DEVELOPMENTS IN THE EU ARRANGEMENTS FOR FINANCIAL STABILITY

The financial system is undergoing important changes as a result of several structural developments, which have a bearing on the functioning of the EU arrangements for safeguarding financial stability and may require their enhancement. These developments include financial integration, the growing number and prominence of cross-border banking groups, and financial innovation with the emergence and growth of new and complex financial instruments. There are a number of policy initiatives at the EU level aiming to reinforce the financial stability arrangements over the medium term so as to cope more effectively with the challenges stemming from such changes. These initiatives include the strengthening of the financial crisis management arrangements, in line with the strategic roadmap adopted by the ECOFIN Council in October 2007, and the enhancement of the Lamfalussy framework for regulation and supervision, as agreed by the ECOFIN Council in December 2007. Several policy actions are also being considered at the international and EU level, with a view to addressing issues stemming from the experience of the financial market turbulence.

I INTRODUCTION

The financial system is undergoing important changes as a result of several developments, which have a bearing on the functioning of the EU arrangements for safeguarding financial stability and may require their enhancement. The first set of developments relates to the increasing financial integration in the EU. The progress towards a single financial market has been fostered by the introduction of the euro and the progressive integration of markets and market infrastructures, which has supported in turn the increase in the access to, and the provision of, financial services on a cross-border basis.1 Second, the financial landscape in Europe is now characterised by a growing number and increasing prominence of banking groups with significant cross-border activities, which hold a considerable share of total EU banking assets. A third set of developments relates to financial innovation, which has involved the rapid growth of new and complex financial instruments for transferring risk and of structured credit markets. In turn, this has fostered the activities of non-bank intermediaries, many of which are highly leveraged and mostly unregulated. These developments have facilitated the transfer and redistribution of risks across the financial system, thus increasing its efficiency and potentially its resilience to shocks. At the same time, as the recent developments in financial markets have shown, the growing complexity of financial instruments and the opacity of exposures of financial institutions can give rise to increased uncertainty regarding the risk involved, the ultimate bearer of risk and the extent of potential losses.

These developments involve a number of challenges to the financial stability arrangements. In particular, given the increasing interlinkages across EU countries between markets, market infrastructures and institutions in the EU financial system, potential disturbances may propagate across Member States. The EU arrangements for financial stability should thus be in place to allow authorities and market participants to effectively detect the risks to the stability of the EU financial system as a whole and to handle any financial crisis with a cross-border dimension in an efficient manner.

Against this background, there are a number of policy initiatives at the EU level, some pre-dating the financial market turbulence, to refine and reinforce over the medium term the ability to cope more effectively with such challenges. These initiatives include the strengthening of the financial crisis management arrangements, in line with the strategic roadmap adopted by the ECOFIN Council in October last year, and the enhancement of the Lamfalussy framework for financial regulation and supervision, as agreed by the ECOFIN Council.

1 For an overview, see the report on “Financial integration in Europe”, ECB, March 2008.
last December. In addition, a list of actions was endorsed by the ECOFIN Council in October 2007 with a view to addressing challenges following the recent financial market turbulence. These actions may have a long-term positive impact on the further strengthening of the EU financial stability arrangements.

This article aims to provide an overview of the main policy initiatives under way and is composed of two main parts. The first one focuses on the review of the Lamfalussy framework for financial regulation and supervision, and describes the main elements of the individual assessments carried out by the Inter-Institutional Monitoring Group (IIMG), the European Commission and the Eurosystem, and the decision taken by the ECOFIN Council in December 2007. The second part addresses the initiatives for strengthening the EU institutional framework for financial stability, in particular in the field of crisis management, through the adoption of a strategic roadmap by the ECOFIN Council.

2 THE REVIEW OF THE LAMFALUSSY FRAMEWORK FOR FINANCIAL REGULATION AND SUPERVISION

Since the extension of the Lamfalussy framework in 2004 to the banking and insurance sectors, EU institutions have devoted considerable attention to the effective implementation and operation of this framework. This is in order to ensure that it remains capable of meeting current and future challenges and delivers the degree of supervisory convergence and smooth cooperation between competent authorities required by a single market for financial services.

In 2007, the functioning of the Lamfalussy framework across financial sectors was subject to a full review, which led to the adoption by the ECOFIN Council on 4 December 2007 of some recommendations for improvement. In formulating its assessment, the Council took into account earlier evaluations of the Lamfalussy framework expressed by various EU institutions and fora, and in particular by the IIMG, the Commission and the Eurosystem.  

2.1 CONTRIBUTIONS TO THE REVIEW OF THE LAMFALUSSY FRAMEWORK

THE IIMG REPORT

The IIMG was re-established in 2005, following the extension of the Lamfalussy framework, with a mandate from the European institutions to assess the progress made in implementing the Lamfalussy process to secure a more effective regulatory and supervisory system for financial services and to identify any possible emerging bottlenecks in this process.

After a broad consultation process, the IIMG published its final report on 15 October 2007, which provided a general assessment of the Lamfalussy framework and an evaluation of its

2 The Lamfalussy process is composed of four levels. At Level 1, the basic principles of the legislation are laid down via the normal legislative process: a co-decision procedure involving the European Parliament and the EU Council, acting on a proposal of the European Commission. At Level 2, measures for the implementation of Level 1 legislation are adopted and amended via fast-track procedures. Level 3 relates to the work of the Level 3 Committees composed of supervisors to strengthen supervisory convergence and cooperation. Level 4 relates to Commission measures to strengthen the enforcement of EU law, underpinned by enhanced cooperation between Member States, their regulatory bodies and the private sector.

3 In 2001 the European Council decided to introduce the Lamfalussy framework in the securities sector. The aim was to adopt a procedure for the regulation of securities markets, notably with respect to the adoption and implementation of the Financial Services Action Plan (FSAP), which was sufficiently flexible to respond to market developments and regulatory standards, and to create conditions for smooth decision-making so as to ensure the EU’s competitiveness in the securities area while respecting the requirements of transparency, legal certainty and institutional balance. The framework was then extended to the insurance and banking sector in 2004 with the establishment of new Committees by Commission decisions. See for further details the article entitled “Developments in the EU framework for financial regulation, supervision and stability” published in the October 2004 issue of the Monthly Bulletin.

4 The review was required by Directive 2005/1/EC of 9 March 2005, which extended the Lamfalussy framework to the banking and insurance sectors.

5 The European Parliament’s “Report on financial services policy (2005-2010)”, published in June 2007, should be mentioned as well as specific contributions provided by the Level 3 Committees.

6 The first IIMG, limited to securities markets, was set up in October 2002 to assess the framework.

7 In March 2006 and January 2007 the IIMG published its first and second interim reports for public consultation. All the reports are available at http://ec.europa.eu/internal_market/finances/committees/index_en.htm.
ability to deliver results, and proposed certain recommendations for the improvement of the process. The IIMG considered that the Lamfalussy process had significantly contributed to the integration of European financial markets and made some suggestions for possible improvements as regards both the adoption of regulations and their enforcement, which relate to Levels 1, 2 and 4 of the Lamfalussy framework. The IIMG addressed in particular the role of Level 3 Committees as a platform for the coordination of supervision and regulation, which should aim at achieving the following objectives: (i) contributing to the full and high quality implementation of the EU legislation; (ii) enhancing supervisory convergence and cooperation; (iii) improving the supervision on a cross-border basis of banking groups; and (iv) facilitating market infrastructure oversight.

In this respect, the IIMG stressed that the Level 3 Committees need to be appropriately equipped to fulfil such objectives and made a number of suggestions to improve their functioning in terms of enhancing their accountability and the effectiveness of their decision-making. First, the mandate and work programme of Level 3 Committees should be endorsed by the EU Council, the European Parliament and the Commission. At the Member State level, national supervisory bodies should have mission statements that require them to cooperate at the EU level and to take into account the European interest and the importance of strengthening an effective European Single Market. Second, the Level 3 Committees’ political accountability in relation to the EU institutions should be strengthened. Second, while the decisions taken by the Level 3 Committees should remain not legally binding, compliance with them by national supervisory authorities should be strengthened. Third, the current legal basis of the Level 3 Committees provided by Commission decisions might need to be reviewed in order to better reflect the committees’ tasks and functions. Lastly, the Level 3 Committees’ internal decision-making procedures should be improved and, subject to possible safeguards, allow for qualified majority voting on all decisions.

**THE COMMISSION’S COMMUNICATION ON THE REVIEW OF THE LAMFALUSY FRAMEWORK**

Drawing also on the aforementioned recommendations by the IIMG, the Commission presented in a communication (published on 20 November 2007) a number of practical proposals to enhance the Lamfalussy structure and in particular improve the functioning of the Level 3 Committees, in order to strengthen supervisory convergence and cooperation. The Commission’s proposals comprised the following enhancements. First, the Level 3 Committees’ political accountability in relation to the EU institutions should be strengthened. Second, while the decisions taken by the Level 3 Committees should remain not legally binding, compliance with them by national supervisory authorities should be strengthened. Third, the current legal basis of the Level 3 Committees provided by Commission decisions might need to be reviewed in order to better reflect the committees’ tasks and functions. Lastly, the Level 3 Committees’ internal decision-making procedures should be improved and, subject to possible safeguards, allow for qualified majority voting on all decisions.

**THE EUROSYSTEM’S CONTRIBUTION**

The Eurosystem confirmed its broad support for the Lamfalussy framework in its published contribution to the Lamfalussy review carried out in the last quarter of 2007. In particular, the Eurosystem considered that the Lamfalussy framework provides the appropriate regulatory

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8 The Level 3 Committees, composed of representatives of national supervisory authorities, were established on the basis of the following decisions by the Commission: Decision 2004/5/EC establishing the Committee of European Banking Supervisors (CEBS – located in London); Decision 2004/6/EC establishing the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS – located in Frankfurt); and Decision 2004/7/EC establishing the Committee of European Securities Regulators (CESR – located in Paris).


10 “Eurosystem contribution to the review of the Lamfalussy framework”, published on 30 November 2007 on the ECB’s website. The support for the Lamfalussy framework was expressed in previous public statements: “Review of the application of the Lamfalussy framework to EU securities markets legislation”, Eurosystem contribution to the Commission’s public consultation, 17 February 2005; “Green Paper on Financial Services Policy (2005-2010)”, Eurosystem contribution to the Commission’s public consultation, 1 August 2005 (also available on the ECB’s website).
and supervisory setting to support the stability, integration and competitiveness of the EU financial sector and supported a number of measures to further strengthen the Lamfalussy framework, in terms of fostering regulatory convergence (at the Level 1 and 2) and the efficient functioning of Level 3 Committees to reach the aim of improved supervisory convergence (see further details below).

2.2 THE MAIN CONCLUSIONS OF THE REVIEW OF THE LAMFALUSSY FRAMEWORK

On 4 December 2007, the ECOFIN Council assessed the experience to date with the Lamfalussy framework as broadly positive, on the basis of the contributions provided by the EU institutions, the IIMG and the Level 3 Committees. In particular, there was broad agreement that the Lamfalussy approach had significantly increased the efficiency and effectiveness of the EU regulatory and supervisory framework, as well as the quality of the legislative process in accordance with the “better regulation” goals, namely through improved consultation, transparency and impact analysis. Accordingly, the Lamfalussy framework is widely supported by stakeholders. Nevertheless, the Council considered that, without changing the inter-institutional balance between the European Parliament, the Council and the Commission, further improvements should be introduced at all levels of the framework.

More specifically, recommendations were endorsed concerning: (a) the arrangements for regulation (Levels 1 and 2 of the Lamfalussy framework); and (b) the institutional setting of the Level 3 Committees. The main decisions taken by the ECOFIN Council as regards each of these aspects of the Lamfalussy framework are briefly assessed below, in the light of the Eurosystem’s contribution.

THE ARRANGEMENTS FOR REGULATION (LEVELS 1 AND 2 OF THE LAMFALUSSY FRAMEWORK)

As regards Level 1, the ECOFIN Council indicated a number of measures to limit the use of national options and discretion in EU directives and in implementing legislation as supported also by the Eurosystem.

An additional aspect highlighted by the Eurosystem’s contribution concerned the need to ensure a clear distinction between Level 1 and Level 2 legislation as a key feature of the Lamfalussy process in terms of fostering regulatory convergence: Level 1 rules should be limited as much as possible to legislative framework principles, while the technical aspects should be specified in Level 2 measures, which can be quickly modified through more flexible legislative procedures. However, so far the distinction between Level 1 and Level 2 has been implemented only to a very limited degree in the banking sector. More specifically, the Eurosystem noted that the Capital Requirements Directive (CRD) was a missed opportunity to revise the EU capital requirements in line with the Lamfalussy framework, as it has only a limited number of provisions which can be adjusted via comitology procedures. In the medium term, there should be an assessment of the need to restructure the CRD and other

11 According to the Council conclusions, the Council “(…) NOTES that the main responsibility for limiting the number of options and discretions in the EU Directives, and thus creating the necessary preconditions for further supervisory convergence, is with the legislator (the Council and the European Parliament), and UNDERTAKES to limit the use of national discretions and “gold-plating” to the minimum extent necessary, given the specificities of national markets and INVITES the European Parliament to join in this effort; – INVITES Member States to keep under review the options and discretions implemented in their national legislation, limit their use (wherever possible) and report to the Commission on these findings, and INVITES the Institutions to introduce a “review clause” in future EU legislation on all options and discretions included in the respective acts. When this review clause comes into effect after a specified time, the necessity and use of the options and discretions should be reviewed and, where necessary, abolished where there is no demonstrated need; (…)”.

banking acts in line with the spirit of the Lamfalussy framework on the basis of an effective cost-benefit analysis.

THE INSTITUTIONAL SETTING OF THE LEVEL 3 COMMITTEES

The Eurosystem, as well as the other contributions to the Lamfalussy review, supported a further enhancement of the institutional setting and functioning of the Level 3 Committees. More specifically, the contributions similarly highlighted possible improvements on some critical features of the Level 3 Committees, as regards the legal basis, accountability and decision-making.

First, the legal basis of Level 3 committees for activities promoting supervisory convergence and cooperation should be further clarified. For instance, the CEBS role of giving advice to the Commission to enact Level 2 rules is clearly underlined in the Commission’s decision establishing the CEBS and in the respective EU banking legislation. There is, however, no clear legal basis as regards the CEBS’s role in the Level 3 activities promoting supervisory convergence and cooperation, for which it works as a network of national supervisors. The Eurosystem noted that a clarification of the EU legal basis of the CEBS (for instance through a legal text adopted by the Council and the European Parliament) would certainly underscore the importance of the work of the CEBS and facilitate the introduction of respective references in relevant Level 1 rules.

On this issue, the ECOFIN Council asked the Commission to undertake further analysis “to clarify the role of the Level 3 Committees and consider all different options to strengthen the working of these committees, without unbalancing the current institutional structure or reducing the accountability of supervisors”.

Second, the accountability of the Level 3 Committees and their members would be enhanced by the specification of the objectives to be achieved by these committees and the reporting to EU bodies of periodic work programmes for comments and high-level political guidance, with due respect for their operational independence. In addition, a reference to a requirement to foster EU convergence and cooperation could be introduced in the national mission statements of supervisors.

These proposals were endorsed by the ECOFIN Council, which invited the Level 3 Committees to report annually to the Commission, the Council and the European Parliament as regards their draft work programmes (so as to allow them to express their view on the key priorities) and on the achievement of their objectives. Moreover, the ECOFIN Council mandated the Financial Services Committee and the Economic Financial Committee to examine further the possibility of including in the mandates of national supervisors, as an explicit task, to cooperate within the EU to work towards European supervisory convergence, and to take into account the financial stability concerns in all Member States.

Third, the committees’ decision-making process could be improved with the introduction of majority voting with a view to fostering further progress in the convergence of supervisory requirements. The ECOFIN Council mandated the Level 3 Committees to introduce, where necessary, in their charters the possibility to apply qualified majority voting, with the obligations for those who do not comply to explain their decisions publicly.

The decisions made by the ECOFIN Council confirm the central importance of the Lamfalussy approach to reach the shared objectives of strengthening supervisory convergence and cooperation. Work has already been started by the Commission and the Level 3 Committees to implement the pertinent political decisions. The ECB is contributing to such follow-up work, with the firm belief that the political reflections made last year as regards the review of the Lamfalussy arrangements should now be accompanied by concrete actions, which will ensure further progress in convergence and cooperation in day-to-day supervisory processes with particular regard to cross-border financial institutions.
3 THE EU FINANCIAL STABILITY ARRANGEMENTS

3.1 OVERVIEW

The institutional framework for safeguarding financial stability comprises the arrangements that are necessary for the financial system to cope with disturbances, which may impair its smooth functioning. This framework is based on three major components: crisis prevention, crisis management and crisis resolution. Crisis prevention relates to the performance of the functions of supervisory authorities, which undertake the surveillance of the safety and soundness of financial institutions, and of central banks, which conduct financial stability monitoring and assessment relying on macro-prudential analysis. Crisis management can be defined as the set of tools that public authorities may deploy if a disturbance occurs in the financial markets. Supervisors may, for instance, take measures regarding the management of a financial institution, require additional capital from shareholders, or impose reorganisation measures. Central banks may take actions aiming at restoring normal liquidity conditions in money markets or at ensuring the smooth operation of market infrastructures. Finally, crisis resolution relates to the arrangements aiming at an orderly handling of a financial institution facing solvency problems and the protection of the rights of creditors, notably depositors. Table 1 below provides a broad overview of the EU financial stability arrangements.

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<td>Deposit guarantee schemes</td>
<td>Bilateral relationships between the competent authorities of Member States</td>
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1) Colleges of Supervisors are permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border banking groups ("College"). See “Range of practices on supervisory colleges and home-host cooperation” by the CEBS of 27 December 2007.
There is a close interrelationship between these three components of the financial stability framework. The effectiveness of crisis management and resolution largely depends on the existence of an efficient supervisory and central banking framework able to identify and react at an early stage to potential threats to financial stability. Conversely, the effectiveness of supervisory action depends also on the existence of appropriate arrangements to support an orderly exit from the market by insolvent institutions. The possibility that financial institutions can exit the market if they are affected severely by a crisis provides a powerful incentive for them to optimise risk management and draw up proper business plans.

At the EU level, the arrangements for safeguarding financial stability have to address the particular cross-border challenges raised by the development of the single financial market. This requires, in particular, smooth and efficient cross-border interplay among the set of authorities involved in crisis prevention, management and resolution. In this context, the EU arrangements for crisis prevention are based on a developed prudential and supervisory framework, largely harmonised by EU legislation, and supported by the activities of the Level 3 Committees, as described in the previous sections.

The arrangements and tools for crisis management and resolution should be based on an efficient framework that maintains the necessary degree of flexibility to cope with a financial crisis. Given the unique nature of a potential financial crisis, and due to institutional factors specific to each Member State, such as insolvency laws, authorities require a higher degree of flexibility than in crisis prevention in the deployment of the necessary policy actions to address financial disturbances. Accordingly, the emphasis on crisis management and resolution arrangements at the EU level has focused on the development of information-sharing and cooperation procedures among EU supervisory authorities, central banks and finance ministries. In this context, these authorities adopted in May 2005 a Memorandum of Understanding (MoU) on cooperation in financial crisis situations, which consists of a set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance of their respective policy functions and preserve the overall stability of the financial systems of Member States and of the EU as a whole.\(^\text{13}\)

Against this background, the effectiveness of crisis management and resolution arrangements at the EU level depends on the efficiency with which authorities share information and cooperate on a cross-border basis. Such effectiveness has been tested in several financial crisis simulation exercises, the last of which was the EU-wide simulation exercise carried out by the Economic and Financial Committee (EFC) in April 2006. This exercise, while confirming the adequacy of existing arrangements, suggested a number of areas for further enhancement.\(^\text{14}\)

This provided the basis for a number of policy initiatives at the EU level to strengthen the EU arrangements for financial stability, which are addressed in the following sections.

### 3.2 A STRATEGIC ROADMAP FOR STRENGTHENING THE EU ARRANGEMENTS FOR FINANCIAL STABILITY

In September 2006, an ad hoc working group of the EFC was mandated to explore ways to further develop financial stability arrangements in the EU, on the basis of the useful insights provided by the EU-wide financial crisis simulation exercise of April 2006. Building on the existing, largely national responsibilities and focusing on reinforcing the EU mechanisms for cross-border cooperation, the ad hoc working group identified a number of actions to ensure consistency between the arrangements for crisis management and resolution, on the one hand, and the arrangements for crisis prevention, on the other. The recommendations proposed by the ad hoc

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\(^\text{14}\) This exercise was organised by the Economic and Financial Committee with the aim of testing the Memorandum of Understanding on cooperation in financial crisis situations among banking supervisors, central banks and finance ministries. For more details, see the ECB’s Annual Report 2006, pp. 138-139.
working group were approved by the EFC in September 2007, and subsequently endorsed by the ECOFIN Council in October 2007 as part of a strategic roadmap for strengthening the arrangements for financial stability at both the EU and national levels.\textsuperscript{15} The strategic roadmap comprises the following measures.

**MEMORANDUM OF UNDERSTANDING ON CRISIS MANAGEMENT**

The first measure consists of the preparation of a new EU MoU on cooperation among EU supervisory authorities, central banks and finance ministries. This MoU should build on the previous agreement of 2005 – as described above – and should include three main components. First, there should be a set of common principles at the EU level for cross-border financial crisis management. The second component is a common analytical framework for the assessment of the systemic implications of a potential crisis which has been developed by the ESCB Banking Supervision Committee (BSC) in cooperation with the CEBS. This framework provides common terminology regarding the assessment of a cross-border systemic crisis. The third component consists of common practical guidelines for crisis management, which should reflect a common understanding of the steps and procedures that need to be taken and followed in a cross-border crisis situation.

**EU COMMON PRINCIPLES FOR FINANCIAL CRISIS MANAGEMENT**

In order to provide a consistent and sound basis for addressing a financial crisis in the EU, the ECOFIN Council adopted a set of nine common principles to be followed by the Member States in the management of any cross-border financial crisis which involves at least one banking group which: (i) has substantial cross-border activities; (ii) is facing severe problems which are expected to trigger systemic effects in at least one Member State; and (iii) is assessed to be at risk of becoming insolvent.

The common principles highlight the consensus of Member States on the fundamental basis for safeguarding the stability of the financial system both at the domestic and at the EU level. Three main elements may be highlighted. First, cross-border crisis management is a matter of common interest to Member States. Second, private sector solutions should be given primacy in the resolution of a crisis. Third, if public resources are used, the direct budgetary costs will be shared among affected Member States on the basis of equitable and balanced criteria, including the economic impact of the crisis and the framework of home and host countries’ supervisory powers. Accordingly, these common principles will be formalised in the new EU MoU (see the box below).

\textsuperscript{15} Luxembourg ECOFIN Council conclusions on “Enhancing the arrangements for financial stability in the EU”.

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**Box**

**COMMON PRINCIPLES FOR CROSS-BORDER FINANCIAL CRISIS MANAGEMENT, AS ADOPTED BY THE ECOFIN COUNCIL IN OCTOBER 2007**

1. The objective of crisis management is to protect the stability of the financial system in all countries involved and in the EU as a whole and to minimise potential harmful economic impacts at the lowest overall collective cost. The objective is not to prevent bank failures.
2. In a crisis situation, primacy will always be given to private sector solutions which as far as possible will build on the financial situation of a banking group as a whole. The management of an ailing institution will be held accountable, shareholders will not be bailed out and creditors and uninsured depositors should expect to face losses.

3. The use of public money to resolve a crisis can never be taken for granted and will only be considered to remedy a serious disturbance in the economy and when overall social benefits are assessed to exceed the cost of recapitalisation at public expense. The circumstances and the timing of a possible public intervention can not be set in advance. Strict and uniform conditions shall be applied to any use of public money.

4. Managing a cross-border crisis is a matter of common interest for all Member States affected. Where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. If public resources are involved, direct budgetary net costs are shared among affected Member States on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries’ supervisory powers.

5. Arrangements and tools for cross-border crisis management will be designed flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries. Competent authorities in the Member States affected by a crisis should be in a position to promptly assess the systemic nature of the crisis and its cross-border implications based on common terminology and a common analytical framework.

6. Arrangements for crisis management and crisis resolution will be consistent with the arrangements for supervision and crisis prevention. This consistency particularly refers to the division of responsibilities between authorities and the coordinating role of home country supervisory authorities.

7. Full participation in management and resolution of a crisis will be ensured at an early stage for those Member States that may be affected through individual institutions or infrastructures, taking into account that quick actions may be needed to solve the crisis.

8. Policy actions in the context of crisis management will preserve a level playing field. Especially, any public intervention must comply with EU competition and state-aid rules.

9. The global dimension will be taken into account in financial stability arrangements whenever necessary. Authorities from third countries will be involved where appropriate.

A COMMON ANALYTICAL FRAMEWORK FOR THE ASSESSMENT OF SYSTEMIC IMPLICATIONS

The second component of the new EU MoU is the analytical framework developed by the BSC and the CEBS in 2007, which aims at providing a common language for discussions among authorities in Member States affected by a cross-border financial crisis. This would support the fulfilment of two main objectives.

First, it should allow authorities in different Member States to address more clearly any differences in their views on the impact of the crisis on their domestic financial systems and...
real economies. In this context, a common language does not imply a common assessment among authorities.

The analytical framework developed by the BSC and the CEBS does not provide a single, uniform measure of the systemic impact of a financial crisis. Instead, it calls for separate assessments of the impact on financial institutions, financial markets, financial infrastructure and the real economy. Each of these components should be considered with regard to the extent of the systemic impact of the crisis, taking into account both the critical importance of the component’s affected parts and the extent of their disturbance. A number of indicators are included in the framework to support the authorities’ assessment.

The second objective is, at the same time, to reduce the risk that under the pressure of circumstances authorities might take measures that put public money at risk before assessing the potential impact of the crisis. Accordingly, such a framework supports the basic principle that in order to resolve a financial crisis, primacy should always be given to private sector solutions.

In accordance with the time frame set by the ECOFIN Council, this analytical framework should be used by the authorities in the various Member States by the end of 2008.

**COMMON PRACTICAL GUIDELINES FOR CRISIS MANAGEMENT**

The third component of the EU MoU consists of common practical guidelines for crisis management, which will be developed in order to reflect a common understanding of the steps and procedures that need to be taken and followed in a cross-border crisis situation. These practical guidelines may cover elements such as the operational procedures for information-sharing among authorities, the conduct of systemic assessments, the coordination of decision-making, the handling of communication with the public, and the related allocation of tasks among the authorities involved in the management of a financial crisis.

**VOLUNTARY SPECIFIC COOPERATION AGREEMENTS BETWEEN RELEVANT AUTHORITIES**

In addition to the extended EU-wide MoU, the ECOFIN Council indicated other mechanisms to support cross-border cooperation among the authorities of the Member States that may be affected by a crisis. In particular, the ECOFIN Council encourages the authorities in different Member States that share financial stability concerns to start developing, as soon as possible, voluntary cooperation agreements consistent with the new EU-wide MoU and building on cross-border supervisory arrangements for crisis prevention. These agreements would focus on detailed principles and procedures, taking into account particular needs of crisis management in a specific cross-border context.

**3.3 OTHER INITIATIVES IN THE STRATEGIC ROADMAP**

In the framework of the measures listed in the strategic roadmap adopted by the ECOFIN Council, the Commission has been invited, in close cooperation with the Member States, to examine possible enhancements, and where necessary propose regulatory changes with regard to cooperation obligations and tools to manage a cross-border crisis, as follows.

**REVIEW OF THE CAPITAL REQUIREMENTS DIRECTIVE**

With the purpose of clarifying the nature and the extent of the legal obligations relating to the exchange of information and cooperation in crisis situations, the Commission has been examining, in close cooperation with Member States, possible amendments to the Capital Requirements Directive. More specifically, the objective of a possible revision of the legal framework is to: (i) clarify the existing obligations of supervisory authorities, central banks and finance ministries to exchange information and to cooperate in a crisis situation; (ii) increase the information rights and involvement of host countries; (iii) clarify
the role of the consolidating supervisors and facilitate the timely involvement of relevant parties in a crisis situation; and (iv) examine whether, to this end, legislative changes are necessary, including reinforcing the legal requirements for supervisory collaboration and information-sharing.

In accordance with the strategic roadmap, the relevant proposals by the Commission should be finalised by the end of 2008, while the adoption of the proposals of new legislation by the Council and the European Parliament should take place by the end of 2009.

**ENHANCING TOOLS TO MANAGE A CROSS-BORDER CRISIS**

In order to improve the availability, as well as the cross-border functionality, of tools specifically designed to manage a crisis or to facilitate private sector solutions with a view to minimising economic and social costs, the Commission has been analysing possible enhancements, and, where necessary, proposing regulatory changes in several fields.

The first field is the transfer of assets within a banking group. Since the subsidiaries of a banking group are separate legal entities subject to the legislation of the Member State in which they are established, national laws may hinder the transfer of assets between them for the purpose of protecting creditors and depositors. In the event of a financial crisis, such obstacles may generate difficulties relating to the transfer of assets to the components of the banking group where they are required, for instance, for the purpose of participating in monetary policy operations. In this context, the Commission has been requested to perform a feasibility study on reducing barriers to cross-border asset transferability, while introducing appropriate safeguards within banking, insolvency and company law, taking into account that the reallocation of assets in a crisis affects the ability of stakeholders in different legal entities to pursue claims. The overall objective is to reinforce the primacy of private sector solutions, avoid counterproductive ring-fencing of assets, and facilitate the smooth management of a crisis.

The second field is that of deposit guarantee schemes. Overall, although there is a degree of harmonisation through the EU Deposit Guarantee Schemes Directive, the features of deposit guarantee schemes vary across Member States, which may hinder their interoperability in the case of cross-border financial crises. In this context, the Commission is requested to clarify the scope of the application of this directive relating to the tasks of deposit guarantee schemes, the arrangements for compensating the schemes of the Member States where branches are established (the so-called “topping-up” arrangements), the information exchange among schemes, the possibility to reduce delays in compensating depositors, and the means to improve depositor information. The Commission is expected to report back by March 2009.

The third field is public financial support. In some cases, such support may be needed to rescue a bank whose failure would have a significant economic impact and could lead to a cross-border crisis. In this context, the Commission has been requested to work towards clarifying when a banking crisis could be considered as “a serious disturbance for the economy” under the Treaty and state aid rules. In addition, the Commission has been invited to consider streamlining procedures, focusing on how state aid enquiries under critical circumstances can be treated rapidly, given the requirement to handle a crisis quickly and effectively.

Lastly, the Commission has been requested to assess the possible extension of the scope of the present EU directive on the reorganisation and winding-up of credit institutions to include subsidiaries, with the objective of increasing the efficiency in the reorganisation and winding-up of cross-border banking groups taking due consideration of the interests of all stakeholders concerned. This directive ensures that a credit institution is treated as one entity and its assets are included in a single process, ruling out the conduct of secondary proceedings. However, the directive does not cover subsidiaries, thus the reorganisation or the
winding-up of a cross-border banking group necessarily involves various national regimes. Hence, a revision of the current directive could cover subsidiaries by providing joint insolvency proceedings. The Commission launched a public consultation on this directive in October 2007 and is expected to release the results of its feasibility study by end-2008.

4 RESPONSES TO THE RECENT FINANCIAL MARKET TURMOIL

Since the start of the financial market turmoil in August 2007, reflections have been set in motion to reach a common understanding on the determinants of the disturbance, to draw policy lessons and take measures necessary to avoid recurrence of a similar disruption. In this respect, initiatives are under way both at the European and international levels.

At the EU level, the ECOFIN Council\(^\text{16}\) agreed on a list of actions that needed to be undertaken by 2008 at the latest. The main areas of work are aimed at: (i) enhancing transparency; (ii) improving valuation processes, in particular for complex or illiquid financial instruments; (iii) strengthening market functioning, in particular by reviewing the role of credit rating agencies, the due diligence process of investors and the underpinnings of the “originate and distribute” banking model; and (iv) improving the prudential framework and banks' risk management. In this respect, the full implementation of the Basel II framework, by introducing more risk-sensitive rules and comprehensive provisions on disclosure, will contribute to improving the regulatory setting. But additional important work is necessary in other areas, for example on liquidity risk management, concentration risk and securitisation. The Commission is expected to come forward with amendments to the Capital Requirements Directive in the autumn.

Parallel to this work, wider international cooperation to address these issues is also advancing at the global level, namely under the aegis of the Financial Stability Forum (FSF)\(^\text{17}\), which is preparing a report with specific recommendations for the April 2008 meeting of the G7 finance ministers and central bank governors. In its interim report, published in February 2008, the FSF sets out six areas where improvements are warranted in order to strengthen the resilience of the financial system: (i) the supervisory framework and oversight, including the implementation of possible refinements to the Basel II framework, as well as the strengthening of banks’ liquidity risk management and stress-testing techniques; (ii) the underpinnings of the “originate and distribute” banking model, in particular ensuring that an appropriate incentive structure is put in place; (iii) the uses and role of credit ratings, namely reviewing methodologies and excessive reliance on ratings as well as addressing potential conflicts of interest; (iv) market transparency, providing enhanced disclosures of structured products and off-balance-sheet vehicles and improving valuation methodologies, in particular when markets are illiquid; (v) supervisory and regulatory responsiveness to risks, calling for enhanced cooperation and exchange of information both at national and international levels and coordination between the supervision of individual institutions and the broader view arising from central banks’ financial stability analysis; and finally (vi) authorities’ ability to respond to crises, entailing the review by central banks of their operational frameworks including an examination of the scope for greater consistency in eligible collateral policies, and the need for authorities to strengthen, where appropriate, their arrangements for dealing with ailing banks both nationally and across borders.

\(^{17}\) The FSF comprises high-level representatives of national ministries of finance, central banks and supervisory authorities and international institutions and forums, namely: the BIS, the IMF, the ECB, the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS), the Joint Forum and the International Accounting Standards Board (IASB).
The ECB strongly supports the initiatives taken by the ECOFIN Council and the FSF, in particular concerning the key areas for policy consideration, and is contributing to the pertinent work. In this context, the ECB considers that existing arrangements for information-sharing among authorities, including between supervisory authorities and central banks, could be further developed and enhanced. In particular, a more effective interplay between the monitoring and assessment of the stability of the financial system as a whole, performed by central banks, and the supervision of individual institutions, carried out by supervisory authorities, should be ensured.

5 CONCLUSION

The significant changes that have occurred in the financial markets over the past decade, the progress in financial integration and the emergence of cross-border banking groups with significant activities in a number of EU countries call for continuous efforts to ensure an efficient regulatory and supervisory framework that promotes financial integration and does not impose an undue regulatory burden on financial groups. At the same time, it is important for the competent authorities to ensure that the EU arrangements for crisis prevention and management are able to safeguard financial stability in an effective way. In that context, the policy decisions adopted at the EU level at the end of 2007, as regards the review of the Lamfalussy framework and the further strengthening of EU financial stability arrangements, are important steps. In addition, the experience with the recent financial market turmoil provides an opportunity to refine the arrangements for financial stability in a number of policy areas.