

**CONCRETE STEPS
TOWARDS MORE INTEGRATED
FINANCIAL OVERSIGHT
THE EU'S POLICY RESPONSE
TO THE CRISIS**

CEPS TASK FORCE REPORT

**RAPPORTEUR: KAREL LANNOO
CEO, CEPS**

**CENTRE FOR EUROPEAN POLICY STUDIES
BRUSSELS**

The Centre for European Policy Studies (CEPS) is an independent policy research institute in Brussels. Its mission is to produce sound policy research leading to constructive solutions to the challenges facing Europe.

This report is based on discussions in the CEPS Task Force on Concrete Steps towards More Integrated Financial Oversight in the EU and was complemented by substantial internal research. The members of the Task Force participated in extensive discussions in the course of several meetings, and submitted comments on earlier drafts of the report. Its contents convey the general tone and direction of the discussions, but its recommendations do not necessarily reflect a common position reached by all members of the Task Force. Nor do they represent the views of the institutions to which the members, the Chairman or the rapporteur belong. A list of participants and invited guests and speakers appears in Annex 4 at the end of this report.

The rapporteur of the Task Force is Karel Lannoo, Chief Executive Officer at CEPS. He wishes to thank Alastair Sutton for chairing the meetings, the members of the Task Force for their helpful remarks and suggestions, and Chris Napoli and Emrah Arbak for research assistance.

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Centre for European Policy Studies
Place du Congrès 1, B-1000 Brussels
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51
E-mail: info@ceps.eu

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EXECUTIVE SUMMARY

A quantum step needs to be taken to upgrade and adapt the structure of financial oversight in the EU. The financial crisis exposed dangerous weaknesses in the regulatory and oversight structure that need to be urgently corrected to restore confidence in the financial system and to keep the single market alive. To date, EU policy-makers have not been sufficiently willing to consider changes in the institutional structure. We believe that this position is no longer tenable, for the following reasons:

- The EU Council of finance ministers has increased the number and magnitude of tasks assigned to the supervisory (Level 3 or Lamfalussy) committees – CESR, CEBS and CEIOPS – to absurd levels, tasks that far exceed their mandate, capabilities or competences.
- Supervisory opinion-sharing and information consolidation remain the Achilles heel of the single financial market. A common data pool, a succinct number of common supervisory data formats and data-sharing with non-supervisory authorities simply do not exist.
- Placing trust in Colleges of supervisors is a provisional solution for the present, not a sustainable one for the long-term. Colleges strengthen the bilateral spaghetti model of European supervision, at the expense of a truly integrated and consolidated oversight. In addition, colleges need to work in a context of non-harmonised statutes, mandates and powers of national supervisors, which greatly undermines their effectiveness.
- The basis for cooperation between national treasuries, central banks and supervisors are Memoranda of Understanding. The total number of authorities involved in such MoUs and their non-binding nature make these instruments almost entirely unworkable in an EU context, and all the more so in times of crisis.

Certain conditions are of critical importance during a financial crisis: a clear hierarchy in the decision-making structure, up-to-date supervisory

information and competence to act. As events have demonstrated, with a multitude of supervisory authorities in charge, these conditions are not in place in the EU today. On the contrary, the asymmetries in the supervisory systems in the EU are widespread, rapidly causing confusion, misunderstandings, and even mistrust and ring-fencing in times of trouble.

The creation of a European System of Financial Supervisors (ESFS), modelled upon the ESCB, is the way to overcome these weaknesses. Under an ESFS, EU supervisors would work under a single umbrella, a single institutional structure, on the basis of harmonised principles and statutes, but with full application of the subsidiarity principle.

Against this background, this report puts forward three recommendations:

- 1) The European Council should formally mandate the High-Level Expert Group on EU financial supervision to analyse the optimal structure of financial oversight and propose concrete steps leading to a European System of Financial Supervisors;
- 2) A European Financial Institute should be created to lay the groundwork for the establishment of the European System of Financial Supervisors; and
- 3) The European System of Financial Supervisors should be given definitive target date to commence operations.

The intention of the ESFS would not be to create a single European Financial Services Authority (FSA). Rather, it would follow the 'twin peaks' or objective-based model of supervision, based on the subsidiarity principle. Only those tasks that can be better performed at the European level would be centralised, namely crisis management, data-sharing and macro-prudential oversight, pooling of expertise in the supervision of large systemically important financial institutions, mediation amongst supervisors and supervisory decision-making. In this spirit, conduct of business control would largely remain at national level.

A European Resolution Trust should be created to work in tandem with the ESFS as a mechanism to address solvency problems in systemically important European-wide financial institutions. The European Resolution Trust would be managed by the European Investment Bank.

These moves should be widely communicated to European citizens to restore confidence in the financial system and in the single financial market.

INTRODUCTION

The financial crisis sounded a rude wake-up call for EU policy-makers and confronted them with the limits of the present framework for European financial supervisory cooperation. What had been established and functioned well during good times proved completely inadequate for crisis situations. In the absence of a European safety net or a European crisis coordination mechanism, EU member states fell back on national responses, which now threaten to unravel the single market.

Financial market integration had made powerful strides in the years leading up to the start of the financial crisis. Assets held by the 15 largest EU banks in other EU countries had doubled in the period 1997-2006. Several EU countries had become bridgeheads to a mighty financial services industry, active all across the globe. But financial supervision had not kept pace with these developments. Supervisors are by and large still working within the same structures as before the start of monetary union, with the home country ultimately in charge of the supervisory and lender of last resort functions. In several EU member states, including a country as large as the UK, the total sum of assets controlled by the banking sector is five (5) times larger than the GDP of the country in question (see the table in Annex 1).

This CEPS Task Force was launched on 10 March 2008, in connection with a CEPS meeting on the EU's reaction to the global financial market turmoil, with Pervenche Beres, MEP, and David Wright, Deputy Director-General of the EU Commission, as keynote speakers. The name of the Task Force is reminiscent of a CEPS study published some 18 years ago, entitled *Concrete Steps towards Monetary Union* (Gros & Thygesen, 1990). Although we are fully aware of the difference in significance between both plans, now is the time to put in place realistic roadmap to move to a more integrated structure of financial oversight. The methods and steps that were taken in the run-up to monetary union can serve as a useful model.

This report starts with an overview of the 2007-08 financial crisis from a European perspective. We will thereby often distinguish between two different phases, the period from August 2007 until August 2008, and the period following. In the second section, we analyse the reaction of policy-makers to the crisis, focusing initially on the roadmap of the finance ministers, and successively on the attempts to unfreeze the interbank market and the large bail-out plans of national governments. In the third section, we analyse the proposals for European regulatory and supervisory reform, and put forward a set of concrete proposals.

1. THE 2007-08 FINANCIAL CRISIS: A EUROPEAN PERSPECTIVE

The impact of the US subprime crisis on the European financial system went far beyond what most had dared to predict. What started as a problem related to one specific asset class in one region, rapidly affected the entire financial system in industrialised countries throughout the world, and the non-financial economy. The market for structured products collapsed, investors withdrew from the asset-backed securities market and the fear that some banks may be in trouble provoked a gridlock in the interbank money market, spreading in a second phase to citizens. The growing mistrust in the financial system led European governments, following the US initiative, to orchestrate a massive bail-out of €1,873 billion by mid-October 2008.

The 2007-08 financial crisis can be subdivided into two phases. During the first, lasting from August 2007 to August 2008, many banks took on ever-increasing amounts of losses related to asset-backed securities. In the second phase, starting in September 2008, with the bail-out in the US of Fannie Mae and Freddie Mac, the insurance group AIG and the bankruptcy of Lehman, the crisis became systemic, because of the generalised loss of confidence, leading to the massive bail-out plans on both sides of the Atlantic. To date, the costs suffered by the financial system related to the subprime losses and write-downs was estimated to amount to almost \$1 trillion, of which over one-quarter was carried by European banks. In the second phase, the issue was no longer the total amount of write-downs, but rather how to keep the system afloat at (almost) any cost.

The financial crisis was not a European crisis, nor was there a European response. Throughout the crisis, the impact on and the response from European countries have been heterogeneous. During the first phase, it was clear that the write-downs and losses concerned some banks more than others: it impacted, in decreasing order of importance, mainly banks in Switzerland, Germany, the UK and France. Banking sectors were affected in more countries in the second phase, but the response varied,

depending upon local circumstances. The UK plan, announced by Gordon Brown on 7 October 2008, was the first large European plan, followed by varying degrees and in different ways by other European states.

Judging from the continuing spreads in the interbank market, the financial problems are far from over. The period of de-leveraging and re-capitalisation in the financial sector can be expected to last for a long time. A prominent characteristic of the product to which the financial turmoil is related, real estate, is that prices are sluggish to react to changes in trends and hence cycles tend to be long (Gros, 2007).

The question arises what the impact of this crisis will be on financial disintermediation in Europe, which had developed at impressive rates since the start of monetary union. The development of mature capital markets in Europe was one of the hallmarks of the EU's Financial Services Action Plan (FSAP), but recent developments have put a sharp brake on this process. Recent Commission proposals would reverse the trend, penalise securitisation and strengthen financial intermediation.¹

1.1 Impact on the European banking system

The financial sector is going through a lengthy period of de-leveraging, which will take many years to accomplish. As banks need to improve their capital ratios, liquidity premia can be expected to be high for a long period of time. As could be observed in the first year of the crisis, there are several ways in which banks can improve their balance sheets: through rights issues, capital injections by sovereign wealth funds or the state, asset sell-offs and cost-cutting. Banks can be expected to focus more on recurrent forms of income in the retail and corporate lending side of the business. At the same time the profitability will decline considerably from the high levels that were recorded over the last three years.

What is remarkable from a European perspective is not only that the exposure of the European banks to the US subprime market was so pronounced, but also that this vulnerability was not evenly spread across countries. Banks in countries such as Italy and Spain were less affected by

¹ See Art. 122a proposed amendments to the Capital Requirements Directive (CRD) in the area of securitisation, in which the European Commission proposed that banks should hold capital for at least 10% of their securitised exposures. This was reduced to 5% in the EU Council compromise, reached on 2 December 2008 (see p. 22 below).

the crisis, whereas in others, most notably Switzerland, Germany and the UK, the losses were serious, leading to national debates about bank governance and supervision in the first phase, and large bail-outs in the second.

It is difficult to calculate an exact figure for the losses the European banking system incurred in the subprime crisis. The data published to date are mostly based on 2007 annual reports and are thus incomplete, as they do not include the write-downs announced since early 2008. One may have to wait for the 2008 reporting season to get the full picture. It must be kept in mind that the losses are often write-downs on the value of the asset-backed securities. As long as the banks that purchased them will hold on to them, these securities may still be re-valued, if the value of the underlying property recovers. In addition, it is difficult to determine what exactly a European bank is. A bank like HSBC, which suffered write-downs of about \$33.1 billion, is headquartered in the UK, but has strong south-east Asian roots. IKB, in contrast, which had losses of about \$13 billion, is an entirely German bank.

Table 1. Subprime losses and write-downs (up to 17/11/08)

\$ billions	Losses/write-downs	Capital raised
Worldwide	966.1	827.4
Americas	664.4	483
Europe	272.6	303.5
Asia	29.1	40.8
EU27-based banks	206.2	
...EU27 % of total	21.3%	

Source: Bloomberg.

The estimates of the total losses related to the subprime crisis to date amount to \$966 billion, of which more than \$272 billion is with banks headquartered in Europe (\$206 billion for the EU or 21%).² Should this be considered as a huge oversight on behalf of European banks? As the underlying assets are largely based in the US, and mostly in a high-risk segment (subprime), it could be considered as a large exposure of the European banking system to a part of the US market. However, a write-down of \$206 (€160) billion on a balance sheet total of €41,072 billion of the

² Data until 17 November 2008 (source: Bloomberg).

EU banking system (2007 data) corresponds to 0.4%, which is not excessive. Moreover, the balance sheet total of the European banking system is four times larger than in the US, which stands at €7,688 billion (2007, only commercial banks). Hence the European exposure to the subprime is, *ceteris paribus*, limited as compared to that of the US.

A similar situation occurred during the East Asia crisis of 1998, when it appeared that the aggregate exposure of European banks to debt from Asian, Latin American and East European countries stood at about €400 billion (end of 1997). This corresponded to 2% of the total balance sheet of €19,636 billion of the European banking system, or about three times the €125 billion exposure of the North American banks (US and Canada). Moreover, lending by European banks to these regions had increased strongly in the three years up to the crisis, even after the first signs of trouble in the emerging markets became apparent in July 1997 (BIS, 1998). That crisis also raised questions about internal risk management within European banks, and external control over lending policies.

With regard to the exposure from a national perspective, similar considerations apply *a fortiori* as to what extent a bank can be called national. German Landesbanken are by and large German, but British and Swiss commercial banks are internationally very active, especially in the US, and hence it is probable that they suffered losses in their international activities, and in particular in the US. The large losses by the German state-owned banks thus stand out as surprising. The combined write-downs of IKB, Bayerische Landesbank, West LB, LB Baden Württemberg and LB Sachsen stood at about \$28.4 (€22) billion (on total assets of the German savings banks of €1,045 billion (2007)). Nevertheless, as the internationally active banks are headquartered and have their consolidated oversight in their home countries, it raises the question whether there is a certain analogy with a governance and supervision system. Also, from a national perspective, the combined write-downs of the two dominant Swiss banking groups of \$54.2 (€42) billion (on a Swiss GDP of €309 billion in 2007!), raises existential questions about the Swiss banking industry and the Swiss financial centre.

This observed difference in the impact on national banking systems can be traced in the profitability figures, but not in the Basel tier 1 capital ratios data. On the basis of data published in the 2007 Annual Report of the BIS, profits of the major banks in Switzerland, Germany and France fell seriously and to a lesser extent in the UK. Spanish banks on the other hand saw an increase in pre-tax profits, even with a sizeable increase in loan loss

provisions, whereas Italian banks withstood the crisis well. The ‘regulatory’ capital ratios seemed to be much less affected, and certainly not yet a reason for concern, although the question can be raised whether they are sufficiently indicative. The (non-weighted) average tier one in the panel below declined from 8.2 to 8% in 2007. The same could be said for the loan-loss provisions, which has to take into account the major that the major losses of the banks discussed above were not on the banking book, but on the trading book.

Table 2. Profitability ratios of major banks^a (as a percentage of total average assets)

	Pre-tax profits			Loan loss provisions			Net interest margin			Operating costs		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Austria (3)	0.85	1.64	1.29	0.30	0.38	0.28	1.64	1.90	2.24	2.10	2.40	2.40
Australia (4)	1.52	1.62	1.67	0.14	0.13	0.15	1.92	1.96	2.01	1.70	1.64	1.63
Canada (5)	1.01	1.32	1.27	0.10	0.10	0.14	1.79	1.64	1.68	3.00	2.56	2.57
Switzerland (6)	0.66	0.87	0.31	0.00	0.00	0.01	0.63	0.53	0.45	1.67	1.73	1.70
Germany (7) ^b	0.38	0.55	0.28	0.06	0.07	0.04	0.65	0.68	0.52	0.96	1.32	0.98
Spain (5)	1.15	1.51	1.65	0.23	0.33	0.41	1.55	1.78	1.94	1.70	1.91	1.96
France (5)	0.76	0.87	0.41	0.06	0.06	0.09	0.93	0.76	0.47	1.47	1.43	1.28
United Kingdom (8)	0.87	0.97	0.67	0.23	0.27	0.23	1.23	1.26	0.94	1.59	1.70	1.36
Italy (4)	1.23	1.12	0.88	0.23	0.26	0.25	1.95	1.93	1.71	2.34	2.34	2.01
Japan (13) ^b	0.66	0.67	0.50	0.12	0.15	0.13	0.89	0.97	0.75	1.05	1.15	0.80
Netherlands (4)	0.58	0.57	0.38	0.05	0.10	0.10	1.09	1.17	0.99	1.29	1.48	1.37
Sweden (4)	0.90	1.06	0.98	0.01	-0.03	0.01	1.03	1.08	1.07	1.07	1.11	1.07
United States (11)	1.93	1.82	1.02	0.20	0.20	0.56	2.72	2.50	2.47	3.44	3.12	3.51

^a All values are IFRS; the number of banks included is shown in parentheses.

^b Values are a mix of local and US GAAP.

Sources: Bankscope; FitchRatings.

Table 3. Capital and liquidity ratios of major banks^a

	Tier 1 capital/risk-weighted assets			Non-performing loans/total assets			Net loans/total deposits		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Austria (3)	7.7	8.9	8.1	2.3	2.1	1.8	56.4	58.1	63.2
Australia (4)	7.5	7.2	6.8	0.1	0.2	0.2	88.3	89.8	85.1
Canada (5)	9.9	10.4	9.6	0.3	0.2	0.2	58.3	56.2	57.2
Switzerland (4)	11.7	11.7	9.8	0.2	0.2	0.1	25.2	26.1	27.3
Germany (7)	8.4	8.4	8.0	1.0	0.6	0.8	36.2	30.4	25.4
Spain (5)	7.9	7.6	7.9	0.5	0.5	0.6	69.9	76.7	76.1
France (4)	8.1	7.9	7.4	1.2	1.2	1.3	32.3	36.5	25.8
United Kingdom (7)	7.5	7.9	7.6	0.8	0.7	0.8	54.8	54.5	51.1
Italy (4)	4.7	5.0	6.6	4.0	3.2	3.1	42.7	49.6	70.9
Japan (10)	7.3	7.9	7.4	1.1	1.0	0.9	53.1	55.1	62.5
Netherlands (4)	10.4	9.4	10.0	0.6	0.6	0.4	54.1	55.8	55.1
Sweden (4)	7.1	7.2	7.1	0.4	0.4	0.3	71.7	74.2	74.9
United States (11)	8.4	8.6	8.0	0.3	0.3	0.6	63.4	63.6	61.5

^a Weighted averages by banks' total assets; in per cent; the number of banks included is shown in parentheses.

Source: Bankscope as reproduced in BIS (2008a), 2007 Annual Report, BIS, Basel.

As indicated above, the full cost of the crisis will only be known from the 2008 reporting season onwards. The year 2007 was the combination of a sparkling first half, and the start of the crisis and the write-downs in the second. The full impact of the crisis will thus only be reflected in the profitability and capital ratios from 2008 onwards. However, it is clear that 2007 will be a trend break of continuously rising profits in the banking sector since 2003. The post-crisis period will be a different era altogether.

The same disconnect between a fundamental decline in profitability figures and capital ratios can be observed in the US. Whereas the profitability of US commercial banks was cut in half, the capital ratios stayed almost at the same level. The write-downs since mid-2007 eliminated all of the profits made by the 10 largest US banks over the period 2004-07.³

The big difference between the EU and the US banking system, however, is the level of leverage, or the share of core capital on total assets. A rough comparison reveals that the level of leverage in the EU is almost double that in the US, or to say it the other way around, the level of own

³ "Vanished profits", *New York Times*, 17 October 2008.

funds in the EU is half what it is in the US, with all the problems this can entail in a context of loss-taking. Table 4 below shows the size of total bank assets as a share of GDP of the top five banks based in a selected group of countries, the loan-to-deposit ratio, or the degree of underfunding, and the leverage ratio. The Basel tier 1 ratio is added as a point of comparison (based on BIS data referred to in the previous table). It shows worrying low levels of core capital, and an unclear relationship between the Basel tier 1 and the core capital ratio. For the EU, it also demonstrates marked differences in the average capital ratios between the southern and northern European countries (see also Table A1 in Annex for a full overview).

Table 4. Core bank soundness ratios in selected EU countries and the US, 2007

	Top 5 bank assets as % of GNP	Loans to deposits	Core capital ratio	Basel tier 1 ratio
Belgium	463	104	4	
France	293	101	3.5	7.4
Germany	165	94	2.6	8
Ireland	404	197	3.6	
Italy	131	161	7.4	6.6
Netherlands	521	125	3.8	10
Spain	184	250	7.2	7.9
UK	313	125	3.9	7.6
EU 27	237	133	4.3	
Switzerland	756	69	3.2	9.8
US	44	91	7.6	8

Sources: Bankscope, Eurostat, BIS.

The difference between the core capital ratios and the Basel ratios is even more pronounced in individual cases. The Belgian bank Dexia, an early casualty of the crisis, had a Basel tier 1 ratio of 11.4% in June 2008, but a core capital ratio of only 1.6%.

Table 5. Basel tier 1 and core capital ratios for selected banks

	Basel tier 1 ratio		Core capital ratio	
	end 2007	Jun-08	end 2007	Jun-08
Fortis	9.5	7.4	3.8	3
Dexia	9.1	11.4	2.4	1.6
ING	7.4	8.15	2.8	2.2

Sources: Annual and half-yearly reports of banks.

1.2 *Impact on the European insurance sector: Less discussed*

The insurance sector is a much smaller actor in the financial system than are the banks. Total assets are about one-fifth of the banking sector in the EU. They are thus systemically much less important. Insurance companies are mostly liability-driven, meaning, as long as their risks on the liabilities side (life insurance, mass risk) are well controlled, and the assets to cover these risks are well diversified, they should not face too many problems. Unlike banks, insurance companies are less cyclical: demand for mass risk and life insurance should be fairly stable over time. The main risk in the context of this crisis should be related to bad investments, or overexposure to the real estate markets, as seems to have been the case with some companies. Notwithstanding this fundamental difference with the banking sector, it seems that markets have put the insurance sector in the same basket as the banks. Indexes have gone down almost to the same degree as banks.

The concern about the insurance sector increased as a result of the bail-out of AIG in the US. However, this problem, together with the bankruptcy of Lehman, affected the banking sector more negatively, as it appeared that AIG had written coverage for over \$300 billion of credit insurance for European banks. AIG itself explained these positions by commenting that they were "...for the purpose of providing them with regulatory capital relief rather than risk mitigation in exchange for a minimum guaranteed fee".⁴ A formal default of AIG would thus have had a devastating impact on banks in Europe, which explains why AIG's problems sent shock waves through the share prices of European banks.

One reason why the insurance sector has been less affected by the crisis is the limited transparency of the published accounts. There is no common method to date at European or international level to measure the minimum solvency requirements of insurance companies, which means that prudential supervision is conducted in different ways across the EU. The European Commission's Solvency II proposal would introduce a single method, but it is still under discussion in the EU Council and Parliament. In addition, the application of International Financial Regulatory Standards (IFRS) is also more limited as compared to the banking sector.⁵ This has not

⁴ K-10 annex of AIG annual report, quoted in Gros (2008).

⁵ See for example the announcement by Allianz of the valuation of its stake in Commerzbank at double the market price, 10 November 2008.

prevented some groups to be exposed, and request participation in the state bail-out plans, such as Aegon in the Netherlands or Ethias in Belgium.

1.3 Impact on financial market activity

The impact on financial market activity was probably the severest, where the crisis broke a trend of growth in European capital markets. The hardest hit were the leveraged finance, asset-backed paper and securitisation markets, which became almost entirely frozen, whereas other segments remained stable, such as corporate bond issuance, at least from a European perspective. Issuance of corporate bonds and notes picked up in the second quarter, after having got off to a very low start in the first. Forecasts for the full year 2008 could end up at the same levels as in 2007. Leveraged finance issuance, on the other hand, which includes leveraged loans and high-yield bonds, declined to €67.0 billion for the first three quarters of 2008 compared to €243.3 billion over the same period in 2007.⁶ Securitisation issuance declined over the same period from €309.2 for the first three quarters of 2007 to €26.3 billion over the same period in 2008.⁷ IPO activity was still strong until the end of 2007, but declined sharply in the first half of 2008.

European mortgage-backed securities (MBS) issuance activity picked up during the second quarter of 2008 as compared to the previous quarter. By nationality, the largest increase was from UK borrowers, following the Bank of England's announcement in April 2008 of a Special Liquidity Scheme that enabled UK banks to swap illiquid assets, such as mortgage-backed securities, against UK Treasury bills (BIS, 2008b). However, the activity is largely concentrated in the residential MBS segment, which will overtake 2007 in issuance volume, whereas other segments, including ABS, CDOs and commercial MBS, were halved.⁸

The clearest market indicator of persistent stress is the interbank money market rate. Since the start of the credit crisis in August 2007, 3-month spreads of interbank (euribor) over overnight rates have jumped from about 10 basic points before the crisis to about 50 in the early days of the turmoil and about 80 basic points until the end of the summer, to reach

⁶ European Third Quarterly High Yield and Leveraged Loan Report for 2008 (available from www.ehya.com).

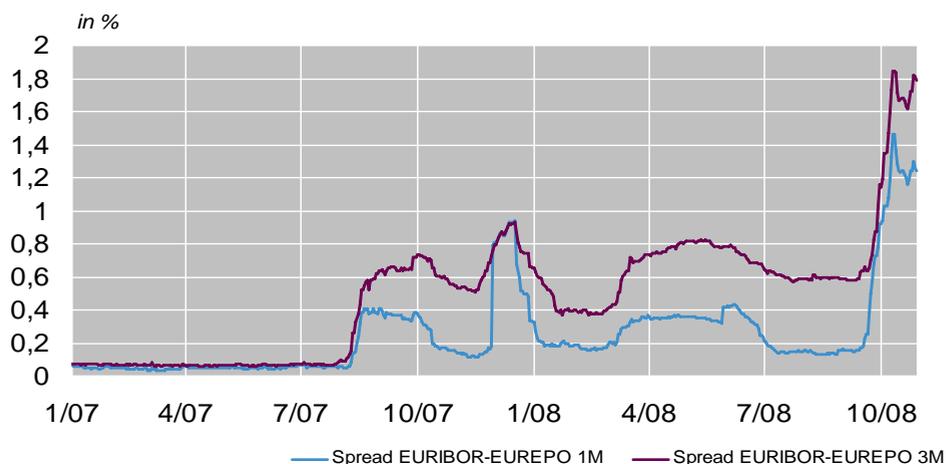
⁷ 2008 Q3 Securitisation Data Report (www.europeansecuritisation.com).

⁸ Ibid.

over 100 basic points in the aftermath of the Lehman bankruptcy. Throughout this period, central banks actively intervened to reduce tensions in the interbank markets, but apparently with limited success. It was only the government actions taken in the second half of October to guarantee interbank claims that managed to bring a halt to the widening spreads. Figure 1 shows the spread of the euribor over the eurepo rate, which is the rate at which one prime bank offers funds in euro to another prime bank in exchange for collateral – the spread of the unsecured over the secured lending. It shows the growing cost for unsecured lending since mid-2007.⁹

Figure 1. Spread of the interbank money market rate (euribor) over eurepo, January 2007 - October 2008

Spread EURIBOR vs. EUREPO - 1M and 3M



⁹ Drawn from Ewald Nowotny (2008).

2. THE POLICY RESPONSE

Policy-makers reacted early on to the mounting problems in the financial sector, as well at international, European and national level. The question that arises is what went wrong to prevent this crisis from turning into a full-blown systemic crisis. More especially from a European perspective, the Ecofin roadmap, put in place from October 2007 onwards, seems not to have been sufficient to stop financial instability from spreading and spiralling out of control. Were ministers underestimating the depth of the problem? Were they too complacent in the belief that it was an essentially US grown problem? Or was it related to a policy coordination problem, as the inter-linkage between international, European and national policy levels gives rise to an unclear division of roles and confusing mandates?

In October 2007, the G7 finance ministers and central bank governors asked the Financial Stability Forum to analyse the situation and make recommendations on how to improve the resilience of financial markets and institutions. At European level, the finance ministers discussed the problems in financial markets at the informal Ecofin Council in September 2007, and came up with detailed conclusions during their October, December 2007, May and October 2008 meetings. But as these reactions seemed insufficient and the financial crisis became full-blown, heads of state and government stepped in and orchestrated the response within the Eurogroup and European Council.

But it is above all at national level that the response was initiated, first as a debate about bank governance and supervision in those countries whose banks were badly hit. Once the crisis spilled out of control, one government after the other stepped in to prepare plans to re-capitalise its financial sector and unlock the interbank market, with differing degrees of conditionality.

One of the reasons why Europe disappeared from the scene is the non-existence of a 'European Treasury'. Although central banks played a dominant role in the first phase of the crisis, treasuries became the leading

actors in the second. As banks had to be recapitalised, or interbank lending markets guaranteed, national treasuries had to step in. The 12 October Eurogroup meeting tried to give some coordination to these national plans, which was endorsed by the European Council three days later, but it did not come up with a European plan.

2.1 *International level*

The lead in the reaction to the crisis was initially taken by the Financial Stability Forum (FSF), which issued its recommendations in April 2008, but it was overtaken in the second phase by the G-20, convoked at the initiative of the French President. The G-20 foresees a reform of the Bretton Wood institutions with a broader participation of countries and a central role for the IMF to detect financial system problems.

The FSF urges actions including strengthened prudential regulation and oversight, transparency in securitisation practices, limitations in the use of rating agents and better tools to detect stress, but it does not propose any fundamental shifts in the regulatory framework. Basel II and its 3 different pillars, with some adjustments, remain the basis for financial oversight. The capital requirements for the trading book remain largely unchanged, but liquidity regulation becomes a new objective. The report puts a considerable burden on the Basel Committee and national supervisors to improve things, but it is questionable whether they will be capable of coping, given the fatigue related to the long and protracted efforts which led to the Basel II Accord in 2006 and the huge oversight failures that were highlighted by the crisis. The immediate requirements for market participants on the other hand are limited, and essentially focused on more disclosure.

To improve the oversight of large internationally active groups, the FSF recommended the expanded use of international colleges of supervisors, as is also proposed by EU finance ministers. The FSF however stopped short of proposing any enhanced role for the IMF or BIS, or any other body in monitoring exposures in the financial system at large, or in allowing information from the colleges to be amalgamated and monitored more centrally.

The G-20 meeting in Washington (15 November 2008) addressed the issue of strengthened international cooperation, but nothing concrete was decided. It proposed an enhanced role for the IMF to better identify vulnerabilities in the financial system and requested all G-20 members to undertake Financial Sector Assessment Programmes (FSAPs) by the end of

March 2009, to review the compatibility of the local regulatory systems with the international financial system. FSAPs have been undertaken by the IMF since May 1999 to analyse financial systems across the globe, but it is unclear how, in the current global governance framework, their enforcement can be strengthened.¹⁰

What the role will be for the European Commission in this global governance framework remains to be seen. The Commission has over the last years been strongly involved in regulatory dialogues with the US and increasingly with other third countries, but was not represented in international fora such as the FSF. Reporting lines from the G-7 or G-20 go directly to its member states, and the international organisations involved. Regional organisations, such as the EU, seem not to have a clear role.

2.2 *European level*

The EU response was initially crystallised in the 'roadmap', adopted in October 2007, and further enhanced and updated in successive EU Council of finance ministers meetings. The roadmap moved to a second plan from October 2008 onwards, as the main concern became the national bail-out plans and their implications for European integration.

2.2.1 *The Ecofin roadmap and the 1st phase of the crisis*

The 'roadmap' is an extensive action plan, with a long series of measures to be taken by certain target dates. It was an early indication of the EU's responsiveness to the crisis and its preparedness to make the adaptations in the regulatory and supervisory framework. At the same time, however, it emphasised at several occasions that no deep structural change would be undertaken. On the contrary, the prevailing view was that the current institutional structure should suffice, which is entirely unrealistic, as the analysis below will show.

The October 2007 Ecofin Council, in response to the first signs of market stress, agreed on common principles for cross-border financial crisis management and on a roadmap to practically enhance supervisory cooperation. The common principles aim to protect the stability of the financial system and to minimise harmful impacts on the economy. In the

¹⁰ See <http://www.imf.org/external/NP/fsap/fsap.asp> for hundreds of FSAP country reports.

statement released to the press following the meeting, the Ministers insisted that they will “carefully cooperate” in the case of a cross-border crisis and will react “based on common terminology and on a common analytical framework”. It built upon difficult work undertaken in recent years in the context of the Economic and Financial Committee (EFC) on financial crisis management and burden sharing.¹¹

The December 2007 Ecofin Council spelled out the role of the EU’s regulatory and supervisory committees in this context. It asked the Commission to consider various options to strengthen the Level 3 Committees, but “without unbalancing the current institutional structure”, a sentence that was repeated by later Ecofin Councils. The Level 3 Committees, which have a mere consultative role, were requested to strengthen the national application of their guidelines “without changing their legally non-binding nature”, and to enhance their efficiency “by introducing...qualified majority voting where necessary”. The Level 3 Committees were asked to analyse the options of “voluntary delegation of supervisory competences”. To deal with the growing workload of the Level 3 Committees, the Commission was asked to consider more financial support under the EU budget.

In a letter to all his European colleagues dated 26 November 2007, the Italian minister Tommaso Padoa-Schioppa, called for formal changes in EU legislation to entrust the Level 3 Committees with the powers to adopt binding decisions, and to endow them with adequate financial and human resources to perform their tasks.¹² He observed that, in view of the financial market turmoil, the European financial system was still unable to effectively respond to the challenges of a globally integrated market. Voluntary agreements, the Italian minister remarked, proved incapable of ensuring an efficient area-wide supervisory teamwork during crisis episodes. The Level 3 Committees should therefore be turned into agencies, with the power to set binding standards and to take decisions in a limited

¹¹ Work on crisis management and burden-sharing started in the EFC in 2004, but was the subject of deep controversy between the member states on the need for a formal agreement on these matters. Cross-border crisis management exercises and simulations have been conducted on a regular basis in recent years.

¹² The letter was published in abridged form on 11 December 2007 in the Financial Times.

number of areas. The proposal however was hardly discussed in the Ecofin Council.

The debate on the appropriate governance structure accelerated in the run-up to the informal Spring Ecofin Council, which took place in Lubljana in April 2008, with clearer positions from different member states. The British Chancellor Alistair Darling proposed to establish supervisory colleges by EU law and create cross-border stability groups to respond to financial crisis (3 March 2008). The Italian Minister reiterated his proposal to turn the Level 3 Committees into EU agencies. And the Hungarian Prime Minister proposed a uniform European financial supervisory authority, based on the model of the ESCB (21 February 2008). The informal Ecofin, to which Alexandre Lamfalussy was invited, discussed the EU dimension of supervision, but without coming to a concrete proposal.

The May 2008 Ecofin Council affirmed and increased the tasks assigned to the Level 3 Committees. In addition to the earlier tasks, these bodies were asked to develop a common European supervisory culture, to ensure efficient cooperation across financial sectors and to monitor financial stability and reporting risks to the Economic and Financial Committee (EFC). On the latter task, the Council stressed “that the EU Committees of supervisors should be able to gather aggregate information in order to assess these features within and across financial sectors and to alert the EFC on potential and imminent threats in the financial system.” One may wonder however whether the Council fully realised what it was asking of the Committees, with each of them employing only about 15 persons. Asking ECB’s Banking Supervision Committee (BSC) to join forces with CEBS and to “ensure an efficient and appropriate division of labour amongst these two” is unrealistic, as the institutional contexts in which both bodies operate is entirely different and not comparable.¹³

On the supervision of EU-wide financial groups, the May 2008 Ecofin Council put its faith in the colleges of supervisors, as the FSF had also proposed. To allow these entities to function, a new memorandum of understanding (MoU) on cross-border financial stability was signed amongst the supervisory authorities, central banks and finance ministries. It specifies a much clearer and more explicit division of responsibilities and

¹³ 2866th Council Meeting, Economic and Financial Affairs, Brussels, 14 May 2008, Council Conclusions, p. 13.

tasks amongst the signatories than what had been in place so far.¹⁴ It spells out common definitions and principles, rules on information exchange and cooperation agreements applicable in normal times and periods of crisis. No less than **113 (!)** authorities are signatories to the agreement, which is a very high number considering that close to one-half of the member states have a single FSA, and that EEA countries are not included. In case of specific agreements pertinent to the supervision of financial groups, however, only those national authorities will be involved where a financial group has a presence. The agreement takes the form of an MoU, i.e. it is not legally binding and cannot give rise to any legal claim, although it was, for the first time, made public in full.

2.2.2 *A full-blown systemic crisis*

Policy-makers only started to realise the full scale of the financial crisis by the end of September 2008. Before that time, they continued to believe that this was essentially a US-grown problem, and that it would not affect the European financial system profoundly.¹⁵ The succession of events in October 2008 dramatically brought home the message that Europe had an enormous problem of undercapitalisation in the banking sector, and that only a massive state-led recapitalisation would bring the systemic crisis to a halt. Calls for a European solution fell on deaf ears, and the reaction to the problems from Fortis onwards were entirely in national hands, with only an appearance of European coordination.

The state-led rescue of Fortis during the weekend of 27-28 September 2008 signalled the start of a series of bank bail-outs across the EU, on a case-by-case basis, or as part of a general plan. The EU was absent during the earlier part of the crisis, and it was only the emergency Eurogroup meeting on October 12th in Paris, convoked at the initiative of President Sarkozy as President of the European Council, that provided some

¹⁴ In March 2003, the ECB initiated a memorandum of understanding on 'high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations', which was updated in 2005.

¹⁵ This was the main message of the historic press briefing given by the German Minister of Foreign Affairs Steinmeyer in front of NYSE building, on 24 September 2008, in the margins of his participation in the UN annual meeting (see for more info: <http://www.auswaertiges-amt.de/diplo/en/AAmt/BM-Reisen/2008/VN-Woche/vn-letzter-Tag.html>). Two weeks later, the German government announced a €500 billion support plan for the financial sector.

European coordination to the national rescue plans. A call for a European bail-out fund, as informally discussed within the French Ministry of Finance, and also supported by a large group of European economists, was not withheld by the European G-4, which met in an emergency meeting in Paris on October 4th, as Germany was said to be radically opposed to any such fund.¹⁶ Two days later, the British prime minister was the first to formally announce a national bail-out plan for a select group of large British banks, although he added explicitly that this should “ideally be solved at European level.”¹⁷

The main concern of the G-4 meeting was to get the European Commission’s flexibility in the approval of the national bail-out plans, as well from a state aid and stability pact perspective, because of the exceptional circumstances. The meeting called for a new framework of financial supervision, and suggested an international meeting on financial sector governance. The meeting requested the Commission and the International Accounting Standards Board (IASB) to allow banks to reclassify trading book as banking book assets in order to embellish their balance sheets, on which a decision was taken by the finance ministers on October 7th.

The Eurogroup meeting on October 12th was the first to come up with a European response to the crisis, in the form of a concerted action plan of the eurozone to temporarily guarantee bank refinancing and keep important banks from failing. The meeting was convened at the level of heads of state and government, under the chairmanship of the French President. The ECB president and the British prime minister Gordon Brown were also invited. The Eurogroup decided that:

- governments can provide state guarantees to bank debt issues for up to 5 years under well-determined conditions, and can participate in these issues. All banks should be eligible to these operations, including foreign-owned banks; and
- governments can take equity stakes in financial institutions and recapitalise banks in trouble.

Moreover, the ECB was requested to ease its rules on collateral.

¹⁶ “European banking crisis, A call to action” (available from www.voxeu.org) *Financial Times*, 2 October 2008.

¹⁷ Gordon Brown on BBC News, 6 October 2008.

Governments were asked to avoid national measures that would negatively affect the functioning of the internal market and harm other member states. They committed to 'coordinate in providing these guarantees, as significant differences in national implementation could have a counter-productive effect, creating distortions in banking markets.' The support actions would be 'designed in order to avoid any distortion in the level-playing field and possible abuse at the expense of non-beneficiaries of these arrangements.'¹⁸

The Eurogroup decisions were endorsed by the European Council, which met a few days later in Brussels. In addition, the European Council decided to establish a 'financial crisis cell' to act in crisis situations. This mechanism will bring together representatives of the Presidency-in-office, the President of the Commission, the President of the ECB (in conjunction with the other European central banks), the President of the Eurogroup and the governments of the member states. The Council also welcomed the setting up of a high-level group by the Commission to strengthen the supervision of the financial sector.

The Ecofin Council had decided in the meantime to increase the minimum level of deposit protection to €50,000, leaving the possibility to the member states to increase it to €100,000. A formal Commission proposal on the subject was adopted a week later. The urgency of the review of the 1994 deposit guarantee directive (1994/19/EC) was widely acknowledged since the September 2007 Northern Rock bail-out, but it took the European Commission more than one year to have a new proposal on the table. The Ecofin Council also adopted conclusions on executive pay and reiterated its call for a timely implementation of the roadmap.

The December 2008 Ecofin Council reached a political consensus on four financial services directives, including the amendments to the deposit guarantee and the capital requirements directive, and draft solvency requirements directive. The agreement on the latter directive confirms the retreat of the European approach and asserts a prominent role for nation states in supervision. The ministers at the Ecofin Council rejected a draft clause, referred to as 'group support', which would have allowed capital to be shifted from subsidiaries in other member states to the parent company, and gave local supervisors the power to block such transfers. This change greatly disappointed the European Parliament and industry alike. The

¹⁸ Eurogroup Summit, 12 October 2008, Press Release, pp. 2-3.

December 2008 Council emphasised the need to establish, without delay, national schemes to support the banking sector, with respect to guarantees, but also and especially recapitalisation plans, in order to sustain credit. It called upon the European Commission to publish guidelines distinguishing between sound and distressed banks, and on the principles governing state support.

2.3 The local debates and national bail-out plans

Although the credit crisis is a global phenomenon, the debates remained largely national, with important nuances in the response. This must be kept in mind when considering an eventual European solution, as discussed in the next section. For some, the crisis has clearly demonstrated the limits of the current cooperative model of financial supervision, whereas for others, it has demonstrated the dangers of too much of a harmonised approach. Some countries have already made adjustments to the supervisory framework. Most interesting from our perspective are the changes that were proposed in the institutional structure at national level and how the roles of the different actors in financial supervision were altered.

The Paulson report, published by the US Treasury (2008) a few days after the Bear Stearns collapse, is the most instructive. Although the drafting of the text had started well before the crisis erupted, in the context of the debate on the competitiveness of the US financial markets, and its contents essentially concern the re-design of the US supervisory system, the report is also relevant for the EU debate. Not only does it demonstrate a willingness to embrace radical change, which many in the US thought to be almost impossible, it also has implications for the EU structure. It should be recalled that US policy-makers and officials have over the last few years been impressed by the EU's capacity to adapt its financial system in the Financial Services Action Programme (FSAP), to implement the Lamfalussy proposals and to create a more competitive financial market.¹⁹

The Paulson report sees the 'twin peaks' model as the long-term ambition for the US, in which supervision is organised by objective, i.e. prudential versus conduct of business supervision. Such an objective-based model of financial supervision is in place in the Netherlands and in

¹⁹ See, for example, the report by the General Accountability Office (US GAO, 2004) as well as the Paulson Report.

Australia.²⁰ It recommends an enhanced regulatory and oversight role for the Fed, as the central authority, with day-to-day supervision in the hands of a prudential and a conduct of business supervisor. Today, the Fed is one of the four federal bank prudential supervisory authorities, and supervises about 15% of the top 50 US-based banks (Petschnigg, 2005, p. 35), whereas prudential supervision of the (until recently) powerful investment banks was formally in the hands of the Securities and Exchange Commission (SEC), although it is debatable whether this was properly done.²¹

In the UK, the Northern Rock bank run, the first since Victorian times, and the losses incurred by several blue chip financial institutions led to broad debate about the adequacy of the structure of financial supervision. Although the FSA model was not called into question, the Bank of England was given a more important role. The UK Parliament report on Northern Rock criticised the lack of leadership in handling the bank failure and thus the non-functioning of the Tripartite Agreement between the FSA, the Bank and the Treasury. It proposed the creation of a new post of Deputy Governor of the Bank of England and Head of Financial Stability.²² In his Mansion speech on 18 June 2008, the Chancellor of the Exchequer, Alastair Darling, said the Government intended to provide a formal legal responsibility for financial stability to the bank as well, alongside its existing role in monetary policy. These proposals were confirmed in the Banking Bill of October 2008, which is expected to come into force in early 2009. In Germany, the large losses in state-owned banking institutions sparked a new debate about the relevance of the FSA model, put into place with the Bafin (the German financial services authority) in 2002, and led to calls for a greater role of the Bundesbank in banking supervision.

²⁰ The Paulson Report came out clearly against the FSA model: “An objectives-based approach also allows for a clearer focus on particular goals in comparison to a structure that consolidates all types of regulation in one regulatory body” (p. 14).

²¹ According to Calomiris (2008), the Basel II rules were effectively applied by the SEC to investment banks.

²² “There is a need for ‘creative tension’ within the regulatory system, and so these powers and responsibilities should not be granted to the Financial Services Authority. We propose the creation of a new post of Deputy Governor of the Bank of England and Head of Financial Stability.” See UK House of Commons Treasury Committee (2008, p. 4).

Further discussion on the structure of financial oversight was overtaken by the urgency of national bail-out plans for the financial sector. At the same time, the acceptance that radical change was needed grew further during the month of October 2008. On the other hand, the need for financial assistance brought the discussion back to the member state level, as there is no European Treasury, and plans for a European fund were shelved by the German government. By October 14th, European governments had committed some €1,873 billion, or about 15% of GDP of the EU15, to national bail-out plans in one form or another. This sum increased to over €2,170 billion by the end of December, and is further growing (see Table A3 in Annex).

The emergence of the national treasuries in dealing with the crisis raises some fundamental problems for the single market. While the European Commission recognised the urgency of the situation, it published guidance for state aid measures to banks in crisis.²³ The Commission stresses in this document that any measure taken should be exceptional, and that the situation in the financial sector should be reviewed every six months. They could otherwise “generate harmful moral hazard”.²⁴ The European Commission specified several conditions that must be met in national support schemes:

- Non-discriminatory access, eligibility for support should not be based on nationality;
- State commitments to be limited in time and scope, while excluding unjustified benefits for shareholders;
- Adequate remuneration of the state financial support;
- Private sector contribution;
- Behavioural rules for beneficiaries that prevent an abuse of state support, such as expansion and aggressive market strategies on the back of a state guarantee;
- State aid should be followed by structural adjustment measures for the financial sector; and
- Winding-up procedures should be open and take place on market terms.

²³ See State aid: Commission gives guidance to Member States on measures for banks in crisis, 13 October 2008 (<http://ec.europa.eu/comm/competition>).

²⁴ European Commission (2008b, p. 10).

It was added that observance of these principles, including in individual aid measures, is the responsibility of the member states, and subject to monitoring by the Commission.

A quick review of the measures adopted at member state level indicates that these rules have already been violated several times (see the table in Annex 3). Overall, most schemes are only open for domestic banks, without a clear definition of what this means, thus leaving much discretion in the hands of the minister of finance. The Dutch scheme for example is only open for systemically important Dutch banks.²⁵ State-sponsored subordinated debt schemes, which were used in the Dutch and Belgian context, are not permitted, according to the European Commission, as they protect the interests of shareholders.²⁶ And the Fortis liquidation procedure was not open. The European Commission has, under the state aid rules, been notified of and responded to most of the general national bail-out plans, and also to some specific cases. It concerns so far the support schemes of 15 member states, in chronological order: Denmark, Ireland, the UK, Germany, Sweden, Portugal, the Netherlands, France, Spain, Finland, Italy, Greece, Belgium, Austria and Slovenia. It approved many individual cases of aid (including Bradford & Bingley, Hypo Real Estate, Roskilde Bank, IKB) and launched in-depth investigations into the Northern Rock and WestLB bail-outs.²⁷

The difficulties these schemes pose to free competition led the EU Commission to publish a further Communication in December 2008 on the principles governing State recapitalisation of financial institutions (European Commission, 2008c). State capital injections need to be appropriately remunerated to avoid distortions of competition at EU level, but need also to take into account the different circumstances of the banks and financial markets in question. Lack of differentiation may also weaken the overall competitiveness of European banks. The Commission Communication therefore proposes some pricing mechanisms, and a price

²⁵ For a bank to qualify as an Eligible Bank under the Dutch scheme, it must satisfy the Bank Eligibility Criteria: 1) be a bank as defined by the Dutch Financial Markets Supervision Act; 2) have a corporate domicile in the Netherlands; 3) have substantial business in the Netherlands; and 4) have an acceptable solvency ratio. See Clifford Chance (2008).

²⁶ European Commission (2008b), p. 3, Art. 23.

²⁷ See http://ec.europa.eu/comm/competition/state_aid/what_is_new.

corridor, determined by the (i) the required rate of return on subordinated debt representing a *lower bound* (being 7%) and (ii) the required rate of return on ordinary shares representing an *upper bound* (being 9.3%).

3. MODELS FOR A EUROPEAN REGULATORY AND SUPERVISORY REFORM

The debate on the reform of the European regulatory and supervisory structure has been running for at least a decade. It started in the wake of the start of monetary union, with the launch of the Financial Services Action Programme (FSAP) and the proposals of the Lamfalussy Committee. Until recently, the EU demonstrated that it was capable of adapting the supervisory structure and instituting a much greater degree of supervisory cooperation than had existed previously.

The reform, however, had not been subjected to a crisis situation, having been crafted during good weather conditions, not stormy ones. Discussions had been going on since 2005 over burden-sharing in the event of cross-border bank failures, but without much result.

The following discussion in section 3.1 should illustrate that we have probably reached the limits of what is possible under the current system, and that a quantum step needs to be taken. We review the shortcomings in the present regulatory and supervisory model, as the basis for formulating in section 3.2 a proposal for a European System of Financial Supervisors.

3.1 Shortcomings in the present regulatory and supervisory model

Two proposals have been debated for quite some time concerning desirable changes to the present supervisory model: i) upgrading the Level 3 Committees and ii) strengthening the role of the supervisory colleges. In the context of European supervisory cooperation, two further issues need to be analysed: the functioning of memoranda of understanding, as they underpin cooperation among supervisory colleges, and the role of the ECB, as it will need to be part of a European solution.

3.1.1 *The role of the Level 3 Committees*

The Level 3 Committees have managed to achieve a lot in a limited period of time, and with scarce resources. They can be credited with having eased the Commission's work on the implementing measures for framework directives and to have contributed to supervisory convergence and a European supervisory culture by continuously bringing together supervisors from the different member states on a wide variety of matters.²⁸ However, it rapidly appeared that their purely advisory role was hampering their drive. A discussion was kicked off in 2004 by the oldest of the Committees, the Committee of European Securities Regulators (CESR), with publication of the Himalaya report (CESR, 2004), which proposed an enhanced role for CESR in mediating between supervisory authorities and in delegating supervisory responsibilities.

Four years on, the issue is still on the table. Although the Committee of European Banking Supervisors (CEBS) has taken sides with CESR, it seems that ministers are unwilling to change the role of the Committees, as is evident from the Ecofin Council deliberations in May 2008, referred to above. CESR, and also the former Italian finance minister, argued that it should not be difficult to turn the Committees into formal EU agencies, like the existing 28 European regulatory agencies. However, this would expand the mandate of the Level 3 Committees from essentially regulatory concerns to also include supervisory matters. This raises important legal, accountability and eventually fiscal issues. With formal mediation and delegation of powers come enforcement and the authority to sanction. This, in turn, raises the sensitive matter of sovereignty. How will accountability be organised if the Committees have a more formal role? In addition, such changes touch upon, or could alter the allocation of responsibilities between home and host supervisors as set out in the EU directives. And what if they incur formal responsibilities in the context of a troubled bank, as the coordinator of national authorities, which may raise financial issues?

Assigning a more formal role to the Committees could give them more clout in discussions with the member states, but this is possibly what some authorities are afraid of. So far, the Committees have acted more as an informal mediator, often coming up with the broadest possible consensus to come to an agreement between the member states. An

²⁸ See Casey & Lannoo (2005), for a more extensive discussion on this issue.

example is the COREP (Common Reporting Framework) project of CEBS, which creates a common format for banks to use in reporting solvency ratios. Table 6 shows how many reporting cells for core (83%) and detailed information (63%) banks have to use on average in COREP. The maximum number of cells in which a bank could be asked to report is about 18,000, according to CEBS, as not all detailed information is applicable to all banks. This very high number is seen by bankers as the lowest common denominator, representing a totally unworkable compromise and a symptom of the lack of powers on the part of CEBS to impose a truly common (and integrated) reporting framework in the EU.

Table 6. Framework for common reporting of the new solvency ratio

	Number of Cells	Average Use % (non-weighted average)	Minimum use %	Maximum use %
Core	1,227	83% for all; 90% disregarding securitisation and market risk templates	20%	100%
Detailed	21,606	63%	5%	100%

Source: CEBS (2006).

The best example of the unwillingness of the May 2008 Ecofin Council to revisit the structural framework is the demand to the Committees to report to the EU Council on key developments, risks and vulnerabilities that could affect the stability of the financial system, as referred to above. This is not a core task of the Committees in the context of the Lamfalussy framework, nor do they have the means to undertake it. That the Council also requests the involvement of the ECB's Banking Supervision Committee (BSC) only emphasises the absence of realism of this request.

Another example of the unclear division of roles was the demand to banks by the European Commission in reaction to the subprime crisis to provide more information on securitisation. The European Commission did not have up-to-date information on securitisation, nor did the Committees for that matter, and it had to rely on sector organisations to provide insights into the size and functioning of these markets.

3.1.2 The model of colleges

The main means by which the EU Council proposes to improve the supervision of with EU-wide financial groups are the supervisory colleges.

Colleges are established in case a financial institution operates in another member state through one or more branches or subsidiaries. The college is chaired by the home supervisor of the group's parent and made up of authorities from all the countries in which the holding company has established a presence through subsidiaries or branches. Colleges function on the basis of mandatory written arrangements agreed upon *ad hoc* by the competent authorities to allow the home country to carry out consolidated supervision of the group (Art. 131 CRD, Directive 2006/48/EC).

In reaction to the financial crisis, the Ecofin Council requested that the role of the colleges should be strengthened, and asked, again, that the EU Committees should play a role "in giving operational guidelines to provide consistency in the working procedures of the different colleges and effectiveness of the decision-making process and provide reassurance to supervisors involved in the colleges, as well as monitoring the coherence of the practices of the different colleges of supervisors and sharing best practices".²⁹ This demand was reiterated after the summer 2008, and also reflected at international level in the G-20 conclusions. Amendments to the EU's capital requirements directive aimed at strengthening the role of colleges were proposed by the European Commission on 1 October 2008.³⁰ Such proposals are also mirrored in the draft solvency requirements directive for insurance companies.³¹

The extensive reliance on colleges raises three major issues. Although supervisors work in a college, their statute, mandate, accountability, *modus operandi* and enforcement powers continue to differ importantly across the EU. EU legislation has introduced the single licence, and obliges supervisors to cooperate, but has not harmonised the national structures. Hence a home country authority may not have the same powers in the host country to enact certain disciplinary measures. The degree of independence

²⁹ 2866th Council Meeting, Economic and Financial Affairs, Brussels, 14 May 2008, Council Conclusions, p. 13.

³⁰ Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, Brussels, COM(2008) 602/3.

³¹ Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance - Solvency II, COM/2007/0361 final of 10/07/2007.

and accountability of the supervisory authority differs. And the formal responsibility for financial stability is limited to the national boundaries. Although the same problem exists at a global level, the legal framework and the degree of market integration differ significantly, thereby raising the question of whether colleges are still appropriate in the EU context. From this perspective, colleges were the solution for the past and may be for the present, but not for the future.

The second issue raised by colleges is whether the information obtained is sufficiently shared and merged to have a broader picture on exposures in the interbank market and risks to stability of the European financial system. A basic problem is that the home country is supposed to have the full picture, not necessarily the host countries. The latter may in case of trouble rapidly feel badly informed, with the result that trust in the college disappears, and the college can no longer function as a college. This is related to a third problem, whether colleges effectively function as college in times of crisis. The information emerging from the rescue of Fortis in the weekend of 27-28 September 2008 is not reassuring in this context. The Belgian policy-makers and supervisors contacted the two most important host countries, the Netherlands and Luxembourg, only after about 48 hours of discussions.³²

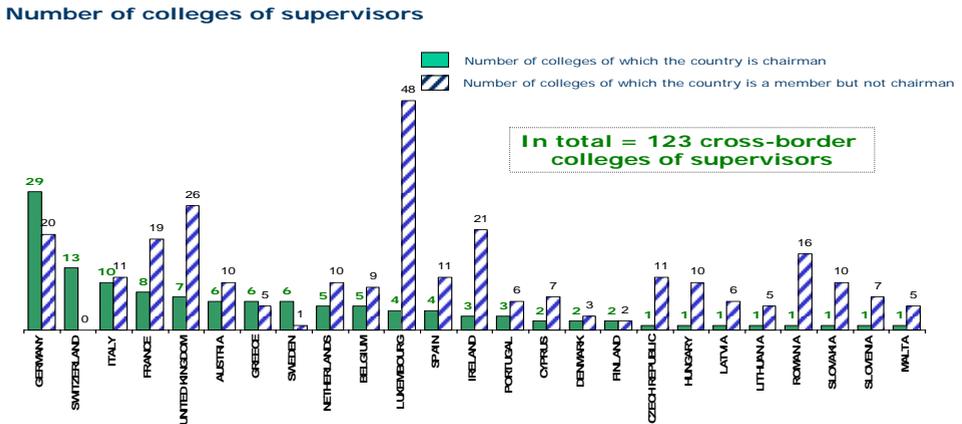
Comparing the location and geographical presence of banking groups in the EU and Switzerland, 123 colleges should have been established in the EU. With 29, Germany chairs the highest number of colleges, followed by Switzerland (13), Italy (10), France (8) and the UK (7).³³ Taking into account the importance of groups of which a country chairs the college, based upon the weighted average market shares of the countries in which the banks are active of which a certain country is the lead supervisors, the ranking is topped by Spain, followed by Belgium and the UK. The question can thus be raised whether these countries have the capabilities and the means to exercise the supervisory tasks as home country of globally active banking

³² According to an article by Pascale Den Dooven, a journalist for *De Standaard*, 15 November 2008, the Belgian authorities only called their Dutch counterpart on midday on Sunday, inquiring why the Dutch had not taken contact, whereas the Dutch replied that they were waiting for a call. This anecdote is highly revealing about the efficacy of colleges, home-host relations and memoranda of understanding.

³³ Data collected by the Italian Bankers Association (ABI), April 2008.

groups, and second, whether the information emerging from so many colleges gets sufficiently coordinated and amalgamated at European level.

Figure 2. Colleges of supervisors per EU member state



3.1.3 Memoranda of Understanding: A good basis?

Memoranda of understanding (MoUs), which essentially have a bilateral nature, provide the legal basis for cooperation between colleges. The recent capital requirements directive (2006/48/EC and 2006/49/EC) further harmonised the structure of cooperation between the home and host country authorities, and clarified the obligations on both sides.³⁴ It requires competent authorities to have written coordination and cooperation arrangements, or MoUs, in place for the supervision of banking groups. MoUs are not legally binding, however, and cannot give rise to any legal claim. The Northern Rock collapse demonstrated already how difficult it is for MoUs to work even at national level. At international level, the limited information available so far on the rescue of Fortis indicates that they are not effective, as discussed above.

³⁴ A proposal for amendment of this directive was recently made by the European Commission (2008c), and provisionally agreed upon by the Ecofin Council of 2 December 2008.

MoUs are also used as a framework for information-sharing and coordination between the various authorities of different states to contribute to financial stability and crisis management. A first MoU was concluded by the ECB's Banking Supervision Committee (BSC) in 2003, setting the specific principles and procedures for the responsible authorities in crisis management situations. This MoU was extended in 2005 to also include finance ministries, and recently radically upgraded (see above).

The core issue of MoUs, i.e. information exchange, continues to be the Achilles heel of the single financial market. At a European Commission conference on the allocation of supervisory responsibilities, organised on 26 June 2007 just before the current financial crisis started, it was apparent just how little progress had been made on information exchange between supervisory authorities. The lack of information exchange had already been criticised in the 2001 EFC report (Brouwer II report), but had hardly been acted upon. This was also highlighted in an IMF report, published in May 2007, which found existing practices for supervisory cooperation and MoUs out of line with market developments. It called for much more ex-ante cooperation and information sharing than was the rule.³⁵

The market turmoil, which started in August 2007, highlighted that the reach of the MoU between supervisors, central banks and finance ministries was insufficient. ECB officials have on several occasions complained about the lack of supervisory information to make financial stability assessments and monitor financial stress.³⁶ Supervisors are often hindered on professional secrecy grounds from exchanging this information with non-supervisory authorities in normal times. When they share the information in emergency situations, it is usually too late. It is highly questionable whether the new updated MoU will change this practice.

Even at national level, it seemed that MoUs are precarious, as illustrated by the Northern Rock case, and the ensuing discussion between the Bank of England and FSA. After the extension of the Bank of England's powers, as was proposed by Alastair Darling, the discussion still revolves

³⁵ See IMF (2007).

³⁶ See e.g. Bini-Smaghi (2008a).

around who will have the formal power to pull the trigger for a bank in trouble.³⁷

3.1.4 *Role of the ECB: Not clarified*

Unlike the Fed and the Bank of England, European authorities have not acted so far to clarify the mandate of the European Central Bank. In addition to establishing a good reputation as a new central bank for Europe, the core task of the ECB is to maintain price stability. In 2002, Wim Duisenburg attempted to broaden the ECB's role to include banking supervision, but he was rebuked by the finance ministers.

According to the EU Treaty, the ECB is in charge of monetary policy and the smooth operation of payment systems, whereas financial supervision and stability remain the competence of the member states. Emergency liquidity assistance can be provided by national central banks in the Eurosystem to an institution operating in its jurisdiction, but at the costs to the central bank in question.³⁸ The ECB can contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision and financial stability (Art. 105.5). Specific tasks concerning policies relating to prudential supervision of banks and other financial institutions, with the exception of insurance companies, could be conferred to the ECB, according to Art. 105.6, but this is seen as a last resort and requires the unanimity of the member states.

Early on after its creation, the ECB attempted to enlarge its powers into the area of prudential supervision. In 2001, the ECB issued a paper on the role of central banks in prudential supervision, in which it argued strongly in favour of combining prudential supervision and central banking (ECB, 2001). It even detected a trend in this direction and refuted the arguments against combining both: "Arguments in favour of a separation of prudential supervision and central banking lose more of their force, while those in favour of combining become more prominent" (ECB, 2001, p. 7). It concluded that "when viewed from a Eurosystem perspective,

³⁷ "FSA should have sole right over bank rescues", *Daily Telegraph*, 17 September 2008.

³⁸ This happened for example with Fortis Bank, when the Belgian central bank provided €45 billion in emergency liquidity over the weekend of 28-29 September 2008. The provisions applicable to these operations within the Eurosystem were clarified by ECB in its 1999 Annual Report (see ECB, 2000, p. 98).

the attribution of extensive supervisory responsibilities (i.e. both macro- and micro-prudential) is likely to prove beneficial” (Ibid., p. 9).

The ECB attempts however lead to a fierce reaction from the finance ministers in the Ecofin Council in 2002, with which the Ecofin until today may want to remain consistent. The May 2002 meeting (EFC, 2002, p. 10) explicitly stated that the structure for financial regulation and supervision must be consistent with:

- “The allocation of powers and responsibilities as set out in the Treaty;
- Appropriate accountability to EU institutions, in particular political accountability to the Ecofin Council;
- Subsidiarity, since supervisory tasks are best performed as close as possible to supervised entities and since financial crises may have implications for public finances;
- Neutrality with respect to models adopted at the national level.”

Since that time, the ECB has kept a low profile on banking supervision matters. The ECB was part of the MoUs that were concluded on financial stability, but it did not make any political statements as it did in 2001. Only recently, it repeated on several occasions the need to have more supervisory information on financial institutions. As the ECB injects liquidity to the banking system based on appropriate collateral, it could suffer losses in case an illiquid bank appears to be insolvent, thereby underlining the “need of timely and exhaustive transmission of supervisory information at European level”.³⁹ But the ECB was hardly in the scope of the discussions of the Ecofin Council during the first year of the crisis. Only its Banking Supervision Committee (BSC) was asked to step up the cooperation with CEBS.

3.2 A European System of Financial Supervisors (ESFS)

To respond to the shortcomings and inconsistencies discussed above, and to establish an effective supervisory system dealing with the current and future supervisory challenges, EU policy-makers will need to take a quantum step. With the reforms undertaken over the last years further to the Lamfalussy proposals, the limits of what can be done within the current EU supervisory structure have been reached, particularly when dealing

³⁹ Lorenzo Bini-Smaghi (2008b), slides from his presentation at the Conference on the ECB and its Watchers, 5 September.

with the cross-border banking crisis. “It is only when the frameworks for regulation, supervision and crisis management match the actual structure of financial markets, that the negative externalities of financial crises can be managed properly,” to quote the Swedish central bank governor.⁴⁰ A further step forward will thus require deeper institutional changes. We propose to follow *mutatis mutandis* the roadmap that led to the creation of the European System of Central Banks (ESCB) in 1998. A European System of Financial Supervisors would bring all financial supervisory authorities in Europe under a single roof, while maintaining a plurality in the operational structure.

3.2.1 A roadmap

The roadmap would be composed of 3 parts: 1) the European Council formally mandates the High Level Expert Group on EU financial supervision (the de Larosière Committee) to analyse the optimal structure of financial oversight and propose concrete steps leading to a European System of Financial Supervisors; 2) European Financial Institute is created to lay the groundwork for the establishment of a European System of Financial Supervisors; 3) the European System of Financial Supervisors starts at a certain target date.

Committees have been widely used in the European integration process, for broader political as well as for more technical issues. Not only are they apolitical in nature, but they also allow the pooling of the necessary technical expertise and knowledge. In addition, as a consensus has not yet emerged at European policy level of the need for a radical change in the structure of European financial supervision, which is also caused by the lack of a European public debate (as opposed to national policy debates) on the subject, a Committee could contribute to creating the necessary consent.

⁴⁰ As remarked by the Swedish Governor Stefan Ingves, “Regulatory challenges of cross-border banking: Possible ways forward”, Conference on the Financial System, Reserve Bank of Australia, Sydney, 21 August 2007 (<http://www.riksbank.com/pagefolders/31131/070821e.pdf>). The Governor referred to the concrete challenges posed for supervisors by a bank like Nordea and called in this speech for a European Organisation for Financial Supervision (EOFS), a variant of the proposal discussed above. The Governor had already made this proposal in a speech in October 2006, in which he emphasised that upgrading CEBS was not the solution, as it would not make it a supervisor.

The Committee's mandate should be fourfold: 1) map the context; 2) analyse the different possible modalities in the institutional design of financial supervision and recommend the optimal structure for the EU; 3) outline in detail the objectives of the ESFS, its statute, primary tasks, administration, governance and financial resources; and 4) assess the relationship between the ESFS and the deposit insurance and resolution authorities. The context should provide the rationale why the current structure is no longer sufficient, and to what extent the supervisory structure is no longer in line with market integration. The different possible responses should emerge from this. It should set out which tasks can be better executed at a centralised level, and which at national or local level.

Depending upon the specific recommendations of the Committee, a European Financial Institute should be created soon after the delivery of the recommendations of the Committee. Its task should be preparatory and at the same time operational. It should do the operational work for the establishment of an integrated ESFS and the structures that are needed to perform these tasks. Pending an eventual Treaty change, it could function as an EU-wide agency, set up by the European Council, and already be empowered to act on certain matters, such as the collection and amalgamation of supervisory information, the execution of certain supervisory tasks such as mediation and delegation of tasks amongst national authorities, and performing a crisis cell function. It could at the same time continue to perform the regulatory tasks of the actual Level 3 Committees.

In a third phase, the ESFS would start to function under:

- common objectives for financial supervision;
- a single statute; and
- a unified governance and accountability structure.

Objectives for financial supervision have so far never been formally harmonised at EU level. Although the broad objectives are the same, safeguarding the stability of the financial system and protecting consumers/investors, important differences may exist in other objectives. The UK Financial Services Authority (FSA) has as one of its objectives "the promotion of public understanding of the financial system", which means that it needs to help users to understand what financial products they buy. To our knowledge, this is not necessarily an objective of other supervisory authorities in the EU. Acceptance of this objective would come to meet a growing need of financial literacy in a world with an increasing complexity of financial products.

Much inspiration for the format of the statute and the governance and accountability structure could be taken from the ESCB statute. The Governing Council of the ESFS should consist of an Executive Board and of the Chairmen of the 27 national authorities, in the same way as the ESCB is governed. As with the ECB president, the chairman should report periodically to the Ecofin Council and the European Parliament on financial stability and supervisory issues.

The Committee should analyse two specific issues carefully in more detail:

- i) To what extent should a functional approach be followed to financial regulation, or should a more objective-based model be followed?
- ii) How will subsidiarity be applied to financial supervision, i.e. which tasks can be more efficiently exercised centrally as compared to locally?

The answer to the latter question could ease the response to the first, in the sense that conduct of business supervision will by and large remain at a local level, which implies that, from that perspective, a more objective-based approach would be easier. The current crisis has also indicated that one of the reasons for separation between banking and insurance (and investment banking) supervision, i.e. the likelihood of systemic effects, is no longer tenable. As demonstrated above, the insurance sector can also be regarded as systemically important, which supports an objective-based approach.

The Committee should also analyse how the links between the ESFS and the ECB will be worked out. This crisis has amply demonstrated that well developed communication lines between central banks and supervisors are extremely important, as are also clear divisions of responsibilities. We would strongly support a further clarification of the financial stability role of the ECB and the ESCB, while maintaining supervision outside their mandate.

Another tricky issue to analyse is the maintenance of the home country control. We would argue in favour of a two-tier system, whereby supervisory responsibilities for systemically important EU-wide groups are shared between the home country and the ESFS. The core supervisory

responsibilities would be delegated to a supervisory board in the ESFS, with day-to-day monitoring placed in the hands of the local supervisors.⁴¹

3.2.2 *Other possible scenarios*

Several other possible scenarios discussed above could be considered for moving forward:

i. Upgrading the Level 3 Committees into EU agencies

The upgrading of the Level 3 Committees is more of a short-term, interim solution that raises more difficulties than it solves. It gives more powers to the Committees without addressing the differences of statutes and powers of the national authorities, and the related issues of accountability and control. It does not solve the supervisory problems discussed above.

More generally, turning the Level 3 Committees into EU agencies would create three new regulatory agencies, in addition to the 28 that already exist at EU level. In the aftermath of the financial crisis, financial supervision issues could be better dealt under a single roof, and the institutional structure put in place as the result of a proper political process, rather than rapidly turning the existing Committees into agencies, and in this way circumventing a deeper discussion about the proper supervisory structure Europe needs.

ii. Using Art. 105.6 of the EU Treaty and giving more powers to the ECB for banking supervision

The Treaty article is limited to banking supervision and to ‘specific tasks’ as related to banking supervision. The fact that insurance companies could not be part of it, and that it is limited to specific tasks means that it poses too many constraints to be used as a long-term solution. In addition, the question remains whether it would be appropriate for the ECB to exercise banking supervision within the ECB, whose main mandate is ensuring price stability.

The report of the High Level Expert Group on EU financial supervision (de Larosière Group) would be of utmost importance in analysing the trends globally in this domain, and summarising the pros and cons of the different institutional models, to come to an optimal

⁴¹ See Schoenmaker & Oosterloo (2008) for a more detailed elaboration on this issue.

structure for the EU, also including the degree of cooperation with the central bank.

iii. A European FSA, or single prudential and single conduct of business supervisor

A fully-fledged single FSA, or single supervisors-by-objective, would not be adapted to the state of European market integration, and would not pass the subsidiarity test.

3.3 A European Resolution Trust

A necessary corollary to an ESFS should be a European Resolution Trust, as a safety net for short-term financial problems of EU-based financial institutions. The European Central Bank can only provide liquidity against collateral to keep the money market functioning, but has no powers to resolve a solvency crisis. A European Resolution Trust could be managed by the European Investment Bank (EIB) (Gros & Micossi, 2008b). Appeals for its funds would be decided by the Governing Council of the ESFS. The EIB is a public agency and issues guaranteed bonds to finance its operations. Its Board of Governors is made up of the ministers of finance of the member states. At present, the EIB has capital and reserves of €30 billion, upon a total balance sheet of €300 billion. In addition, it can call upon an additional capital of €156 billion, which is currently uncalled for. Its capital is subscribed for on a proportional basis by the different member states.

A European Resolution Trust could take equity stakes in or provide guaranteed loans to financial institutions in trouble. Support by the Trust would be based on adequate remuneration, to preserve the value of the public investment and to make sure that those who mismanaged would pay for the consequences. Losses could be distributed across member countries according to where they arose.

A European Resolution Trust would be a much more appropriate safety net for European-wide active banks than having to rely on national solutions. It would be more neutral, as it would come from an EU-wide institution and do away with distortions created by national bail-out plans. It would be more efficient, as it would provide guarantees to depositors on a European-wide basis. And it would be more appropriate, certainly for those banks that have outgrown their national boundaries. The Trust would apply to troubled financial institutions of a certain size that have a Community dimension, based on a minimum share of their total EU assets outside their home country. The thresholds of the EU merger control

regulation could function as a benchmark to distinguish between Community and national competence.⁴²

In this context, one could also consider creating a federal deposit protection fund in the EU. Rather than attempting to further harmonise the different national deposit protection schemes, as the European Commission did in its proposal of 15 October 2008, it may be easier, and probably more efficient to create an EU-wide deposit protection fund from the beginning.⁴³ Although the minimum level of deposit protection was increased, the Commission proposal continues to leave a large degree of discretion to the member states, and does not solve the home-host problem. As with the Icelandic banks, citizens cannot be expected to know whether a foreign bank in a given country is a branch or subsidiary, and the different implications this distinction may have on the insurance of their deposits under the host or home deposit protection scheme.

⁴² Council Regulation (EC) No 139/2004. In addition, the merger control has two exceptions in the application: the 'Dutch clause' (article 22) and the 'German clause' (article 9), which add more flexibility to the system to decide whether a merger is Community or national competence.

⁴³ The Commission proposal (Art. 12) requests the Commission to report on the possible introduction of a Community deposit-guarantee scheme, together with any appropriate proposals by the end of 2009, Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay, COM(2008) 661 final. The EU Council endorsed the directive on December 2nd, the European Parliament on December 18th.

4. POSTSCRIPT: THE GLOBAL DIMENSION

EU policy-makers have rapidly brought the debate about the reform of financial regulation and supervision to the global stage by launching a debate for the reform of the Bretton-Woods institutions and calling for a G-20 meeting. While there rightly are certain issues that should also be discussed at global level, this should not stop the EU from bringing its own house in order. This is even more important since the EU represents more than 50%, on some accounts even more than 55%, of global bank assets. Seen from the perspective of developing countries, calling for concerted action on bank governance, supervision and oversight, means that those who are principally hosting these markets have to take the lead in controlling them.

Table 7. Main indicators of the size of the EU's financial markets, 2007 (€ billion)

	<i>World</i>	<i>EU</i>	<i>EU in %</i>	<i>US</i>	<i>US in %</i>
GDP	37,461.57	10,775.07	29%	13,682.43	37%
Gross national savings	8,647.60	2,344.96	27%	1,053.74	12%
Domestic stock market capitalisation	44,714.11	10,116.56	23%	13,682.43	31%
Total bank assets	58,229.99	29,632.88	51%	7,688.11	13%

Note: According to the ECB, total EU bank assets are €41,072 billion, meaning that the EU percentage of global bank assets could well exceed 51%. As the ECB does not offer statistics on bank assets at global level, it is not possible to use ECB data for purposes of comparison.

Sources: IMF, Global Financial Stability Report September 2008; IMF International Financial Statistics.

By taking a clear initiative along the lines outlined above, the EU could demonstrate to the outside world that it is assessing the full policy implications of the crisis and aligning its structure of financial oversight along lines similar to that used for monetary policy. It would at the same time be a clear indication globally that it is taking the lead in reforming the structure of financial oversight.

Asking the IMF to take a more important role in financial oversight, by undertaking Financial Sector Assessment Programmes (FSAP), is noteworthy, but nothing dramatic. The IMF has been undertaking these assessments since 1999, and the outcome has been used by besieged supervisors in EU countries to claim that they had high ratings. In addition, the enforcement powers of the IMF are limited. But should not the EU start to undertake its own assessments? Regulatory compliance can be enforced by the EU, but this is not so easily achieved in the area of supervision. The creation of an ESFS could fill this void.

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ANNEXES

Annex 1. Key financial indicators of the top 5 banks in the EU and selected other countries (2007)

Country	Total assets (mil €)	Total equity (mil €)	Loans to customers (mil €)	Deposits from customers (mil €)	Asset/ GDP (%)	Loans/ deposits (%)	Equity/ assets (%)
Austria	698475	44722	392763	299996	257.9	130.9	6.4
Belgium	1550751	62342	621514	598792	463.0	103.8	4.0
Bulgaria	17080	1976	11259	11126	59.1	101.2	11.6
Cyprus	83675	6623	44702	55020	535.1	81.2	7.9
Czech Republic	105850	7276	51718	74986	83.3	69.0	6.9
Denmark	625020	20960	373771	187028	274.5	199.8	3.4
Estonia	34665	2653	27278	14662	227.0	186.0	7.7
Finland	274996	21561	140087	91409	153.0	153.3	7.8
France	5550460	196302	1593553	1580763	293.3	100.8	3.5
Germany	3990498	104581	931919	988265	164.7	94.3	2.6
Greece	287210	22754	196660	165573	125.9	118.8	7.9
Hungary	69416	6359	49255	38481	68.6	128.0	9.2
Ireland	769816	27508	480773	244336	403.9	196.8	3.6
Italy	2006529	147987	1221732	758484	130.7	161.1	7.4

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Latvia	21620	1797	14315	9899	108.4	144.6	8.3
Lithuania	23035	1540	17047	10418	82.2	163.6	6.7
Luxembourg	309875	15998	103668	104238	854.2	99.5	5.2
Malta	14010	1698	6421	8981	258.7	71.5	12.1
Netherlands	2954809	113227	1500757	1197983	521.1	125.3	3.8
Poland	106567	10756	62595	79588	34.5	78.6	10.1
Portugal	317520	18585	221113	144597	194.7	152.9	5.9
Romania	40746	3247	25360	23951	33.6	105.9	8.0
Slovakia	31029	2320	16240	22151	56.6	73.3	7.5
Slovenia	31719	2140	21896	16114	92.0	135.9	6.7
Spain	1934416	138873	1838315	734621	184.1	250.2	7.2
Sweden	1013630	40785	623086	327833	305.4	190.1	4.0
UK	6406952	248052	2846061	2280745	312.9	124.8	3.9
EU	29270369	1272622	13433858	10070040	237.2	133.4	4.3
Iceland	129934	8228	82684	39809	890.0	207.7	6.3
Norway	243316	13004	195088	110360	85.7	176.8	5.3
Switzerland	2357865	74747	557616	807249	756.3	69.1	3.2
USA	4474314	339328	1966141	2156126	44.4	91.2	7.6

Source: Bankscope, Eurostat.

Annex 2. Timeline of the main crisis events and policy responses, summer 2007-present

Date	Event
9 Aug. 07	BNP Paribas suspends redemptions of three money market funds exposed to US ABS assets. AXA had earlier announced support for its funds
9 Aug. 07	European Central Bank (ECB) injects €95 billion overnight to improve liquidity. Injections by other central banks
17 Aug. 07	Federal Reserve approves a temporary 50 bp reduction in the discount rate, extends term financing, and notes it will 'accept a broad range of collateral'
13 Sept. 07	Bank of England announces that it will widen the range on banks' reserves targets within which they are remunerated at bank rate
14 Sept. 07	Bank of England announces it has provided a liquidity support facility to Northern Rock
15 Sept. 07	Informal Ecofin Council in Porto at which ministers discuss financial stability arrangements
17 Sept. 07	Following a retail deposit run, the UK Chancellor announces a government guarantee for Northern Rock's existing deposits
9 Oct. 07	Ecofin Council decides on a roadmap for EU arrangements for financial stability
Oct. 07	Citi, Merrill Lynch and UBS report significant write-downs, top management changes
Nov. 07	Several banks support SIVs or take them on their balance sheet
4 Dec. 07	Ecofin Council discusses the EU's regulatory and supervisory architecture
11 Dec. 07	The Italian finance minister Tommaso Padoa-Schioppa calls for a single financial rulebook and European supervisory agencies
20 Dec. 07	Bear Stearns announces expected 2007 Q4 write-downs
Jan. 08	Announcements of significant 2007 Q4 losses by Citi and Merrill Lynch, among others
24 Jan. 08	Société Générale reveals trading losses resulting from fraudulent trading by a single trader

- 17 Feb. 08 UK government announces temporary nationalisation of Northern Rock
- 11 Mar. 08 Federal Reserve announces the introduction of a Term Securities Lending Facility and Bank of England announces it will maintain its expanded 3-month long-term repo against a wider range of high-quality collateral
- 16 Mar. 08 JPMorgan Chase & Co. agrees to purchase Bear Stearns. Federal Reserve provides \$30 billion non-recourse funding
- 4 April 08 Informal Ecofin Council in Ljubljana agrees on an updated MoU between supervisory authorities, central banks and finance ministries
- 21 Apr. 08 Bank of England launches its Special Liquidity Scheme (SLS) to allow banks to swap temporarily their high-quality mortgage-backed and other securities for UK Treasury bills
- 15 May 08 Ecofin Council updates the roadmap and assigns new tasks to the Level 3 Committees. It publishes a new MoU
- 16 June 08 Lehman Brothers confirms a net loss of \$2.8 billion in Q2
- 13 July 08 US Treasury announces a rescue plan for Fannie Mae and Freddie Mac
- 15 July 08 US Securities and Exchange Commission (SEC) issues an emergency order to enhance investor protection against 'naked short-selling'
- 7 Sept. 08 Fannie Mae and Freddie Mac taken into conservatorship
- 15 Sept.08 Lehman Brothers files for bankruptcy. Bank of America announces purchase of Merrill Lynch
- 16 Sept. 08 US government provides emergency loan to AIG of \$85 billion, in exchange for a 79.9% stake and right to veto dividend payments
- 18 Sept. 08 Lloyds TSB/HBOS merger announced
- 18 Sept. 08 FSA announces regulations prohibiting short-selling of financial shares
- 19 Sept. 08 SEC prohibits short-selling in financial companies, followed by other securities commissions in the EU and worldwide
- 21 Sept. 08 Federal Reserve approves transformation of Goldman Sachs and Morgan Stanley into bank holding companies
- 29 Sept. 08 Bradford & Bingley is nationalised by the UK government. Abbey buys its branches and retail deposit book

- 29 Sept. 08 Belgian, Dutch and Luxembourg governments announce they will invest €11.2 billion in Fortis
- 30 Sept. 08 Dexia receives equity capital injection from Belgian, French and Luxembourg governments and from existing shareholders
- 30 Sept. 08 Irish government announces full guarantee of bank liabilities
- 3 Oct. 08 US House of Representatives passes \$700 billion government plan to rescue the US financial sector (having voted against an earlier version of the plan on 29 September 2008)
- 3 Oct. 08 FSA raises the limit of the deposit guarantee to £50,000 (with effect from 7 October 2008)
- 3 Oct. 08 Dutch government acquires Fortis Bank Nederland (Holding) N.V.
- 4 Oct. 08 G4 meeting in Paris
- 6 Oct. 08 German authorities announce €50 billion package to save Hypo Real Estate
- 6 Oct. 08 BNP Paribas announces it has agreed to take control of Fortis' operations in Belgium and Luxembourg as well as the international banking franchises
- 7 Oct. 08 Ecofin Council agrees to raise the minimum level of deposit protection to €50,000 in the EU
- 7 Oct. 08 Icelandic banks Glitnir, Landsbanki and Kaupthing were put into administration, causing EU-wide ramifications
- 8 Oct. 08 UK financial sector support package announced, including provision of capital to UK incorporated banks and guarantees for new short to medium-term senior unsecured debt issuance
- 8 Oct. 08 Coordinated interest rate cut of 50 basis points (including the Bank of England, the ECB and the Federal Reserve)
- 12 Oct. 08 Eurogroup meeting in Paris at level of heads of state to which Gordon Brown is also invited
- 14 Oct. 08 Several EU governments announce national financial sector bail-out plans
- 16 Oct. 08 European Council meets, decides to create a financial crisis cell
- 19 Oct. 08 Dutch government injects €10 billion into ING as subordinated debt
- 26 Oct. 08 Belgian government injects €3.5 billion into KBC as subordinated debt
- 7 Nov. 08 Informal European Council meeting to prepare G-20

- 15 Nov. 08 G-20 Meeting in Washington
- 24 Nov. 08 US government injects €20 billion in Citi and guarantees \$306 billion of its real estate loans and securities
- 28 Nov. 08 UK government takes a majority stake in RBS
- 2 Dec. 08 Ecofin Council agrees on the amendments to the EU's capital requirements and deposit guarantee schemes directive
- 4 Dec. 08 ECB cuts interest rate with 75 bp to 2.50%
- 11 Dec. 08 SEC charges Bernard L. Madoff for \$50 billion Ponzi scheme fraud, exposing European banks and investors to losses of \$10 billion
- 16 Dec. 08 Fed reduces interest rate to 0.25%

Source: Drawn and updated from Bank of England (2008), *Financial Stability Review*, Issue 24, London.

Annex 3. Government bail-out plans for the financial sector (as of end December 2008)

Country	€ billion	Tools/Legislation	Eligible Institutions	Conditionality	Date Approved by European Commission
Denmark	4.6	Guarantee scheme; bank wind-up scheme	All banks in Denmark that have a banking licence and participate in the Sector Fund	Limited to fundamentally sound financial institutions; banks pay premium to remunerate debt guarantee; insolvent banks to be wound up using private funds when possible	10 Oct 08
Ireland	n/a	Guarantee scheme for deposits and debt issued by credit institutions between 29 Sept 2008 to 28 Sept 2010	Banks with a systemic relevance for the Irish economy	Firm will be subject to specific terms and conditions so that the taxpayers' interest can be protected	13 Oct 08
United Kingdom	608	€60 billion used to buy preference shares in banks; €240 billion of short-term loans; guarantees of up to €308 billion	All UK financial institutions	Government will consider adjusting dividend policies and executive compensation	13 Oct 08 amended on 23 Dec 08
Germany	500	€400 billion in loan guarantees; up to €80 billion for recapitalisation of banks; €20 billion to cover potential losses from loans	Credit institutions, financial service providers, insurance companies and pension funds, operators of securities and commodities exchanges	Conditions on state remuneration; restrictions for executive pay; capital requirements; distribution of dividends; reporting requirements	28 Oct 08 amended on 12 Dec 08
Sweden	152	€150 billion in guarantee scheme covering new short and medium term debt and support for solvent banks and mortgage institutions, instruments with a maturity of three years maximum, or exceptionally five years for covered bonds, €2billion for equity participations	Open to all solvent banks incorporated in Sweden	Guarantees to be remunerated, restrictions on expansion and marketing of beneficiaries restrictions on compensation for their top executives	30 Oct 08

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Portugal	20	State guarantees for financing agreements and the emission of non subordinated short and medium term debt	All banks incorporated in Portugal	The beneficiary who has called on a guarantee has to reimburse the state in full, either by paying back the loan or by exchanging it for preferential shares.	30 Oct 08
France	286	€21 billion capital injection into France's banks; bank debt guarantee of €265 bn.	All French financial institutions	Remuneration mechanism; banks will have to provide monthly reports on capital use. Firms will also have to sign a 'code of ethics'	31 Oct 08 updated on 08 Dec 08
Netherlands	200	Guarantees for unsecured loans.	Any institution defined as a bank and having its corporate domicile in the Netherlands; has substantial business in the Netherlands, and an acceptable solvency ratio	Guaranteed debt instruments are subject to a fee of 50 basis points if the tenure is no more than one year, and 50 basis points and the 5 year average if more than one year; remuneration restrictions	31 Oct 08
Spain	130-150	€100 billion in state guarantees; €30 billion - €50 billion to buy 'healthy assets' from banks.	All solvent credit institutions registered in Spain having a share of 1/1000 of the credit market	restrictions on expansion and marketing of beneficiaries	4 Nov 08 amended on 23 Dec 08
Finland	50	Guarantee to cover, against remuneration, the issuance of new short and medium term non-subordinated debt between 90 days and three years. Five year maturity for mortgage-backed bonds only	All solvent Finnish deposit and mortgage banks, including Finnish subsidiaries of foreign banks	Restrictions on beneficiaries' balance sheet growth with regard to national and EU averages, limitations on expansion and marketing and strict conditions for staff remuneration or bonus payments	14 Nov 08
Italy	60	Guarantee on new liabilities between 3 months and 5 years; 6 month renewable swap scheme between matching bank debt certificates and Treasury bills (max. €40 billion); recapitalisation scheme of €15-20 billion	Solvent banks authorised in Italy, including the subsidiaries of foreign groups	A market oriented pricing mechanism; appropriate safeguards against abuses. Remuneration clauses for recapitalisation, special redemption price	14 Nov 08 amended on 23 Dec 08

Greece	28	State to buy non core tier 1 preference shares; guarantee scheme for debt between 3 months and 3 years; securities scheme, government bonds lent against bank collateral	All financially sound credit institutions licensed in Greece	Beneficiaries to pay a market-oriented remuneration	19 Nov 08
Belgium	n/a	Guarantee begins 9 October 2008 and finishes 31 October 2009; Guarantees must be applied for between 9 October 2008 and 31 October 2009	Any institution that is facing liquidity or insolvency problems that could have implications on the Belgian economy	Firms must promise to use government aid to institute measures to improve the financial situation of their firm; the Minister of Finance determines the conditions of the guarantee, including issues of remuneration	20 Nov 08
Austria	100	Government to guarantee €75 billion in loans, inject up to €15 billion in capital, and allocate up to €10 billion to guarantee public savings		Dividend restriction and a remuneration corridor	10 Dec 08
Slovenia	12	The state guarantee covers, against remuneration, the issuance of new short and medium term non-subordinated debt with a maturity between 90 days and five years. The scheme's overall budget is capped at €12 billion.	The scheme is open to all solvent Slovenian credit institutions, including Slovenian subsidiaries of foreign banks.	Beneficiaries will be subject to behavioural commitments to avoid an abusive use of the state support	12 Dec 08
United States	557	€200 billion purchase of preferred shares with possibility of an additional €80 billion; further €277 billion for guarantees and deposit insurance	Bank holding companies, financial holding companies, insured depository institutions, and savings and loan holding companies; foreign controlled entities not eligible.	Restrictions on executive compensation; participation is not completely voluntary	n/a
Switzerland	45	Government to buy €41 billion in USD and non-USD debt; €4 billion capital injection.	UBS. Credit Suisse turned down state aid offer	UBS must commit to increasing its capital base	n/a

Sources: National Official Journals, Clifford Chance and European Commission.

Annex 4. List of Task Force Members and Invited Guests & Speakers

The recommendations of this report generally reflect a common position reached by the Task Force, yet neither the recommendations nor the report represent a fully unanimous position of the members of the Task Force. Accordingly, each member of the Task Force does not necessarily subscribe to each assessment contained in this report, nor does the report reflect the views of the respective institutions to which they belong.

Chairman: Alastair Sutton
Partner
White & Case LLP

Rapporteur: Karel Lannoo
Chief Executive Officer
CEPS

Members of the CEPS Task Force

Rym Ayadi
Senior Research Fellow
CEPS

Carlos da Silva Costa
Vice President
European Investment Bank

Maurice Bauer
Head of Legal & Compliance
Bourse de Luxembourg

William Dazy
Account Manager, Public Affairs
Hill & Knowlton International S.A.

Rainer W. Boden
Senior Advisor
European Financial Services
Round Table

Gerben de Noord
Institutional Affairs Representative
Standard & Poor's

Sebastien Cochard
Head of European Affairs Brussels
BNP Paribas Securities Services

Vicki From Joergensen
Legal Advisor
Confederation of Danish Industries

Annabel Garnier
Economic and Social Affairs Unit
European Parliament

David Green
Advisor on International Affairs
Financial Reporting Council

Simon Greaves
Account Manager, Public Affairs
Hill & Knowlton

Hubert Grignon Dumoulin
Head of the issuers and securities
department
Bourse de Luxembourg

Antonio Hernandez-Laviades
Former Director of European Affairs
Euronext

Alan Houmann
Director
European Government Relations
Citi

Richard Kaye
Head of Government Relations,
EMEA
JP Morgan plc

Jens Valdemar Krenchel
Head of Brussels Office
Realkreditradet (Association of
Danish Mortgage Banks)

Helmuth Martin
Senior Vice President
EU Liaison Office Brussels
Commerzbank

Stefano Mazzocchi
Staff to the Managing Director and
CEO, International Affairs
Intesa Sanpaolo

Penelope Naas
Vice President
Global Government Affairs
Citi

Maria Nieto
Advisor
Banco de España

David C. Pollard
Head European Affairs
Corporate Communications &
Affairs
ING Group

Mattia L Rattaggi
Executive Director
UBS AG

Wendy Reed
Director
PriceWaterhouseCoopers

Jörn-Jakob Röber
EU Affairs Advisor
EU Liaison Office Brussels
Commerzbank

Alexander Schaub
Counsel
Freshfields Bruckhaus Deringer

Natalie Stevenson
Advisor
PriceWaterhouseCoopers

Georgios S. Zavvos
Legal Advisor - Legal Service
European Commission

Invited Guests and Speakers

Pervenche Beres
Member of the European Parliament
Chair, Committee of Economic and
Financial Affairs

Carlo Comporti
Secretary-General
CESR

Carmine Di Noia
Deputy Director General & Head of
Capital Markets and Listed
Companies
Assonime

David Green
Adviser on International Affairs
Financial Reporting Council

Daniel Gros
Director
CEPS

Fabio Recine
Legal Counsel
Legal Services
European Central Bank

Ruth Walters
Associate
White & Case

David Wright
Deputy Director-General
DG Market
European Commission