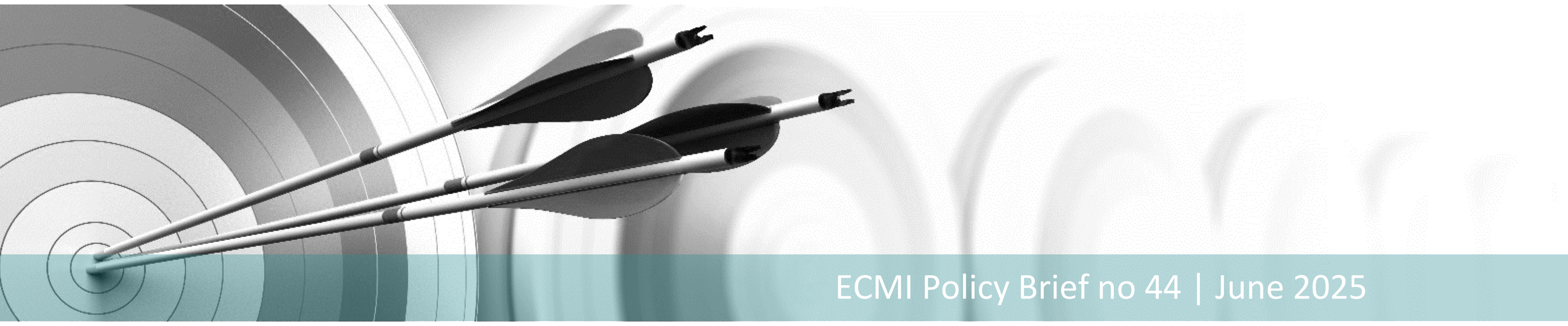

A supervisory efficiency test for EU financial markets: Taking an operational approach to integration and oversight

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Summary

The EU's supervision of financial markets remains fragmented and misaligned with the depth of market integration achieved through initiatives such as the Capital Markets Union (CMU) and the Savings and Investment Union (SIU). Political resistance to centralising supervision, particularly under ESMA, has stalled reform, leaving a hybrid system of national oversight, mutual recognition and limited supranational authority. This fragmented landscape hampers consistency, weakens enforcement and exposes the EU to regulatory arbitrage and inefficiencies – especially in fast-evolving and cross-border segments like fintech, ESG, and crypto-assets.

This ECMI Policy Brief proposes a supervisory efficiency test as a practical, functional tool to assess whether supervisory arrangements match the degree of market integration for specific financial products, services or actors. Rather than forcing political agreement on institutional reform, the test offers an evidence-based, task-specific method to evaluate which level of supervision (e.g. national, coordinated, centralised) is most appropriate.

If systematically embedded into the EU's regulatory process, the test can help build a more coherent, proportionate and resilient supervisory framework that evolves in step with Europe's financial markets.

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Supervision and its objectives: banking versus capital markets

The EU supervisory architecture reflects the legal framework of each financial sector (e.g. banking, insurance, capital markets) and their distinct supervisory objectives. In the banking sector, the case for centralised supervision was both urgent and straightforward: the global 2007-09 financial crisis exposed how interconnected and vulnerable national banking systems had become, and preserving financial stability emerged as the overriding imperative. This logic justified the creation of the Single Supervisory Mechanism (SSM), underpinned by the European Central Bank (ECB), and politically enabled by Member States' willingness to pool sovereignty in exchange for credibility and control. Banking supervision is thus framed around a singular objective – mitigating systemic risk through prudential oversight and maintaining depositors' trust.

Capital markets supervision, however, is shaped by a more diverse and complex set of objectives. These include ensuring market transparency, protecting investors, guaranteeing fair and orderly market functioning, and safeguarding integrity against manipulation, abuse and conflicts of interest. Another cross-cutting objective deriving from the rationale of the Single Market, preventing regulatory arbitrage and promoting a level playing field, has grown in prominence as financial activity becomes more digital, mobile and cross-border in scope.

The contrast in supervisory design is not accidental – it reflects the deeper institutional logic and legal architecture of each domain. While the failure of a single bank can trigger systemic contagion, the collapse of an individual fund, trading venue or financial intermediary, though disruptive, rarely constitutes a macroprudential event. This difference is often used to justify maintaining national supervision over capital markets. Yet such reasoning underestimates the growing interdependence of market actors, infrastructures and products across Member States.

Moreover, capital markets evolve through continuous innovation, financial engineering and technological disruption. Effective supervision must therefore be agile, data-driven, and forward-looking – able to anticipate structural shifts, not just enforce compliance retroactively. The continued reliance on 27 national competent authorities (NCAs), each interpreting and applying EU legislation differently, has created a fragmented supervisory landscape that undermines the ambitions of the Capital Markets Union (CMU) and the Savings and Investments Union (SIU).

Importantly, the political argument against a one-size-fits-all model, often grounded in the principle of subsidiarity, must not be conflated with a case for permanent divergence. A nuanced, risk-based and integration-aware supervisory framework is not only more conceptually robust, but also more politically feasible in the long run. It offers a way forward that respects national sensitivities while pushing supervisory coherence forward.

This institutional divergence is not merely a legacy of political compromise, it's embedded in the distinct supervisory logics and legal foundations that govern each sector. Banking supervision, centred around financial stability, has developed within a relatively unified and compact framework focused on prudential capital rules. The transfer of supervisory powers to the ECB under the SSM was enabled by this legal clarity and narrow mandate.

In contrast, capital markets supervision, anchored in the broader objective of market confidence, is legally and operationally more fragmented. ESMA's remit spans more than 30 directives and regulations, covering trading, asset management, credit rating, auditing, clearing and settlement, digital finance and ESG disclosures – though in some areas its role is indirect and exercised through participation in EU-level coordination bodies rather than through direct supervisory powers. This legal heterogeneity makes any wholesale transfer of supervisory functions infeasible.

Any further EU-level reform must begin by acknowledging this specificity. Supervisory functions should be structured in ways that enhance both national effectiveness and EU-wide consistency. In capital markets, this means ensuring progress across five interlinked objectives: transparency, investor protection, market orderliness, integrity and the preventing regulatory arbitrage. These goals cannot be met through a uniform supervisory model. Instead, they demand a differentiated, functionally grounded approach, one that embraces market diversity while striving for integration where it's most needed.

The patchwork of supervisory arrangements in the EU

Despite sustained efforts to integrate financial markets through the CMU and successive waves of harmonising legislation, the EU continues to operate under a fragmented and uneven supervisory framework. Rather than reflecting the integrated nature of financial activity across the EU, supervisory arrangements remain largely anchored in national jurisdictions, underpinned by a patchwork of legal instruments and institutional compromises. These include traditional national supervision under minimum harmonisation, mutual recognition mechanisms for passported services, colleges of supervisors for cross-border entities, and – in a limited number of cases – direct supervision by ESMA, notably over credit rating agencies, trade repositories and certain securitisation requirements.

This patchwork reflects an evolutionary process shaped more by political expediency and crisis response than by a strategic blueprint for market oversight. The financial crisis, followed by the euro area sovereign debt crisis, exposed fundamental weaknesses in the EU's ability to oversee integrated markets with fragmented supervisory authority. In banking, these pressures triggered the SSM's creation. In capital markets, however, institutional innovation has been far more incremental and uneven. Reforms have typically followed a sector-specific logic (and extending ESMA's powers in narrowly defined domains) without addressing the broader structural inefficiencies of a dispersed supervisory system.

The result is a hybrid landscape where supervisory effectiveness often depends more on the administrative capacity and NCA's political priorities than on uniform EU standards. While some NCAs possess strong enforcement capacity and market expertise, others remain under-resourced, exposed to governmental pressure or misaligned in interpretation and implementation. These divergences are particularly problematic in areas such as sustainable finance, fintech and crypto-assets, where cross-border activity is expanding rapidly and regulatory arbitrage becomes an increasing risk.

The colleges of supervisors, established to coordinate the oversight of cross-border market participants, often operate with limited efficiency or legal force. They are coordination platforms rather than integrated supervisory bodies, and their effectiveness depends heavily on informal cooperation and goodwill among national authorities. This has led to inconsistencies in supervisory practices, particularly around enforcement, sanctioning and investor protection standards.

Although ESMA has gradually accumulated technical mandates and regulatory convergence tasks, it still lacks the authority – in terms of both powers and resources – to systematically oversee or intervene in most national supervisory processes. Crucially, there's been no deliberate or structural transfer of supervisory powers from NCAs to the European level. The few instances where ESMA was granted direct supervisory responsibilities, such as over credit rating agencies and trade repositories, were not the result of a broader political agreement to centralise supervision, but rather reactive and *ad hoc* responses to clear gaps or failures at the national level.

These powers were conferred politically and opportunistically, to fill specific voids, and not as part of a coherent shift toward supranational oversight. Consequently, ESMA's direct supervisory role remains narrowly defined, and past proposals to expand it (e.g. through the 2017 ESAs review) have encountered persistent political resistance from Member States due to their concerns about preserving national control.

In theory, the EU has developed a suite of tools that could enable more consistent oversight: Q&As, supervisory briefings and peer reviews. In practice, however, these instruments often lack binding effect, suffer from slow adoption or are only unevenly applied. Even ESMA's peer review reports, which are intended to promote convergence and highlight gaps, rarely translate into enforceable change.

In sum, the current framework delivers neither full subsidiarity nor effective centralisation. It's a compromise structure that functions adequately during stable periods but lacks resilience, coherence and strategic alignment when faced with rapid market evolution or systemic disruption. The absence of a guiding principle for how and when to allocate supervisory responsibilities – based on integration level, risk exposure, or market function – has become a structural constraint on the EU's ability to effectively supervise its own financial union.

Matching supervision to market integration – the conceptual framework

The EU's current supervisory architecture suffers from a lack of guiding principles to determine when financial supervision should remain national, when it should rely on mutual recognition and cooperation, and when it should be transferred to the supranational level. To move beyond this *ad hoc* and politically constrained landscape, this Policy Brief proposes a **conceptual framework that links the degree of EU financial market integration with the most efficient corresponding supervisory arrangement**. This 'supervisory efficiency test' offers a functional, evidence-based approach to assessing whether the current supervisory model for a given financial activity is fit for purpose.

The premise is straightforward: **the more integrated and cross-border a financial activity becomes, the more coordination or centralisation is needed to effectively supervise it**. Conversely, when financial activity remains local in nature (with limited cross-border spillovers or standardisation), national supervision would likely remain the most efficient and proportionate model.

At the most decentralised end of the spectrum are financial products and services that are distributed and consumed almost exclusively within national borders. These tend to be designed in accordance with national legal or regulatory characteristics, are provided by smaller domestic market participants, and target a local investor base. **In such cases, national supervision is the most efficient solution**, as it allows authorities to tailor oversight to domestic market conditions, respond quickly to market failures and apply local rules and enforcement cultures with precision.

A step further towards integration are financial activities governed by EU-wide, principle-based rules and featuring some degree of cross-border provision. These products or services are relatively standardised and see limited but growing levels of passporting or cross-border investment. Where risks to the level playing field remain low, **the mutual recognition of national supervisory decisions may offer**

the best trade-off between national autonomy and internal market functioning. This model assumes, however, a high level of trust and convergence in supervisory practices among national authorities.

However, mutual recognition becomes less effective when the same financial product or service sees more significant cross-border activity and is subject to diverging supervisory intensities across jurisdictions. Even under harmonised EU legislation, supervisory discretion can result in enforcement gaps and regulatory arbitrage. **In these cases, supervisory convergence must be reinforced, potentially through common methodologies, supervisory guidelines and recommendations, or coordinated supervision exercises led by ESMA**.

Where financial services are provided by larger cross-border groups or dominant market players, the coordination challenge increases. **Here, colleges of supervisors may be the most appropriate solution**. Colleges facilitate information exchange and joint decision-making among the NCAs involved and can be enhanced through delegating specific tasks and responsibilities – either horizontally among national supervisors or vertically to ESMA[1]. However, the effectiveness of colleges depends heavily on the legal clarity of their mandates, the trust among supervisors, and the strength of dispute resolution mechanisms.

At the most integrated end of the spectrum lie financial markets characterised by full-scale harmonisation, market concentration among cross-border entities and a high risk of supervisory fragmentation. These markets could often *de facto* be supervised by one or two NCAs, even though their activities span multiple jurisdictions. **In such cases, direct EU-level supervision by ESMA is not only justified but necessary to ensure uniform rule application, to avoid enforcement asymmetries and to preserve market integrity**.

This graduated approach to supervision recognises that institutional design should follow the functional realities of financial integration, rather than defaulting to political compromise. The supervisory efficiency test thus becomes an operational tool – one that assesses the degree of standardisation, cross-border activity, risk of arbitrage and market structure to recommend the most effective level of supervisory responsibility.

By embedding such a test into the EU's regulatory decision-making process, policymakers could finally align supervisory structures with the actual dynamics of European capital markets.

Measuring market integration for a supervisory efficiency test

While the conceptual link between market integration and supervision is clear, operationalising a supervisory efficiency test requires objective and systematic ways of measuring the degree of integration in each market segment. Without this, any attempt to tailor supervisory arrangements to

[1] Article 28 of the ESMA Regulation, which allows delegating tasks and responsibilities between ESMA and NCAs, remains largely unused. Yet the provision offers a high degree of flexibility that could support innovative supervisory arrangements – including the mutualisation of supervisory tasks, the establishment of colleges of supervisors under ESMA's coordination, or even allowing cross-border financial groups to opt into ESMA-led oversight with the consent of the relevant Member States. However, legal uncertainty and the lack of implementation guidance have limited its practical application. The European Commission should provide interpretative clarity and legal guidance to facilitate the structured use of Article 28, enabling more extensive and consistent delegation practices between NCAs and ESMA in line with the spirit of supervisory convergence.

market realities risks reverting to political bargaining or *ad hoc* judgments. Defining robust, neutral and replicable criteria is thus essential.

Several indicators can be used to assess the level of integration for a specific product, service or market participant type (see *Figure 1*).

First, **standardisation plays a foundational role**. This involves assessing how far legal harmonisation has been achieved – is the activity governed by a regulation or a directive? Are the provisions fully harmonised, or do they leave room for national discretion and options? How detailed is the Single Rulebook, particularly for secondary and tertiary legislation (Level 2 and Level 3 measures)? And crucially, how much interpretive leeway remains for NCAs in applying these rules?

Figure 1. Six core dimensions for assessing the level of market integration in EU financial segments

Source: Authors' own elaboration.

Second, the **intensity of passporting can serve as a proxy for actual cross-border market activity**. This requires mapping both inward and outward passport flows across all 27 Member States. Are there dominant 'exporters' or 'importers' of financial services? Is passporting merely formal or does it reflect genuine cross-border economic activity and competition? Importantly, is passporting fully operational in practice or are there instances where NCAs impose additional requirements or interpret rules in ways that hinder effective market access? What role do cost differentials, service quality or regulatory arbitrage play in shaping these flows?

A *third* dimension is **market concentration**, which helps to illuminate the market's structural characteristics. This includes the number and size of firms, the degree of concentration at national and EU levels, and whether firms operate primarily domestically or across borders. The ability (or difficulty) to form cross-border groups may also reflect the market's maturity and integration.

The *fourth* consideration is the **investor base**. A market primarily serving institutional or wholesale investors may have different integration dynamics than one dominated by retail clients. Equally, markets that attract a significant share of cross-border investors, either directly or via intermediaries, may require a higher degree of supervisory coordination or centralisation.

Fifth, the **supervisory landscape** must be assessed. This involves mapping how many NCAs are responsible for supervising a given market and how those responsibilities are allocated. Is one NCA acting as a *de facto* lead supervisor? Are supervisory competences fragmented across multiple authorities at national level (e.g. when responsibilities assigned to agencies other than the authority represented on ESMA's Board of Supervisors)? The number and structure of supervisory actors can significantly influence the consistency and effectiveness of oversight.

Finally, **enforcement fluidity** is a critical yet often overlooked factor. It captures how easily enforcement actions can be carried out across borders, including the ability to access, exchange and act on relevant data. Key issues include the degree of reporting standardisation, the legal and operational ability to conduct cross-border investigations, and the convergence (or lack thereof) in sanctioning powers and procedures. In short, enforcement bottlenecks often expose weaknesses in the broader supervisory framework.

These criteria are not exhaustive and will need to be refined through empirical testing and stakeholder validation. **Nonetheless, they offer a pragmatic starting point for embedding measurable, outcome-oriented indicators into the supervisory efficiency test**. Wherever possible, such indicators should rely on quantifiable data rather than qualitative or discretionary assessments. This approach helps to ensure that the test remains both methodologically robust and politically neutral, capable of guiding supervisory reform without reopening fundamental treaty debates.

The supervisory efficiency test – a functional framework for dynamic oversight

The increasing complexity and cross-border nature of EU financial markets – driven by shifting savings patterns, financial innovation, digitalisation and the policy ambitions of the SIU – point towards a continued trend toward deeper integration. However, this integration is inherently uneven. Not all financial services, products or actors evolve at the same pace or reach the same level of cross-border penetration. Consequently, a one-size-fits-all supervisory model is neither realistic nor efficient. There will continue to be a mix of national, mutually recognised and supranational supervision across different market segments, depending on the degree of integration and systemic relevance.

Against this backdrop, **the supervisory efficiency test offers a pragmatic and adaptive tool** for aligning oversight arrangements with market realities. Its **core objective is to periodically assess whether the existing supervisory model for a given product, service, or market player continues to meet its intended goals in an efficient and proportionate manner**.

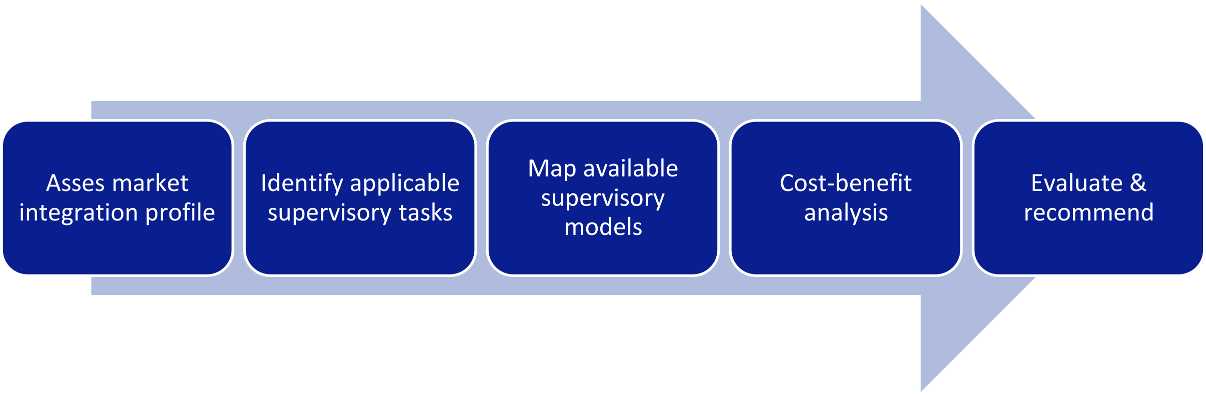
Such a test would ideally be triggered at predefined intervals, such as when a legislative review clause expires, or in response to significant market developments, regulatory innovations or shifts in cross-border activity.

Crucially, the test is not conceived as a rigid institutional mechanism **but rather as a flexible, function-by-function diagnostic**. It could be applied to all EU legislative instruments (e.g. MiFID, ELTIF, AIFMD) or, more usefully, disaggregated into specific supervisory tasks defined in EU law (e.g. licensing, reporting, ongoing supervision, product vetting, market surveillance, enforcement). Each task may yield different results and the outcome could support a range of supervisory configurations rather than a binary 'national-versus-ESMA' dichotomy.

At its core, the test rests on a dual axis. First, it involves assessing the level of EU market integration using the criteria defined earlier (i.e. standardisation, passporting intensity, market concentration, investor profile and enforcement capability). Second, it confronts this integration profile with the range of available supervisory models, evaluating which model (or combination thereof) most efficiently supports the four foundational pillars of capital markets supervision – transparency, investor protection, market functioning and integrity. A fifth test criterion, namely avoiding regulatory arbitrage, serves as a cross-cutting constraint.

The process unfolds in several steps (see *Figure 2*). For a given financial activity, the first step is to establish its integration profile using the full set of market indicators. Next, one must identify the applicable supervisory functions required under EU law. Each of these tasks is then assessed against the five feasible supervisory arrangements (e.g. national supervision, mutual recognition, mutual recognition reinforced with supervisory convergence, colleges of supervisors and direct supervision by ESMA). A structured cost-benefit analysis should accompany this step, considering not only ESMA and NCAs' administrative efficiency but also the implications for market participants and systemic oversight.

Figure 2. Supervisory efficiency test: Step-by-step process



Source: Authors' own elaboration.

The final step involves aggregating these findings into an evaluative outcome. This could take the form of a scorecard, rating each supervisory arrangement's capacity to fulfil the objectives of efficient, proportionate and risk-sensitive supervision. The preferred model would be the one that offers the best balance between regulatory effectiveness, cross-border coherence and resource efficiency.

In this way, the supervisory efficiency test functions as an evidence-based subsidiarity mechanism. It doesn't mandate centralisation, nor does it entrench decentralisation. Instead, it provides an institutionalised method for ensuring that supervisory design evolves in tandem with market integration, driven by function and not politics. **If embedded within the EU's legislative and regulatory lifecycle, it could become a critical tool for making supervisory reform both more dynamic and more legitimate**.

Conclusions – a smarter path to supervisory reform

The EU's ambition to build deep, liquid and integrated capital markets cannot be achieved without addressing the persistent inefficiencies and inconsistencies in its supervisory architecture. Yet decades of political stalemate have shown that purely institutional solutions, particularly those requiring a wholesale shift of competences to the EU level, are unlikely to succeed in the near term. Against this reality, introducing a supervisory efficiency test offers a pragmatic and principled alternative.

Rather than forcing political agreement on institutional change upfront, the proposed test provides a structured, evidence-based approach for assessing whether current supervisory arrangements remain fit for purpose. **It links the degree of market integration with the most appropriate form of oversight, offering a dynamic, task-specific mechanism that can evolve alongside financial markets**. In doing so, it transforms the debate from one of 'centralisation versus subsidiarity' into one concerned about functional effectiveness.

This approach is not only more likely to gain political traction across Member States, it's also more adaptive, proportionate and aligned with the EU's Better Regulation agenda. By embedding the test within the legislative review cycle and applying it systematically across different sectors and functions, the EU can gradually build a more coherent and resilient supervisory system – and all without triggering institutional deadlock.

Ultimately, **the supervisory efficiency test is a tool for regulatory realism**. It acknowledges the diversity of European capital markets while recognising the necessity of supervisory convergence in areas where integration is deepest and the risks are most pronounced. It allows the EU to move beyond institutional inertia and make meaningful progress towards a capital markets union that is not only integrated in name – but also coherent in oversight.

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