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Report on financial crisis management

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REPORT ON FINANCIAL CRISIS MANAGEMENT

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ECONOMIC AND FINANCIAL COMMITTEE

REPORT ON FINANCIAL CRISIS MANAGEMENT

1 INTRODUCTION

At the Informal Ecofin Council of April 2000, ministers and governors discussed the EFC's report on financial stability issues.¹ The report concluded that the existing regulatory and supervisory arrangements in Europe provide a coherent and flexible basis for safeguarding financial stability, but recommended that their practical functioning needs enhancement. The EFC agreed that the implementation of the recommendations should be kept under review.

The present EFC report discusses crisis management - a topic that had only been touched on in the Spring 2000 document - and was prepared by an ad hoc working group (see Annex). More specifically, this report takes stock of the institutional framework for crisis management in the European Union, and checks the appropriateness of the current arrangements.

Chapter 2 provides an overview of the progress made in implementing the recommendations of the Spring 2000 report on financial stability. The subsequent chapters deal with the issue of financial crisis management. After delineating this topic (chapter 3), the various stages of crisis management are outlined (chapter 4), followed by policy options from which the authorities may choose to address financial crises (chapter 5). Finally, chapter 6 provides the main conclusions of the report and policy recommendations.

¹ Report on Financial Stability (ref. EFC/ECFIN/240/00-EN-Final, 8 April 2000), also published as Economic Paper nr. 143 of the European Commission, May 2000.

2 PROGRESS REPORT

2.1 Introduction

The Banking Advisory Committee (BAC), the Banking Supervision Committee (BSC), the Groupe de Contact (GdC) and the Mixed Technical Group (MTG) were requested to specify to what extent they have implemented the recommendations of the Spring 2000 report. The responses indicate that substantial progress is being made, as described in the following section (the recommendations are presented in italics).

2.2 Implementation of recommendations

1 Strengthening the cross-sector co-operation at the international level, since the present supervisory arrangements are primarily designed to enhance cross-border co-operation. Within the EU, an important development is that the European Commission has facilitated a round table discussion among the chairs of the supervisory committees of the different disciplines. International cross-sector co-operation could be further improved by clarifying and extending the concept of co-ordinating supervisor(s) for large financial groups domiciled in Europe.

In the Cross-Sectoral Roundtable of Regulators, the BAC, the BSC, the GdC, the Insurance Committee (IC), the Conference of Insurance Supervisory Authorities, the Forum of European Securities Commissions and the High Level Securities Supervisors Committee (HLSSC) are represented. The Roundtable is an informal grouping with the objective of promoting information exchange among supervisors across sectors. Members meet regularly and consider participation in the Roundtable an important way to strengthen cross-sector co-operation on issues of common interest at the European level.

As far as supervisory co-ordination is concerned, it may be noted that for banking, securities or insurance firms, the identification of the co-ordinating supervisor is relatively straightforward. In the case of banking groups, for instance, the supervisor who exercises consolidated supervision can be considered to be the co-ordinator. For financial conglomerates, the Commission has produced a working text – based on the recommendations prepared by the MTG, which was set

up for this purpose in October 1999 – for an EU directive.² The draft directive provides for the mandatory appointment of one or more co-ordinator(s) for any financial conglomerate that falls within the scope of the directive. The co-ordinator(s) will have three core tasks: (1) assessing capital adequacy and the group's structure; (2) gathering and disseminating information; and (3) planning supervisory activities. The draft directive requires the conclusion of clear co-ordination arrangements that lay down the specific tasks of the co-ordinator(s) for each financial conglomerate. The Commission is committed to presenting its proposals in April 2001. The EFC emphasises the importance of this draft EU directive (see also number 2 of this section).

2 Making the exchange of information among different supervisory authorities, and between supervisory authorities and central banks, on the major financial institutions and market trends a key feature of the strengthened co-operation between the authorities involved. In this respect, the BSC and the GdC can be expected to work in close collaboration. Furthermore, it is important that the ministries of finance and supervisory authorities regularly exchange views on the adequacy and necessary adjustments of financial regulation in a national context as well as in the context of the BAC, the IC and the HLSSC.

For the exchange of information on banking supervisory matters, a comprehensive legal framework is in place in the EU and its Member States, which is complemented by bilateral agreements between the national supervisory authorities (Memoranda of Understanding, MoUs). On this basis, information can be, and indeed is, exchanged in order to allow for the on-going prudential supervision of banks undertaking cross-border operations, especially through branches, whenever this is required. Information can also be shared among banking supervisors in the GdC, particularly on problems concerning individual credit institutions. The BSC serves, too, as a forum for supervisors to exchange information, and provides for co-operation and information sharing between supervisors and central banks. Both fora may provide a network for communication in crisis situations; the BSC is also developing a logistical infrastructure for this purpose.

Similarly, the cross-sector exchange of information has been arranged in both sectoral directives and national regulations. The former have been analysed in the context of the work on the draft

² Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (hereinafter referred to as directive on financial conglomerates).

directive on financial conglomerates. Subsequently, the draft directive proposes, among other things, to oblige Member States to ensure appropriate access by supervisors to information within a conglomerate. The draft directive also provides for the obligation for the competent authorities responsible for the supervision of regulated entities in a financial conglomerate - whether or not established in the same Member State - to co-operate closely and to provide one another and/or the co-ordinator with relevant information. This underscores the importance of the work of the MTG on the draft directive on financial conglomerates.

With respect to the flow of information between supervisors and central banks, a recent fact-finding exercise by the BSC concluded that there are no legal obstacles to information flows at the national level. In most cases, national laws also allow for cross-border information sharing, although certain supervisory authorities do not consider themselves as being entitled to share information on major financial institutions on a regular basis in a multilateral context solely for the purpose of monitoring systemic stability. (Regarding the follow-up to the recommendation with respect to a regular exchange of views on financial regulation, see number 4 of this section).

3 Strengthening the co-operation between supervisors and central banks, with a view to ensuring that, if the emergence of financial problems at a major group may have contagion effects in other EU countries, this is reported to the relevant authorities of the countries concerned.

In the BSC, all EU banking supervisory authorities and national central banks meet in order to foster mutual co-operation and exchange of information. The BSC regularly undertakes macro-prudential analyses and analyses of banking developments for the purpose of assessing the soundness of the European banking system. To this end, it has developed a set of macro-prudential indicators, which captures the broad developments in banks' aggregated risk exposures and describes current features of the banking sector in the EU. This kind of monitoring – the results of which are confidential – is intended to provide early warning signals by shedding light on issues such as the development of asset prices, the distribution of profitability and solvency across banks, the soundness of their credit standards and credit exposures towards emerging and developing countries.

Recently, a multilateral MoU has been adopted on co-operation between payment systems overseers and banking supervisors in the EU. The memorandum is aimed primarily at promoting co-operation in relation to large-value payment systems. Additionally, the MoU may serve as a

basis for co-operation regarding retail payment systems, including electronic money schemes. The overall framework provided by the memorandum is defined with a view to ensuring the soundness and stability of the payment systems, participating credit institutions and specific investment firms. Co-operation and information sharing are explicitly foreseen (1) in the case of the establishment of a payment system and the application to access such a system, (2) on an ongoing basis, and (3) in crisis management situations.

4 Working on the convergence of supervisory practices, which can significantly enhance the efficiency of the national supervisory authorities involved in monitoring cross-border financial institutions.

In the context of the revision of the Basel Capital Accord and of the EU capital adequacy framework, and more specifically the development of the so-called supervisory review process as one of their main constituent elements, a substantial amount of work is underway on the convergence of supervisory practices. Indeed, the enhanced role of supervisory discretion that this supervisory review process entails, calls for supervisory convergence to safeguard the level playing field in, and also beyond, the EU. Competitive disadvantages for European banks and competitive inequalities among them should in any case be avoided. The objective of the work on supervisory convergence is thus to eliminate, as far as practicable, any potential for different interpretations and application of common legal requirements for banks' capital adequacy.

The BAC, as the forum for regulators and supervisors in the EU, is working on the legislative framework for capital requirements for banks and investment firms and considering the regulatory mechanisms to achieve supervisory convergence. The latter may include recommendations and communications from the Commission, an agreement on best practices among supervisors or some form of peer group review. The GdC carried out a stock-taking exercise of existing risk assessment practices at supervisory authorities, and asked for the views of supervisory authorities and ministries of finance on how the future supervisory review regime should look. This is also relevant to the second recommendation, according to which ministries of finance and supervisory authorities should regularly exchange views on the adequacy of and necessary adjustments to financial regulation. The BSC's contributions with respect to supervisory convergence lie primarily in the areas of co-operation between supervisory authorities and central banks, and of policies related to financial stability including the response to potential crises. The BSC intends to concentrate its work in areas where further convergence

will be most beneficial. The committees mentioned are also working on provisioning and liquidity practices; their different remits bring a different focus to common areas of attention. Work is also underway in individual committees on country risk analysis and on the use of the Internet to provide cross-border banking services.

As to cross-sector convergence, the MTG did not recommend any institutional arrangements. Instead, it noted the existence of the relevant sectoral forums, as well as the Roundtable, which has assumed a useful informal co-ordinating function for all sectoral groups in addressing the cross-sector issues that have arisen.

2.3 Conclusion

The EFC recognises that substantial progress is being made by the various supervisory committees and the national authorities in the EU in implementing the recommendations of the first report on financial stability. At the same time, the EFC encourages them to pursue their work to improve further the functioning of the current institutional arrangements. Also, it may be recalled that the Committee of Wise Men on the Regulation of European Securities Markets presented proposals for reform in this field, which were broadly endorsed by the Stockholm European Council in March 2001.

3 CRISIS MANAGEMENT

3.1 Definition

Despite the preventive arrangements discussed in the previous report, financial difficulties at individual financial institutions cannot be ruled out. The issues that arise in such crisis situations are the subject of the following chapters of this new report. Crisis management is defined as the set of actions that can be taken by authorities aimed at containing a financial crisis and avoiding potentially disruptive effects on the financial system or the real economy. The term financial crisis has been interpreted as any situation in which a financial institution (or a number of financial institutions) is not able for whatever reason to meet its obligations, which may disturb the proper functioning of the financial system. Beyond private sector solutions, the public authorities have several instruments to address crises, ranging from granting financial support to the liquidation of a troubled financial institution. These instruments will be described in chapter 5 of this report.

3.2 Scope of the report

Financial crises, or more specifically banking crises, have not been uncommon in Europe in the past decade. Such crises have a number of common features, including a combination of adverse external conditions and poor risk management practices. Some crises arise from unexpected market events. Most of the subsequent problems arise because losses on loans, derivatives and collateral have a direct impact on the ability of an institution to meet its financial obligations. At the same time, however, it can be argued that every crisis is unique, in the sense that its immediate causes, the characteristics of the institution(s) involved, the potential for contagion and so on are different. In order to take these specific circumstances into account, (national) authorities deal with each crisis on a case-by-case basis.

Against this background, it is not surprising that there is no blueprint for crisis management, either at the European or at the national level. For the same reasons, this report will not attempt to lay out such a blueprint. It does, however, take stock of the current institutional arrangements for crisis management in the EU. Next, it assesses whether these are adequate in view of the trends in the financial system that have been identified in the previous report, in particular internationalisation, consolidation and the blurring of distinctions between financial sectors and firms, in combination with the introduction of the euro.

The scope of this report is the management of crises that threaten the stability of the financial system as they manifest themselves at financial institutions. These institutions may be banks, insurance companies, securities firms or financial conglomerates, the latter providing services in two or more different financial sectors, one of them being the insurance sector. The report pays due regard to cross-sector aspects of financial crises. However, while financial crises may originate at non-bank financial institutions, the working hypothesis is that such crises are transmitted most rapidly through the banking channel. This derives from the maturity mismatch in the balance sheets of banks, the prominent role which they play in payment and settlement systems, and their substantial interbank exposures. Shocks can also originate in and be transmitted through financial markets, as was shown by the Asian crisis and the LTCM affair, or through payment and settlement systems. Indeed, there are strong interrelationships between the various components of the financial system, for instance via market risks or when financial firms act as clearing members.

Crises that threaten the stability of the financial system will most likely involve authorities in several countries, giving rise to (cross-border) co-ordination issues. Indeed, a crisis at a large financial institution can be assumed to have cross-border effects because of the integration of financial markets world-wide, and more specifically in the euro area as a result of the introduction of the single currency, the new monetary policy framework and the set-up of systems for large value cross-border payments in euros. While the degree of integration within the euro area differs among various market segments, the most integrated are the unsecured interbank deposit market and the derivatives markets. The linkages among market participants and the potential cross-border effects of a crisis in the euro area have increased, particularly for the larger financial institutions in Europe. For these reasons, the report gives extra attention to the institutional mechanisms for information sharing and emergency liquidity assistance in the euro area, as described in sections 4.4 and 5.3. In this context, the role of the ESCB, as set out in Article 105(5) of the EU Treaty, may be recalled.

3.3 General principle

At this place, it should be noted that as a matter of principle private institutions should be involved as much as possible in both crisis prevention and, if this fails, in crisis management. Each financial institution is responsible for its own safety and soundness. If financial losses occur, the firm's shareholders should bear the costs and its management should suffer the consequences. For this reason, the winding down of the institution may be a sensible strategy.

4 STAGES OF CRISIS MANAGEMENT

4.1 Introduction

As stated in the preceding chapter, financial crises take a variety of forms. This makes it difficult to describe the features of crisis management in general terms without any categorisation. For presentational purposes, this chapter is based on a stylised chronology, which distinguishes successive stages of crisis management in order to make clear the policy issues that then arise. Once crisis prevention (section 4.2) has failed and a financial institution runs into trouble, there is a need to identify the precise characteristics of these problems and their possible effects as clearly as possible (4.3). Information is required and should be exchanged among the authorities (4.4). Co-ordination is needed (4.5) and policy actions should be decided upon (4.6). In practice, of course, these stages may overlap, particularly in a rapidly breaking crisis.

4.2 Crisis prevention

Crisis prevention is a priority, both for private institutions, as well as public authorities. Although the former are operated by their management to generate profits, and their shareholders expect a reasonable return on their investment, they have to avoid excessive risks, financial losses or other difficulties to the extent possible. To this end, they must, among other things, have a competent and reliable management, maintain adequate capital, preserve liquidity and have an effective system of internal controls and risk management. Their management information systems, which should entail contingency procedures, are also essential for crisis prevention (see section 4.3).

Crisis prevention by the public authorities is based on both micro-prudential and macro-prudential measures. Regulation and supervision are among the most important micro-prudential tools to foster financial stability, and which permit early detection of potential problems at individual financial institutions. In the latter case, supervisors are able to exercise gradually increasing pressure on managerial choices in order to prevent illiquidity or insolvency. Possible pre-emptive actions include constraints to asset growth, calls for capital injections, pressures for restructuring, requests to downsize some areas of business and the like. In the implementation of these instruments, supervisory discretion exists in the EU countries. However, a comprehensive survey of national preventive rules and practices goes beyond the scope of this report.

Moreover, in the EU and world-wide, supervisory efforts are currently directed at developing a sharper focus on the risks within a financial institution. New supervisory methods in banking, for instance, will entail more risk-sensitive capital requirements that are linked to credit, market and operational risks. In addition, extra supervisory attention is being paid to adequate internal controls and risk management. More proactive supervision is reinforced by greater public disclosure, enhancing market discipline and increasing incentives for prudent policies of financial firms. In order to allow for these new supervisory approaches, the EU capital adequacy framework is being renewed. The new regulations require the convergence of supervisory practices in Europe, which can bolster the efficiency of the national supervisory authorities involved in monitoring cross-border financial institutions (see chapter 2).

Next to micro-prudential policy efforts, crisis prevention is being reinforced at a macro-prudential level, both world-wide and in Europe. In the wake of the financial crises in Mexico and Asia, many initiatives have been taken by international organisations in this area: enhancing transparency and market discipline, developing and implementing codes and standards on fiscal

and monetary policy, as well as strengthening financial sectors themselves. These organisations have also increased their efforts in detecting and assessing potential vulnerabilities in the international financial system. The macro-prudential analysis by the BSC is a case in point (see chapter 2). Macro-prudential analysis is needed because of the ongoing integration of financial markets and consolidation in the financial industry. It pays great attention to the development of vulnerabilities in the financial system and focuses on the risks of correlated failures. In addition, measures are taken by national and international authorities to make the financial system infrastructure more robust.

4.3 Identification

Despite these preventive arrangements, financial institutions may run into trouble. The problem may become apparent from regular supervisory information, which may for example indicate a deterioration in the quality of assets, losses in trading or the depletion of own funds, or from central bank sources, such as monetary policy or financial markets transactions, or the oversight of payment systems. A firm may also notify its supervisors or central bank directly in the case of an emergency. Moreover, market signals in the form of rising spreads may reveal that counterparties have lost confidence, particularly in the case of unregulated institutions.

In order to identify the problem more precisely and to assess the situation, adequate information is needed. As the crisis unfolds, information requirements are likely to become more focused and detailed. Since the main source of information is the firm itself, its management information system should generate sufficiently detailed information in a timely and reliable manner. Particularly the timeliness of information is crucial, since financial markets usually learn quickly about problems at a firm. With these qualifications, the following broad categories of information, which the supervisors of an internationally active financial institution may need in an emergency situation, can be distinguished.

The first category consists of information that should be readily available to supervisors. An up-to-date organisation chart is required to verify the legal structure of the institution or the group and to facilitate the identification of affiliates that may put the supervised entity at risk. Recent balance sheet and income statements are needed in order to gain insight into the potential impact of current risk exposures on the institution's financial condition. Information on the liquidity and funding profile, including the maturities of major funding arrangements, is of vital importance, because it indicates how long the financial institution can withstand a situation of financial stress.

Principal market risk and credit risk exposures will provide insights into those major exposures that may not be readily apparent from the financial statements of the institution.

The second category is information that may not be available when problems emerge, but which supervisors and central banks are likely to require in the course of the crisis. This concerns the responses of the financial institution itself or the group to its critical situation. It also entails the reactions of its counterparties (wholesale and retail clients, exchanges and clearing houses), particularly whether they are willing to enter into new funding or trading transactions, and information on upcoming settlements, actual and expected margin and collateral calls. In addition, a supervisor should investigate the extent to which affiliates of the institution are affected, necessitating information on the size and nature of intercompany balances and exposures, current flows of funds and the like. Information on potential operational or functional difficulties resulting from the emergency situation, such as strains in processing securities transactions, insurance claims or other operational difficulties may also be needed.

A third category concerns information that enables the relevant authorities to assess the impact of the emergency situation on other financial institutions and markets. Such linkages may significantly threaten financial stability, particularly when the institution is systemically relevant in a cross-border sense. In an integrated financial area it may be difficult, if not impossible, to identify a priori exactly the systemic implications of a crisis at a major financial institution. Nevertheless, in order to make such an assessment, general data along with emergency-specific information such as substantial credit and market risk exposures and linkages through payment, settlement and clearing systems, will be necessary. Obviously, the information received will usually give rise to further and more detailed information needs.

In order to further the timeliness of information and a rapid response by the management, major financial institutions should perform stress tests and have contingency procedures, addressing their liquidity needs and funding options, capital needs, downsizing options and potential spillover effects particularly within their own groups, in specific crisis scenarios. These contingency procedures should be shared regularly with the firms' main supervisors and the directly concerned central banks.

4.4 Information exchange

Clearly, the impact of an emergency at an internationally active financial institution will extend beyond the jurisdiction of one supervisor. In order to be effective, crisis management then entails co-operation between the relevant authorities. In this context, some general principles for co-operation and information exchange apply. There is an international consensus that (1) there should be no obstacles to co-operation and information sharing between supervisors, both at the domestic and the cross-border level; (2) the confidentiality of shared information must be secured; and (3) supervisors should take a proactive stance toward co-operation, both in providing and in requesting assistance and information.

These principles have been incorporated into EU directives. Although it is not practical to give an overview of all the detailed provisions on co-operation between EU supervisors, the following elements are important at the Community level. Firstly, the relevant directives impose an obligation for banking, insurance and securities supervisors to co-operate and exchange information with their counterparts in other Member States in order to supervise the activities of institutions operating there, in particular by having established branches. Secondly, the relevant directives allow for exchanges of information with supervisors from other sectors in the same Member State as well as in other Member States. Finally, the post-BCCI directive has enhanced the possibilities for exchanging information between supervisory and non-supervisory authorities within and between Member States. On the basis of this directive, confidential supervisory information can be passed to bodies administering deposit-guarantee schemes, overseers of payment systems and central banks for the purpose of the performance of their tasks. The latter authorities may also provide relevant information to supervisors.

The BSC has conducted a survey on the state of implementation by the Member States of the relevant provisions on information exchange. As described in chapter 2, the outcome is that there are no legal obstacles to information flows at the national level. In most cases, national laws also allow for cross-border information sharing, although certain supervisory authorities do not consider themselves as being entitled to share information on major financial institutions on a regular basis in a multilateral context solely for the purpose of monitoring systemic stability. Any impediments that may still exist to cross-border exchange of information need to be removed.

The relevant EU directives do not impose an obligation for information sharing *in crisis situations*, nor do they provide for the content and timing of the information to be exchanged in

such circumstances. As to the content, to do so would be difficult, as crisis situations are unique, so that the type of information needed depends on the specific case. As to the timing, it is similarly not feasible to define in operational terms the precise moment at which information should be conveyed. The EU directives therefore allow for discretion for the national authorities. Much depends on their willingness to inform their counterparts in time. Supervisors should thus be proactive in raising material issues and concerns with central banks and other authorities involved. As financial problems deepen, the frequency and scope of information flows need to increase, and likewise the number of authorities involved rises. Since major financial institutions also operate in American and Asian financial markets, the supervisors and central banks in the Americas and in Asian countries may need to be informed of looming crises as well.

In practice, information exchange in crisis situations relies on co-operative arrangements between the competent authorities belonging to different geographical jurisdictions. These are mainly bilateral MoUs, clarifying the relationships between home and host-country supervisors, and specific MoUs for cross-border financial conglomerates, such as Dexia, Fortis and Nordea. The first category of MoUs generally follows a common format; they primarily deal with the supervision of branches. Currently, a comprehensive set of MoUs is in place in the EU, and bilateral MoU-meetings are usually held on a regular basis. In most MoUs, however, crisis management procedures are not explicitly foreseen. Therefore, supervisors should further develop these MoUs, and make them more concrete on crisis management issues, whilst recognising the interests of other authorities involved (see section 4.5) and allowing for the necessary flexibility to cope with each specific case. Procedures for information exchange when a major financial institution runs into trouble, including issues such as the type of information that might be needed, who can produce the information and to whom this can be provided, should be agreed upon in advance. The relevant fora, such as the BSC and the GdC, could be requested to describe the main elements for such procedures. Moreover, supervisors should consider extending MoUs into agreements among the competent authorities of different countries likely to be involved in a crisis, particularly where the structure of specific institutions so demands. Similarly, to the extent that major institutions operate in non-EU countries, it may be desirable to conclude MoUs with the relevant authorities in these countries as well. Importantly, meaningful information exchange between supervisors and other competent authorities requires a culture of co-operation and trust. To that end, the regular contacts between these parties should be maintained and fostered, as they provide a basis for communication in emergency situations.

At the multilateral level, there is general agreement between the Eurosystem and EU banking supervisors on the need for information sharing. Indeed, it is important that co-ordination mechanisms are in place to the extent that a crisis originating in a Member State may trigger decisions at the level of the Eurosystem. The Eurosystem can provide banking supervisors with confidential information on individual institutions stemming from its basic tasks, such as monetary policy operations and oversight of payment systems, to be used for supervisory purposes only. Conversely, banking supervisors are prepared to inform the national central banks and the ECB as soon as a banking crisis arises in view of its possible systemic implications, although they assess the actual timing and modalities in the light of the specific features of each case. Also, banking supervisors stand ready to detect non-compliance by the Eurosystem's counterparties with the obligations stemming from the rules on monetary policy instruments and procedures. Monetary policy counterparties may be suspended or excluded from these procedures on prudential grounds; the same applies to participants in the Eurosystem's payment systems. Moreover, a multilateral MoU has been adopted on co-operation between EU payment overseers and banking supervisors (see chapter 2).

4.5 Co-ordination

When a crisis at a major financial institution occurs, there is a need for co-ordination on a cross-border and/or a cross-sector basis between the various authorities in order to avoid any mutual inconsistencies in their policies. Effective co-ordination of supervisory measures can only take place if the co-ordinator and the roles it may play have been identified previously. Time is short in an emergency, and crisis management efforts should not be burdened by consultations on those matters. For banks, securities firms or insurance companies, the identification of the co-ordinating supervisor is relatively straightforward. In the case of banks, for instance, the supervisor who exercises consolidated supervision is generally considered the co-ordinator. For financial conglomerates, the draft EU directive establishes that the competent authorities shall seek agreement as to who the co-ordinator will be, and defines criteria for cases in which there is no such agreement.

Admittedly, in every crisis situation, there is a need for some flexibility in the sense that arrangements made in advance might require some adaptation to take specific circumstances into account. The co-ordination model, however, allows for such flexibility. In any case, the co-ordinator should be informed as soon as possible by the other supervisor (or supervisors), once the latter becomes aware of adverse developments for the financial group or considers

supervisory measures to deal with these. This will allow the co-ordinator to assess developments at the group level and, in turn, to alert other country authorities to potential problems and to provide them with relevant information. Thus, the co-ordinator can ensure that a consistent approach is adopted by all authorities involved. However, the arrangements for a co-ordinator are without prejudice to the responsibilities of, and the actions that need to be taken by, the relevant authorities to address the emergency. More generally, the identification of the co-ordinator and the allocation of extra responsibilities to this authority do not imply that responsibilities of the solo supervisors have been transferred.

It should be noted that the co-ordinating role in crisis situations differs from the co-ordinating role on a going-concern basis, in the sense that in the former case non-supervisory authorities are also involved and may co-ordinate crisis management, if appropriate. Supervisory authorities will have a key role in the initial stages of the crisis, i.e. identification and information exchange, but also subsequently when decisions on policy actions are taken. Central bank(s) will need to be involved at an early stage, since they can assess possible systemic implications, particularly if (potential) liquidity problems arise or if financial markets become destabilised. They bring into the assessment information derived from their monetary policy operations, oversight and market surveillance. In addition, central banks may have to take decisions and initiate appropriate actions to safeguard the integrity of the payment systems that they oversee, or to suspend or exclude counterparties in monetary policy operations. Other authorities, such as the ministry of finance and the deposit insurance fund, if any, may also become involved, and thus should be informed in a timely manner. Finance ministries need to be informed about any developments that might put public money at risk or have serious stability or macro-economic implications. Each authority has distinct legal responsibilities and should develop its own checklist, identifying the main issues to be addressed and the other authorities to be informed in a crisis. Depending on how the crisis unfolds and what decisions need to be taken, each authority contributes differently and has a different say. In this context, the co-ordinating supervisor could take on a central role in convening the relevant parties, act as the central point for gathering information and for communication, also with the public, if needed.

4.6 Decision-making

An issue that is closely related to co-ordination is the question of the responsibility for, and thus the initiative in, decision-making with respect to crisis management, particularly among countries. As stated before, even if a co-ordinator has been identified, the responsibilities of the

authorities involved have not changed. Although there are no specific references in EU directives to crisis management, the presumption in international banking supervision is that the home country authorities are responsible for decisions on crisis management, at least regarding an individual institution and its branches. The principle of home country responsibility can also be found in the directive on deposit-guarantee schemes and the draft EU directive on the reorganisation and winding-up of credit institutions (section 5.5). In the areas of investment services and retail insurance, the home country control principle applies as well. It seems, however, to be less predominant there than in banking supervision, as a result of more elaborate host country controls on compliance with domestic conduct of business rules and national differences in contract law and taxation.

The principle of home country control is not directly applicable to foreign subsidiaries, as the host country authorities are obliged to treat these as domestic institutions with their own legal identity. In the event of a crisis at a foreign subsidiary, the host country supervisor – which is in fact the subsidiary's home country supervisor – can take any preventive measure envisaged in this context. There are no specific rules requiring the host country supervisor, when taking measures, to request the opinion of the other supervisors involved, notwithstanding the fact that in practice such co-operation should be the norm. Indeed, the host country authorities should make full allowance within the scope of their own legal responsibilities for measures taken by the home country authorities, and vice versa.

In addition, several developments in the financial sector may affect the home country responsibility. The growth in size and complexity of financial firms as a result of consolidation gives rise to financial institutions whose failure could pose serious risks to the financial system. In order to check these systemic risks *ex ante*, some countries have implemented more intensive and risk-based supervision for the major financial institutions. Also, as a preventive measure, the supervisory authorities could value the solvency of these firms more prudently and have them perform stress tests, so that they are well-prepared and can intervene quickly if serious problems occur.

Moreover, internationalisation causes more financial institutions to be systemically relevant in host countries. In the case of a crisis at such an institution, the home and host country authorities need to co-operate, but their interests are not necessarily similar. In specific cases, for example, the systemic impact of the distress at a financial institution in the home country can be relatively

small, but considerable in a host country. Situations can then arise where the home country authorities estimate the risks of allowing the bank to fail as limited, whereas the failure would create systemic risks in the host country. Although such cases are currently not very common, where they arise, the home country authorities should consult the host country authorities in the decision-making process. Such consultation could be arranged in the relevant MoU.

Finally, there may be cases in which the traditional division of responsibilities between home and host country authorities may not provide for sufficient guidance in the decision-making process. When, for example, disturbances are being channelled through money and capital markets, a potentially large number of intermediaries located in different jurisdictions could be affected. Under such circumstances, multilateral co-operation may be required in order to provide for a co-ordinated response.

5 POLICY RESPONSES

5.1 Introduction

When a financial crisis occurs, the private sector should be involved as much as possible in its resolution. In this regard, there are several options, including the winding down of an institution in trouble. If these options are deemed to be impossible or have been exhausted, the authorities may consider policy measures to try to limit or contain the crisis, although some of these may be more difficult to implement in a cross-border context than at the national level. The choice of instruments will depend, for instance, on the characteristics of the institutions concerned, the perceived causes (for example adverse macro-economic conditions or institution-specific factors) and the stage of the crisis. In actual emergency situations, these policy options entail co-ordination by the authorities involved (section 4.5) and need to be considered simultaneously, because the choice for any particular instrument determines the course of the crisis and may preclude subsequent use of alternative instruments. This chapter describes private sector solutions and public policy measures.

Section 5.2 discusses private sector solutions. Liquidity support (5.3) might have to be granted in order to stabilise the troubled institution or the market as a whole in order ‘to buy time’. In a less volatile environment, public measures (5.4) may then be considered, if the winding-down (5.5) of

the institution is not a viable option. Competitive implications of crisis management measures are treated separately in section 5.6.

5.2 Private sector solutions

Private sector solutions may be defined as those solutions implemented by private firms without claiming public or central bank money. There are two types of such solutions. The first relates to predetermined mechanisms aimed at preventing spillover effects of financial crises. An example of such a mechanism is the Liquidity Consortium Bank (Liquiditäts-Konsortialbank) in Germany. The Liko Bank is a private limited company, in which all major domestic banking associations, represented by certain banks, as well as the Bundesbank participate. The Liko Bank may provide liquidity assistance to basically solvent banks that encounter sudden liquidity problems, with the objective of assuring their payment transactions. The second type refers to ad hoc mechanisms, such as a merger or acquisition (capital infusion) or rescue operations, which may be considered when an emergency surfaces. These solutions have a higher probability of success when the maximum exposures of the financial institution in trouble are clear and the potential losses are not too large for the related entities. In order to allow for such an ad hoc solution, much effort is necessary to determine the prospective losses, as well as to solve practical issues, possibly in the form of protracted negotiations with shareholders and large creditors. When the ailing financial institution is an internationally diversified group, a joint effort of the authorities involved may be needed.

Private sector solutions can be promoted by the authorities acting as honest broker, especially given the time constraints under which most crises have to be solved and the potential information asymmetries that then exist. Honest brokering is particularly expedient, since private parties generally do not want to share information with competitors, but may be willing to inform a neutral third party. The honest broker is then in the position to design a constructive and acceptable solution and reinforce commitment amongst all parties involved. However, honest brokering carries some risks. It may be interpreted as implying moral suasion, undermining market discipline, and as a commitment to subsequent official support if the brokering proves ineffective. Most often the honest broker is either the central bank or the supervisor (or a senior private expert on their behalf). Both of the authorities have relevant information on institutions that may be able to participate in the rescue of the troubled firm. The central bank, in addition, may provide a transitional financing arrangement, but should take the aforementioned risks into account.

5.3 Liquidity support measures

The provision of emergency liquidity (i.e. not risk capital), either to an individual financial institution or to the market as a whole, is an instrument almost invariably in the hands of the central bank. As liquidity support is provided with a view to stabilising the situation, the central bank(s) doing so will need to be kept involved in the subsequent decisions made in the crisis management process.

Emergency liquidity assistance should be distinguished from the provision of liquidity to individual firms under the central bank's standing facilities. Whereas the latter are available on demand and the rules of access are clear *ex ante*, emergency liquidity assistance is typically available only in exceptional circumstances at the discretion of the central bank (see below). Yet, regular and emergency liquidity support are not independent. The broader (narrower) the facilities and the types of collateral accepted, the less (more) likely is the need for emergency liquidity assistance. Similarly, emergency liquidity assistance to the market, i.e. the banking system as a whole, can be distinguished from an easing of monetary policy. Emergency assistance to the market is provided temporarily to relieve market pressures following an adverse exogenous shock, whereas changes in monetary policy are directed at maintaining longer-term price stability. Apart from the actual provision of liquidity, the central bank may also issue a statement indicating a willingness to provide liquidity if needed, in an attempt to shore up confidence and thereby contain the crisis. Following the collapse of Barings, for example, the Bank of England made clear to the market that it was ready to make liquidity available. In that event, however, additional liquidity was not actually needed.

Central banks generally do not lay down explicit and publicly known guidelines for liquidity support. Yet, any central bank will, where possible, want to secure its lending with acceptable collateral and take an appropriate margin to protect itself against credit risk. Such collateral requirements also help to limit moral hazard. For the same reason, penalty rates, i.e. above-market rates, on liquidity assistance could be used, and conditionality could be imposed. For example, a borrower may be asked to provide additional data while borrowing, may be subject to supervisory actions which limit its ability to engage in various activities, or may be asked to develop plans to restore its regular funding. The provision of liquidity support may also have implications for the level playing field, and has to be seen in the context of competition policy regulations, as discussed in section 5.6.

Within the Eurosystem, there is general agreement that emergency liquidity assistance, unlike regulation, supervision and adequate risk management within financial institutions, should not be seen as a primary means of safeguarding financial stability. If nevertheless required, the Eurosystem has the necessary mechanisms in place. Two main guiding principles have been adopted. Firstly, the provision of emergency liquidity assistance to individual illiquid institutions, if and when appropriate, is primarily a national responsibility and national arrangements continue to apply. The costs and risks would thus be fully borne at the national level. Secondly, mechanisms are in place to ensure that any potential liquidity impact deriving from the provision of emergency liquidity assistance can be managed in a way consistent with the maintenance of the appropriate single monetary policy stance. These mechanisms can be activated in a tight time frame, and any cross-border implications can be dealt with by the competent authorities. In addition, in the case of a general liquidity crisis, the instruments and procedures identified for the single monetary policy and payment system operations will be available to the Eurosystem to cope with the situation.

5.4 Public intervention tools

In exceptional circumstances, if the crisis persists and the systemic risks increase, other measures may have to be considered. Deposit insurance funds, if available, might play a role here. These schemes were originally aimed at preventing bank runs, but in a number of EU countries they can also be involved in the restructuring of ailing banks, sometimes even in the provision of liquidity support. The existence of deposit insurance funds may, however, not be enough to prevent or stop bank runs and to stabilise the financial system. In that case, the government could consider making a public announcement providing for full protection of depositors. Experience suggests that this could be an effective instrument in regaining confidence and thus in containing a crisis, but a blanket guarantee generally implies a very sizeable contingent liability for the government against assets of uncertain value.

The government may decide to recapitalise the firm, at least up to minimum capital requirements and preferably even higher, or nationalise the company. If the latter option is chosen, the initial fiscal impact will be relatively high. As the owner of the firm, the government can try to resell it at a later date at an acceptable price. Often, rehabilitation of assets may be necessary, entailing the creation of an asset management company, which purchases and manages the impaired assets of the troubled institution. This company can either be in private or public hands, with the latter more likely if there is a threat of a widespread systemic crisis. In taking such action, the

government will have more leverage over the troubled institution, as it can impose conditions linked to its purchases of the assets.

As a quid pro quo for public support, the government might require a restructuring of the troubled institution, such as the closure or liquidation of non-viable parts of the firm. One reason to do so would be to restore the profitability of the institution. Similarly, shareholders should be forced to bear the firm's losses. Once the crisis is over, the authorities can call upon the firm's management to give an account of its policies and can take corrective actions, if needed. Given their deterrent effect, such measures can be considered to be instruments that limit moral hazard.

5.5 Winding-down

In many cases, winding-down of the troubled institution is the preferred solution. The business of the firm will then be suspended for liquidation and the authorities will activate the close-down procedures under relevant insolvency laws, if private counterparties have not already done so. In this context, the draft EU directives on the winding-up and liquidation of banks and of insurance companies, which are close to adoption, should be mentioned. These directives re-affirm that the principles of home country control and mutual recognition apply to reorganisation measures and winding-down proceedings regarding an institution and its branches. This means that the home country authorities are exclusively competent to decide and implement reorganisation measures and liquidation proceedings. Pursuant to the directives, the authorities in the home country need to inform without delay the host country authorities of such a decision, and if possible to inform them before the decision is taken.

Clearly, the winding-down of a large and complex financial institution creates potential for disruption, especially to market functioning and liquidity. Therefore, the authorities should ensure that the winding-down, or the significant restructuring of a major financial organisation, is managed in an orderly manner. Ring-fencing procedures or liquidity support to other firms or the market generally may be needed to contain the repercussions of the crisis or escrow services may be provided to facilitate settlement. The issues which are critical to an orderly winding-down of complex institutions, such as the unwinding of interbank and forex positions, clearing and settlement of payments and securities transactions, the sale of swaps and so on, fall beyond the scope of this report.

5.6 Competitive implications

Decisions with respect to crisis management may have competitive implications. In the field of competition policy, the EU and national regimes co-exist, but EU rules prevail over national laws. The EU framework for competition policy has been laid down in Articles 81 to 89 of the EC Treaty and in a Council Regulation on the control of concentrations between undertakings (EEC/4064/89). The rules on mergers should be distinguished from those on state aid.

A merger in the financial sector, also in the aftermath of a crisis, may be subject depending on its size and cross-border impact to the Council Regulation. If so, the Commission assesses, among other things, whether competition would be significantly impeded. The Commission can oppose a merger, or attach conditions or obligations to it. The Regulation also stipulates that Member States may take appropriate measures to protect their legitimate interests, which include prudential matters.

The EC Treaty, Article 87(1) declares that any state aid that distorts or threatens to distort competition is incompatible with the common market. Decision-taking on this issue is an exclusive competence of the Commission, which should be notified by a Member State of any state aid measure. The Commission has repeatedly stated that Article 87(1) applies to the banking sector. Indeed, the article has been applied in all cases where a bank received some form of aid from a public body, including central banks. The Commission's assessment is based on the so-called 'market economy investor principle'. Under this principle, a state measure qualifies as state aid if a private investor would not be willing to provide the aid under similar circumstances. In the case of liquidity support for otherwise solvent institutions, the Commission takes the view that such support does not constitute state aid, the liquidity being granted on terms which are not more favourable than the discount rate, and appropriate guarantees being provided.

Article 87(3)(b) provides for a possible derogation for measures which are taken to 'remedy a serious disturbance in the economy of a Member State'. Measures to remedy a systemic crisis could therefore be deemed compatible with EU competition law if they support the whole national banking system without unduly distorting competition, and if they are limited to what is strictly necessary. Any such aid is, however, assessed in the light of the general Community guidelines on state aid for restructuring firms in difficulty, and the Commission takes the view that even a crisis at a large bank does not automatically entail a derogation. Indeed, such a derogation has never been granted. Article 87(3)(c) provides for another derogation for aid to an

ailing institution. When assessing such a measure, the Commission verifies that a number of conditions are met to ensure that competition has been restored. These conditions have been set down in the Community guidelines on state aid for rescuing and restructuring firms in difficulty. These rules cover both urgent rescue interventions and longer-term restructuring operations. The guidelines therefore allow for an appropriate treatment of all possible cases.

6 ASSESSMENT

6.1 Scope of the report

In addition to monitoring the implementation of recommendations in its Spring 2000 report, the EFC has taken stock of the institutional arrangements for crisis management in the EU. Crises may occur in various parts of the financial system, including its markets, but very often involve financial institutions, particularly banks, being exposed to excessive risks. The linkages among these institutions in conjunction with the integration of financial markets facilitate the transmission of shocks and enhance contagion effects. The report focuses on the management of crises that threaten the stability of the financial system as they manifest themselves at financial institutions. The cross-border effects of such crises give rise to co-ordination issues within and beyond the EU, and among the various competent authorities. Importantly, every financial crisis is unique and needs to be dealt with on a case-by-case basis. Hence, the report does not give a blueprint for crisis management, but presents several general policy principles. An overriding principle is that private institutions should be involved as much as possible in both crisis prevention and crisis management. Each financial institution is primarily responsible for its own safety and soundness, should act prudently and have effective risk management systems. If, nevertheless, financial losses occur, the institution, its management and its shareholders have to bear the consequences fully.

6.2 Crisis management

Prevention

Preventive measures by both private firms and public authorities are essential to minimise the risk of financial crises and their potentially disruptive effects on financial systems. For that purpose, regulation, micro- and macro-prudential supervision, oversight and surveillance are being reinforced in the EU. In this context, substantial progress is being made by the various

supervisory committees and the national authorities in the EU in implementing the recommendations of the first report (see chapter 2 of this document).

Policy responses

If, despite preventive arrangements, a crisis at a financial institution occurs, a private sector solution should prevail, whenever possible. Such a solution could entail facilitating private sector liquidity support, finding strategic investors for the troubled firm, selling off parts of it or a take-over. Where an arrangement among private firms were precluded by conflicts of interest, the public authorities may act as honest broker. When these private solutions are deemed insufficient or impossible, the winding down of the institution concerned should follow. If the authorities would decide to manage the crisis, they have several instruments, although some may be more difficult to implement in a cross-border than in a national context. In any event, the public authorities – supervisors, central banks and ministries of finance alike – need to attach strict conditions to any intervention.

Information exchange

In crisis situations, the need for accurate information is great, while time is short. This implies a risk that at some stage critical decisions will need to be taken on the basis of incomplete information. In order to mitigate this risk, financial institutions should be able at any time to provide their management and the supervisory authorities with reliable information on the whole financial group at short notice. Critical information includes the scope of the activities of the institution on a geographical and business basis, its financial position and its major risk positions. In addition, major financial institutions should perform stress tests and develop contingency procedures, which should be shared regularly with their main supervisors and the directly concerned central banks.

If the emergence of financial problems at a major group can reasonably be expected to have contagion effects in other EU countries, supervisory authorities should share the available information with their cross-border counterparts at an early stage, so that the latter can respond effectively. Central banks should be informed sufficiently quickly to enable them to take stock of the systemic implications and more particularly in case liquidity support is needed. Information sharing is a precondition for effective crisis management.

In terms of Community law, legal obstacles to the exchange of information between supervisory and non-supervisory authorities within and between Member States have been lifted. In terms of national law, there are no legal obstacles to the information flows at the national level. National laws in most

cases also allow for cross-border information sharing between supervisory authorities and central banks. At the same time, the relevant EU directives do not impose an obligation for information sharing in crisis situations. Neither do they provide for the content and the timing of information to be exchanged in a crisis. Since there are no formal obligations for information sharing in such circumstances, much depends on the authorities and their willingness to inform their counterparts in time.

In practice, the exchange of information is dealt with in regular co-operative, bilateral arrangements between supervisors (MoUs). Most MoUs, however, do not deal specifically with the exchange of information in crisis situations. Supervisory authorities should thus further develop these MoUs, and make them more concrete with respect to crisis management, whilst recognising the interests of other authorities involved and allowing for the necessary flexibility to cope with each specific case. Moreover, supervisors should consider extending the bilateral MoUs into agreements among the competent authorities of different EU- countries, or non-EU-countries, particularly when the structure of specific institutions would demand so. At the multilateral level, several committees can be used to exchange information among supervisors and between supervisory authorities and central banks. Also, they may provide a network and infrastructure for communication in crisis situations.

Co-ordination

In crises, supervisory co-ordination will be considerably enhanced if the co-ordinator and the role it may play have been previously identified. For most financial institutions, the legal structure determines who should be the co-ordinating supervisor; for conglomerates, a mandatory appointment and criteria to identify the co-ordinator have been proposed in a draft EU directive. It should be noted, though, that supervisory co-ordination and co-ordination in a crisis situation are different, in the sense that in the latter case other authorities will also become involved and may co-ordinate crisis management, if appropriate. Central bank(s) may need to be involved at an early stage, since they can assess possible systemic implications, particularly if (potential) liquidity problems arise or if financial markets become destabilised. Other authorities, such as the ministry of finance and the deposit insurance fund, if any, should also be informed in a timely manner. Finance ministries need to be informed about any developments that might put public money at risk or have serious stability or macro-economic implications. The various authorities have distinct legal responsibilities. Depending on how the crisis unfolds and what decisions need to be taken, they contribute differently and have a different say. Each authority likely to be involved in crisis management should develop its own checklist identifying the main issues to be addressed and the

authorities to be informed. The crisis manager could also co-ordinate communication, if any, with the public.

Decision-making

The responsibility for decision-making in crisis situations rests – at least regarding an individual institution and its branches – with the home country authorities, as is also the case with prudential supervision in the EU. In this setting, close cross-border co-operation among national authorities, particularly supervisors and central banks, is of the utmost importance in order to safeguard financial stability in the EU. Although the division of responsibilities for crisis management among Member States has not been explicitly addressed in the relevant directives thus far, the draft EU directives on winding-up of banks and insurance companies that will soon come into effect, re-affirm the principle of home country control.

In this context, a number of aspects need to be considered. First, the principle of home country control is not directly applicable to foreign subsidiaries, as the host country authorities are obliged to treat these as domestic institutions with their own legal identity. Although there are no specific rules on co-operation in such cases, the host country authorities should make full allowance within the scope of their own legal responsibilities, for measures taken by the home country authorities, and vice versa. Second, internationalisation and consolidation may lead to more financial institutions being systemically relevant in host countries, even as branches. If so, home country authorities should consult host country authorities in the decision-making process. Third, the distinction between home and host country authorities may no longer be relevant when disturbances spread via financial markets to a relatively wide number of institutions. In such cases, multilateral co-operation may be called for in the decision-making process.

Competitive implications

Crisis management measures also have competitive implications, which the competition authorities have to assess. In this process, they should maintain confidentiality and take into account the need for speed of action in crisis management in view of the systemic implications that have guided the measures taken.

6.3 Recommendations

The current institutional arrangements in the EU are based on the competence of national authorities, both for the prudential supervision of financial institutions and for crisis management. The EFC

recognises the progress being made by the various supervisory committees and the national authorities in the EU in implementing the recommendations of its first report on financial stability, and encourages them to pursue their work in this respect. Regarding the institutional framework on crisis management, the EFC is of the opinion that closer co-operation among the competent authorities is required in the context of increasing financial integration. Thus, in line with the conclusions of the Spring 2000 report, a further strengthening of cross-border co-operation and co-ordination is needed to ensure effective crisis management. For this purpose, the following is recommended:

- Supervisory authorities should ensure that the management information systems of financial institutions and groups are able to generate accurate information on their financial position at short notice. Importantly, major institutions should perform stress tests and have contingency procedures, addressing specific crisis scenarios, which should be shared regularly with their main supervisors and the directly concerned central banks.
- In a crisis situation, all authorities likely to be involved should be informed in a timely manner. Any remaining legal impediments to the exchange of information among supervisors, with central banks, overseers of payment systems and bodies administering deposit-guarantee schemes, both cross-border and cross-sector, should be removed. In addition, each authority should develop its own checklist, identifying the main issues to be addressed in a crisis and the other authorities to be informed.
- For the major financial institutions, including conglomerates, which are domiciled in the EU, agreement should be reached on the co-ordinating supervisor and its responsibilities including information gathering and communication, particularly in crisis situations. This underscores the importance in this respect of the draft EU directive on financial conglomerates, whilst recognising that the roles of the respective authorities involved in any crisis will vary.
- Supervisory authorities should further develop MoUs to deal more concretely with issues related to crisis management. Procedures for information exchange when a major financial institution runs into trouble should be agreed upon in advance, whilst recognising the interests of other authorities involved and allowing for the necessary flexibility to cope with each specific case. The relevant fora, such as the BSC and the GdC, could be requested to describe the main elements for such procedures. Supervisors should also consider extending MoUs into

agreements among competent authorities of a number of EU-countries, or non-EU-countries, particularly where the structure of specific institutions demands so.

- Competition authorities are called upon to maintain timely and robust procedures for considering the competitive implications of crisis management measures.

ANNEX

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