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REGULATION OF FINANCIAL SUPERVISION IN THE EUROPEAN UNION

Abstract
This contribution offers a broad theory on the regulation of the financial supervisory architecture in the European Union. It discusses the macro- and micro-prudential competences of the specialised agencies that are now ranging from direct supervision of individual financial institutions to the ability to impose market-wide restrictions on financial activities. The regulatory response to the financial crisis of 2007/08 centralised and strengthened the EU competences of monitoring financial markets and enforcing cooperation between the national competent authorities, especially in cross-border situations. It is however observed that – with some notable exceptions – the supervisory model in the European Union remains fragmented. Lack of direct supervisory powers – especially in the securities and payments markets – means that many international institutions remain without appropriate supervision. This results not only in weaker consumer protection and increased systemic risk, but also in jurisdictional arbitrage and, ultimately, damaged competitiveness of the European financial sector.

Keywords: financial supervision, supervision models in the EU, effectiveness of supervision

Introduction

The purpose of this contribution is to present and discuss legal sources governing financial supervision in the European Union. The research hypothesis examined in this article aims to determine the extent to which these provisions contribute to the proper functioning of the financial market. In the legal sense, financial supervision is defined as a set of rules and standards that allow authorities to oversee and control activities of the participants of the financial markets [Wielka Encyklopedia PWN 2003, p. 285]. The question of financial control was one of the main research topics of Professor Eugeniusz Ruśkowski, to whom this issue of the Annual Center Review is dedicated. In his last book he distinguished four main elements of financial control analysis. Firstly, it is concerned with finding of the facts applicable in financial matters. Secondly, it determines the actual state of play and, thirdly, it compares results with initial recommendations and best practices to establish their (lack of) conformity. Finally, it explains reasons for the observed conformity or non-compliance [Ruśkowski 2001, pp. 135-136]. Thus, Professor Ruśkowski's work became integral part of the Polish scientific culture in the field of financial oversight [Rybarski 1937, pp. 47-51; Kurowski 1968; Kurowski 1990; Ruśkowski 2021].

Purpose of Financial Supervision

The rules, objectives, and limitations of financial supervision in the European Union are defined in a series of applicable legal acts [Głuchowski 2010, p. 143]. Accordingly, the purpose of this oversight is to ensure the proper functioning of the financial market, its stability, security,

transparency, trust and the protection of the interests of the participants, both retail and professional.

It can be observed, from the point of view that is particularly interesting to us, that financial supervision in a given country can be internal (national) and external (international). An example of the latter is the financial supervision exercised within the single market of the European Union. In the wake of the 2007/08 global financial crisis, the cross-border interconnectedness of individual financial institutions had serious negative impact on macro-savings structures. The regulatory response attempting to remedy existing shortcomings in external (international) oversight led to a series of legal acts that reshaped the supervisory architecture in the EU.

The stage-setting report by de Larosière placed great emphasis on the need to coordinate financial supervision across national borders. The report drew attention to the fact that the lack of consistent supervisory practices and uniform prudential requirements, especially at the international macro-economic level, was one of the main reasons for inadequate response to the financial crisis in 2008 [de Larosière et al. 2009, p. 10]. The national regulators were accused of devoting too much attention to micro-prudential supervision to allow them to respond in a timely and appropriate manner to a number of cross-border links between individual financial institutions that had, unsurprisingly, serious macro-prudential implications [de Larosière et al. 2009, p. 10].

Until the financial crisis of 2007/08, Member States' supervisory authorities have coordinated their policies through three committees that did not exercise directly any supervisory powers: 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) [Ringe, Morais, Muñoz 2019, p. 5]. In 2011, the three *Committees* were transformed into three *Authorities* with a task to ensure proper implementation of the rules throughout the European Union: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). In literature, the European Union represents thus the-so called sectoral supervisory model, which means that there are three different competent authorities for each sector: banking, insurance and securities markets [Wymeersch 2007, p. 251]. The topic of supervision of the insurance market will be omitted in the remaining part of this article.

Specialised Authorities

The new authorities became independent institutions acting solely in the interest of the European Union, even though accountable to the European Parliament and the Council [Regulation 1093/2010, art. 1(5), art. 3; Regulation 1095/2010, art. 1(5), art. 3]. It should be however mentioned that in the case of credit institutions, the EBA shares many competences with the all-powerful European Central Bank (ECB), which has been given extensive supervisory powers within the Single Supervisory Mechanism (SSM) [Ferran, Babis 2013, pp. 255-260]. The additional competences of the ECB are centred around the licensing and prudential supervision of credit institutions [Treaty on the Functioning of the European Union (TFEU) 2012, art. 127(7); Council Regulation 1024/2013, art. 4(1)(a); European Central Bank 2019, p. 2].

At the macro-prudential level, the chairs of the three sectoral supervisors as well as of the ECB meet together at the European Systemic Risk Board (ESRB) [Regulation 2019/2176, art. 1, art. 3]. The ESRB is responsible for issuing recommendations related to the macro-prudential supervision of all financial institutions in the EU. To complete the picture, as part of banking supervision, the Single Resolution Board (SRB), through its management of the Single Resolution Mechanism (SRM), sets standards for the rules and procedures for the orderly resolution of credit institutions [Regulation 806/201, art. 1, art. 42]. Noteworthy, the competences of direct supervision of the ECB and the SRB are limited to the participating Member States (i.e. those that adopted the single currency – Euro). Although other Member States could join the SSM by virtue of an agreement with the ECB [Council Regulation 1024/2013, art. 7; European Commission 2017, p. 2], only Croatia and Bulgaria did so in 2020 [European Central Bank 2020]. In other Member States, including Poland, the national supervisory authorities remain competent in all matters related to the direct supervision of financial institutions [Darvas, Wolff 2013, p. 141].

It is necessary to observe that neither of the EU Treaties provide for specific supervisory competences of the three sectoral supervisors: the EBA, the EIOPA, the ESMA. Since their establishment, the European Commission assumed that the role of the specialised agencies will always be limited to the implementation of the European laws, but they will not become part of the legislative process *per se*. Therefore, such bodies can be established within the framework of the existing EU Treaties [Commission

of the European Communities 2002, p. 3; Howell 2019, p. 327]. In practice, the usefulness of specialized bodies was hardly ever controversial and widely used in the Community since its inception, even in the absence of uniform foundations at the level of primary law [Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community (Meroni) 1958, pp. 151-154]. As a result, the general article 114 of the TFEU, which deals with the approximation of laws, became the legal basis for the functioning of the three sectoral authorities. Although the possibility of setting up supervisory authorities does not stem directly from that article, the European Court of Justice generally agreed with the reasoning of the European Commission as long as the tasks entrusted to the three sectoral authorities are "contributing to the implementation of a process of harmonisation [and are] closely linked to the subject-matter of the acts approximating the laws, regulations and administrative provisions of the Member States" [United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union 2006, par. 44-45]. Consequently, the three sectoral authorities may take decisions on specific legal bases, but they are not authorised to adopt new European laws. In other words, the powers of the supervisory authorities cannot contradict or limit the powers of the European legislators [European Commission 2001, p. 20].

We have examined below the legal bases that confer upon ESMA competences of financial supervision in the securities market:

a) ESMA has the task of ensuring consistent, efficient and effective supervision of firms providing investment services, collective investment undertakings and markets of financial products and services marketed based on the following legal bases [Regulation 1095/2010, art. 1(2), art. 8-9, art. 1(5)]: Directive 2014/65/EU, Regulation 600/2014 [art. 1(1)(e)], Directive 2009/65/EC [art. 4(1)(4)], Directive 2011/61/EU [recitals 73-74] as well as Regulation 1095/2010 [art. 1(2), art. 5]. ESMA can publish best practices for the conduct of financial activities and develop draft regulatory technical standards [Regulation 1095/2010, art. 8(1)(aa), art. 10, art. 15, art. 16, art. 17(3), art. 29a] as the second and third levels of the so-called Lamfalussy procedure [Lamfalussy et al. 2001, pp. 6-7, p. 24]. ESMA is also empowered to issue warnings in the event of overreaching threat to public interest [Regulation 1095/2010, art. 9(3)] and may "temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union" [Regulation 1095/2010, art. 9(5), art. 17(6), art. 18(4), art. 19(4)].

ESMA has two core competences related to the interpretation and enforcement of the European financial law. First, in the event of an alleged breach of the European law by national competent authorities, it may make recommendations and requests for information to such an authority [Regulation 1095/2010, art. 17(2), art. 17(2a), art. 17(3), art. 17(4); ESMA 2020, pp. 1-16]. In the event of an unsatisfactory response, ESMA may request the European Commission to issue a formal opinion "requiring the competent authority to take the action necessary to comply with Union law" [Regulation 1095/2010, art. 17(4)]. Where a national competent authority fails to comply with a formal opinion issued by the European Commission, ESMA may adopt a binding decision addressed directly to a financial institution [Simoncini 2015, p. 324]. However, this is only possible "where urgent remedying is necessary to restore the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union" [Regulation 1095/2010, art. 17(6), art. 18(4)]. Second, ESMA can settle disputes between national competent authorities related to the financial institutions providing financial services on a cross-border basis in the single market [Regulation 1095/2010, art. 8(1)(b), art. 19; ESMA 2021]. On this basis, ESMA may issue binding decisions "requiring [national competent authorities] to take specific action or to refrain from action in order to settle the matter" [Regulation 1095/2010, art. 19(3)]. Where the national competent authority does not comply with the ESMA's decision, the ESMA may directly issue an individual decision addressed to the financial institution. However, it is only possible if the provisions applicable to the financial institution in question are not subject to interpretation and are hence directly applicable [Regulation 1095/2010, art. 19(4), art. 39].

While ESMA may adopt individual decisions requiring national competent authorities to take certain actions when financial stability is at stake [Regulation 1095/2010, art. 18(3)], its competence in the micro-prudential supervision of individual institutions

remains severely limited. The lack of this competence is particularly visible in the case of the so-called key financial market participants, for which it can only draw up guidelines and recommendations [Regulation 1095/2010, art. 4(2), art. 22(3)]. The only institutions that are directly supervised by ESMA are credit rating agencies and trade repositories [Spendzharova 2017, p. 4; European Commission 2014, pp. 3-4].

The above analysis leaves no doubt that ESMA's remit goes beyond coordinating the activities of national competent authorities. It is particularly noticeable in ESMA's power to intervene by imposing restrictions on the marketing of financial products and activities. In addition to the ban on the marketing of binary options, ESMA also introduced short selling restrictions in 2012 [Regulation 236/2012, art. 28; Regulation 1095/2010, art. 9(5)]. Not without a pushback from the Member States. The British opposition argued that the competence that allows ESMA to impose restrictions when they threaten the proper "functioning and integrity of financial markets" constitutes too broad discretionary power allowing the authority to make political choices that affect the economy at large [United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union (UK v EP and the Council) 2014, par. 28-34]. However, the European Court of Justice ruled that introduction of these restrictions does not constitute an abuse of power since ESMA can only impose restrictive measures on condition that "no competent national authority has taken measures to address the threat or one or more of those authorities have taken measures which have proven not to address the threat adequately" [UK v EP and the Council 2014, par. 46]. Moreover, the Court drew attention to the fact that the market-wide restrictions always stem from specific legal basis and relate to specific financial instruments. ESMA is therefore not exercising a legislative power but an executive one as it only implements the existing European laws [UK v EP and the Council 2014, par. 63]. On that basis, the European Court of Justice held that the normative measures adopted by ESMA did not go beyond the framework of the EU Treaties, since they were a harmonising tool aimed at improving the internal market [UK v EP and the Council 2014, par. 103, 113-114].

Consequently, the delegation of supervisory competences to the three sectoral authorities appears to be in line with the existing EU Treaties. However, the limits of the provisions of article 114 of the TFEU will remain controversial as long as the subject is not regulated more specifically at the level of primary law, as it was done with respect to the European Central Bank's competences. To illustrate, article 127(6) of the TFEU conferred general competences of prudential supervision of financial institutions upon the ECB [Ringe, Morais, Muñoz 2019, p. 24]. In addition to the ECB's accountability to the European Parliament and the Council [Memorandum of Understanding between the Council of the European Union and the ECB 2013, pp. 2-4], it had to ensure that its direct involvement in the European monetary policy [TFEU, art. 282(3)] is not creating conflicts of interests with the newly granted supervisory powers [Interinstitutional Agreement between the European Parliament and the European Central Bank 2013, pp. 1-6; Jurkowska-Zeidler 2015, p. 515]. As a consequence, without a dramatic change in the EU Treaties, supervision by the three sectoral authorities at the level of individual financial institutions does not seem to be possible [Kálman 2014, pp. 212-213]. This is particularly striking when considering financial institutions (other than banks) that are systematically important. At the moment, the supervision of such institutions by ESMA is limited to the preparation of EU supervisory manuals and stress tests [Regulation 1095/2010, recital 37, art. 22, art. 27]. The only elements of direct supervision are only allowed in emergency situations and require the Council's approval [Regulation 1095/2010, art. 18(2)], which significantly limits ESMA's ability to act [Moloney 2011, p. 45].

The situation looks different with respect to the banking sector. We have discussed below the legal bases that confer upon the EBA and the ECB competences of financial supervision:

b) The task of the EBA is to ensure consistent, efficient and effective supervision of credit institutions, financial conglomerates, investment firms, payment institutions and electronic money institutions that operate on the basis of the following legal acts [Regulation 1093/2010, art. 1(2), art. 1(3), art. 8, art. 10-16, art. 34]: Regulation 1093/2010 [art. 1(1)(e)], Directive 2013/36/EU, Regulation 575/2013, Directive 2009/110/EC and Directive 2015/2366. The basic competences of the EBA are equal to those set out above for ESMA. It can publish best practices, develop draft regulatory technical standards and issue warnings in the event of a threat to the public interest [Regulation 1093/2010, art. 1(5), art. 9(3), art. 10, art. 15, art. 8(1)(aa), art. 16, art. 16a, art. 16b]. The EBA

may also adopt decisions against national competent authorities and individual financial institutions [Regulation 1093/2010, art. 17, art. 19, art. 39] and "temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union" [Regulation 1093/2010, art. 9(5), art. 17(6), art. 18(4), art. 19(4)].

The key difference between the supervision of the securities sector and the banking sector lies in the centralisation of micro-prudential supervisory powers at the European level. An example of this is the conferral of specific supervisory powers to the ECB by the Single Supervisory Mechanism (SSM) [Council Regulation 1024/2013, art. 1, art. 3, art. 7]. In this respect, the ECB has exclusive competence to issue and revoke authorisations for credit institutions under the EU law and the national legislation transposing the EU law [Council Regulation 1024/2013, art. 4(3), art. 14]. In addition, the ECB conducts direct supervision of credit institutions of "systemic importance" (among others, if the value of the assets exceeds EUR 30 billion or "subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities" [Council Regulation 1024/2013, art. 6(4); European Central Bank 2018, pp. 61-110]).

The ECB also takes an active role in cross-border situations. Where a credit institution licensed in a participating Member State intends to provide banking services in the territory of a non-participating Member State, the ECB shall act as the "home competent authority" for all the procedural aspects [Council Regulation 1024/2013, art. 4(1)]. On the other hand, where a credit institution established in a non-participating Member State intends to provide services within the territory of a participating Member State, the ECB shall act as the "host competent authority" [Council Regulation 1024/2013, art. 4(2)]. In addition, the ECB enjoys a number of investigative and controlling powers [Council Regulation 1024/2013, art. 10-14] allowing it to impose additional prudential requirements on any credit institution provided that there are reasons for doing so dictated by the institution's failure to comply with the existing prudential requirements [Council Regulation 1024/2013, art. 16]. It must be reiterated that the power of direct supervision over financial institutions can be in conflict with the competences connected to the monetary policy. For this reason, ECB is legally bound to ensure [Council Regulation 1024/2013, art. 25] that management of both aspects – prudential supervision and monetary policy – are operationally separate [Gortsos 2016, pp. 285-295].

The banking sector in the European Union has therefore two authorities exercising formal supervision. In contrast to ESMA's clear position in the securities market, EBA's position in the banking sector is largely dependent on the decisions taken by the ECB, especially with regard to the interpretation of the rules for credit institutions and the development of European banking policy [Farran, Babis 2013, p. 23]. Moreover, although the overall competence of the EBA has not been formally limited [Regulation 1022/2013, recital 4], some competences (e.g. related to the preparation of EU supervisory manuals and stress tests) are among the competences of both authorities, which may lead to duplication of certain activities and unclear responsibility for supervision [European Commission 2014, p. 35].

The most important missing competence of the European supervisory authorities is the ability to exercise direct supervision over key market participants (e.g. investment funds for ESMA and payment institutions for EBA). These are increasingly large-scale international institutions and can have a significant impact on the stability of financial markets, equal to the influence of credit institutions in the banking sector [Jenkins 2020].

The three sectoral authorities have also very limited powers with respect to financial institutions providing services across borders on the basis of freedom to provide services (the so-called "European passport"). Although they can intervene and require national competent authorities to ensure that a financial institution meets all the requirements related to doing business in the EU [Regulation 1093/2010, art. 17(6), art. 19(4); Regulation 1095/2010, art. 17(6), art. 19(4)], there is no legal basis for the sectoral authorities, with the exception of the credit institutions described in the section on EBA/ECB, to require national competent authorities to recognise a "European passport". Such a solution, which does not require prior initiation of proceedings before the European courts would be particularly useful in a situation where the three sectoral supervisors consider that the requirements imposed by a Member State in the context of reliance on a "European passport" are manifestly incompatible with the EU law.

Conclusion

In conclusion, it should be noted that effective and consistent supervision of financial institutions is a necessary step in the creation of an internal market for financial services. Harmonisation of supervisory practices and rules – as well as ensuring uniform interpretations of the law in the EU – aims to ensure a high level of security and financial stability, especially in the cross-border situations. Nevertheless, there are many inconsistencies in the EU related to the obligation to cooperate and exchange information between national competent authorities. Moreover, the three sectoral authorities do not have sufficient competences to enforce cooperation or to initiate direct supervision of financial institutions, especially those active in more than one Member State. This can lead to jurisdictional arbitrage, as the supervisory authorities in the home Member State currently enjoy a privileged position in conducting day-to-day supervision.

The lack of consistent and uniform supervision in cross-border situations can also lead to errors and gaps in supervision. This is dictated by the fact that the practices of innovative financial institutions that make full use of cyberspace to operate across the geographical borders of the Member States may be overlooked or misinterpreted by the authorities of the home/host Member State. Consequently, although the principle of "same activity, same risk, same rules" is of great importance to the question of fairness and neutrality of the law, some situations require tailor-made (i.e. international) supervision. On the basis of the observed regulatory obstacles and shortcomings, it can be concluded that only a stronger obligation to cooperate – consisting primarily in the automatic exchange of information – between national competent authorities and the centralisation of supervisory powers at the European level, can solve the problem of fragmentation of European financial markets. The effect of the said fragmentation currently leaves many international financial institutions without effective supervision and creates an unlevel playing field between the EU Member States.

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Authors biographies

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