

# Are the powers of ESMA sufficient for CMU?

Well-integrated capital markets are essential for the financing of the EU's real economy, for a well-functioning Capital Markets Union and to act as important shock-absorbers in the Economic and Monetary Union. More integrated supervision at the EU level also means fewer costs and obstacles for financial firms that wish to expand within the EU and more choice for consumers. In addition, integrated supervision reduces the risk of regulatory arbitrage, ensuring the same standard of supervision for non-EU players who can also benefit from a single point of entry into the EU.

The three European supervisory authorities (ESMA, EBA, EIOPA) have strengthened substantially the stability and efficiency of the European financial system in response to the 2008 financial crisis which exposed significant failures in financial supervision. Their responsibilities include defining common practices and standards for the regulation and supervision of banking, securities markets and insurance activities, and ensuring the consistent application of these measures within the Single Market. They launched their activities on January 1, 2011.

The positive role that the ESAs have played in fostering the creation and implementation of common rules for financial services in the EU is widely recognized. This objective has however not been fully achieved yet, since the implementation of EU laws is not always consistent across the Union. There remains significant potential to further enhance regulatory and supervisory convergence in the Single Market. Brexit is a further reason for strengthening EU supervisory arrangements, particularly those regarding ESMA, since the decision of the UK to leave the EU reinforces the importance of developing financial markets within the EU in order to continue to support the EU economy and of appropriately managing interactions with third countries.

In 2019 the EU institutions adopted a review of the supervisory framework for financial institutions. This note presents the progress and limitations of the EU agreement reached last year on the ESAs review and focuses solely on ESMA. Any future review should start with a vision of what the EU wants to achieve in the financial sector and adapt the desirable European supervisory structure to that.

## 1. Commission legislative proposals from September 2017 and conclusion of the legislative process in March 2019

On 20 September 2017, The EU Commission presented a proposal to review the operations of the ESAs. Its objective was to further enhance regulatory and supervisory convergence in the internal market in order to support the implementation of the Capital Markets Union (CMU) and the Banking Union in particular.

The ESA review proposal included a broad range of measures concerning the governance of the ESAs, their direct supervisory responsibilities and their interactions with National Competent Authorities (NCAs) in order to ensure a more consistent application of EU law, the enhancement of the powers of the ESAs regarding third countries to support appropriately equivalence decisions, as well as measures to ensure that ESAs benefit from sufficient funding: These legislative proposals were finally concluded on the political level in March 2019.

## 2. The political outcome is indeed less ambitious than the initial Commission proposals.

### 2.1. Very limited changes in the ESAs structure

The main significant change on the governance side is the strengthening of the powers of the Chair, who will be able to propose decisions to the Board of Supervisors on issues relating to breach of Union law, binding mediation and inquiries into financial products or institutions. The Chair can now also vote in the Board of Supervisors, with a few exceptions.

Regrettably even the proposal to increase the independence of the existing Management Board, with the addition for instance of two independent members coming from academic and corporate circles was not adopted.

### 2.2. The current funding system was not improved

The funding of ESMA should guarantee its independence and avoid creating potential conflicts of interest. The current model, where NCAs provide an important part of the ESAs' funding, creates pressure on NCAs budgets and does not appropriately reflect the size of the financial markets of Member States. Bigger and more interconnected financial markets need more supervisory resources to ensure their stability and investor protection, at both EU and national level.

However, the final agreement unfortunately did not successfully address these drawbacks of the current model, which is a missed opportunity. Indeed, the Commission proposal to make financial institutions pay to the budget of the ESAs for non-supervisory activities of the ESAs was not maintained. In the end, the current system of 40% direct contributions from the EU budget, and 60% from the NCAs was kept, which means some member states pay proportionally too much in relation to the local financial activity.

## 3. However, the text agreed will mean a step forward for ESMA and ESMA's contribution to the objectives of the Capital Markets Union

The EU agreements on the ESAs review and EMIR 2.2 enhance the role and responsibilities of ESMA and strengthening the supervision of EU and non-EU CCPs.

### 3.1 Enhancing the role and responsibilities of ESMA

The most important changes come via new and improved instruments to foster convergence in the way the European financial sector is supervised. Also, by 2022, ESMA will directly supervise additional significant parts of the EU's financial market infrastructure.

#### 3.1.1. Three new powers to foster consistent supervision

ESMA's mission is to enhance investor protection, ensure financial stability and promote stable and orderly financial markets. It is already supervising credit rating agencies (CRAs) and trade repositories (TRs), including for securities financing transactions.

The agreement extends ESMA's direct supervision to some specific areas of capital markets. In particular, ESMA will directly supervise specific sectors which are highly integrated, have important cross-border activities and which are, in most cases, regulated by directly applicable EU law. Indeed, ESMA will authorise and supervise administrators of benchmarks that are deemed to be

critical for the EU (such as EURIBOR and EONIA) and will also recognise non-EU administrators of benchmarks used in the EU.

ESMA will also centralise the authorisation and supervision of data reporting service providers which enables the reporting of transactions in financial instruments to regulators and to the public under MiFID II.

In addition, ESMA will also centralise its direct supervision of third-country CCPs that have systemically important activities within the EU. ESMA will play a central role in deciding if a non-EU CCP is systemically important, based on a number of criteria, and will subsequently be responsible for supervising those systemically important non-EU CCPs. The supervision of third-country CCPs is the third and important area of expansion in ESMA's powers. While it is not part of the ESA Review, it is a clear consequence of Brexit, and the 'EMIR 2.2' (see below, 3.2)

The new rules allow ESMA to set supervisory fees, to conduct on-site inspections, and to impose fines and periodic penalty payments upon the entities concerned, as is already the case for rating agencies and trade repositories

### 3.1.2. *The peer review has been improved*

The assessment of the work of national supervisors, the so-called peer reviews, will be headed by senior ESMA staff and be carried out by ESMA staff together with representatives of competent authorities, bringing more efficient and objective steering to the process.

The Management Board can also set up specific coordination groups to examine any emerging supervisory issues in a collective way.

### 3.1.3. *The outcome of the ESAs Review introduces a range of changes across the spectrum of ESMA's duties and objectives*

Firstly, ESMA will now be able to use a tool similar in nature to so called non-action letters used by other financial markets regulators, in cases where certain regulations can be conflicting and/or not compatible with dynamically changing market realities. The change of the underlying legislation will remain however with the Brussels-based EU Institutions.

Secondly, ESMA will play a more pronounced role in the advising, monitoring and following up on equivalence decisions with third countries. These are both changes that will bring more supervisory certainty and stability to the EU.

The amended ESMA Regulation, with new powers and tasks, entered into force on 1 January 2020, except for the direct supervisory mandates which will start two years later (1 January 2022).

To accommodate these new responsibilities, ESMA will grow to 384 by 2022.

## 3.2. **Strengthening the supervision of EU and non-EU CCPs (as of 1 January 2022)**

For EU CCPs under EMIR 2.2, supervision will continue to be carried out at national level. The licensing of CCPs notably remains with national authorities, but there is an enhanced role for ESMA under the supervisory framework. EMIR 2.2 maintains the central role of the colleges for the effective supervision of Union CCPs, but it complements the EU-level supervision with a new CCPs Supervisory Committee under the responsibility of ESMA to carry out the tasks assigned to ESMA in relation to both EU- and third country CCPs. This Committee will with the help of ESMA staff monitor EU-based CCPs and supervise third-country CCPs, which will be paid for by supervisory fees.

The more significant changes come for non-EU CCPs operating in the EU, based on an equivalence decision. CCPs based outside the EU who want to offer clearing services within the EU, need to be recognised by ESMA under the revised EMIR<sup>4</sup>.

In particular, ESMA will determine, in consultation with the ESRB and the relevant central bank of issue, whether a third country CCP is systemically important or likely to become systematically important for the financial stability of the Union or one or more of its Member States. The CCPs which are determined not to be systemically important (Tier 1 CCPs) will continue to be subject to a very similar regime as the one established today for the recognition of third-country CCPs. Instead, third-country CCPs which are deemed to be systemically important or likely to become systemically important (Tier 2 CCPs) will be subject to additional requirements and direct ESMA's supervision.

EMIR 2.2 also tasks ESMA to monitor regulatory and supervisory developments in third country CCP regimes that have been deemed equivalent by the Commission.

The CCP Supervisory Committee will be composed of a Chair and two Independent Members, the competent authorities of EU Member States where a CCP is established and, where applicable, the respective EU central banks, in most cases the ECB, which it has to consult. The committee is responsible for preparing draft opinions or decisions in relation to EU and third country CCPs for adoption by the ESMA Board of Supervisors. The Committee will participate in the supervisory colleges, but on a non-voting basis.

EMIR 2.2 came into force – similarly like the ESAs review – on 1 January 2020.

## 3.3. **The EU equivalence model is expected to grow**

In the near future, more supervised entities will fall under the remit of ESMA, and this concerns both EU market participants as well as third country market participants active in the European market through equivalence and recognition.

The EU financial markets are and will continue to be very open for business coming from outside the EU. With over 120 equivalence decisions in the area of securities markets across various legal frameworks and jurisdictions, the EU has been the world leader in applying the deference principle. A large number of third country market participants, like trading venues, CCPs, and CRAs, can do business in the EU while the EU relies on their home country regulation and supervision.

With the UK leaving the EU soon, the use of the EU equivalence model is expected to grow once an orderly exit is agreed, not only in terms of additional equivalence decisions but also through the proportion of non-EU market participants active in the EU Single Market. From this perspective it is important that the EU creates certain supervisory mechanisms concerning the most significantly important market infrastructures – like CCPs – in order to be able to ensure financial stability, orderly markets and consumer protection within the EU. ●

<sup>4</sup> The requirements for these third-country CCPs to do business in the EU are quite strict, but less strict than corresponding requirements in the US or Japan: 1) compliance with the relevant and necessary prudential requirements for EU CCPs, 2) compliance with EU central banks' requirements on liquidity, payment or settlement arrangements and 3) written consent allowing ESMA to visit its premises (Art. 25h). Reciprocal 'comparable compliance' may be established between ESMA and any third-country's competent authority (Art. 25a). ESMA can also impose fines or penalty payments on third country CCPs