

## EPFSF Briefing

# Financial Crisis: Next Steps in the EU

### Introduction

Since last September, strains in the financial system have increased significantly. Governments worldwide have been forced to take emergency measures such as recapitalising banks and guaranteeing their liabilities to alleviate tensions in financial markets. In the EU, these measures amount to EUR 1,800 billion in government guarantees and EUR 280 billion in recapitalisation schemes. The European Commission (EC) is obliged to ensure that such measures serve the rest of the economy and do not create distortions of competition.

The effects of the emergency measures on the functioning of credit markets - especially the interbank market - will take some time to fully materialise. The EC has said that it wants to be pragmatic and offer Member States as much flexibility as possible in designing their aid schemes. The increasing participation of the state in the capital of financial institutions gives rise to important questions about how the European financial services sector can return to normal, privately funded operation as quickly as possible.

Whilst emergency measures have been instrumental in the partial restoration of financial stability, they have not prevented the financial crisis from affecting the “real” global economy. As the 2 December ECOFIN meeting conclusions have recognised<sup>1</sup>, economic activity in the EU as a whole has contracted in the third quarter of 2008 and could have contracted further in the fourth quarter. At this stage, European governments debate how to best contain the effects of the financial crisis on the real economy, fundamentally through monetary and fiscal measures. A package in the magnitude of 1.5% of GDP is being considered to provide a stimulus to the European economy.

Against this background, the financial regulatory reform agenda - promoted by the EC and coordinated at the international level through the Financial Stability Forum (FSF) and the governments of the G20 - continues to make progress, on many occasions at such a high speed that crucial better regulation principles are unintentionally overlooked, thus giving rise to reasonable concerns regarding regulatory effectiveness. A raft of regulatory proposals emerged in the autumn of 2008 i.e. proposals on capital requirements, deposit guarantees and credit rating agencies, as well as new rules on accounting. A second phase of work, currently under preparation, will come forward in 2009. As the EC indicates in its Legislative and Work Programme for 2009<sup>2</sup>, this package of initiatives will likely include proposals to regulate and supervise all financial actors - including all significant capital market investors - and will cover executive remuneration and derivative markets among other issues. The outcome of the High Level Expert Group on EU financial supervision (the “de Larosière group”) set up by the EC may also feed into this regulatory process.

### Consequences of public support for the financial sector

In October, the emergency measures agreed to help restore the stability of the financial system were decided on at national level but within a coordinated framework and on the basis of a number of EU common principles<sup>3</sup>: essentially that the interventions had to be targeted, proportionate and temporary. The EC’s DG COM ensured that such measures did not generate unnecessary distortions of competitions between financial institutions operating in the market or negative spillover effects on other Member States.

<sup>1</sup> [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/104457.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/104457.pdf)

<sup>2</sup> [http://ec.europa.eu/atwork/programmes/docs/clwp2009\\_en.pdf](http://ec.europa.eu/atwork/programmes/docs/clwp2009_en.pdf)

<sup>3</sup> (i) Interventions should be timely and the support should in principle be temporary; (ii) Member States will be watchful regarding the interests of taxpayers; (iii) Existing shareholders should bear the due consequences of the intervention; (iv) Member States should be in a position to bring about a change of management; (v) The management should not retain undue benefits — governments may have inter alia the power to intervene in remuneration; (vi) Legitimate interest of competitors must be protected, in particular through the State aid rules; and (vii) Negative spill-over effects should be avoided.

Amidst significant criticism on the way the EC has assessed the various national emergency measures, DG COM has prepared further guidance<sup>4</sup> based on the following broad principles: (i) the individual situation of each financial institution should be taken into account; (ii) the schemes must include incentives for the State capital to be redeemed; and (iii) behavioural safeguards are needed to limit distortions of competition.

Going forward, the EU authorities are seeking to ensure that enhanced guidance and closer coordination between Member States can appropriately balance the primary role of national treasuries in crisis management with the need to ensure that national measures are consistent with EU, and global, stability. It is also important to ensure that the national approach is consistent with the single market, taking into account that Member States have not endorsed a European recapitalization / guarantee fund. Lastly, there is the need to ensure that the implementation of state aid commitments of Member States preserves a competitive level playing field in the European financial sector.

### **The regulatory reform agenda going forward**

The EU institutions have acted swiftly on regulatory reforms, with further progress on the ECOFIN Road Maps on financial stability and supervisory cooperation, and important legislative proposals scheduled for approval before the end of the current European Parliament (EP) mandate. Regulatory activity concentrates on four main areas.

#### ***a) Transparency on the markets***

The EC has made a proposal for a Regulation on credit rating agencies (CRAs) broadly based on the IOSCO Code, but with some additional requirements. The proposal also includes a registration regime for CRAs, unique European arrangements for CRAs supervision and, more controversially, the scope of the proposal is such that it would prevent the use of non-EU CRAs' ratings by EU authorised institutions, and prohibit the execution, by certain EU authorized financial institutions, of client orders in respect of non-EU-rated financial instruments.

In the area of accounting standards, further proposals may be forthcoming as the International Accounting Standards Board (IASB) explores the possibility of technical solutions to a number of pending issues around the application of fair value measurement: reclassification out of the Fair Value Option category; difference in treatment of synthetic collateralised debt obligations (CDOs) between IFRS and US GAAP; and impairment of available for sale (AFS) items. The EC has already raised these issues bilaterally with the IASB.

With regard to investors' information and transparency in the securitisation markets, the ECOFIN has acknowledged that banks have improved the disclosure of financial information related to their exposures, losses and write-downs arising from the financial crisis. For its part, the industry has now implemented most of its 10 initiatives to improve transparency in the securitisation markets as per its commitment letter to the EC in February 2008<sup>5</sup>.

#### ***b) Strengthening of prudential rules***

The proposed amendments to the Capital Requirements Directive (CRD), whose approval is scheduled for April 2009, are designed to enhance the management of liquidity risk; improve the quality of bank's own funds; review the large exposure regime; harmonise (by 2012) the formats, frequencies and dates of reporting for banks; and introduce new requirements relating to the originate-to-distribute model. In the insurance field, the new risk-sensitive prudential requirements introduced via the Solvency II Directive are designed to provide incentives for good risk management and better taking into account the risks taken by insurance undertakings.

<sup>4</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1901&format=HTML&aged=0&language=EN&guiLanguage=en>

<sup>5</sup> [http://www.europeansecuritisation.com/Advocacy/Market\\_Standards/Industry-letter-08Feb08.pdf](http://www.europeansecuritisation.com/Advocacy/Market_Standards/Industry-letter-08Feb08.pdf)

Prudential rules are also rightly being discussed at a global level. A capital monitoring exercise is in place with analysis of the first data submissions being made available to the Basel Committee in the first quarter of 2009. The challenge therefore is how to match the initiative that the EU is taking in prudential regulation with the indispensable need to achieve outcomes which are, over time, harmonised with those in other significant jurisdictions.

### ***c) Reinforcement of the European supervisory framework***

Both the CRD and Solvency II directives are expected to enhance the supervision of cross-border financial groups, with the formalisation of colleges of supervisors and an increased coordination between supervisory authorities on key decisions. Coordination between supervisors will be enhanced by the modification of national mandates of supervisors at the national level to ensure that they are able to take into account the EU dimension in the performance of their duties, including having regard to the financial stability concerns in other Member States.

In addition, the ECOFIN has agreed to strengthen and improve the functioning of the EU committees of supervisors: their decision making will be facilitated by the possibility to adopt measures by qualified majority voting, coupled with a "comply or explain" mechanism. The EC will also modify by the end of this year the Decisions on the 3L3 Committees, so as to give a more formal role to them in relation to specific tasks, such as, for example, mediation, providing non-legally binding recommendations and guidelines, and training and staff exchange.

In parallel, the EC has established a high-level group on supervision chaired by Jacques de Larosière. This group has been tasked to make proposals on how EU supervisory arrangements should be organised, how to strengthen EU cooperation on financial stability oversight, and how EU competent authorities should cooperate with other major jurisdictions. The group is expected to report by end-February 2009.

### ***d) Further strengthening of financial stability***

The ECOFIN anticipates work in 2009 in the following areas: measures to alleviate potential undue pro-cyclical effects of the prudential and accounting rules; alignment of incentives in executive pay systems; early intervention tools for financial crisis management; counterparty and risk mitigation in Credit Default Swap (CDS) markets; and transparency enhancement in OTC derivatives markets.

## **The global perspective**

On 2 April 2009, G20 Finance Ministers will report on the implementation of a number of immediate actions, agreed at the 15<sup>th</sup> November Washington summit, aimed at the stabilisation of financial markets. The G20 action plan contains measures in seven different areas:

1. Transparency and accountability
2. Sound regulation
3. Prudential oversight
4. Risk management
5. Integrity in financial markets
6. International cooperation
7. International Financial Institutions (IFIs) reform

The G20 action plan comes after the FSF's April 2008 recommendations for financial markets regulatory reform, which were in turn consistent with the October 2007 ECOFIN Roadmap. Although direct comparison between the G20 communiqué and the FSF report is not uniform, e.g. G20 measures to reform IFIs and on the integrity of financial markets are specific to the G20 action plan, there is a strong similarity of approach. However, it can be expected that, going forward, the FSF recommendations will closely reflect the mandate from G20 governments.

### **Conclusion**

The EU financial services industry will be profoundly affected by the increased public sector involvement in recapitalisation and guarantee of liabilities, and by regulatory reforms as they develop. On the one hand, an avalanche on new - and in certain corners, controversial - EU regulatory proposals will re-write the rules and guidelines that govern the provision of financial services. Given the ongoing nature of the crisis and the speed with which those regulatory proposals are progressed, there is a risk that the latter fail to take account of all the lessons to be learned from the global financial crisis. At the same time, major public intervention in the financial sector gives rise to concerns about how trust and confidence between financial institutions and between the financial sector and the "real" economy will evolve in the short to medium term. These variables will profoundly affect the development of a single financial market in the EU. The G20 warned against the dangers of 'turning inward' (i.e. the dangers of rising protectionist sentiments). As a key priority going forward, the existing, and new, EP and EC will need to continue to work carefully to ensure an effective, proportionate, and globally consistent European policy response that promotes the integration and openness of international financial markets.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

**Chairman Financial Industry Members**

Guido Ravoet, *EBF Secretary General*  
Rue Montoyer 10, B-1000 Brussels  
Tel: +32 2 508 37 11 / Fax: +32 2 502 13 30  
E-mail: [g.ravoet@ebf-fbe.eu](mailto:g.ravoet@ebf-fbe.eu)

**Secretariat**

Catherine Denis, *EPFSF Director*  
Rue Montoyer 10, B-1000 Brussels  
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00  
E-mail: [cdenis@epfsf.org](mailto:cdenis@epfsf.org)

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