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**Accompanying document to the**

**Commission Communication on European financial supervision**

**SUMMARY OF THE IMPACT ASSESSMENT**

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## 1. INTRODUCTION

In its Communication "Driving European Recovery" of 4 March 2009, the European Commission committed itself to come forward with proposals for reform of the EU framework for financial supervision. The Commission's action in this area builds on the report of the "de Larosière" Group on financial supervision in the EU, which recommended a new European financial supervisory framework for supervision of individual financial institutions (micro-prudential supervision) and supervision of the stability of the financial system (macro-prudential supervision).

### Consultations

The Commission conducted a public written consultation on the de Larosière report between 10 March and 10 April 2009. 116 submissions were received, the great majority of them generally supportive of the supervision proposals in the report.

An Impact Assessment Steering Group to steer the preparation of this Impact Assessment, comprising representatives from various DGs, met twice.

## 2. PROBLEM DEFINITION

### General Problems

EU financial markets are increasingly integrated, and dominated by pan-European groups whose risk management functions are centralised in the groups' headquarters. Especially in the EU-12, banking markets are dominated by foreign financial groups.

Recent events have shown that it is very difficult to achieve a single financial market and stability in the financial system, while preserving nationally-based supervision. The crisis has brought into relief the weaknesses of the present EU arrangements which place too much emphasis on prevention and management of crises concerning individual firms and too little on risks affecting the stability of the financial system as a whole.

Therefore, the current organisation of financial supervision in the EU is characterised by a general problem of **mismatch between the level of European integration of EU financial markets and the national organisation of supervisory responsibilities.**

This is magnified given the other **General Problems** exposed by the financial crisis:

- Increased risks of cross-border contagion for EU financial markets linked with the increased integration, both throughout the EU and with global financial markets.
- Undermined confidence of consumers, employees, pensioners, small business and retail investors, contributing to the economic recession.
- Reduced global competitiveness of the European financial industry, compared with what would have been the case with better supervisory practices.

- Risks of uncoordinated policies focussed on national considerations, with negative impact on the Single Market

### **Affected stakeholders**

Due to its broad impact on the financial sector and the whole economy, financial instability affects a very wide range of stakeholders, i.e.:

- Financial institutions, including their shareholders and employees;
- Users of financial services, including depositors, investors, pensioners, and non-financial companies; and
- Public authorities, including supervisors, central banks and finance ministries.

### **3. ANALYSIS OF SUBSIDIARITY**

On micro-prudential supervision, the EU has reached the limits of what can be done with the present advisory EU Committees of Supervisors. The Internal Market needs a mechanism to ensure that national supervisors arrive at the best possible decisions for cross-border financial groups. An integrated EU financial market, including companies operating on a cross-border basis, cannot work properly if the supervision remains fragmented along national lines. Therefore, transfer of competences to the Community level is necessary.

On macro-prudential supervision, the weaknesses of the present arrangements clearly played a role in the recent financial sector turbulence. Like the G20 and the US, the EU should establish a new body responsible for identifying financial stability risks at European level and, where necessary, issue risk warnings and ensure follow-up. Only Community action could provide assessment at the EU level and with an EU-wide perspective, and effective responses to EU-level systemic risks.

### **4. OBJECTIVES**

The following **General Objectives** apply to the reform of the EU supervisory framework:

- (1) Establish a more effective framework for financial supervision in the EU, adapted to the level of financial market integration;
- (2) Enhance financial stability in the EU (and thereby contain potential risks to the real economy and to public finances);
- (3) Safeguard the interests of consumers, investors, other users of financial services and other relevant stakeholders, notably employees;
- (4) Increase the competitiveness of EU financial markets, and
- (5) Foster integration of EU financial markets supportive of sustainable development.

The following **Specific Objectives** have been set in the areas of micro-prudential supervision and macro-prudential supervision:

## Specific Objectives

Micro-prudential supervision	Macro-prudential supervision
(1) Balance home and host supervisor interests, i.e., reinforce processes and practices for challenging the decisions of national supervisors on a cross-border basis;	(1) Develop European macro-prudential risk assessment;
(2) Ensure a level playing field for financial institutions operating in various Member States;	(2) Enhance effectiveness of early warning mechanisms, and
(3) Improve crisis prevention and crisis management on the European scale, and	(3) Allow for risk assessments to be translated into action by the relevant authorities.
(4) Improve effectiveness and cost efficiency of supervision for supervised companies.	

## 5. POLICY OPTIONS

### 5.1. Micro-prudential supervision

The options for organising micro-prudential supervision in the EU have been considered in two stages:

#### Stage 1: Supervisory system

1. **Dynamic status quo:** based on the continuation of the current home country model and the Lamfalussy framework.

2. **Step back: host country model:** granting to national supervisors full responsibility for supervision of both domestic and foreign-owned companies operating in a given country, including both subsidiaries and branches.

3. **Lead supervisor model:** involving extended powers for the supervisor of the parent company of a cross-border group. In practise this would mean that the home country authority of a cross-border group is given full responsibility for EU-wide operations, both branches and subsidiaries. This option could be an evolution of the existing supervisory framework.

4. **De Larosière proposal: European System of Financial Supervision (ESFS):** transforming the existing EU Committees of Supervisors into one, two or three European Supervisory Authorities. The new European Supervisory Authority/ies would work in a network with the national financial supervisors, which remain competent for the day-to-day supervision of individual institutions. These Authorities would co-ordinate supervision of cross-border groups in colleges of supervisors, contribute to harmonising detailed rules, lay down guidelines and have powers to intervene in certain strictly-defined cases of disagreement between national supervisors.

5. **A single EU-level supervisor:** involving giving all day-to-day supervisory competences for institutions with cross-border activities at the Community level in a single supervisor, leaving national supervisors responsible for companies with domestic activities only.

## Stage 2: Institutional structure

A. **One body, i.e., the integrated approach:** covering the whole financial sector (banking, insurance and securities markets) and all aspects of financial supervision<sup>1</sup>

B. **Two bodies, the approach by objective** (often referred to as "twin peaks"): based on separation of tasks between two supervisors: one that performs prudential supervision and the other that carries out conduct-of-business supervision.<sup>2</sup> A steering committee could coordinate between the two bodies.

C. **Three bodies, i.e., the sectoral approach:** including a banking supervisor, an insurance and pensions supervisor, and a securities supervisor<sup>3</sup>, in line with the sectorally-based EU financial legislation<sup>4</sup>. This model could be complemented by an overarching steering committee.

D. **Four bodies, i.e., the institutional approach:** in addition to the three bodies responsible for supervision of the respective sectors, a distinct fourth body could be created for supervision of financial conglomerates.

### 5.2. Macro-prudential supervision

Five options have been assessed regarding the European framework for macro-prudential supervision:

A. **Dynamic status quo:** according to this scenario macro-prudential supervision would be carried out through the existing EU arrangements, involving several institutions and bodies and lacking a mechanism to ensure proper follow-up to warnings and recommendations.

#### B. Building on existing or proposed structures:

**Tasking the Economic and Financial Committee (EFC):** this body provides high-level assessments of developments in financial markets and services and advises ECOFIN and the European Commission. This option would involve the EFC taking over the key role in the future framework for macro-prudential supervision.

**Tasking the European System of Central Banks (ESCB)/The European Central Bank (ECB):** Under this option, the ECB would be entrusted with the task of carrying out macro-prudential supervision in the EU. In so far as compatible with the Treaty and the Statute of the ECB, the new tasks and related powers could be implemented by the ECB or with the support of an "enlarged and empowered" Banking Supervision Committee (including for instance the Chairs of the Committees of Supervisors).

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<sup>1</sup> Member States with a single supervisory model separate from central banks: DE, AT, DK, HU, MT, PL, UK, SE. Member States with a single supervisory model with a link to (or integrated within) central banks: FI, IE, SK, BE, EE.

<sup>2</sup> This model is adopted only by NL in the EU.

<sup>3</sup> Member States with a sectoral model: CZ, ES, FR, EL, IT, LT, LU, PT, SI.

<sup>4</sup> For example, the Markets in Financial Instruments Directive for securities sector; the Capital Requirements Directive for banking sector and the Solvency II Directive (not yet adopted) for the insurance sector.

**Tasking the ESFS:** under this option, the new European Authority(ies) as recommended by the de Larosière report to strengthen EU micro-prudential supervision, could also be entrusted with the task of macro-prudential supervision. They would be supported by the network of national supervisors.

**C. Establishing a new body: the European Systemic Risk Council:** this option foresees, in line with the recommendations of the de Larosière Group, the establishment of a new body, the European Systemic Risk Council (ESRC). The ESRC would be an independent body placed outside the ECB, but chaired by the President of the ECB. Operational and technical support would primarily be provided by the ECB/ESCB. Its main tasks would be to detect macro-prudential risks; to identify the appropriate measures to reduce these risks; and to trigger remedial action by competent authorities via warnings.

## **6. PRELIMINARY ASSESSMENT OF IMPACTS AND COMPARISON OF OPTIONS**

### **6.1. Micro-prudential supervision**

In the first stage the identified options were assessed with regard to effectiveness in fulfilling the objectives of the reform (see the Table above). In light of this analysis, options 1 (Status quo), 2 (Step back) and 3 (Lead supervisor) were rejected as not fulfilling the vast majority of the Specific Objectives.

Option 4 (ESFS) and option 5 (EU Supervisor) were retained for further comparative assessment according to the criteria of effectiveness, efficiency, coherence and subsidiarity & proportionality. This led to identifying the ESFS as the preferred option for reform of the EU financial supervisory system. With respect to effectiveness, it is questionable whether a single EU-level supervisor would be sufficiently close to the activities of a financial group to guarantee adequate protection for depositors, policy-holders and investors, as well as financial stability of financial institutions in the EU. Nor would it have the legal power to apply rules made at national level within the Member States. Within the ESFS, the national supervisors would carry out day-to-day supervision. It is a decentralised and evolutionary model, allowing if needed for the transfer of additional supervisory responsibilities to the EU level over time. Another key point in favour of a decentralised solution such as the ESFS is that at present there is no EU-level financing mechanism for use when intervention is needed to assist an institution in difficulty. Both options are equally coherent with the other relevant EU policies.

The four options for institutional set-up were then analysed according to the criteria of effectiveness, efficiency and coherence. Although no one option emerged as a clear leader under this analysis, it was considered at this stage that the most proportional solution, involving the minimum of necessary change, is to retain the current sectoral structure of the three Committees of Supervisors by creating three European Authorities with the same sectoral mandates as these Committees, combined with an analysis of the functioning of the new structures three years after the entry into being of the ESFS.

### **6.2. Macro-prudential supervision**

The ESRC emerges clearly as the best solution for the EU framework for macro-prudential supervision. It would be effective as centralising responsibility for macro-prudential risk warnings and having a composition which would enhance valuable synergies, ensure a

balanced representation of all concerned EU and national institutions and authorities, and contribute to the stability of the financial system. Tasking the EFC, due to its political dimension, could jeopardise the candour of its analysis. As for tasking the ESFS, the major drawback lies with the substantial difference between the scope of macro-prudential supervision and that of micro-prudential supervision. Finally, as far as the ECB/ESCB is concerned, three main arguments can be raised against that option: the potential conflict of interest between financial and monetary stability; the reputational risk linked to the conduct of macro-prudential supervision; and the excessive concentration of power with reference to the oversight of EU financial system.

As for efficiency, the ESRC would build on operational and technical support from the ECB/ESCB with limited need for additional resources.

## 7. IMPACT OF THE SELECTED OPTIONS

The selected options should fully achieve the objectives described in section 4 by giving effect to a number of immediate changes to the organisation of financial supervision in the EU. These expected changes are reflected by the Operational Objectives set for the ESFS and the ESRC. In general, by contributing to safeguarding financial stability and to a more effective control over the conduct of financial companies, the proposed new framework would increase the welfare of most stakeholder groups in the Internal Market:

**Financial institutions, including their shareholders and employees:** by improving the business environment due to enhanced financial stability and more effective crisis prevention in the EU; ensuring a level playing field and reducing compliance costs for cross-border companies; attracting investments to the Internal Market from third countries thanks to enhanced financial stability; maintaining jobs and creating new jobs in the financial sector.

**Users of financial services, including depositors, investors, pensioners, and non-financial companies:** by increasing consumer and investor confidence in relation to the increased reliability of the financial sector; reducing risks of default of individual financial institutions; improving stability of pension funds and providing incentives for development of cross-border occupational pension funds; facilitating access to finance by strengthening the single capital market in the EU.

**Consumers and employees in the wider economy.** The successful identification and prevention by the ESRC of systemic financial crises with the potential to spill over into the real economy can have a beneficial effect in preventing or reducing macro-economic recessions and the associated effects on output consumption and jobs.

**Public authorities, including supervisors, central banks and finance ministries:** by clarifying roles and responsibilities at the national and Community level and establishing an effective framework for conflict resolution; indirect strengthening of supervisory independence; creating a framework linking micro-prudential supervision with macro-prudential supervision; providing governments and other concerned authorities with recommendations for actions needed to protect macro-economic stability in the EU and individual Member States, and giving effectiveness to the analysis of macro prudential developments carried out in the central banks; and by diminishing risks of having to inject public money into the financial system.

## **8. MONITORING AND EVALUATION**

To monitor effectively the impact of the EU action in the area of micro- and macro-prudential supervisions, specific indicators should be developed to evaluate the performance of the ESFS and the ESRC. This should be done in the impact assessment of legislative proposals implementing the supervisory reform.