6th Euroframe Conference on Economic Policy Issues in the E.U.

Friday, 12 June, 2009, London

Financial integration and crisis management arrangements in the EU

John Grahl, Middlesex University Business School
Marica Frangakis, Nicos Poulantzas Institute, Athens[1]

I. Introduction

The pursuit of a single, financial market in the EU dates from the 1980s and the institution of the Single Market project. At that time, a number of directives were adopted, relating especially to the banking sector. The main obstacle to the integration of the EU financial services sector was however the lack of a single currency, which was not introduced until the early 2000s. In 1999 the Euro was officially introduced initially across 11 member states, soon spreading to encompass 16 out of the 27 member states of the EU today.

As the single currency project approached realisation, the issue of financial integration came to the forefront of economic policy considerations. An ambitious plan, the Financial Services Action Plan, was agreed upon, aiming at establishing the legal and policy framework for the deepening of financial integration across the EU over a relatively short period of time, namely 1999-2005. The completion of the Plan on time was indeed an achievement from the point of view of the administrative and the decision-making process, pointing to the political expediency of the exercise. However, the asymmetry between integration, on the one hand, and stability and consumer protection, on the other, implicit in the FSAP, was disregarded by the European Council and the European Commission.

The FSAP was followed by the Financial Services Policy 2005-2010. This was mainly concerned with promoting integration in the retail sector, which remained relatively fragmented.

The preoccupation of the EU institutions with financial integration was abruptly interrupted by the current financial crisis. In the autumn of 2008, the full impact of the crisis was realised and a number of urgent measures were decided, while a group of high-level experts – the De Larosière Group – was convened, with the urgent mandate of submitting a report on the financial crisis and what to do about it. The relevant Report was submitted in February 2009, while the European Commission is pushing through a variety of measures, aiming at remedying at least some of the excesses of the past.

Two questions arise: the first is, "to what extent was EU integration policy responsible for the crisis?" Clearly some of the key destabilising factors relate to the US financial

[1] J.Grahl@mdx.ac.uk; The Burroughs, Hendon, London NW4 4BT , + 44 (0) 20 8411 5905; frangaki@otenet.gr; 4 Lazaradon Street, Athens 11363, +30 210 8836248

system – the sub-prime bubble and, in the background, the huge imbalance in the US current account. However, this does not mean that EU decision-makers can be absolved of all responsibility. The second question is "has the EU got right this time?" Radical though some of the new measures may be by EU standards, can they be relied upon to produce a more stable, socially responsible and democratically accountable financial system? In view of the amount of taxpayer funding used to support the failing financial institutions across the EU, this question is central to the public debate today.

This paper is organised as follows. First, we shall examine the financial integration policy of the EU and the financial committee architecture it gave rise to. We shall argue that far too much emphasis was placed on the simple reduction of transactions costs, to the neglect of stability, consumer protection and other public goods. We shall then go on to look into the current EU regulatory and supervisory framework and into the new policy initiatives under way. We shall finish by discussing the adequacy of the emerging EU regulatory and supervisory system in terms of dealing with stability in the future, rather than in the past – with the next financial crisis.

II. Financial integration in the EU

EU financial integration policy is embedded in the liberalisation and privatisation thrust of the 1980s, following the collapse of the Bretton Woods Agreement and the oil crises of the 1970s. As early as 1983, a White Paper on financial integration by the European Commission called for greater liberalization in the area of European finance[2]. Following the 1986 Single European Act, the 1988 Council directive on the liberalization of capital controls and the 1992 Treaty on the European Union, the introduction of the single currency in 1999 marked a watershed in the integration process.

More specifically, the direct effects of the European Monetary Union on financial markets, put forward by the European Commission (1990) report "One Market, One Money", comprise standardization and transparency in pricing, the shrinking of the foreign exchange market, the elimination of currency risk, the elimination of currency related investment regulations and the homogenization of the public bond market and of bank refinancing procedures. These are all drivers of financial market integration.

Furthermore, the indirect effects of the introduction of the euro have strengthened the tendency toward a more market-led financial system in the EU. For example, Danthine et al (2000) found that the increased activity in the EU capital markets signified a "shift from banks to markets", benefiting the more market-based asset management and investment banking activities, by comparison to the traditional deposit and lending business of commercial banks.

The advent of the euro in 1999 produced a new sense of urgency, because it made many economies of scale feasible for the first time and EU policy makers became aware of the importance of scale and scope for financial services and especially for the capital markets. This led to a new regulatory harmonization phase, beginning in the late 1990s

[2] European Commission (1983)

with the Financial Services Action Plan (FSAP) and expected to have been implemented by 2010, on the basis of the Financial Services Policy (FSP). This phase involved the further liberalization of financial services on the national level and their re-regulation along Community lines, while financial integration was seen as a vital part of a broader economic reform package, the so-called Lisbon Strategy.

In particular the FSAP was designed to ensure (i) a single market for wholesale financial services, (ii) open and secure retail markets and (iii) state-of-the-art prudential rules and supervision. Progress under the FSAP was impressive in terms of breaking the previous political impasse reached in a number of areas. Thus, with few exceptions, long-standing differences of opinion either among national governments, or among the Council and the European Parliament were resolved, or a compromise was reached, due to the political commitment of the EU political elites to monetary and financial integration. At least two significant policy areas were however underplayed, those of supervision and of the protection of consumers. In both areas, the Plan was especially lightweight, insofar as it introduced no new measures, commensurate with the degree of market integration it sought to promote. Neither was there any full consideration of the possible impact on European employment relations of the shifts in corporate finance implied by the Plan.

On the successful completion of the FSAP, the emphasis shifted to the implementation and enforcement of the new legislation by the member states, the development of EU financial sector infrastructure, such as clearing and settlement and payments, as well as the removal of the remaining barriers to cross-border activity in certain areas, such as retail finance and asset management. The central objectives of the EU Financial Services Policy for the period 2005-2010 were outlined in a White Paper published by the Commission in 2005[3].

Generally, the White Paper follows the general argument and financial policy framework already set out by the FSAP, extending it to sectors previously left out and in particular to the retail financial services sector. Although it recognizes the dangers to stability that are inherent in financial integration – in terms of the possible spill-over effects of a system failure affecting several financial markets and/or groups on a EU-wide basis – it introduces no new measures. Similarly, while acknowledging the need for consumer protection, no new policy initiatives are presented in this respect.

- *EU financial committee architecture – The Lamfalussy Process*

Delays in passing legislation and complaints, from the financial industry, about the quality of the legislation as it emerged from the European Parliament and about “gold-plating” by member states in transposing the new rules into national law, led to a new governance structure known as the “Lamfalussy Process”, bearing on the allocation and exercise of power in the area of financial services policy. Its main characteristic is that it distinguishes between “framework” legislation, to be decided on the political level by the Council and the European Parliament (Level 1) and legislation concerning the “technical details” of framework measures, to be decided by the Commission, which is assisted for

[3] European Commission (2005a)

this purpose by a number of committees, the members of which include representatives of the Commission, the member states and the market participants (Levels 2 and 3). The Commission is also responsible for ensuring that such legislation is transposed into national law by the member states (Level 4). The users of financial services and the employees of the financial industry are not represented anywhere in this process. A schematic representation of how the 4 levels of decision making work under the Lamfalussy Process is shown in Table 1 below.

Table 1
The Lamfalussy Process

Level 1
Community legislation adopted under the co-decision procedure – Legislation should be only about framework principles and define implementing powers for the Commission

Level 2
Community legislation adopted by the Commission to lay down the technical details for the principles agreed at Level 1. Particular features: * Technical advice prepared by the Committee of European Securities Regulators (CESR) following mandates issued by the Commission and based on consultation with market users; * Favourable vote of member states (qualified majority) as represented in the European Securities Committee (ESC). * European Parliament may adopt resolutions a) within 3 months on the draft implementing measure; b) within one month after the vote of the ESC if level 2 measures go beyond implementing powers.

Level 3
The CESR, in which the national supervisory authorities are represented, to facilitate consistent day-to-day implementation of Community law. CESR may issue guidelines and common, non-binding standards.

Level 4
The Commission checks compliance of member state laws with the EU legislation. If necessary, it takes legal action against member states before the Court of Justice.

First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe, May 2003

On the basis of the Lamfalussy Process, two new sets of committees were thus set up, dealing with (a) regulatory matters and (b) operational matters in banking, insurance - including pensions - and securities (Table 2), whereby the regulatory committees represent member state governments and the committees of supervisors represent the supervisory authorities of each member state.

Table 2
The EU organizational committee architecture of the EU financial services sector

	Banking	**Insurance and Occupational Pensions**	**Securities (incl. UCITS)**
Regulatory Committee (Level 1)	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)	European Securities Committee (ESC)

Committee of Supervisors (Level 3)	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)	Committee of European Securities Regulators (CESR)

In 2007, the functioning of the Lamfalussy Process was subjected to a full review[4]. This led to the adoption by the ECOFIN Council on 4/12/2007 of certain recommendations regarding (i) the arrangements for regulation and (ii) the institutional setting of the Level 3 committees.

In particular, the Council strongly supported the view that the use of national options and discretion in implementing legislation should be limited. Further, it recommended that the role of Level 3 committees be enhanced as regards their legal basis, accountability and decision-making. It is worth noting that in the Commission's view, "at this stage more ambitious institutional changes such as granting of independent rule-making powers in Level 3 is not feasible given, inter alia, the lack of agreement among member states and other stakeholders"[5]. Thus the Commission was asked by the Council to "strengthen the working of these committees without unbalancing the current institutional structure"[6].

On the issue of accountability, it was recommended that the Level 3 committees submit "reports to EU bodies of periodic work progress for comment and high-level political guidance, with due respect for their operational independence" (ECB, ibid). On the issue of decision-making, it was decided that the Level 3 committees apply qualified majority voting, with the obligation for those who do not comply to explain their decision publicly ("comply or explain" model).

Further, it was recommended that national supervisors' mandates explicitly include the task to work towards European supervisory convergence. This recommendation was formally endorsed by the May 2008 ECOFIN Council.

Lastly, with regard to the cooperation between home-host supervisors, it was decided that the role of the "lead" supervisor[7] for cross-border financial institutions should be reinforced and that "colleges of supervisors" should be established, which could serve as a forum for the exchange of information, although a legal underpinning in the EU directives is to be sought.

Overall, it may be argued that the review of the Lamfalussy Process has laid the ground for a EU-wide system of supervision. In particular, the role of the Level 3 committees has been significantly enhanced, going beyond that of providing mere "technical advice". This is a development which may fill some of the gaps and deficiencies of the present

[4] This was required by Directive 2005/1/EU, which established the new regulatory structure of the EU financial services.
[5] European Commission (2007a : 3)
[6] ECB (2008:79)
[7] Referred to as the "consolidating supervisor" in the Capital Requirements Directive, the "coordinating supervisor" in the Financial Conglomerates Directive and the "group supervisor" in the Solvency 2 proposal.

financial services regulatory and supervisory system of the EU. At the same time, it raises a number of other questions, which we shall discuss in relation to the new EU policy initiatives in relation to the current crisis.

- *Direction and emphasis of the Financial Integration Project*

From the start, the FSAP was intended not only to integrate, but also to transform European financial systems. In the past, financial integration had been seen as essentially concerned with banking. This was logical because most national financial systems within the EU were bank-based, with relatively narrow securities markets and limited trading of corporate equities. However, by 1999, policy-makers had to respond to an emerging global financial system, centred on the US and heavily influenced by US practice, in which securities trading played a much wider role. Integration now was seen as encouraging an ongoing shift away from classical bank intermediation towards a much greater use of tradable assets.

Although some commentators criticised this shift as such,[8] because it was seen as weakening established socio-economic systems, the ambition to build big, integrated security markets appears to be a logical response to global developments. A wider role for securities trading may be related to the increased scale and scope of finance in the emerging global economy and to the multiplication of actors involved. It may have been the continent-wide scale of the US economy itself that made it the forerunner in the move to a more market-oriented financial system. Moreover, the advantages of security-based finance over classical bank intermediation may be cumulative – as the markets grow, they become more liquid and the cost of using them declines. If there is any validity in such suggestions, then the main consequence of a failure to build big liquid security markets in Europe would be to drive every issuer and investor on the planet into the North American ones.

However, although the objective was logical it was pursued with a reckless lack of concern for the dangers and difficulties involved. As to the subordination of stability issues to the drive for rapid integration, we have the testimony of Alexandre Lamfalussy himself.[9] In his draft report on the problems of the FSAP he wrote that "…greater efficiency does not necessarily go hand in hand with enhanced stability….Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks….there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential regulation."

He summarises the Commission's response to this concern. "It was politely but firmly suggested that we drop the subject."

[8] See for example, Dore (2000)
[9] Lamfalussy (2003)

Of course, the FSAP and the wider Lisbon strategy of which it became a key component were formulated at a time when US productivity growth seemed to be much more rapid than in the EU and when the equity markets were booming. It is hard to deny that EU policy-makers were affected by the exuberance of the times. They displayed almost complete unanimity on the need for financial change – national governments, European Commission and corporate leaderships all endorsed both the need for financial integration and the new emphasis on security markets. But the measure of success in this integration was explicitly stated to be lower transactions costs, and it was thought that regulation should be lightened to this end. As the Commission put it: "Business and citizens in the European Union need a regulatory environment which is clear, effective and workable in a rapidly changing, global market place. This is a key element if the European Union is to become the **cheapest and easiest place to do business** in the world."[10]

In at least one respect, subsequent developments made European financial systems particularly vulnerable. Their effective capital/assets ratios were in most cases even lower than those of US banks, as they increased their exposures to the US mortgage market while relying increasingly on inter-bank borrowing to do so. Daniel Gros and Stefano Micosi report that, "the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks." These economists recognise that the leverage numbers reported to regulators are much lower, but they explain this by the "massive in-house investment banking operations of European banks" which "are not subject to any regulatory capital requirement." They give the following figures for the leverage ratios of European banks as of 30th June 2008: UBS, 46.9; ING 48.8; Barclays, 61.3; Crédit Agricole, 40.4, Deutsche (2007) 52.5 (Gros & Micosi, www.voxeu.org).

This exceptionally high leverage translates into particularly high exposures to "toxic" assets. Walter Münchau of the *Financial Times*, reacting to a recent stability report (IMF, 2009), emphasised both the scale of these exposures and the fact that they had still not been written down by the banks concerned:

> The most shocking news from last week's excellent Global Financial Stability Report from the International Monetary Fund was not the headline estimate of total bad assets. That number stands at $4,100bn (£2,800bn, €3,000bn) and will almost certainly be revised upwards. Much more shocking was that the lion's share of these assets belongs to European, not North American, banks. Of the total $4,100bn, the global banking system accounts for $2,800bn. Of that, a little over half – $1,426bn – is sitting in European banks, while US banks account for only $1,050bn.
>
> Even worse, European banks have written down much less than American ones. According to Reuters, the US and European banking and insurance sector has so far written down $740bn. More than 70 per cent of the write-downs come from the US. The eurozone's share has been an appalling 14 per cent.

[10] European Commission (2001). Emphasis added.

> Another statistic from the IMF report: to recapitalise the banking system to reach capital ratios that prevailed in the mid-1990s, capital injections of $275bn would be required for US banks, and a whopping $500bn for European banks.
>
> You get the picture. All these data tell us that Europe has both the biggest problem and has made the least progress.
>
> *Financial Times*, 26th April 2009

In fact, the IMF (2009, p36) estimates that allowing for expected write-downs would leave Eurozone banks with negative equity, while banks in the UK and in other non-euro western European countries are not in much better case.

Figure 1: Bank Equity Requirement Analysis
(In billions of dollars, unless shown)

	United States[1]	Euro Area	United Kingdom	Other Mature Europe[2]
Estimated Capital Positions at end-2008				
Total reported writedowns to end-2008	510	154	110	70
Capital raised to end-2008	391	243	110	48
Tier 1/RWA ratios at end-2008 *(percent)*	10.4	7.3	9.2	7.3
TCE/TA end–2008 *(percent)*	3.7	2.5	2.1	2.3
Scenario Bringing Forward Writedowns				
Expected Writedowns 2009-10 (1)	550	750	200	125
Writedown-adjusted Tier 1/RWA ratio *(percent)*	6.7	1.1	4.7	1.7
Writedown-adjusted TCE/TA *(percent)*	0.1	–0.2	0.4	0.5
Allowance for Expected Earnings				
Expected net retained earnings 2009 and 2010 (2) (after taxes and dividends)	300	600	175	100
Net drain on equity (retained earnings) 2009 and 2010 (3) = (1) – (2)	250	150	25	25
Equity Requirements				
Equity needed to reduce leverage to 25 times[3]	275	375	125	100
Equity needed to reduce leverage to 17 times[4]	500	725	250	225

Source: IMF staff estimates.
Note: Tier 1 = Tier 1 capital; RWA = risk-weighted assets; TA = tangible assets; TCE = tangible common equity.
[1]Excludes government-sponsored enterprises, which are expected to receive equity injections from the government of up to $250 billion to help support writedowns.
[2]Denmark, Iceland, Norway, Sweden, Switzerland.
[3]The approximate leverage assumed in the GFSR deleveraging scenario (a 4 percent TCE/TA ratio).
[4]The approximate leverage of U.S. banks in the mid-1990s (a 6 percent TCE/TA ratio), prior to the buildup in leverage in the banking system that contributed to the crisis.

IMF (2009)

A press release from the Commission in February 2008[11] claimed that European banks were well capitalised: "The origin of the current financial turmoil came from the US sub-prime mortgage sector and a large portion of the European financial sector is not directly affected by the turmoil at this stage. Where financial institutions have sizeable direct exposures to the US sub-prime market, or indirect exposures through structured products, the affected entities have well diversified portfolios and large capital buffers." It appears that this was simply wrong.

It is of course true that the sub-prime crisis itself occurred in the US. But one can add that if Europe did not have its own sub-prime bubble this is not the fault of the Commission who were until well into 2007 pressing hard for integration of European mortgage markets. The rationale offered for this proposal in the Commission's *Green Paper* is of

[11] D.-G. Internal Market and Services (27/2/2008)

some interest. It could hardly be argued that retail mortgages could be made cheaper by integration – integration of wholesale markets would be quite sufficient to resolve problems of capital allocation. Rather was it claimed that the range of choice could be widened for consumers.[12]

American practice was in the background here. One example was the view that with improved "risk assessment", the risk capital required in the mortgage sector could be reduced (p11). Another was the belief that a big secondary market in mortgages was the way forward: "Many….. express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market" (p13). There is no hint in this document that a continent-wide secondary market in mortgages might pose certain informational difficulties and the word, "stability" does not appear in the *Green Paper*.

A background report commissioned from London Economics (2005) dwelt on the merits of the US system, including its sub-prime component:

"US experience suggests that:

- Legal or other restrictions to banks' geographical expansions will reduce the efficiency of the mortgage-lending industry.
- Steps to create a single EU mortgage market would increase incentives to develop automated systems to process loan applications, which would reduce origination costs.
- Removing restrictions on maximum mortgage interest rates would **allow a subprime mortgage market to develop**, thus expanding total mortgage lending." (p168, emphasis added)

Events led to a change in perspective. By the end of 2007 the *White Paper* showed signs of a reappraisal. It asserted that "recent events in global mortgage markets have confirmed the pertinence of the approach proposed" (European Commission 2007:10). Of course, the opposite is the truth – the whole D.-G. Internal Market argument was based on the supposed desirability of more product diversity although product diversity was a key factor making US mortgage-backed securities opaque and risky.

The abortive mortgage initiative reinforces the argument that stability questions were repeatedly underestimated in the implementation of the financial integration project and, although the Commission does not have any direct responsibility for bank supervision, the way in which it pursued integration did nothing to discourage the slack regulatory environment in which the European banks became dangerously exposed to the mortgage-backed securities being issued in the US.

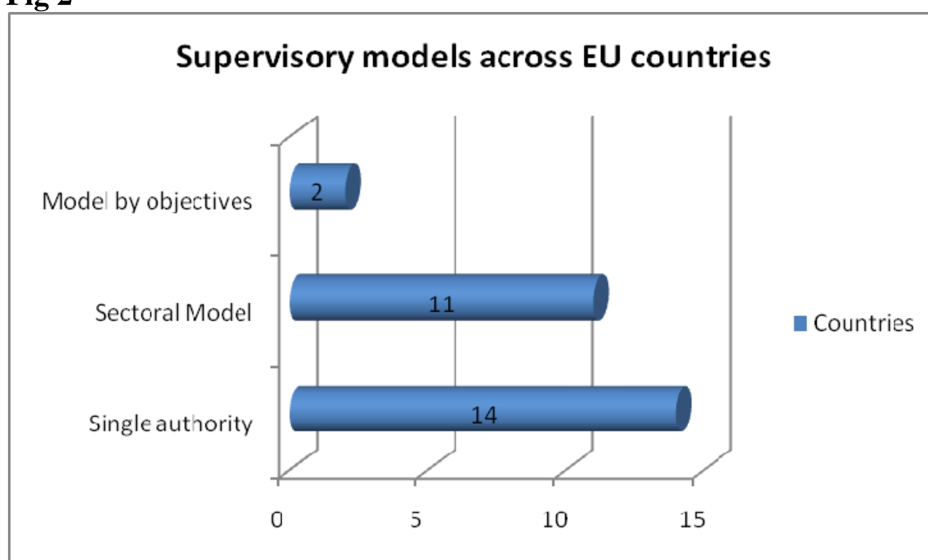
III. Financial crisis arrangements in the EU

➢ *Supervisory framework*

[12] European Commission (2005)

Financial crisis prevention and management arrangements in the EU are based on three principles: decentralization, segmentation and cooperation.[13] That is, supervision is exercised by a multiplicity of bodies both at the EU and the member state level. Furthermore, in many instances, different segments of the financial industry are overseen by different bodies, while coherence across such a decentralized and segmented structure is sought through bilateral and multilateral cooperation. There are arrangements, largely under the auspices of the ECB, for the exchange of information and the possible coordination of policies relating to financial stability, but stability measures remain essentially the responsibility of the member states. Fig. 2 depicts the multiplicity of supervisory models across the EU member states.

Fig 2



More specifically, 14 member states have set up a single authority for the whole of their financial services sector; 11 have a dopted a "sectoral model", according to which each sector (banking, securities and insurance) is supervised by a different authority, while 2 (Netherlands and Portugal) have allocated responsibilities on the basis of the supervisory objectives, with prudential supervision and conduct of business regulation attributed to two different authorities (the "twin peaks" model). Implicit in the multiplicity of supervisory structes in the EU are two challenges, concerning (a) the role of the ECB as a lender-of-last-resort (LOLR) and (b) the mismatch between home-country control of supervision and host-country operational conduct of financial market surveillance.

The lender-of-last-resort function is primarily a national responsibility and liability. The issues that arise in this respect relate (i) to the role of the European Central Bank and (ii) to the coordination between national central banks in the case of a pan-European banking group.

[13] Lastra (2003) and Schinasi & Teixeira (2006)

In particular, the European System of Central Banks has only a limited role with regard to the safeguard of financial stability[14]. According to Art. 105.5 of the Treaty, "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". In this sense, prudential supervision is a "non-basic" task of the ESCB.

On the other hand, according to Art. 105.2 of the Treaty, the ESCB is responsible for the "smooth operation of payment systems". That is, should there be an explicit *payment system failure*, the ECB has competence to act as LOLR. Thus, although payment system supervision is difficult to dissociate from banking supervision, the Treaty does so. However, should a crisis occur outside the payment system, then the role of the ECB is ambiguous. In particular, Art. 105.6 of the Treaty, also known as the "enabling clause", allows for a possible expansion of an ECB supervisory rule on the basis of a unanimity rule, rather than the formal amendment of the Treaty:

> "The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning the policies relating to the prudential supervision of credit and other financial institutions with the exception of insurance undertakings."

The exercise of the LOLR function may further give rise to problems of coordination between national central banks in the case of a pan-European banking group. In particular, a gap between micro and macro prudential controls may arise out of the mismatch between home-country control of supervision and host-country operational conduct of financial market surveillance. This is even more so in the case of a foreign financial institution that is especially large in relation to the size of the host economy, as is true of many of the new member states of the EU, the financial industry of which is dominated by a small number of foreign owned concerns. Further, where the foreign-owned concern is small in relation to the parent institution or group, the home-country authorities may not even have the incentive to intervene. That is, there arises a case of a conflict of incentives.

- *Regulatory framework*

The supervisory structure described above is complemented on the EU level by a number of regulatory agreements and cooperation arrangements, as shown in the table below.

Table 3 – Overview of the EU framework for financial crisis management

<table>
<tr><th rowspan="2"></th><th colspan="3">Authorities responsible for financial stability</th></tr>
<tr><th>Central banks</th><th>Banking supervisors</th><th>Finance Ministries</th></tr>
<tr><td rowspan="2">Regulatory arrangements</td><td colspan="3">Capital Requirements Directive (2006)</td></tr>
<tr><td colspan="2">Financial Conglomerates Directive (2002)</td><td></td></tr>
<tr><td></td><td colspan="3">2008 MoU on cross border financial crisis situations</td></tr>
</table>

[14] The ESCB consists of the ECB and the national central banks of all EU member states. By contrast, the Eurosystem consists of the ECB and the national central banks of the states that participate in the EMU.

Voluntary cooperation agreements	2005 MoU on crisis management	
	2003 MoU on crisis management	
	2001 MoUon payment systems	
	Regional MoUs	
	National MoUs	

Source: ECB, 2007, The EU arrangements for financial crisis management, in Monthly Bulletin, February 2007, pp. 73-84

More specifically, the Capital Requirements Directive (Dir 2006/48/EC and Dir 2006/49/EC) and the Financial Conglomerates Directive (Dir. 2002/87/EC) contain provisions which have a direct bearing on crisis management situations, by defining the information flows between the authorities potentially involved in the management of cross-border crises, i.e., supervisors and central banks.

In addition, there are certain general agreements, known as "Memoranda of Understanding" (MoU), designed to commit the signatories to a regular exchange of information and timely consultation on enforcement action. Further, certain countries have entered into regional MoUs to deal with individual cases of regional systemic importance. The MoUs are not public documents, neither are they legally binding (Box 1).

Box 1 – Memoranda of Understanding on crisis management

2003 MoU on crisis management - The first MoU on crisis management situations was designed to ensure a smooth interaction betwen the authorities concerned, thus facilitating an ealy assessment of the systemic scope of the crisis at the national and EU levels. It sets out specific principles and procedures for the identification of the authorities responsible for the management of a crisis in the EU. It also indicates the required flows of information between banking supervisors and central banks and the practical arrangments for sharing information across borders. It establishes a framework for cross-border communication between banking supervisors and central banks, including a list of emergency contacts.

2005 MoU on crisis management – This provides a set of principles and procedures for sharing information, views and assessments by the signatory authorities. It also includes arrangements for the development of contingency plans for the management of crisis situations, along with stress-testing and simulation exercises. Lastly, the MoU includes an explicit statement that it should not be construed as representing an exception to (i) the principle of the firm's owners'/shareholders' primary financial responsibility; (ii) the need for creditor vigilance and (iii) the primacy of market-led solutions when it comes to solving crisis situations in individual institutions.

2008 MoU on cross-border financial crisis situations – The latest MoU on cross-border financial crisis situations goes further than the previous two, insofar as it contains a recognition that financial stability is a common concern and that a common analytical framework for the assessment of a potential crisis is necessary. It also introduces a framework for cooperation agreements for crisis management in the case of cross-border financial institutions and an agreement that the costs of bank resolution will be shared among affected member states on the basis of the economic impact of the crisis and the framework of the home and host countries' supervisory powers ("equitable and balanced criteria").

Sources: ECB, 2007, The EU arrangements for financial crisis management, Monthly Bulletin, February 2007 and Hardy, Daniel C., 2009, A European Mandate for Financial Sector Supervisors in the EU, IMF, WP/09/5.

Overall, the financial crisis management arrangements of the EU as provided by its supervisory and regulatory framework are fragmented and diverse across both sectors and member states. Any such co-ordination as exists concerns information flows and the distribution of roles, in case of crisis. The global financial crisis that in fact erupted in 2007 brought out the inadequacies of the present system. This is however not surprising in view of the fact that the financial integration policy, which was vigorously pursued in the past ten years, has had no counterpart in the area of stability.

IV. The current financial crisis – New policy initiatives

"Comparing the ex post returns with the considerable costs of the current turmoil, we have to realise that our financial system as a whole, including its non-regulated and non-listed entities, was neither strong nor efficient. It did not allocate capital properly and it did not manage risks well. ... We have to put reserves and buffers back into the system; they are the protection against serious damage in a downturn and they are an integral part of sound finance", in the words of Jean Claude Trichet, the President of the ECB[15].

The financial crisis which began in 2007, the duration and outcome of which remain uncertain, became felt in the EU over the course of 2008, as a number of large financial institutions faced liquidity problems, which soon evolved into solvency problems. These in turn caused broad repercussions because of the close linkages between Europe's major financial institutions and their high leverage. For example, 16 cross-border banking institutions account for about one-third of EU banking assets, hold on average 38% of their EU banking assets outside their home countries and operate in just under half of the other EU countries[16].

Since the early stages of the crisis, the ECB acting within its mandate took measures to deal with what appeared to be a "systemic liquidity risk". As the crisis evolved in 2008, the ECB stepped up its efforts to support bank liquidity by easing its money policy stance, lengthening the maturity of refinancing operations and adjusting its collateral framework. Further, it brought down its key policy rate from 4.25% in October to 1% at present[17].

As the liquidity risk turned into a solvency one, many European governments stepped in with a variety of measures, including recapitalisations, guarantees and asset support schemes, as shown in Table 4. No common, coherent framework was applied.

---

[15] Keynote address at the Committee of European Securities Regulators, 23/2/2009

[16] IMF, 2009a

[17] On 8 October 2008 the ECB announced that, starting from the operation to be settled on 15 October, the weekly main refinancing operations would be carried out through a *fixed-rat*e tender procedure with full allotment at the interest rate on the main refinancing operations, as opposed to a *minimum bid rate*, whereby a minimum rate refers to the minimum interest rate at which counterparties may place their bids. It should be noted that a *fixed-rat*e tender procedure was employed between 1/1/1999 and 28/6/2000, when variable rate tenders were first introduced with respect to the Eurosystem's refinancing operations. The shift back to a *fixed rate* tender procedure implies a relaxation in the refinancing operations.

Table 4
Financial support given to EU banks

	Bank liabilities				Bank assets		Other		
	Increase deposit insurance	Guarantee or buy bank debt	Inject capital	Nationalise	Ring-fence bad assets	Purchase toxic assets	Fund commercial paper	Fund ABS	Ban or restrict short-selling
Germany	#	#	#			#			#
France		#	#						#
Italy	#		#						#
UK	#	#	#	#	#		#	#	#
Austria	#	#	#						#
Belgium	#	#	#						#
Denmark	#	#	#					#	#
Finland	#	#	#				#		#
Greece	#	#	#						
Hungary	#	#	#						
Ireland	#	#	#	#					
Luxembourg	#	#	#						
Netherlands	#	#	#	#					#
Slovak Rep	#								
Poland	#		#						
Portugal	#	#	#						
Sweden	#	#	#					#	
Spain	#	#						#	#

Source: OECD Economic Outlook, Interim Report, March 2009

Generally, the recent financial crisis brought out the gaps in the EU financial services policy in relation to stability and to consumer protection. In the words of the European Commission, "The crisis has exposed unacceptable risks in the current governance of international and European financial markets, which have proved real and systemic in times of serious turbulence"[18].

Furthermore, by way of remedying such deficiencies, the EU member states violated the "principle of the firm's owners'/shareholders' primary financial responsibility" at a time of crisis, as not only stipulated in the 2003 MoU, but also confirmed by the ECOFIN Council of October 2007. Namely, that "(i) the objective of crisis management is to protect the stability of the financial system… not to prevent bank failures; (ii) in a crisis situation, primacy will always be given to private sector solutions and (iii) the use of public money to resolve a crisis can never be taken for granted"[19].

- *De Larosiere Report*

In a typical Community fashion, the response of the EU Council and Commission to the crisis was to set up a high-level expert group to look into the problem and suggest necessary policy adjustments. The group was headed by Jacques de Larosière, a former

[18] European Commission (2009:4)
[19] ECB (2008:82-83)

Bank of France president. It submitted its report on 25/2/2009. On the basis of this report, a number of new policy initiatives are under way. These include the following[20].

i. Macro-prudential supervision – Completely neglected until now, it is going to be the responsibility of a European body. The de Larosière Report (LR) has recommended that a European Systemic Risk Council be set up, consisting of the EU central bankers, the chairs of the Level 3 Committees and the ECB President and Vice President, under the auspices of the ECB.
ii. Micro-prudential supervision – A new architecture is envisaged. The LR has recommended that a network of European financial supervisors - the European System of Financial Supervision - be set up, operating on the basis of harmonized rules and high quality information.
iii. Regulatory framework – The Commission is to submit proposals pertaining to the following areas: hedge funds and private equity (previously unregulated); tools for early intervention; increasing transparency for derivatives; increasing the quality and quantity of prudential capital for trading book activities and complex securitization.
iv. Consumer/investor issues – Measures include the strengthening of the effectiveness of marketing safeguards for retail investment products; reinforcing bank depositors; investor and insurance policy holder protection; 'responsible lending'.
v. Corporate governance – Remuneration schemes in the financial services sector are to be brought within the scope of prudential oversight.
vi. Sanctions against market wrongdoing – Strengthening sanctions in a harmonized manner; review of the Market Abuse Directive.

Most of the above measures are at the stage of the formulation of proposals by the Commission, to be submitted to the Council in the course of 2009. Assuming the relevant political decisions are taken by 2010, it will take approximately two years for these initiatives to become Community rules. By that time, the present crisis will hopefully have abated!

➢ *Capital Requirements Directive and Credit Rating Agencies*

Two further policy initiatives, which preceded the publication of the LR, need to be mentioned: the revision of the Capital Requirements Directive (CRD) and the approval of a new regulation concerning the issuance of credit ratings used in the EU.

The CRD comprises two Directives 2006/48/EC and 2006/49/EC, which adapted the Basel II framework to Community law. This came into effect in 2008. On the basis that "this legal framework needs to be regularly updated and refined to respond to the needs of the financial system as a whole", the Commission has proposed the following changes.

✓ Large exposures – Banks to be restricted in lending beyond a certain limit to any one party.

[20] European Commission (2009)

- ✓ Supervision of cross-border groups – “Colleges of supervisors” to operate in multiple EU countries, aiming at resolving home-host issues.
- ✓ EU-wide criteria for assessing whether “hybrid” capital, consisting of equity and debt, can be considered as part of a bank’s overall capital.
- ✓ Liquidity risk management - To be discussed and coordinated with “colleges of supervisors”.
- ✓ Securitised products – Firms that re-package loans into tradable securities will have to retain some risk exposure to these securities, while those investing in such products will need to conduct due diligence.

As opposed to the revision of the CRD, which is a relatively recent development, the question of credit ratings and of the credit rating agencies (CRA) issuing them was raised for the first time in 2004. In particular, in response to a European Parliament resolution in February 2004 after the ENRON and PARMALAT scandals, the Committee of European Securities Regulators (CESR) was asked to suggest possible ways of supervising CRAs. The CESR however concluded that there was no need for formal regulation. The issue came up again in 2007, at the start of the current financial crisis.

In October 2007, the EU Finance Ministers asked the Commission to assess the role played by CRA and the EU Councils of 20 June and 16 October 2008 called for a legislative proposal to strengthen the rules on CRA and their supervision at EU level. By April 2009, both the European Parliament and the Council approved the proposed regulation on CRAs, which bears on disclosure, transparency and remuneration issues. Further, CRAs will need to apply for registration in the EU, in order for their ratings to be used. The “college of supervisors” will supervise the CRAs.

- ➢ *Level 3 Committees*

Another area, where changes are being contemplated is supervision. Both the Commission’s review of the Lamfalussy Process and the Larosière Report point to the need for changes on the supervisory level. In fact, the LR goes further by pointing out “a lack of frankness and cooperation between supervisors”[21].

As mentioned above, the LR has recommended that a European System of Financial Supervisors be set up, working with enhanced Level 3 Committees and constituting the so called “Authorities”, to be politically independent. The Commission’s proposal in this respect is that: “In a first phase the three Committees of European Supervisors as well as national supervisors would be strengthened, and a more harmonized set of supervisory powers and sanctioning regimes would be introduced. In a second phase, the Committees would be transformed into Authorities carrying out certain tasks at European level, whilst relying on colleges of supervisors and national supervisors for the day-to-day supervision

[21] De Larosière (2009:41, para 159)

of individual companies. A review after three years would consider the need for further consolidation of the ESFS."

Thus the trend already started by the review of the Lamfalussy Process towards establishing an EU-wide micro-prudential, supervisory framework is further strengthened by the above proposals. In this respect, the role of the Level 3 committees is greatly enhanced. Although these were originally set up to provide advice on the complex, technical aspects of finance, they are likely to acquire a legal basis and a political status, possibly commensurate to that of the ECB.

Overall, the new policy initiatives put forward by the Commission and the Council are impressive in terms of the range of issues they tackle and the gaps in EU financial services policy they attempt to close. However, to the extent that they are dealing with the problem areas the present crisis has brought to attention, it may be argued that they are in fact dealing with yesterday's crisis.

V. Concluding remarks

The response of the EU to the current financial crisis can be criticized on many grounds. It was slow, to begin with. The so called first line of defence in dealing with a crisis, whereby private resources are to be mobilized, was quickly given up, in favour of public funds, as the seriousness of the crisis hit home. Further, the mobilization of public funds in rescuing ailing private financial institutions was not accompanied by strengthened accountability standards. Neither has the voice of social actors, other than the financial industry, been taken into account in searching for alternative measures. Interesting and far-reaching as the new EU policy initiatives may be, they pose the question "can they prevent the next financial crisis?"

In other words, is it just a question of devising a new EU regulatory and supervisory framework, that will work more efficiently and effectively than the one currently in place, or is it a question of re-examining the financial integration paradigm adopted by the EU since the 1990s? Is a piecemeal approach, focusing on particular aspects of the financial system, adequate to produce results? If anything, the present financial and economic crisis has highlighted the need for a broader perspective. The fact that very little, if any, self-criticism has been forthcoming from the EU institutions and especially from the Commission, does not encourage such a broadening of the discussion.

More specifically, the present crisis has brought out in a striking fashion the two major deficits of the European construction, the social deficit and the democratic one. Thus, the exclusive concentration of the ECB and of economic policy on restraining consumer inflation allowed the asset price inflation to go virtually unnoticed. Further, the rising income and wealth inequalities increased the risk appetite of investors, providing thus an incentive for the introduction of ever more complex, risky and high-yielding financial products. The emphasis on the integration of the markets meant that the increasing importance of the "shadow banking system" was tolerated. By contrast, stability and consumer protection issues were seriously underestimated.

The democratic deficit of the EU is also pertinent to our discussion. In particular, the issue of political and social accountability is especially important, in view of the huge amounts European taxpayers have been called upon to devote to the rescue of EU financial institutions. Should the financial players have been more accountable, some of the present problems might have been avoided.

Both of the above aspects of EU policy and of the EU institutions are however outside the core of the mainstream discussion. Although the need for and the usefulness of the integration of the EU financial markets in a globalised, complex world is not disputed, the ways and means by which this has been pursued were found to contain serious flaws. Going beyond these flaws requires extending the boundaries of the discussion.

The sum of the individual policy initiatives proposed by the EU Commission and the Council does not make for a fundamentally new approach. They deal to a certain extent with at least some of the proximate causes of the present debacle. They do not however address the fundamental issues at hand. In this sense, it is not clear that they can prevent the next financial crisis.

References

Danthine, J.P., Francesco Giavazzi and Ernst-Ludvig Von Thadden (2000) *European Financial Markets after EMU: A first assessment*, Discussion Paper Series, No. 2413, Centre for Economic Policy Research, Brussels

De Larosière Report (2009)

Dore, R. (2000) *Stock Market Capitalism-Welfare Capitalism: Japan and Germany versus the Anglo-Saxons*, OUP, Oxford

European Central Bank (2008) “Developments in the EU arrangements for financial stability” in Monthly Bulletin, April 2008

European Commission (1983) *Financial Integration: communication from the Commission to the Council*, COM (83) 207 final, 20th April

European Commission (2001) *Realising the European Union’s Potential: consolidating and extending the Lisbon Agenda*

European Commission (2005a) *White Paper on Financial Services Policy 2005-2010*, COM(2005) 629

European Commission (2005) *Green Paper: mortgage credit in the EU*, COM (2005) 327

European Commission (2007) *White Paper: on the Integration of EU Mortgage Credit Markets* (COM (2007)

European Commission (2007a) *Review of the Lamfalussy Process*, 727/20.11.07, P. 3

European Commission (2009) *Driving European Recovery*, Vol. I, COM(2009) 114 final

IMF (2009) Global Financial Stability Report, April 2009-06-07

IMF (2009a) World Economic Outlook, *Crisis and Recovery*

Lamfalussy, A. (2003) “Creating an Integrated European Market for Financial Services” in Philip Booth and David Currie (eds) *The Regulation of Financial Markets*, IEA, London

Lastra, R.M. (2003) “The Governance Structure for Financial Regulation and Supervision in Europe” in *Columbia Journal of European Law*, 10, 1, Fall

London Economics (2005) *The Costs and Benefits of Integration of EU Mortgage Markets*, August

Schinasi, G.J. & P.G. Teixeira (2006) *The Lender of Last Resort in the European Single Financial Market*, IMF Working Paper WP/06/127