

New dogs unleashed – ones that can bite

In the first of four articles by *FW* experts on the powerful European Supervisory Authorities, **Nicolas Véron** says that the City of London cannot escape their reach but would be misguided to see them as intrinsically hostile

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It may not be the standard way of looking at it, but there is such a thing as a London-Brussels nexus. The clichés from both sides tend to be all about incompatibilities: between London's free-marketism and the corporatism of Brussels; London's light touch and the heavy-handed approach of Brussels; London's private-sector-led self-regulation and Brussels's politically-driven agenda.

Beyond the optics, though, the alignment of objectives and of outcomes between the City and the EU institutions was surprisingly strong throughout the pre-crisis decade. Both shared the same

project: European financial integration, which is part of the EU's mission statement and from which the City benefited enormously as the dominant pan-European financial hub.

There are obvious cultural differences but, unlike with some continental countries, no fundamental tension of economic philosophies, as the emphasis on eliminating national barriers and competitive distortions that lies at the heart of the EU legal and institutional framework chimes with the UK's fondness for economic openness. The EU was happy to embrace a largely liberalising agenda as long as it did not contradict major political priorities within individual member states; and the City was fairly comfortable with the growing scope of EU legislation as long as supervision stayed in the hands of the local team, first and foremost the FSA.

However, the financial crisis has unravelled some underpinnings of this alignment, both in London and Brussels. Re-regulation is the new catchword and, even though it has many sceptics, it means that a new era is beginning. Probably nothing better symbolises this shift than the start of the three new European Supervisory Authorities (ESAs) on 1 January 2011. To some observers, the ESAs are only a continuation of the "level-three committees" that had been in place since the early 2000s. But in reality, the difference is as significant as between unarmed and armed security guards. Unlike those committees, the ESAs have an ability to make decisions in controversial cases and to have them

enforced, which is firmly grounded in EU legislation that binds all member states. They can plausibly be labelled the world's first supranational financial supervisors. What that means in practice is a major shift of public oversight of the City from the UK level to the EU level, which will eventually force a clarification of City attitudes *vis-à-vis* the EU.

As is common with watersheds, this one does not appear obvious when seen from close up and the real significance of the ESAs will only reveal itself

The difference from the old committees is as big as between armed and unarmed security guards

with the passing of time. They start very small, each with no more than a few dozen staff, a paltry budget and severe constraints on pay levels. Their governance framework is highly problematic, as it gives each member state equal weight in crucial decision-making and, unlike at the comparatively better-designed ECB, does not give voting power to any representation of the EU interest beyond individual member states. Their first real-life tests, including the European Banking Authority's coordination of this semester's pan-European banking stress tests and the steering of supervisory colleges, are likely to lead to

disappointing outcomes and to a dent in their credibility.

Given the diversity of supervisory cultures across member states, there is a risk that their initial orientation will be towards an excessively formal, “box-ticking” approach to regulation, which may not deliver the best outcomes in terms of both performance and stability of the financial system. The impact of their respective locations (London for banking, Paris for securities, Frankfurt for insurance and pensions) is hard to predict but may result in partial capture by the local financial establishments, at least in an early phase, even though there is no evidence of this in the track record of the level-three committees.

But over the medium term, these uncertainties and shortcomings will at least partly fade away. The main reason why the ESAs will not be rolled back into insignificance is not their legal basis, despite its strength; it is because the previous combination of member states committing to a single market while retaining essential autonomy for their domestic supervisors, including the FSA, has been deprived of credibility and rendered unsustainable by the crisis. As Lord Turner, FSA chairman, memorably put it two years ago, the crisis forces a choice between less Europe and more Europe. By endorsing the creation of the ESAs at a June-2009 EU summit, the UK has irrevocably taken the path of more Europe, at least in this area. One proof is the remarkable extent to which the Cameron government has kept to its predecessor’s commitment even as the European legislation creating the ESAs was still under discussion. This choice is in line with London’s overwhelming economic interest in Europe’s continued financial integration.

Thus, the City cannot credibly think of escaping the reach of the ESAs. But it would be misguided to see these new players as intrinsically hostile just because continental Europeans will form the majority of their staff – after all, continentals are also a majority in many of the City’s best firms. To a considerable extent, the ESAs’ regulatory philosophy is a blank slate that will be filled by future interaction with their constituents. If the City tries to resist

their ascent, it will evidently find it difficult to communicate constructively with them. But if it chooses to engage, it will find them open to reasonable solutions, though certainly – and legitimately – focused on public-interest objectives rather than private-sector ones, nor without teething difficulties and a steep initial learning curve for all the reasons mentioned above.

On the face of it, then, the calculation should be easy and lead the City to embrace the ESAs’ authority unequivocally. What makes it thornier is that this puts the City at odds with its immediate environment. The UK supervisory and regulatory authorities are as eager to defend their existing turf as any other powerful public institution – they are aligned in this with their continental

peers. This can, and will, lead them to be more hostile to the ESAs’ empowerment than the City itself should be. The deep euroscepticism of the British public, which is widely shared inside the Square Mile, is another complicating factor. All this means that the redefinition of City attitudes *vis-à-vis* the ESAs and the EU, while indispensable, will be far from straightforward. To avoid unnecessary bumps on that road in the next few years, the City needs more open and in-depth debate on its link with the EU institutions, both within itself and with the wider UK community.

Nicolas Véron is a Senior Fellow at Bruegel, a Brussels think-tank, and a Visiting Fellow at the Peterson Institute for International Economics in Washington DC