The Financial Crisis and the EU Policy Responses

Aliénor Margerit
European Commission - DG ECFIN
Directorate Macrofinancial Stability

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Globalisation, European integration and economic crisis
Structure of the presentation

- The crisis
  - Origin of the crisis
  - The crisis in figures

- EU policy responses
  - Coordinating Member States
  - Direct financial support to MS
  - Application of state aid rules
  - Regulatory responses
  - Exit strategies
The crisis
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Origin of the crisis

Macroeconomic roots

- Abundant global liquidity, real estate bubble
- Rapid credit growth, high leveraging
- Supervisory failure: supervision too focused on individual institutions, no global picture

Domino effects and feedback loops when bubbles pop

Microeconomic roots

- Originate and distribute model
- Complex and opaque financial products (CDS…)
- Conflicts of interest of rating agencies
- Incentives for short-run risk taking (Compensation schemes…)
- Maturity mismatches in banks balance sheet
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Crisis in figures: Interbank market

Source: EcoWin
Crisis in figures: Corporate bonds spreads

Source: EcoWin, own calculations
Crisis in figures: losses and capital injections in the EU (banks and Insurance companies)

Source: Bloomberg. Cutting date 16/02/2010
Crisis in figures: Capital injections in the banking sector (as % of GDP)

Source: Commission Services, cutting date 31/12/2009
Crisis in figures: budget deficits (% of GDP)

Source: Commission Spring forecast
Crisis in figures: public debt

Public debt

60% Maastricht criteria

Source: European Commission
Public Finance

Public debt level and medium term projections

Budget deficit as % of GDP in EU, US and Japan
Crisis in figures: unemployment

Unemployment rate in the EU

Source: Commission services.
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Coordinated EU response

- G20 Summits
- Commission Communications:
  - Driving the European recovery
  - Financial Supervision in Europe
- ECOFIN roadmaps
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Direct financial support to MS

- Ceiling increased from EUR 12 to EUR 50 billion
- 3 MS benefit from the mechanism (HU / RO / LV)
- Conditionality
- Coordinated action with IMF

<table>
<thead>
<tr>
<th></th>
<th>HU</th>
<th>LV</th>
<th>RO</th>
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<tbody>
<tr>
<td>Total assistance</td>
<td>20</td>
<td>7.5</td>
<td>20</td>
</tr>
<tr>
<td>% PIB</td>
<td>21.7</td>
<td>40.5</td>
<td>17.1</td>
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European Union
- Instalment 1: 6.5, 3.1, 5
- Instalment 2: 2, 1.2
- Instalment 3: 1.5

IMF
- Instalment 1: 12.5, 1.7, 13
- Instalment 2: 4.9, 0.6, 5
- Instalment 3: 2.3, 0.2, 1.9
- Instalment 4: 1.4
- Others: 0.1

Others: 1, 0.5, 2
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Application of State aid rules

- 4 Commission communications on the issue:
  - Application of state aid rules to measures taken in relation to financial institutions;
  - Recapitalisation of financial institutions,
  - Treatment of impaired assets,
  - Assessment of restructuring measures.

- The objective: Ensuring a level playing field in Member States’ support to banks in a flexible way.
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Regulatory responses

- 5 priorities:
  - Developing a more efficient supervisory structure
  - Enhancing capital requirements
  - Mitigating procyclicality
  - Improving crisis management
  - Extending the perimeter of regulation and supervision
Developing a more efficient supervisory structure

- De Larosière Report

- A ‘macro pillar’: the European Systemic Risk Board (ESRB), responsible for macro-prudential supervision

- A ‘micro-pillar’: the European System of Financial Supervisors (ESFS)

- The day-today supervision remains at national level
More and better capital in the banking system

- **CRD 2**: colleges of supervisors, better liquidity management, retention clause for securitised assets

- **CRD 3**: higher capital requirements for re-securitisations and trading book items

- **CRD 4** (under discussion): Definition of capital, liquidity ratios, leverage ratio.

- Specific measures for the ‘big ones’? (Obama’s proposals on systemically important institutions)

- Testing the resilience of the EU banking system: the CEBS stress test
Mitigating procyclicality

- **CRD 3**: remuneration schemes

- **CRD 4**: Dynamic provisioning, countercyclical capital buffers

- Accounting issues: role of the Fair Value accounting
Towards a EU crisis management framework?

- Crisis management
  - Commission public consultation on crisis management
  - Reflection on burden sharing and bank resolution
  - Discussions on bank levy, stability funds (SE and DE initiatives)

- Deposit Guarantee Schemes
  - Protected amount raised from EUR 20,000 to EUR 100,000
  - DGS currently under review in the EU
Extending the scope of regulation

- Hedge Funds
- Credit Rating Agencies
- On-going reflections on the trading of credit derivatives (over-the-counter trading vs trading through CCPs)
- Non cooperative jurisdictions
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Exit strategies

- Exit from State guarantee schemes first
- Case by case approach for banks under restructuring
- Fiscal exit: fiscal consolidation should start in 2011 at the latest