EUROPEAN SYSTEM OF FINANCIAL SUPERVISION (ESFS)

The European System of Financial Supervision is a multi-layered system of micro- and macro-prudential authorities that aims to ensure consistent and coherent financial supervision in the EU. It includes the European Systemic Risk Board, the three European supervisory authorities (EBA, ESMA and EIOPA) and the national supervisors. The European Central Bank, as part of the Single Supervisory Mechanism (SSM), is the banking supervisor for the largest banks.

LEGAL BASIS

Articles 114 and 127(6) of the Treaty on the Functioning of the European Union.

BACKGROUND AND OBJECTIVES

The financial sector is subject to a strict regulatory and supervisory framework designed to promote financial stability and protect the customers of financial services. EU regulations set out the rules and standards by which financial institutions must abide. Supervision is a process of oversight designed to ensure that financial institutions apply those rules and standards properly. Among other issues, the 2007-08 global financial crisis laid bare the need to improve and strengthen the European regulatory and supervisory architecture. Following the recommendations of the report by the de Larosière expert group on strengthening the European supervisory arrangements, the European System of Financial Supervision (ESFS) was introduced in 2010 and became operational on 1 January 2011. The ESFS consists of the European Systemic Risk Board (ESRB), the three European supervisory authorities (ESAs) – namely the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) – the Joint Committee of the ESAs, and the national supervisors.

The main objective of the ESFS is to ensure that the rules applicable to the financial sector are adequately implemented across Member States in order to preserve financial stability, promote confidence and provide protection for consumers.

The ESFS is a system that combines micro- and macro-prudential supervision. The main objective of micro-prudential supervision is to reduce the probability and limit the impact of the failure of individual financial institutions. Macro-prudential supervision is concerned with the exposure of the financial system as a whole to common risks, and aims to limit its distress in order to protect the overall economy from significant losses in real output.

The 2007-08 global financial crisis demonstrated how the EU's pre-crisis supervisory architecture placed too much emphasis on the supervision of individual financial institutions and too little on the macro-prudential aspects. The ESRB was therefore established, and was handed responsibility for the macro-prudential oversight of the EU financial system and the prevention and mitigation of systemic risk. Micro-prudential oversight is performed by the EBA, ESMA and the EIOPA in each of the relevant sectors of financial services – banking, capital markets and insurance. The three micro-prudential authorities work together on cross-sectoral and horizontal issues in the Joint Committee.

FRAMEWORK

A. Micro-prudential supervision

In the EU, micro-prudential supervision is characterised by a multi-layered system of authorities separated according to sectoral area (banking, insurance and capital markets) and the level of supervision and regulation (EU and national).

1. European supervisory authorities (ESAs)

The EBA, ESMA and the EIOPA are EU agencies with their own legal personalities and are represented by their respective Chairs. The ESAs must act independently and only in the interests of the EU as a whole. They are accountable to Parliament and the Council for their actions.

The primary objective of the ESAs, as defined in their respective founding regulations (the 'ESAs Regulations'), is to protect the public interest by helping to underpin the stability and effectiveness of the financial system.

The ESAs contribute to the development of a single rulebook by drafting two types of technical standards (regulatory technical standards and implementing technical standards), which are adopted by the Commission (as delegated or implementing acts). With a view to enhancing supervisory convergence, they issue guidelines and recommendations and have certain powers in cases of breaches of EU law by national supervisory authorities, emergencies and disagreements between competent national authorities.

In its relevant sector of activity, each of the ESAs, in consultation with the ESRB, is tasked with developing criteria for identifying and quantifying systemic risk and devising an adequate stress-testing regime for the institutions within its purview. The ESAs also initiate and coordinate EU-wide stress tests to assess the resilience of financial market participants.

In the three ESAs, the Board of Supervisors is the main decision-making body and consists of the Chair, the head of the competent supervisory authority in each Member State and one representative from each of the Commission, the European Central Bank (ECB), the ESRB and the other two ESAs.

a. European Banking Authority (EBA)

Legal basis: Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), as amended by subsequent legislation.

Originally based in London, the EBA relocated to Paris in June 2019. The purview of the EBA encompasses credit institutions, financial conglomerates, investment firms, payment institutions and e-money institutions. With the review of 2019, the EBA was also entrusted with preventing the financial system from being used for the purposes of money laundering and the financing of terrorism.

b. European Insurance and Occupational Pensions Authority (EIOPA)

Legal basis: Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), as amended by subsequent legislation.

The EIOPA's seat is in Frankfurt am Main. It is primarily concerned with insurance and reinsurance undertakings, insurance intermediaries, financial conglomerates and institutions for occupational retirement provision (IORPs). It mainly contributes to the single rulebook on insurance and occupational pensions through the Solvency II and IORP regimes, respectively.

c. European Securities and Markets Authority (ESMA)

Legal basis: Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority), as amended by subsequent legislation.

ESMA is located in Paris. Its purview covers capital markets and participants (exchanges, traders, funds, etc.). In the EU, ESMA has direct oversight and sole responsibility for the registration, supervision and sanctioning of credit rating agencies and trade repositories. It is also in charge of recognising third-country (i.e. non-EU-country) central counterparties and trade repositories, and certifying and endorsing third-country credit rating agencies.

2. Joint bodies

A Joint Committee of the European Supervisory Authorities (Joint Committee) is responsible for overall and cross-sectoral coordination, with the aim of ensuring supervisory consistency. It is also responsible for the settlement of disputes between the ESAs on cross-sectoral matters.

The Board of Appeal is independent from the three ESAs and is responsible for appeals from parties affected by the decisions of the ESAs. The decisions of the Board of Appeal can be contested before the Court of Justice of the European Union.

3. Competent national supervisory authorities

Each Member State designates its own competent authorities, which form part of the ESFS and are represented in the ESAs.

B. Macro-prudential oversight – European Systemic Risk Board (ESRB)

Legal basis: Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, as amended by subsequent legislation, and Council Regulation (EU) No 1096/2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board.

The ESRB carries out macro-prudential oversight at EU level. Its objective is to prevent and mitigate systemic financial stability risks in the light of macro-economic developments. It is composed of a General Board, a Steering Committee, two advisory bodies (Advisory Scientific Committee and Advisory Technical Committee) and a Secretariat. The ECB provides analytical, statistical, administrative and logistical support to the ESRB. The President of the ECB is also the Chair of the ESRB.

C. Cooperation at various levels

Financial markets are complex, interconnected and increasingly globalised. Coordination and cooperation between the supervisory authorities in charge of the different entities and sectors, both within the EU and globally, is therefore key. In that context, the ESAs play an important coordinating role. The various entities within the ESFS also coordinate with international institutions – including at supervisory forums such as the International Organization of Securities Commissions (IOSCO), the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) – and with third-country supervisors.

D. Development of the supervisory framework

During and in the aftermath of the 2007-08 global financial crisis, it became clear that a deeper integration of banking supervision in the euro area was necessary. Consequently, the EU banking union was established in 2013, and became operational in November 2014, introducing new elements and actors. As one of the banking union's main pillars, the Single Supervisory Mechanism (SSM) is a particularly important element of the supervisory framework.

Under the SSM's founding regulation, the ECB is the banking supervisor for the largest banks ('significant credit institutions') in the euro-area Member States, plus any non-euro-area Member States that decide to join. For this purpose, the governance structure of the ECB has been adapted through the establishment of a Supervisory Board. The tasks of the ECB in that capacity include authorising credit institutions, ensuring compliance with prudential and other regulatory requirements, and carrying out supervisory reviews. The national banking supervisors continue to oversee the remaining banks. In addition to these micro-prudential tasks, the ECB also has macro-prudential tasks and tools. In order to ensure consistent supervision, the ECB cooperates closely with the national banking supervisors within the SSM and with the other authorities that make up the ESFS, most notably the EBA.

Moreover, the Single Resolution Mechanism (SRM) was established for banks covered by the SSM and became operational in 2016. The Single Resolution Mechanism allows bank resolution to be managed effectively through a Single Resolution Board (SRB) and a Single Resolution Fund (SRF), financed by the banking sector. It aims to ensure the orderly resolution of failing banks with minimal costs to taxpayers and to the real economy.

In the pursuit of building an EU capital markets union, and as part of a broader range of measures, a 2019 review of the ESFS framework concluded by amending the founding regulations of the ESAs and the ESRB. The amendments aimed to reinforce the powers, governance and funding of the ESAs and strengthen the ESRB's capacity to oversee the financial system and detect risks to financial stability, including in new fields such as financial technology (fintech).

The latest review of the ESAs' operations was envisaged under the 2020 capital markets union action plan and concluded in May 2022. It suggested carrying out targeted amendments to foster supervisory convergence in sectoral legislation and continuing the reflection process on possible further areas for improvement.

ROLE OF THE EUROPEAN PARLIAMENT

As co-legislator, Parliament played an important part in setting up the founding legislation for the ESFS. Moreover, Parliament has a scrutiny role as regards the measures adopted in developing the single rulebook, i.e. delegated acts (including regulatory technical standards) and implementing acts (including implementing technical standards). The Chairs and Executive Directors of the ESAs have to be confirmed by Parliament. Parliament also has extensive information rights, e.g. being entitled to receive the annual work programme, the multiannual work programme and the annual reports of the ESAs. In addition, Parliament may request opinions from the ESAs. It also votes on the discharge of the budget of the ESAs each year.

Furthermore, Parliament and the ECB have concluded an Interinstitutional Agreement (2013/694/EU) in order to ensure accountability and oversight regarding the tasks conferred on the ECB within the SSM framework. In particular, Parliament decides on the approval of the candidates proposed by the ECB for Chair and Vice-Chair of the Supervisory Board, respectively, through a vote in the Committee on Economic and Monetary Affairs (ECON) and in plenary. Moreover, the Chair of the Supervisory Board attends regular hearings and exchanges of views with MEPs to present the ECB's Annual Report on supervisory activities and explain the ECB's execution of its supervisory tasks, and also answers questions from MEPs.

For more information on this topic please see the website of the Committee on Economic and Monetary Affairs.

Christian Scheinert
10/2023