors, or persons to whom services are provided in one or several other Member States, or on the financial stability of these Member States. The Authority reserves the right not to launch a settlement procedure or adopt any decision where such requirements are not fulfilled. These arrangements are subject to the safeguards set out below.

*Ensuring a common supervisory culture, including the consistent functioning of supervisory colleges*

The ESAs are proposed to play an active role in building a common European supervisory culture and ensuring uniform procedures and consistent supervisory practices throughout the Community. The common supervisory culture should help build trust and co-operation, and may increasingly create opportunities for supervisors to delegate certain tasks and responsibilities to one another. Additionally, it is proposed that the ESAs periodically conduct non-binding peer review analysis of national supervisory authorities.

Colleges of supervisors are central to the EU supervisory system and play an important role in ensuring a balanced flow of information between home and host authorities. The ESAs will contribute to promoting the efficient and consistent functioning of colleges of supervisors and monitoring the coherence of the implementation of Community legislation across colleges. Against this background, the ESAs may participate as observers in colleges of supervisors and receive all relevant information shared between the members of the college.

*Direct decisions addressed to individual institutions in the proposals*

As discussed above, it is proposed that the ESAs have powers to adopt decision addressed directly to financial institutions, as a last resort, in three areas: settlement of disagreements between national supervisors, ensuring correct application of Community law, and emergency situations. The main objective is to ensure efficient and coherent application of Community law in all Member States, ensure a level playing field for all market operators and to avoid regulatory arbitrage. This is particularly important for the effective enforcement of a common rulebook and dispute settlement. It is therefore in the interest of every financial institution and supervisory authority to know that the law is applied in the same way in all Member States. Therefore, in the few cases in which such a procedure will be launched, it is of vital importance that the decision is applied effectively on the ground, to restore equal conditions of competition. In cases of such relevance, a national authority should not be able to delay compliance until the markets have moved on.

Direct decisions are a last resort option, which each national authority can avoid by simply complying with the recommendation or decision addressed to it in the first place, and which will thus hopefully never be needed in practice. This will provide assurance that the law will be applied in the same way in other

Member States Furthermore, decisions will be taken by national supervisors themselves in the Board of the ESAs, therefore they will only do so when it is absolutely necessary—taking into account the concerns of their peers. Furthermore, actions taken under these provisions do not represent "day to day" supervision. They are by definition exceptional circumstances.

Experience in other areas confirms that this is a very efficient system with which national authorities are very satisfied. In the European Competition Network, a similar power of the Commission to intervene in national proceedings in exceptional circumstances, to prevent incorrect application of Community law[25] has proven highly efficient to improve co-operation between authorities, and is appreciated by national competition authorities to a high degree (the power has never been used in five years, but has served to impose discipline on the system). In spite of the numerous differences between the field of competition and the field of financial services—which are fully reflected in our proposals (decisions taken by independent Authorities composed of peers, decisions always addressed first to national authority, presence of a safeguard clause), the valuable practical experience of how to co-operate in European networks of authorities in other areas can be useful for the design of the European Network of Financial Supervision. Experience has shown that in a well functioning network such last resort measures never need to be applied, but their existence is important to ensure uniform application of the rules.

*Safeguards*

The proposal contains two important safeguards to the tasks/powers listed above.

Board of Appeal

An appeal system will ensure that any natural or legal person, including national supervisory authorities, may in first instance appeal to a Board of Appeal against a decision by the ESAs to ensure the coherent application of Community rules, action in emergency situations, and the settlement of disagreements. The Board of Appeal shall be a joint body of the three ESAs, ie, it will deal with issues related to banking, insurance and securities. The Board of Appeal will have six members and six alternates with relevant knowledge and experience, excluding current staff of the national supervisory authorities or other national or Community institutions involved in the activities of the Authority. Two members of the Board of Appeal and two alternates shall be appointed by the Management Board of each ESA from a short-list proposed by the European Commission. The existence of a Board of Appeal will be without prejudice to the right to appeal further to the European Court of Justice.

Fiscal responsibilities

In line with the Ecofin and European Council conclusions of June 2009, which stress that, without prejudice to the application of Community law and recognising the potential or contingent liabilities that may be involved for Member States, decisions by the ESAs should not impinge on the fiscal responsibilities of the Member States, a safeguard clause is introduced. This clause ensures that, where a Member State considers that an ESA decision taken in the context of an emergency situation or settlement of disagreements between national supervisors impinges on its fiscal responsibility, it may notify the Authority and the Commission that the national supervisory authority does not intend to implement the Authority's decision, clearly demonstrating how the decision by the Authority impinges on its fiscal responsibilities. Within a period of one month, the Authority shall inform the Member State as to whether it maintains its decision or whether it amends or revokes it. Where the Authority maintains its decision, the Member State may refer the matter to the Council and the decision of the Authority is suspended. The Council shall, within two months, decide whether the decision should be maintained or revoked, acting by qualified majority. For Authority decisions adopted in emergency situations, an expedited procedure applies to take into account the need for rapid decisions in emergency circumstances.

The safeguard clause applies to ESA decisions in emergencies and the settlement of disputes. These are the relevant areas to this article given they will relate to specific decisions which could interfere with fiscal responsibilities. Other ESA powers (for example in the area of consistent application of community rules, and proposing technical standards) are in areas where it is not appropriate to apply a fiscal safeguard clause, as fiscal interests are not at stake. While the Authorities may look at fiscal implications when developing the standards, once a standard is endorsed it is a general rule applicable throughout the Community. According to long-standing case law, Member States cannot invoke financial grounds for not complying with Community law, as this would undermine the equal application of the law across the Community. Incorrect application of Community law cannot be justified by financial grounds. The remainder of the Authorities decisions are either not directed to individual supervisors, or non-binding, therefore by definition cannot have fiscal implications.

The Commission has proposed a safeguard Article which includes two "lines of defence" ensuring that the ESAs do not impinge on Member States' responsibilities: First a legal requirement for the ESAs not to take decisions impinging in any way on Member States' fiscal responsibility, which refrains from defining

[25] See Article 11(6) of Council Regulation (No) 1/2003 and declaration in Council Document 15664/02 ADD 1 at p 11 No 21.

the notion of fiscal responsibility because it is very difficult to foresee in which situations fiscal responsibilities may be affected. Second, a procedure that allows a Member State to suspend any decision impinging on its fiscal responsibilities, by referring the matter ultimately to the Council.

The second element in particular needs to be designed in such a way that it can effectively prevent abuse of the safeguard clause. If a Member State was able to invoke the safeguard clause without effective control, the effectiveness of the ESA's binding decisions and the independence of the Authorities from political influence would ultimately be at risk. The Commission considers that in this regard it would be problematic if a Member State could simply invoke the safeguard clause and suspend the ESA's decision forever, or if the Member State concerned could block a vote in the Council against it.

4. The Proposals' Effect on the Competitiveness of the European Financial Industry in General and the City of London in Particular:

The proposals aim to support four key objectives, among others:

- reducing the probability and cost of failure of financial institutions through higher quality, more independent technical rule-making;
- reducing the probability and cost of failure of financial institutions following from the crystallisation of systemic "macro prudential" risks across financial institutions;
- strengthening the internal market through more common and consistently applied rules; and
- strengthening co-operation between national supervisors, in particular supervisors of cross-border groups/branch networks.

The Commission has produced a detailed impact assessment on the appropriate way to best deliver these objectives.[26] The size of the potential benefits will depend on how the Authorities develop over time, however, the prevention of failure of financial institutions through systemic contagion from other financial institutions in difficulty, the improved business environment due to stronger financial stability and crisis prevention in the EU and the prevention of failure of financial institutions through better co-ordinated supervision will in the long run reduce costs to both financial institutions and society in general. Ensuring a level playing field through more common standards and supervisory practices will reduce compliance costs and support the deepening of the single market more generally.

5. The Timescale for Establishing the ESAs

The proposals are a key part of Europe's response to the financial crisis and will play an important role in rebuilding confidence and reinforcing the single market. They follow a period of extensive consultation and analysis which began with the work of the de Larosi€re group which was established in October 2008. The Commission has proposed that the European Supervisory Authorities be established on 1 January 2011, and would encourage the Council and the European Parliament to work together to achieve this goal by adopting the Regulations creating the ESAs as soon as possible.

*9 November 2009*

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**Supplementary written evidence submitted by Dr Kern Alexander**

The Commission's proposed regulations will lead to significant institutional consolidation of European financial supervision and macro-prudential oversight. The creation of a European Systemic Risk Board (ESRB) would enhance EU member states's capacity to assess and monitor the level of systemic risk in European financial systems and to obtain data on large systemic financial institutions and other financial market information from member state supervisors. The creation of a European System of Financial Supervisors would bring important changes to the operations and functions of the three Level 3 Lamfalussy Committees by creating three new European supervisory agencies with legal authority to ensure consistent application of EU financial legislation. The proposed regulation for a European Systemic Risk Board would allow the ESRB to obtain data and other information from micro-prudential supervisors in order to assess the level of risk in European financial markets.

Identifying Systemic Risk in European Financial Systems

Oral evidence was presented to the Treasury Committee on 3 November 2009 that there is inadequate understanding of the causes of systemic risk in financial markets and that the proposed Regulation for a European Systemic Risk Board (ESRB) does not provide any information on what systemic risk means and how to measure it. Accordingly, it was argued that the design of the ESRB is flawed and should be substantially revised. In addressing this concern, it is submitted that although systemic risk is difficult to measure, and its causes are even more difficult to identify precisely (especially for a future financial crisis), EU policymakers should not conclude therefore that they should not try to establish institutional

[26] Available at: http://ec.europa.eu/internal_market/finances/docs/committees/supervision/20090923/20090923_impact_en.pdf

frameworks to monitor systemic risks across EU financial markets. Indeed, the financial crisis demonstrates that macro-prudential risks are evident in the European financial system.[27] Banks have exposure to each other throughout Europe in the money markets through a variety of risk exposures, and European policy-making needs to have better surveillance of the systemic risks posed by certain banking groups and financial institutions that operate in Europe. The crisis also demonstrates that systemic risk arises in the wholesale capital markets—especially through the securitisation and the over-the-counter credit default swap markets—as well as from individual financial institutions. The Turner Review recognised that the sources of systemic risk can be macro-prudential in nature and that this necessitates that central banks and regulators establish enhanced cross-border (international and European) frameworks for identifying and monitoring macro-prudential systemic risks and, in certain circumstances, for issuing early warnings to affected countries. The absence of a consensus view on the sources of systemic risk therefore does not preclude the design of effective cross-border institutional structures to monitor and measure systemic risks in European financial markets.

The Commission's proposals are premised on the notion that current supervisory arrangements proved incapable of preventing, managing and resolving the recent financial crisis. Moreover, following the Turner Review, the Commission has observed that cross-border macro-prudential risk assessment was inadequate prior to the financial crisis and that more effective cross-border monitoring of system-wide risks and financial supervision are needed to promote the Treaty objectives of the internal market. The proposed regulation to establish the ESRB with the objective of enhancing cross-border macro-prudential surveillance and oversight of European financial markets should be a welcome public policy objective.

### The Urgency of the Proposals and Short Period for Consideration

It should be recalled that consideration of the creation of these types of bodies began on 25 February 2009 when the De Larosière group presented its report making recommendations to create a European Systemic Risk Council and European System of Financial Supervisors. Building on these recommendations, the Commission issued a Communication on 4 March 2009 setting forth its proposals for a new European supervisory framework. Following this, the Communication embarked on a consultation from 10 March to 10 April which contributed to another Communication on Financial Supervision issued on 27 May 2009 which in turn led to another consultation from 27 May to 15 July. The latter consultation led to a number of responses that were largely supportive of the proposed reforms while making detailed and constructively critical comments on key aspects of the proposed ESRB and ESFS. The consultation was followed by two impact assessments in May and October.

These communications, consultations and impact study were followed by the Commission's proposal on 23 September 2009 for a Council Decision to establish a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS) along with separate proposals for a European Banking Authority, European Securities and Markets Authority (ESMA), and European Insurance and Occupational Pensions Authority (EIOPA). ECOFIN will consider these proposals on 3 December and the Council of Ministers will vote on their adoption into Community law on 10 December 2009. The short period in which these proposals are being considered reflects the urgency of the financial crisis and its immediate aftermath and the economic necessity of adopting institutional and legal reforms while the political climate supports the necessity of regulatory and supervisory reforms.

### European Systemic Risk Board

#### *The General Board and Voting*

During oral evidence, Committee members raised the concern that non-eurozone central banks and Finance Ministers did not have adequate representation on the ESRB. Article 6 of the ESRB Regulation[28] states that the members of the ESRB General Board with voting rights shall be: the President and Vice-President of the ECB; the Governors of the national central banks; a Member of the European Commission; the Chairperson of the European Banking Authority; the Chairperson of the European Insurance and Occupational Pensions Authority; and the Chairperson of the European Securities Markets Authority.[29] The General Board shall take the decisions necessary to ensure that the ESRB performs the tasks entrusted to it.[30] Each member of the General Board with voting rights shall have one vote each. The General Board shall act by simple majority vote of Members present with voting rights.[31] This means that representatives of central banks from all EU states will be able to exercise one vote per representative in making the decisions that govern the ESRB.

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[27] See "Financial Supervision and Crisis Management in the EU" (December 2007) K Alexander, J Eatwell, A Persaud and R Reoch, Commissioned Report for the European Parliament Committee on Economic and Monetary Affairs pp 2–3, 17–18.
[28] Regulation of the European Parliament and of the Council on Community macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, art 6.
[29] Art 1(a)–(f).
[30] Art 4(2).
[31] Art 10(2). Also, a quorum of two-thirds of the member with voting rights is needed for any vote to be taken by the General Board.

The ESRB, however, provides a voting advantage to eurozone member states by requiring that the vote of the General Board to elect the Chair and the Vice Chair of the ESRB can only be taken by members of the General Board who are also members of the General Council of the European Central Bank. This means that the ECB General Council will control the voting for the Chair and Vice Chair of the ESRB. However, the members of the ECB General Council who vote for the Chair and Vice Chair of the ESRB could potentially vote for central bank governors or regulators or other officials from countries not in the eurozone. For instance, these Board members could vote for the Chair and/or the Vice Chair of the ESRB to be an official from a central bank or regulatory authority from a non-eurozone EU state. Nevertheless, there is a legitimate concern that because the election of the Chair and Vice Chair is controlled by ESRB board members who are also ECB General Council members that this will lead to a disproportionate influence of eurozone representatives electing the Chair and Vice Chair and thus undermine the accountability and legitimacy of the ESRB governance structure.

The Treasury Committee should therefore consider an amendment to the ESRB Regulation that allows non-eurozone representative members of the ESRB General Board to vote for the Chair and Vice Chair of the ESRB General Board. This would create more balance in the governing structure of the ESRB without undermining the effectiveness of the European Central Bank in providing secretariat and other administrative support to the ESRB's operations.

Similarly, the ESRB Steering Committee is disproportionately influenced by representatives from the eurozone countries. The Steering Committee will have 12 members consisting of the Chair and Vice Chair of the ESRB and "five other members of the General Board who are also members of the General Council of the ECB."[32] The five members of the General Board who are elected to the Steering Committee can only be elected by members of the ESRB General Board "who are also members of the General Council of the ECB for a period of two years."[33] The accountability and legitimacy of the Steering Committee would therefore be enhanced if members of the ESRB General Board who were not members of the ECB Governing Council could also vote for the five members of the ESRB Steering Committee.

### The Legally Binding Nature of ESA Decisions and the Fiscal Authority of States

Treasury Committee members raised concerns about the powers of the European Supervisory Authorities to issue directives that might infringe on the fiscal responsibilities of member state governments. For example, article 11 of the ESA regulations provides ESAs with the authority to settle disagreements between national authorities where the disputes involve procedural co-ordination or joint decision-making between authorities in the colleges of supervisors. At the request of a national supervisory authority or of the Commission, the ESAs can assist national supervisory authorities in following a common approach with respect to co-operation or co-ordination or other procedural decision-making between supervisors (ie decision-making in the colleges of supervisors). In case of a dispute between supervisors, the ESA can settle the dispute and, in doing so, must follow a procedure consisting of three steps:

1. If one or more supervisory authorities request ESA to assist in resolving disagreements, it may require conciliation between the authorities with the ESA involved if necessary in a mediatory capacity.

2. If there is no resolution after conciliation, the ESA may through a decision settle the matter. However, this would clearly be exceptional, as most authorities would normally reach agreement in conciliation.

3. Where a national authority has not complied with a ESA's decision, the

ESA may also decide to adopt decisions addressed to financial institutions specifying their obligations in respect of Community law if the financial institution is based in the member state in breach of the ESA decision.

For a dispute under article 11, the fiscal safeguard provision of Article 23 provides that no resolution of a disagreement by the ESA between the national authority and/or financial institution concerned can infringe on the fiscal responsibility of the member state concerned. The member state authority or financial institution concerned can appeal an ESA ruling regarding fiscal responsibility to Council which then has two months to decide the appeal.

It should also be emphasised that a national supervisory authority or financial institution subject to an adverse decision of an ESA under articles 9, 10, and 11 and any other decision taken by the Authority according to legislation designated in the Regulation can appeal the ESA's decision to the ESA Board of Appeal[34] and, if unsuccessful, can bring an action before the Court of First Instance of the European Communities.[35]

[32] Art 11(1)(a)–(h).
[33] Art 11(c).
[34] See Regulation of the European Parliament and of the Council establishing a European Banking Authority, art 46(1)–(7).
[35] Art 47 (1)–(3).

In addition, regarding ESA emergency directives to a national authority during a financial crisis or similar period of declared disorderly markets, Article 10 provides that the ESAs shall fulfil an active co-ordination role between national authorities during adverse market developments in the EU financial system.[36] In some cases, co-ordination may not be sufficient, in which case ESAs would have the power to require national supervisors to take specific action. If a state authority believes that such action infringes on its fiscal responsibilities as provided in Article 23 of the Regulation, the state may appeal the ESA's directive on an expedited basis to the Council of Ministers.[37]

Specifically, Article 23 (1) provides that no decision adopted under Article 10 or 11 can impinge "in any way on the fiscal responsibilities of Member States." This safeguard clause applies only to situations where the ESA or Commission have made determinations regarding co-operation or co-ordination of supervisory practices between member states with respect to the functioning of the colleges of supervisors and related home-host state procedural matters (art 11) and any emergency co-ordination to be taken during a financial crisis or disorderly markets (art 10).

The fiscal safeguard, however, does not apply to matters or disputes falling under Article 9 because this article deals with pre-existing obligations of Community law as set forth in designated EU financial directives and provides a mechanism for ESAs to ensure that technical standards are implemented in a coherent way without derogations to ensure the harmonised application of EC legislation.[38] Nevertheless, *any decision* taken by an ESA under articles 9, 10 and 11 or any other decision taken according to legislation referred to in Article 1(2) of the Regulation can be appealed to the Board of Appeal[39] and, if the appeal fails, bring an action to the Court of First Instance of the European Communities.[40]

Article 9 addresses the role of the ESA in ensuring compliance with the substantive standards of Community law with respect to Community legislation listed in Article 1(2) of the Regulation.[41] The ESAs will have authority to ensure the consistent application of Community law as set forth in the relevant directives. The ESA will adopt a rulebook or code that provides harmonised core standards that cannot be derogated from. These technical standards are designed to enhance the effectiveness of Level 3 of the Lamfalussy guidelines which have been legally non-binding The ESAs can adopt the draft technical standards by a qualified majority vote of the ESA Boards of Supervisors. The draft technical standards would then have to be adopted by the Commission to become Community law. In exceptional circumstances, the Commission could decide to adopt, or not, the standards, in part or in whole with amendments.

The ESAs would have the authority to resolve differences in member state application of standards and to ensure that national supervisors' rules and practices do not diverge from existing Community legislation (including technical standards). This supports the ESAs general power under the Regulations to ensure coherent application of Community legislation. It can exercise this authority though three steps:

1. ESA would, sua sponte, or at recommendation of other supervisor or Commission, would investigate cases of alleged violation of technical standards or related breach of Community legislation and adopt a recommendation for action by the designated national authority. The supervisory authority would then have 1 month to comply.

2. if recommendation not complied with, the Commission may, after being informed by ESA or on its own initiative, take a decision requiring the national authority to take either specific action or refrain from action. The national; supervisor to whom measures directed shall within 10 days of receipt of the decision inform the Commission and ESA of the steps it has taken—or intends to take—to implement the decision.

3. In exceptional circumstance, where the supervisory authority concerned does not comply, the ESA may as a last resort adopt a decision addressed to financial institutions in respect to Community law which is directly applicable to them (ie Regulations).

The Article 23 fiscal safeguard provisions do not apply here because it deals with substantive requirements of existing Community legislation designated in the Regulation.[42] These obligations do not involve additional direct fiscal obligations of member states, such as bailing a bank out in a financial crisis.

[36] The Commission will have the authority to make a determination of a cross-border emergency or adverse market conditions. Art 10(2).
[37] Art 23(3). Member states can appeal an adverse decision by the Commission or ESA that might infringe on their fiscal responsibilities to the Council of Ministers.
[38] Essentially, the fiscal safeguard clause in Article 23 is inapplicable for ensuring that member states comply with Article 9 because this article requires compliance with European legislation that has already been adopted into law by member states and for which member states are required to comply with, notwithstanding the possibility that such compliance might result in indirect fiscal expenditures.
[39] Art 46(1).
[40] Art 47(1).
[41] The applicable EC legislation under the European Banking Authority Regulation is: Directive 2006/48/EC, Directive 2006/49/EC, Directive 2002/87/EC, Directive 2005/60/EC, Directive 2002/65/EC and Directive 94/19/EC, including all directives and regulations and decisions based on these acts.
[42] As with other provisions of the ESA regulations, a member state competent authority or financial institution subject to a directive can appeal any decision of the ESA "referred to in Articles 9, 10, and 11 and any other decision taken by the Authority according to legislation as referred to in" the Regulation. See Regulation of the European Parliament and of the Council establishing a European Banking Authority, art 46(1).

### ESRB Advisory Role to EU Supervisors

The ESRB's role will be to monitor system-wide risk in European financial markets and to issue warnings and recommendations to EU member state authorities and ESAs regarding systemic risk in financial markets. These warnings and recommendations are legally-non-binding, but will likely influence the European Supervisory Authorities in overseeing the supervisory practices of member state regulators. ESAs have a legal obligation to "take the utmost account of the warnings and recommendations of the ESRB." For example, Article 21 of the European Banking Authority Regulation provides that the European Banking Authority shall co-operate closely with the ESRB. The ESAs shall provide the ESRB with regular and up-to-date information. Significantly, the ESA shall convene a meeting of the ESA Board of Supervisors when ESRB has issued a warning or recommendation to the ESA or a member state authority. The ESA Board shall decide by qualified majority voting what action it should take regarding an ESRB recommendation or warning. If the ESA votes not to take action, it shall inform the ESRB with an explanation.

Where a member state authority decides not to follow the recommendation of the ESRB, it shall inform the relevant ESA Board of Supervisors of its reasons not to do so.[43] Where an ESA, by qualified majority vote, decides to order a member state authority to take certain actions and such actions are authorised by the powers granted to the ESA in its regulations, the member state may be compelled to act in order to comply with the ESA's order to take "actions in accordance with the powers conferred upon it by this Regulation for addressing the issues identified in the warnings or recommendations." As discussed below, a member state authority could contest such an order through appeal to the Board of Appeal and by action to the Court of First Instance of the European Communities.

Treasury Committee members expressed a concern that this might lead to a member state authority being ordered to take an action that might infringe on its fiscal autonomy (ie taxpayer bailout of a large bank). It should be noted however that the ESA would only have the authority to order an action that derives from powers it expressly has in the European Banking Authority Regulations, which means that such powers could only be exercised to compel a member authority to comply with an order that was based on pre-existing obligations which the state already had to implement European legislation that was expressly designated in the Regulation. Nevertheless, the concern that the fiscal safeguards provisions of Article 23 only apply to the ESA powers exercised in articles 10 and 11, and not to other articles such as article 21, is well-taken. The minor amendments to article 21 should therefore be made to make it clear that a member state authority would not be compelled to take fiscal measures to comply with a ESA order under article 21 and that accordingly the fiscal safeguards measure of article 23 should apply.

### UK Regulation and the City's International Influence

The causes of the crisis have been attributed to macroeconomic factors, major weaknesses in corporate governance in financial institutions, and serious regulatory failings. The costs of the crisis for the UK economy have been enormous, with recent estimates of more than 19% of UK GDP. It is evident that poorly regulated financial markets can lead to huge social costs for the broader economy and that these social costs in regional and globalised markets can be exported to other economies. The UK is a member of the European Union's internal market with free capital flows and cross-border trade in financial services. The crisis demonstrates that London's important position as an international financial centre brings both economic benefits and social costs to the European economy.[44] It is essential therefore that Europe have a more comprehensive framework for regulating and controlling the social costs of financial risk-taking, especially the systemic risks by weak UK regulation and poor corporate governance at UK banks and financial firms that together destabilised EU financial markets and which contributed significantly to Europe's economic recession.

The proposed EU Regulations for an ESRB and ESFS complement the trend in UK financial regulation and policy as reflected in recent FSA initiatives to adopt more intrusive regulation on the financial sector that attempts to control the social costs of financial risk-taking and which will lead to stronger and more robust economic growth and development. The Commission's adoption of the Regulations creating the ESRB and ESFS has the objective of enhancing the monitoring and control of systemic risks in the European financial system. It is for this reason that UK policymakers should support these important regulatory initiatives.

*9 November 2009*

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[43] Art 21(5).

[44] For example, the collapse of the Royal Bank of Scotland demonstrated how the risk-taking of UK banks can generate cross-border externalities to other countries and financial systems.

**Written evidence submitted by The Takeover Panel**

1. Introduction and Summary

1.1 This submission reflects the views of the Takeover Panel (the "Panel") on the Commission's proposal for a Regulation to establish the European Securities and Markets Authority ("ESMA"), focussing on the impact that Regulation might have on the UK's system for the regulation of takeover bids. It does not comment more broadly on the Commission's proposals.

1.2 The Panel is an independent body, established in 1968, whose main functions are to issue and administer the Takeover Code (the "Code") and to supervise and regulate takeovers and other matters to which the Code applies in accordance with the rules set out in the Code. The Panel has been designated under the Companies Act 2006 as the competent supervisory authority in relation to takeovers for the purposes of the Directive on Takeover Bids (2004/25/EC) (the "Takeovers Directive").

1.3 As currently drafted, ESMA's powers could fundamentally undermine the proven system of takeover regulation in the UK by:

- reducing the Panel's ability to make its own rules and apply them flexibly; and

- providing scope for prolonged disputes and tactical litigation in the course of bids.

The Panel considers that the proposal to include the Takeovers Directive in the scope of ESMA's powers has no justification in regulatory failure or otherwise and no argument has been made for giving ESMA extensive powers in this field.

The Regulation should therefore be amended to remove the Takeovers Directive from the ambit of ESMA's powers.

1.4 The Takeovers Directive is a minimum standards harmonisation measure which was agreed in 2004 after some 20 years of negotiation. Takeover regulation spans both company and securities law and since the former, at least, varies significantly between Member States, the Directive:

- provides for detailed rules to be made by national competent authorities based on a core set of general principles;[45]

- specifically permits derogations from rules, recognising that they may have to be applied flexibly to accommodate fluid markets and case-specific circumstances;[46] and

- enables Member States to limit the possibilities for tactical litigation at the national level.[47]

1.5 It is proposed that ESMA should "assume all the tasks and competences"[48] of the Committee of European Securities Regulators ("CESR"). CESR currently has no formal competence pursuant to the Takeovers Directive; it facilitates an informal network of takeover regulators which provides an effective forum for the exchange of experiences and information. While this network could usefully continue under the auspices of ESMA, ESMA's wider powers, which include the ability to promulgate technical standards and guidelines and to intervene directly in cases where a national competent authority is perceived to have "incorrectly applied" Community law, would, in the Panel's view, undermine the regime agreed in the Takeovers Directive and, specifically, the UK system of takeover regulation.

1.6 The Panel's widely recognised effectiveness reflects three key elements in the performance of its functions, namely speed, flexibility and certainty. The imposition of a further superior level of regulation would undermine each of these elements and provide scope for prolonged disputes and litigation, which are currently not a feature of the UK market.

1.7 The genesis for the Commission's proposals is the credit and banking crisis and the report of the High Level Group on Financial Supervision in the EU chaired by Jacques de la Rosière. There has been no crisis or failure in takeover regulation and the de la Rosière report did not make any proposals with regard to takeover regulation or the Takeovers Directive. No public argument has thus been made for the inclusion of the Takeovers Directive within the scope of ESMA's powers.

1.8 The Commission will be undertaking a review of the Takeovers Directive in 2011; this will provide the appropriate opportunity to examine the needs of takeover regulation throughout the EU.

[45] Article 3, Takeovers Directive.
[46] Article 4(5), Takeovers Directive.
[47] Article 4(6), Takeovers Directive.
[48] Recital 8 of 2009/0144, Regulation establishing ESMA.

## 2. ESMA's Proposed Powers

2.1 The Panel is most concerned about how the powers set out in Articles 7, 8 and 9 of the ESMA proposals would affect takeover regulation if the Takeovers Directive were to remain within the scope of the proposal.

*Article 7—technical standards*

2.2 Article 7 gives ESMA power to "develop technical standards in the areas specifically set out in the legislation referred to in Article 1(2)".

2.3 At present, this power will not extend to technical standards relating to takeover regulation. This is because the Takeovers Directive does not currently set out any areas for the development of Level 3 guidelines and no amendments are proposed to the Takeovers Directive in the Omnibus Directive[49] to specify matters in relation to which ESMA would be able to develop standards. However, the Takeovers Directive does provide for the Commission to make Level 2 rules, solely, at present, in relation to the contents of an offer document. Such rules have not yet been made but, under the terms of the Takeovers Directive,[50] the Commission is due to carry out a review of the Directive in 2011. This review will provide the opportunity to assess the needs of takeover regulation in the light of experience of the operation of the Takeovers Directive since its implementation in 2006 and it is possible that greater specificity may be sought on some matters at that time. If the Takeovers Directive remains within the scope of ESMA's powers, there must be a risk, in the Panel's opinion, that, at the time of the review, it will be assumed that the Directive should be amended in order to make ESMA's standards-setting power exercisable in relation to detailed aspects of takeover regulation.

2.4 The objective of ESMA's setting technical standards appears to be to enable the creation of a "single rule book which will ensure the uniform application of rules in the EU". The Explanatory Memorandum adds that "to this end, differences in national transposition of Community law stemming from exceptions, derogations, additions or ambiguities must be identified and removed so that one harmonised core set of standards can be defined and applied".[51] It would be inappropriate, as was recognised in the Takeovers Directive, to adopt a "one size fits all" approach to the standards applied to takeover regulation, particularly in view of national differences in underlying company law.

For as long as the Takeovers Directive remains within the scope of ESMA's powers, there exists a risk of the future application of the Article 7 standards-setting power to takeover regulation. This would be inappropriate given the underlying differences in national company law, on which much of takeover regulation is based. In particular, in the UK, it would compromise the ability of the Panel to set and modify its own rules and thus undermine the proven effectiveness of the UK regime.

*Article 8—guidelines and recommendations*

2.5 Article 8, "with a view to establishing consistent, efficient and effective supervisory practices within the ESFS and ensuring the common, uniform and consistent application of Community legislation", gives ESMA power to issue guidelines and recommendations to competent authorities or financial market participants, apparently without consultation. This power appears to be wide in scope and potentially applicable to specific cases as well as general questions of application of the law. While the guidelines and recommendations are non-binding, individual competent authorities are obliged to "make every effort to comply with those guidelines and recommendations" and must inform ESMA of their reasons if they do not do so. This implies a considerable degree of coercion, which runs contrary to the recognition in the Takeovers Directive that national competent authorities should have power to derogate from rules made pursuant to that Directive, to take account of specific circumstances. If the power were exercised in relation to individual cases, it could have serious implications in the UK for the Panel's ability to apply the Code in a flexible and determinative manner to take account of the circumstances of particular cases.

2.6 Even if only applied to general questions of application of the law, ESMA's power to issue guidelines or recommendations directly to market participants, thus effectively bypassing national authorities, would weaken the authority of those national authorities in making decisions in the context of individual cases and provide scope for disputes about whose (ESMA's or the national competent authority's) interpretation of rules should prevail.

The power for ESMA to issue guidelines and recommendations to competent authorities and market participants in the context of takeover regulation would undermine the flexibility afforded to national takeover regulators under the Takeovers Directive and could create opportunities for different approaches between ESMA and the national takeover regulator, which could lead to disruptive disputes as to which was correct in a particular situation.

[49] 2009/0161(COD).
[50] Article 20, Takeovers Directive.
[51] Explanatory Memorandum para 6.2.1 of 2009/0144, Regulation establishing ESMA.

*Article 9—Direct intervention*

2.7 Article 9 provides ESMA with a power to intervene directly when a competent authority has "incorrectly applied" Community legislation falling within its scope. It would be able to do this at the request of another competent authority or the Commission or "on its own initiative". The process is likely to be prolonged, comprising:

— an initial investigation conducted by ESMA, lasting up to two months, and followed by a recommendation to the competent authority, setting out action necessary to comply;

— in a case of continued non-compliance for one month, the Commission, after a maximum of a further four months, taking a decision requiring compliance by the competent authority; and

— ultimately, if the competent authority does not comply with the Commission's decision, ESMA adopting a decision "directly applicable" to financial market participants which prevails over any previous decision by the competent authority, where: "it is necessary . . . in order to maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system"; and "the relevant requirements are directly applicable to financial market participants."

All decisions would then be subject to an appeals procedure under Article 46.

2.8 This process would be inappropriate in the context of the regulation of an individual takeover bid because it would detract from the certainty and speed of decisions by the Panel, which the UK markets and market participants value so highly. It would open up the possibility of tactical litigation by parties to bids, who would be able to encourage ESMA to conduct an investigation "on its own initiative" if it were alleged that the Panel had incorrectly applied Community legislation. This would run contrary to the philosophy underlying the Takeovers Directive, which allows Member States to determine their own dispute settlement procedures for takeovers and impose measures to limit the possibility of tactical litigation[52] and which specifically provides that a contact committee established to facilitate the harmonised application of the Takeovers Directive should not appraise the merits of decisions taken by competent authorities in individual bids.[53]

2.9 It appears from Article 9(1), which refers in particular to a competent authority "failing to ensure that a financial market participant satisfies the requirements laid down in (the Community legislation)" that it was the failure of prudential supervision which was the driver behind the inclusion of this power. While it might be appropriate for such a power to be exercisable to prevent future prudential crises, its application to takeover regulation would introduce a highly undesirable element of uncertainty which could only act to the detriment of the interests of offerors, offeree companies and investors wherever they might be in the EU.

2.10 We also believe that it is inappropriate for ESMA to be empowered to make any determination in relation to compliance with Community law; such decisions should properly lie with the European Court of Justice.

The application of the power of direct intervention in Article 9 is inappropriate in the context of the Takeovers Directive. If this power were to be exercised in relation to individual takeovers, it could lead to the disruption of effective takeover regulation in the UK and other Member States.

3. Composition and Internal Structures of ESMA

3.1 Article 25 sets out the composition of the Board of Supervisors of ESMA and provides that the "Head of the competent authority" in each Member State will be the representative. Where there is more than one competent authority in any Member State, they must decide who the representative will be. Article 25(3) does, however, make specific provision for each Member State representative to be accompanied by a representative of that Member State's compensation scheme for the purposes of acting within the scope of the Investors' Compensation Scheme Directive. This provision should be broadened to permit the Member State representative to be accompanied by a representative of any other relevant national competent authority, as appropriate. In particular, if the Takeovers Directive were to remain within the scope of ESMA's powers, the Panel would want to be able to be represented when ESMA is acting in relation to that Directive.

Article 25 should be broadened to permit the Member State representative to be accompanied by a representative of any other relevant national competent authority (for example, the Panel) when the subject matter so demands.

[52] Article 4(6), Takeovers Directive and section 956 Companies Act 2006.
[53] Article 19, Takeovers Directive.

4. Conclusion and Recommendation

4.1 The Panel understands that the proposals for the establishment of the European System of Financial Supervisors and the three European Supervisory Authorities have been driven by the crisis in financial supervision. Takeover regulation did not, however, form part of that crisis and the Panel believes it is inappropriate for the Takeovers Directive to be brought within the full scope of ESMA's powers. Removal of the Takeovers Directive would not affect the proposals for the reform of prudential supervision within Europe.

4.2 The Network of Takeover Regulators facilitated by CESR is an effective forum in which regulators from different Member States are able to exchange information and experiences and learn from each other. It should be able to continue under the auspices of ESMA. However, given the underlying differences in company law and governance throughout the Community, it is not appropriate for takeover regulation to be made subject to the full force of ESMA's powers.

If the Takeovers Directive remains within the scope of ESMA's powers, there is a significant risk that the UK's effective and respected system of takeover regulation, which operates with speed, flexibility and certainty, could be undermined, to the detriment of UK markets and of all EU investors in UK markets.

Similar risks, particularly in relation to the regulation of individual bids, would also apply in other EU markets.

The Panel therefore recommends that the Government should seek to amend the proposed Regulation to ensure that the Takeovers Directive does not come within the scope of ESMA's powers.

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