EU acts to counter the international financial turmoil

Since the crisis in the United States mortgage loans market unfolded in mid 2007, the EU has been a key player in international efforts to bring stability back to the financial system.

EU policy responses such as the 'road map' agreed in October 2007, are at the heart of international efforts to address the evident weaknesses in the international financial system. Whilst market-led initiatives are part of the solu- and the industry players are being given full opportunity to put their own houses in order - actions are being stepped up in a certain number of areas, such as prudential regulation, market functioning or market transparency.

In the future the EU wants a refocusing of financial supervision to permit better anticipation and management of market problems and mitigate the risk of crisis situations of the scale we have been experiencing over the past months. &

Long before the U.S. subprime crisis unfolded there had been concern at EU level about financial stability arrangements in the fast-moving and fast changing global financial markets. Indeed a dedicated Commission working group had been set up to focus on this and develop concrete proposals for change. &

As a result, the EU was well positioned to move rapidly once the crisis broke and propose in autumn 2007 a 'road map' of key areas where action should be taken. The October ECOFIN Council meeting conferred a special role on the Commission to closely follow the different work streams so as to shape its views, ensure consistency, including with its own work programme and formulate and propose appropriate policy responses. &

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At the global level, EU action is being coordinated and synchronised with the relevant organisations (Financial Stability Forum, IMF, G-7 etc.) so that all players in the global financial market work 'in step' towards achieving a consensus on the way forward. Indeed the work done at the EU level has in many keys areas helped shape thinking and action at the international level.

The ECOFIN Council - In May the EU's economics and finance ministers endorsed plans to tighten up the system of financing and banking supervision.

Growing complexity of securitisation

Although the crisis was triggered by inadequate regulation of mortgage selling in the U.S., credit rating shortcomings and the redistribution of financial risks through complex financial products, the events that unfolded were in many respects an 'accident waiting to happen'.

McCreevy: The financial industry has been asked to come forward with a credible, comprehensive proposal, which responds to the needs of regulators..

It had been clear for some time that the increasing size and sophistication of financial markets was becoming a challenge for the existing framework for prudential regulation and supervision. After several years of price stability, ample liquidity, strong global economic growth and continued search by investors for ever better yields, there was a growing perception that credit risk in global asset markets was mispriced and that the conditions were set for a potentially disorderly correction - should investors' appetite for risk suddenly decline.

Addressing the European Parliament's Committee on Economic and Monetary Affairs Brussels, in April 2008 Commissioner Charlie McCreevy highlighted the problems underlying the turmoil saying:

"The issues are known: weak internal valuation models, opaque securitisation process, business models that were built upon disproportionate maturity mismatches between assets and liabilities, weak internal controls and poor disclosure standards, to name but a few."

Transparency and valuation&

At the last Spring Council, EU leaders agreed that the primary responsibility for dealing with the market failures lies with the private sector, whose activities caused the problem. National and supranational authorities have to be prepared to take regulatory and supervisory actions where necessary, they concluded. Reflecting the priorities set out in the Autumn 2007 Road Map (see box opposite) EU leaders identified four key areas of work to be done:

A first priority is to enhance transparency for investors, & markets and regulators. The key challenge here is to provide better information on exposures to structured products and off-balance sheet vehicles. &

The financial industry has been asked to come forward with a credible, comprehensive proposal, which responds to the needs of regulators, and industry has agreed to compile complete data on markets for structured products and to provide regularly updated data on a continual basis. The first industry report was published mid-June.

A further complex area for action concerns risk assessment and improved approaches to valuation standards, in particular for illiquid assets. The complex issue of valuation is being worked on at international level by organisations such as the International Accounting Standards Board (IASB) and the International Organisation of Securities Commissions (IOSCO). Indeed there is a growing debate on whether fair value and mark-to-market measurements may have aggravated the crisis by bringing cyclical elements (pro-cyclicality) into financial statements.

Incentives structures &

Certain potential conflicts of interest have been evident in the functioning of the financial markets. The operation of the credit rating agencies has been singled out for attention given the generous ratings they gave to financial products which subsequently defaulted.

The Commission plans to finalise its assessment by end-June, taking into account the final position of the industry, and the assessments from the Committee of European Securities Regulators (CESR), the European Securities Markets Expert Group (ESME) and IOSCO. The objective is to ensure proper treatment of conflicts of interest and to improve the quality of ratings and methodologies and the transparency of the agencies.

What is the roadmap?

The roadmap agreed by EU ministers in October 2007 combines actions of a regulatory and non-regulatory nature which are structured around four main objectives:

- improving transparency in the market, notably with respect to banks' exposures relating to securitisation and off-balance sheet items;
- upgrading valuation standards to respond in particular to the problems arising from the valuation of illiquid assets;
- strengthening the prudential framework for the banking sector, including the treatment of large exposures, banks' capital requirements for securitisation, and liquidity risk management, and
- investigating structural market issues, such as the role played by credit rating agencies and the 'originate and distribute' model.

Next to this there may be a need for some sort of oversight of CRAs activities, processes and performance.

Banking legislation

Critical changes need to be made to the EU banking legislation, i.e. the Capital Requirements Directive (CRD) which governs risk management practices and financial buffers of banking groups.

The current regime needs to be updated to take account of changes in the structure of the market and the changing nature of its products. It has to be adapted to the evolution of risk management practice.

The prudential framework and risk management in the banking sector needs to be reinforced through a targeted revision of certain aspects of the Capital Requirements Directive (CRD).

Proposals for changes to the Capital Requirements Directive will include:

- %new rules to limit the risk stemming from large exposures;
- %a harmonisation of the definition of hybrid capital instruments;
- %supervisory arrangements, i.e. the introduction of colleges of supervisors for all large EU banking groups (see 'cross-border banking' hereunder);
- %the waivers for banks organised in networks, and
- %adjustments to certain technical provisions, including quantitative requirements for securitisation, and
- %a series of changes to ease the administrative burden..%

In April the Commission launched a public consultation on the Capital Requirements Directive which ended on 16 June. This is in part a response to the recommendations of the Financial Stability Forum and its aim is to assess the concerns of the stakeholders and ensure that any changes are robust and practicable. The Commission proposals aim to strike a balance between 'large and small' banks on the one hand and 'old and new' Member States on the other.

Modernised Supervisory committees

All are agreed that there must be strengthened cooperation at international level and convergence of supervisory practices. The EU already as system of supervisory committees in place - known as the Level 3 committees (CEBS, CESR and CEIOPS) made up of the 27 banking, insurance and securities markets regulators. This structure was devised by the former central banker Baron Alexandre Lamfalussy.

Commissioner for Economic and Monetary Affairs, Joaquin ALMUNIA: the EU has been a leading force in consensus-building at world level.

There is a widespread view that the current supervisory architecture must be modernised and upgraded. The Commission is proposing a wider array of tasks they should perform such as mediation, early warning and harmonised reporting. It takes the view that the implementation of a series of practical, incremental and result-oriented initiatives will strengthen European supervisory and stability arrangements. Clarifying and reinforcing the role of the Committees of Supervisors by amending their constituting Decisions is also seen as a necessary step in this direction. It will lead to a more cost-effective supervisory framework and to better financial stability monitoring.

A public consultation on this has been initiated by the Commission to help set out a clearer framework for their activities (see page 15).

Adding a European dimension&

EU Ministers have been discussing what steps should be taken to make the national watchdogs work more closely in these committees. The objective is to add a European dimension to the mandate of the national supervisors and that they take EU-wide considerations into account.

Cross-border banking Cross-border banks like Santander, UniCredit, Deutsche Bank, Fortis and Nordea now account for the bulk of deposits in Europe but supervision is still nationally based. Cross-border groups want to report to one main regulator to save on compliance costs.

Colleges of supervisors can make a decisive contribution to improve the supervision of cross-border financial groups. Within these colleges, supervisors will be expected to agree on key supervisory issues such as the approval of internal models or reporting requirements. Colleges may also facilitate the sharing of information between home and host supervisors.

Leading the debate in the May ECOFIN Council: Commissioner Joaquin Almunia, Andrej Bajuk, Slovenian Minister for Finance (President of the ECOFIN Council) and Commissioner Laszlo Kovacs.

The suggested amendments to the CRD aim to reinforce & supervision of cross-border banking groups by requiring

- the establishment of colleges of supervisors for all cross border groups;
- agreement within colleges on key home/host issues e.g. the approval of internal models, reporting requirements;&
- referrals to the Committee of European Banking Supervisors (CEBS) in case of disagreement within colleges.

In addition, initiatives such as the inclusion of an EU dimension into the mandates of national supervisory authorities and the improved functioning of EU committees of supervisors, will further strengthen the efficiency and effectiveness of EU supervision.

Crisis management memorandum &

EU ministers have also agreed on a Memorandum of Understanding which lays down how supervisory authorities, central banks and finance ministries from the 27 states should work together more closely when a cross-border bank is in trouble.

EU ministers have also given the go ahead for an EU-wide

intervention? Who should contact whom? Who should

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cise should test the ability of authorities to answer these questions.

"The turmoil has shown that we need to improve and strengthen the EU tool box for the supervision of financial groups," commented Commissioner McCreevy. "We need to build up an EU capacity for financial crisis prevention, management and resolution. The way forward was agreed at the end of last year and has been endorsed by the Council.

"The implementation of the overall road map is progressing well. In the months to come, it will be crucial to stick to the timetable and show that the EU is responding to the crisis effectively and in a coherent way."

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