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Review of the European Supervisory Authorities: Opportunities to ensure a safe and sound financial system

ALDE Seminar on the Review of the European Supervisory Authorities

European Parliament, Brussels

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Chair

Ladies and gentlemen,

I want to thank MEP Sylvie Goulard and ALDE for organising today's event on this important topic – the review of the three European Supervisory Authorities (ESAs). This is an excellent opportunity to take a step back and look at what we have achieved, what went well and what needs to improve to equip ESMA for the future. While my contribution focuses on ESMA, I want to make some general comments on regulation, supervision and the role of financial markets in the financial system.

Financial markets perform essential functions in our societies. They finance economic activities that result in jobs and growth, and they allow citizens to save and invest. As financial markets are prone to risks, they are governed by extensive rules that are supervised and enforced by financial markets regulators, including ESMA at the European level. Unique to the European Union (EU) is the combination of integrated financial markets, where market participants have extensive freedoms to decide where to locate their activities, with most day-to-day supervision conducted by competent authorities at national level (NCAs).

When looking to the future, and in line with the Capital Markets Union's (CMU) objectives, we should expand the role of financial markets in the EU's financial system. Looking back at the past decade, financial markets have performed relatively well in terms of stability and an improved balance between the banking system and financial markets has several additional benefits: it provides another source of funding; it allows a shift from debt-funding to equity-funding, and it can increase the overall competitiveness of the financial system. The fact that the UK has decided to leave the EU, reinforces the need for the EU27 to progress with CMU.

Before I expand on the developments just described, and how we can prepare ESMA for the future, let me give you my quick assessment of ESMA's performance since its establishment six years ago. This assessment should not surprise as I have previously presented this to the ECON Committee in our annual hearings.

ESMA in its formative years has had a strong focus on building the single rulebook and establishing direct supervision of Credit Rating Agencies (CRAs) and Trade Repositories (TRs). These activities are linked to the regulatory reform in response to the financial crisis and the related G20 commitments.

The granting, by the European Commission (Commission) and co-legislators, to ESMA of mandates regarding the single rulebook and direct supervision, and the accompanying powers, was a bold step and I commend them for this. I believe that ESMA has progressed well in both areas, but we should not be complacent and always look for opportunities to improve, so I will outline some possible improvements I have identified previously:

1. The process and timing of the various stages of making draft Technical Standards should be improved. For the delivery of high quality Technical Standards, including appropriate involvement of stakeholders through consultations, ESMA requires at least 12 months after publication in the Official Journal (OJ). In addition, I would like to recall the general expectation that draft Technical Standards are endorsed by the Commission within deadlines envisaged in the ESAs Regulations, based on which the Parliament and the Council can exercise their scrutiny. Also, I would very much welcome better coordination and communication to improve ESMA's understanding of the co-legislators' intentions to further improve the alignment between Level 2 and Level 1 work;

2. We need to have an instrument similar to the *no-action letters* – available to other financial markets regulators. While changing Technical Standards is quicker than amending a Directive or Regulation, in some cases the time required is still too long. For example, in the case of quickly evaporating liquidity it is important to have an instrument to allow the rapid termination of a clearing or trading requirement; and

3. ESMA needs to have the power to impose higher fines on supervised entities. In the last four years ESMA has issued one censure and three fines on supervised entities, both CRAs and TRs.

However, the fines we can impose need to be higher to ensure that our enforcement is seen as a credible support to our supervision.

ESMA's focus has gradually shifted from the single rule book to supervisory convergence. This change of focus is only natural as we move from rulemaking to rule implementation and the question we need to answer is whether ESMA is appropriately equipped to ensure consistency of supervision across the EU. We need to have the appropriate instruments and powers to ensure supervisory convergence considering the developments described earlier:

1. In a successful CMU, where financial markets grow and are more interconnected, it is even more important to achieve consistent supervision across the NCAs; and

2. The decision of the UK to leave the EU results in increased risks to consistent supervision. Let me explain this briefly. As UK-headquartered market participants are considering their options across the EU27, it is essential that national regulators do not compete on regulatory or supervisory treatment. Some practical examples where this may be a risk include such issues as the possibilities to delegate and outsource to a UK entity, while being registered and supervised by one of the EU27 financial markets regulators.

Considering the reasons above, I will focus in the remainder of my contribution on supervisory convergence within the EU. A closely related topic, which I will also discuss in more detail, is how to coordinate supervision between the EU and jurisdictions outside the EU.

One final issue for the ESAs that needs to be improved is their funding. The weakness of the current model, where NCAs provide an important part of the ESAs' funding is well-known, and I hope the Commission comes forward soon with proposals to implement funding based on levies. A final reflection on this point, also in the context of the CMU, is that bigger and more interconnected financial markets need more supervisory resources to ensure their stability and that investors are protected, at both the EU and national level.

Supervisory convergence

Let me now focus on supervisory consistency by the NCAs. Nearly ten years after the start of the financial crisis, and memory fading, it is insightful to read again the recitals of ESMA's Regulation. They reflect the expectations of what the ESFS should achieve in the area of supervisory convergence:

> "The Union cannot remain in a situation where there is no mechanism to ensure that national supervisors arrive at the best possible supervisory decisions for cross-border financial market participants. … Greater harmonisation and the coherent application of rules for financial market participants should … be achieved."

Supervisory convergence is a very important issue in the EU. The key policy question is, and as reflected in the recitals, how to ensure that national regulators take the best possible supervisory decisions from an EU perspective. For market participants there is a great degree of freedom, both economically and legally, to decide where to locate entities and activities in the EU. As providing cross-border financial markets services is relatively easy, and probably easier than in banking or insurance, concentration of financial market activities has developed, with financial centres developing that focus on such activities as market infrastructures, asset management, high frequency trading firms, or the provision of CFDs and binary options. As a result, a substantial share of national supervision concerns cross-border activities and the question is whether national regulators sufficiently assess and address the risks that their supervised entities might be creating outside their jurisdiction, in other parts of the EU.

ESMA has various mechanisms to ensure that supervision across the EU is conducted consistently. Some of these measures are generic, like the possibility to issue guidelines, opinions, or Q&As, conducting peer reviews of national supervisory practices, and initiating mediation in case of disagreements between NCAs or a Breach of Union Law procedure in case of the incorrect application of EU law by an NCA. Other convergence measures are legislation specific, like the requirement for a CCP to obtain approval from ESMA, in addition to the national regulator's approval, of a proposed change to its margin models, and the upcoming power for ESMA to ban certain products under MIFID II.

Since ESMA's establishment, the convergence tools have improved, compared to those available to our predecessor, but experience shows that the current supervisory convergence tools are too weak. This point is illustrated by the case of CFDs and binary options, highly speculative products with a low chance of positive returns, which continue to create consumer detriment across the EU. The offering of CFDs and binary options to the EU retail market is mainly concentrated in one EU member state, where investment firms use aggressive marketing campaigns and large call centres to sell their products. While ESMA has undertaken various convergence activities on this matter, and the NCA concerned has stepped up its supervision and enforcement activities, our tools are not sufficiently effective to ensure that the risks to consumer protection are sufficiently controlled or reduced.

To conclude, we need to strengthen the instruments available to ensure supervisory consistency across the EU. Some of these instruments will be generic, while some will be specific for individual pieces of legislation.

Framework for third countries

Since its establishment, ESMA has been involved in the development and implementation of the third country framework for financial markets. We have, for example:

- given equivalence advice under EMIR and the CRA Regulation, and recognised 26 third country CCPs and credit rating agencies;
- provided advice on passporting for third country asset managers under the AIFMD; and
- have been involved in the conclusion of more than 1,100 MOUs.

The EU framework for third countries rightly tries to achieve consistent regulation and supervision of global financial markets, and to strengthen the EU as a stable global financial region where it is attractive to conduct financial activities where investors are protected.

It is clear to me, based on this experience, that the EU third country framework needs to be overhauled. First, there is no generic third country framework: it is a patchwork of arrangements varying across the various pieces of legislation. No arrangement is identical and they are mixtures of equivalence, endorsement, recognition, third country passporting or no arrangement at all. While some differentiation seems inevitable to respond to the different nature of various financial market activities, based on the experience of the past few years it would be beneficial to see greater consistency.

Second, the third country framework is time and resource intensive as it requires detailed assessments of the regulatory and supervisory regimes of third countries, lengthy negotiations if a third country is initially not equivalent, and the assessment of applications for third country entities that need to be recognised. ESMA, at a minimum, should be in a position to charge fees to third country entities requiring recognition to cover some of the resources involved.

There are also more fundamental problems with the EU third country framework. I will illustrate these problems with the equivalence system as applied under EMIR. When the regulatory and supervisory outcomes are determined to be equivalent, subject to certain conditions, a third country CCP can be recognised and provide its services to EU clients. However, under this regime there is a heavy reliance on the home regulator. In its 2015 EMIR review reports, ESMA raised two main concerns regarding the equivalence mechanism.

First, the main benefits of the equivalence system materialise when all main jurisdictions apply this approach: an internationally active CCP would mainly be supervised by its home regulator. This is beneficial from the perspective of avoiding duplications and inconsistencies in supervision and regulation.

However, the EU is *an island* of third-country reliance in a world that has mostly opted for individual registration of CCPs that want to do cross-border business. Therefore, third country CCPs have benefited from the EU's system, while internationally active EU CCPs must be authorised and are subject to the supervision of third country regulators. This was not the intended result when designing the equivalence mechanism.

The second concern relates to the strong reliance on the home country regulator: do we have sufficient assurance that risks of the third country infrastructures' activities in the EU are adequately assessed and addressed by the third country home regulator? While we have excellent cooperation with our international colleagues, we have no assurance that a third country regulator has the right incentive to appropriately assess and address the risks associated with the activities of its supervised entities outside its jurisdiction. Additionally, ESMA has very limited opportunities to see the specific risks that third country CCPs might be creating in the EU as we have very limited powers regarding information collection and risk assessment, and no regular supervision and enforcement tools.

Therefore, we need to rethink and overhaul the framework for third countries in financial markets legislation. The point of departure should stay the same: achieving consistent regulation and supervision of global financial markets, and strengthening the EU as a stable global financial region. An important element to consider in such a new system is ensuring that risks posed by the activities of third country entities in the EU can be adequately assessed and addressed. This is especially relevant the bigger the third country's financial markets and the more interconnected with the EU's financial markets. A final consideration is that the risk of regulatory competition is reduced when execution of the third country framework is conducted at EU level.

Conclusion

Ladies and gentlemen, I want to conclude by expressing my deep conviction that the future of European financial markets is directly linked to the CMU project. The need for a CMU has only increased and we cannot afford to have a CMU which would not deliver on full integration of EU financial markets, financial stability or investor protection. I look forward to working with you over the next months and years in making the CMU – supported by effective European regulation and supervision – a true success.