

RESPONSE TO THE EUROPEAN COMMISSION'S TARGETED CONSULTATION ON THE SUPERVISORY CONVERGENCE AND THE SINGLE RULE BOOK

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COVER NOTE / SUMMARY

Finance Watch strongly supports convergence of supervisory practices and European law application in the Member States as an indispensable precondition for building a truly single capital market in the EU. Only when common rules are applied in a consistent way and supervisory expectations and practices are in line with these rules, can the European Union ensure that its common capital market is attractive for domestic and foreign investors and investees, interests of all stakeholders are protected and, last but not least, European financial institutions are resilient and serve their purpose in the economy. It is important to ensure that the common European supervisory framework is fit-for-purpose in today's world of globalised finance, complex value chains and corporate structures, rapid technological innovation and strong competition between leading capital market locations. The departure of London as the formerly EU largest financial centre has accentuated some of the challenges for the European capital market. Thus, competitiveness of the European capital market emerges as an important goal and requires competitive supervision. We are strongly convinced that such competitive supervision should be achieved by sound supervisory practices across the EU and consistent application of common rules by all Member States rather than by undermining regulatory standards and quality of supervision at the expense of public interest, financial stability, consumer and investor protection.

Finance Watch recognises the achievements made by the three European Supervisory Authorities (ESAs) towards supervisory convergence and convergence in application of the European law, in particular given their constrained enforcement powers, conflicts of interest inherent to their governance, limited resources and still dominant role and large degree of autonomy of National Competent Authorities (NCAs). All of these obstacles are also a sign of a lack of political will on the European level and preference for narrow national interests over common European ones. While benefits of common regulatory and supervisory standards for the Capital Market Union have been long recognised, the previous ESAs review in 2017 demonstrated a lack of ambition, as many of the Commission's proposals did not make their way into the finalised amendments to the ESAs Regulations. Thus, some of the legislative changes and/or actions, which we propose in this consultation response, go back to certain long existing problems in the supervisory convergence area.

We also recognise the importance of striking the right balance between ESAs' supervisory powers and the autonomy of NCAs who will always remain closer to the supervised institutions, which offers better possibilities for dialogue and understanding of local market specifics. However, achieving convergence of supervisory practices and Union law application does not contradict taking a proper account of national financial market specifics. Such specifics should

not be used as an excuse for regulatory arbitrage, unfair market practices and protectionist attitudes of NCAs towards national financial institutions at the expense of the CMU objectives.

With regards to the topics raised in the consultation document, the following considerations are essential to achieve a true convergence in supervision and application of the Union law across Member States.

- **ESAs governance and resources**

Governing bodies: Governance and funding structure constraints have prevented ESAs from utilising their available supervisory and regulatory convergence tools effectively. In particular, ESAs governing bodies should be reformed to eliminate the conflicts of interest embedded in the current structure, where the ESAs' Board of Supervisors composed of the NCAs' governors have the authority to take decisions on all tasks related to ESAs mandates. Such decision-making often promotes national interest rather than serves broader EU objectives. Decisions are often delayed or there is an inaction bias in the execution of the ESAs' powers such as breach of EU law procedures, binding mediation, initiation of peer reviews and raising issues based on their results. We therefore support a reform of ESAs' governance, which would include independent appointed directors with a major role in the day-to-day execution of ESAs' mandate and the Boards of Supervisors with truly supervisory roles. The governance would thus follow the traditional corporate management board vs supervisory board structure.

Stakeholder groups: Changes are required to stakeholder group governance and resources to address the issue of the balance of powers between different stakeholder types. For this, a truly balanced representation of industry and non-industry stakeholders should be effectively ensured. ESAs should devote additional resources to the non-industry stakeholders in order to support their contribution in discussions from the financial, as well as expertise perspective - such as by organising workshops and forums for these stakeholders. In order to eliminate relative dominance of industry stakeholders in the discussions and opinion drafting, a split of stakeholders' work into panels should be considered, for which experience from the Financial Conduct Authority could be drawn.

Resources: Additional resources should be made available to ESAs, as the current budget arrangements constrain ESAs' activities and their ability to effectively execute their tasks. This is particularly noticeable in ESAs' coordinating role, investigative activities, mystery shopping exercises, participation in peer reviews and on-site visits. Further extensions of ESAs' tasks and toolkit, especially in the cross-sectoral regulatory and supervisory domains, will also require new resources. Increase in funding could come from contributions by supervised entities, in particular the ones which would fall under the direct supervision by ESAs, as well as from rebalancing of the EU budget and NCA contributions. Potential for a reform of ESAs-NCAs budgets with entities indirectly supervised by ESAs contributing to the budgets of ESAs should be explored given that a similar proposal did not obtain an approval of the legislators in the ESAs review of 2017.

- **ESAs supervisory powers, tasks and tools**

Enforcement powers and access to information: Some of the existing supervisory convergence tools are not matched by the necessary enforcement powers to fully utilise their potential and effectively execute the ESAs mandates. This particularly relates to peer reviews, breach of Union law procedures, acting in emergency situations and binding mediation. The underlying reasons lay in the already discussed ESAs' governance and own resource deficiencies, ESAs' insufficient access to information and non-binding character of ESAs' decisions and guidelines. To rectify this, we strongly support strengthening the enforcement powers of ESAs in those domains, which are already part of the ESAs mandate, as well as in certain cross-sectoral domains, as discussed further below. This can be done via:

- Changes to the ESAs governance and resource provisions, as discussed above.
- Endowment of ESAs with sufficient information rights to any supervisory information NCAs have access to in order support their mandate. Such information rights should be supported by the actual enforcement powers to implement these rights, for which we refer to the Commission's legislative proposal in the ESAs review 2017, where a number of provisions were included to provide ESAs with necessary means to ensure compliance with requests for information.

- Granting a more binding status of „recommendations” to ESAs’ decisions and applying “comply or explain” principle to NCAs and financial institutions, which are subject to such decisions.

Existing tools – peer reviews: We consider peer reviews to be an important and powerful tool to achieve convergence of supervisory practices; however, as mentioned above, their effectiveness hinges crucially on the appropriateness of the governance structure. In addition to the governance proposals above, it is necessary to make peer reviews more independent by increasing the number of independent ESA-employed staff/experts in the peer review teams to 50%. This will also allow ESAs to grow their own expertise in different sectoral areas, contributing to the quality of supervisory outcomes and strengthening the position of ESAs as Pan-European supervisors. We also emphasize the importance of the follow-up process on peer review results in the context of the new ESAs Regulations provision in force since January 2020, which granted the status of “recommendations” rather than “guidelines” to the peer review results.

Existing tools – coordination function: ESAs should strengthen their efforts in fostering coordination, communication and data sharing between the NCAs in cases of cross-border provision of financial products and services. Evidence from reviews conducted by ESAs¹ shows that i) notifications and exchange of information between home and host NCAs need to be improved and ii) the distribution of responsibilities between home and host NCAs needs to be clarified in certain cases. Further, EBA needs to play a stronger coordination role in enforcing anti-money laundering and combating the financing of terrorism (AML & CFT) actions and sanctions, as deficiencies in this area have manifested themselves in major money-laundering cases in recent years.

Extension of the ESAs toolkit – NCA mandates and powers: NCAs continue to play a paramount role in the European System of Financial Supervision (ESFS): Their expertise, day-to-day execution of supervisory tasks and local presence remain the main factors which make achievement of supervisory and regulatory convergence indispensable. Thus, there is a clear need for the highest possible and appropriate convergence of the mandates, supervisory independence, enforcement powers, access to information, sanction procedures and financial resources of NCAs. We suggest to grant ESAs powers to define and implement minimum standards for the mandates, powers, information rights and resources of NCAs. For this, a review should be conducted to take stock of existing powers, mandates and resources and identify the biggest national divergences, obstacles preventing ESAs from effectively executing their mandates, as well as issues which have led to major materialisation of risks in the financial sector (such as accounting fraud, financial market manipulations etc.). The recent Wirecard case has offered ample support for this position, as it brought to light gaps in national supervisory coverage, lack of powers of national supervisors, lack of clarity when to use certain powers (such as investigation powers) and existing conflicts of interest within NCA (such as trading of securities issued by the supervised entities by the NCA employees).

Extension of the ESAs toolkit – cross-sectoral supervisory themes: Holistic supervisory approach to cross-sectoral topics is necessary to address the challenges and opportunities of transversal developments in the ESFS, which was chosen to have sectoral structure. Therefore, the existing ESAs’ toolkit should be expanded by adding instruments and governance solutions to achieve a truly coordinated and convergent supervisory approach in cross-sectoral domains, set clear regulatory priorities and avoid tensions and inconsistencies in different segments of the financial markets. Specifically, this refers to:

- **Consumer protection:** Upon creation of the EBA Committee on consumer protection and financial innovation following the previous ESAs review, there is a need for a stronger mandate and enforcement powers for this committee to ensure Level 2 guidelines in relation to consumer protection topics are truly consistent. The Committee should be given direct supervisory and product intervention powers in the cases relevant for consumer protection, which should be supported by commensurate resources. The latter are crucial to conduct mystery shopping and product investigation exercises, which have proved to be well-designed supervisory tools in the retail finance domain with so far insufficient resources for their effective implementation.
- **Sustainable finance:** Due to the relative novelty of the topic in the financial sector, rapid developments of sustainability standards and disclosures, it is absolutely necessary that sustainability dimension is handled

¹ ESA Joint Committee’s Report on cross-border supervision of retail financial services, July 2019.

consistently – in order to provide reliable information to the financial agents as a basis for them to act (invest, finance, disclose) and eventually to achieve the EU environmental and social objectives. A recent example of discrepancies in the ESAs’ guidance on the EU Taxonomy Article 8 disclosures demonstrated the current lack of supervisory coordination.

- **Technological innovation and digital finance** increasingly erase distinctions between sector-specific financial products, pose challenges in the domains of data privacy, AML & CTF and big data (such as biases in input data and customer profiling). In these circumstances, ESAs should have appropriate tools to ensure that i) new/innovative digital financial service providers and new digital financial products are handled consistently; ii) digital products and services are incorporated into the existing rules as much as possible in accordance with the principle “same risk - same rules”. This is essential to prevent regulatory arbitrage and build-up of risks in certain sectors as well as to ensure consumer and investor protection standards are adhered to.
- **Outsourcing and delegation arrangements:** The current supervisory practices of outsourcing, delegation and risks transfer from between licensed entities vary across Member States, which creates a risk of regulatory arbitrage and financial stability implications across the EU. The Wirecard Group case demonstrated the complexity of outsourcing relationships in practice and highlighted the importance of the uniform supervisory approach across sectors to the definition of outsourcing, assessment of materiality and criticality, affiliates, subcontracting and outsourcing on a cross-border basis.
- **Supervision of mixed holdings:** Proper understanding of complex group structures by the supervisors and adequate application of regulatory requirements to these is essential to avoid regulatory arbitrage and misuse of supervisory loopholes for tax evasion and fraudulent activity.

The suggested expansion of the ESAs’ toolkit could be implemented by strengthening the role and powers of the Joint Committee (JC) of ESAs and including the above areas among its tasks. Dedicated standing sub-committees could be established within the JC with appropriate resources and enforcement powers. Importantly, such strengthening of the JC role needs to be accompanied by streamlining of its governance in order to make the coordination and decision-making process more efficient.

- **Market abuse:** ESMA’s tools need to be strengthened in relation to market abuse investigations, in particular in the cases where cross-border activities are involved. This was already included in the Commission’s proposal in the ESAs review 2017, which covered ESMA’s enhanced coordination role, specifically: recommending NCAs to initiate investigations and facilitating the exchange of information relevant for those investigations in cases of activity with significant cross-border effects that threatens the orderly functioning and integrity of financial markets or the financial stability. The recent Wirecard Group example confirmed the necessity to improve supervision on the subject of market abuse.

• **Direct supervision by ESAs**

With the increased integration of European capital markets, more direct supervision is necessary in targeted areas such as the ones with substantial cross-border activities and systemic risk/contagion implications due to reliance on a small number of market player. Such areas should potentially include central counterparty clearing houses (CCP), central securities depositaries (CSD), payment systems, big audit companies, as well as Pan-European products such as Pan-European Pension Product (PEPP), European long-term investment funds (ELTIF) etc. We further support enhancement of EIOPA’s supervisory powers in the area of supervision and approval of internal models. In any case decisions to grant direct supervisory powers to ESAs should be criteria-based, as outline above, and be accompanied with commensurate enhancements of ESAs resources and expertise.

• **Single rulebook**

In certain areas significant differences in national interpretations and/or transposition of Union law into national legislation persist despite the progress made towards convergence. Such discrepancies lead to regulatory arbitrage, infringements of market discipline, competition law and consumer rights, all of which are detrimental to the goal of

building the CMU. In particular, stronger harmonization of rules and their application is required in the area of financial services provider authorization and product passporting, exercise of the freedom to provide services (FPS) and right of establishment (ROE) in the cross-border context. We have already mentioned the need for a stronger cooperation between ESAs and NCAs in this domain, including the need for additional guidance on the supervisory responsibilities of home and host NCAs in case of cross-border product distribution/service provision.

Further reduction of national discrepancies in the EU law application should be done via increased use of regulations instead of directives as Level 1 legislation, as directives leave room for divergent national interpretations. This should be done on a case-by-case basis allowing to preserve those existing directives, which have proven to work well.

- **Systemic risk and macroprudential framework**

Herewith we draw attention to the fact that the current consultation focuses on the ESAs mandates, tasks and tools, whereas supervisory convergence in the financial services domain is not limited to the ESAs' activities. In order to reflect on supervisory convergence holistically, the current review should be complemented by a revision of the European macroprudential policy framework, which would cover the role and mandate of the European Financial Stability Board (ESRB), as well as broader considerations beyond the existing institutions. The EU macroprudential framework in its current form is largely bank-focused, while in the non-bank financial sector corresponding holistic framework, tools and regulatory powers have not been established. At the same time, systemic risks from the non-bank financial sector gain importance with the increasing shift to non-bank/market-based financing, which is one of the objectives of the CMU Action Plan.

Considering this, we emphasize the need for a stronger role for ESRB as regards the systemic risk monitoring and management across all sectors of the financial system. ESRB should have powers to oversee the application of macroprudential tools in order to promote harmonisation of their use by NCAs, including the use of the countercyclical buffer, the systemic buffer and the designation of institutions as Other Systemically Important Institutions (O-SIIs). Finance Watch has already raised these points on the occasion of the ESAs review in 2017.