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*Enhancing European Cooperation in  
Financial Supervision  
and Crisis Management*

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**1. Introduction: Shifting Boundaries in Financial Markets Governance**

Since the 1970s, financial market integration has progressed through an increasing amount of cross-border and cross-exchange trade. Advances in financial technology made various risks tradable, and risks and costs associated with certain transactions and financial institutions spread beyond national borders. Accordingly, enhanced collective action has become necessary to ensure financial market stability. The European Union's (EU) scope for collective action has been even larger due to its

single market policy. Regional and international organizations started to play a greater role in encouraging cross-national cooperation in financial supervision.

At the same time, financial market integration and advances in financial technology led to increasing reliance on self-regulation by financial institutions. Such self-regulation included an internal risk-based (IRB) approach that was adopted through Basel II and Capital Requirements Directive (CRD). Financial institutions were obligated to develop an adequate risk management system, and those that developed an advanced risk management capacity (typically, internationally active financial conglomerates) were allowed to take into account their risk assessments in calculating risk-weighted assets and regulatory capital.

The 2007 financial crisis revealed the limitations of the existing financial regulatory framework. Such limitations include: 1) over-reliance on self-regulation of financial institutions, 2) uncoordinated financial supervisory practices across the countries, and 3) ad-hoc international cooperation in financial crisis management.

First, to ensure financial stability, risk management practices need to be improved by financial institutions as well as regulators. In order to encourage disclosure of financial transactions and impose tighter capital requirements on financial investments in complicated financial products, monitoring functions by regulators over

self-regulation must be strengthened. For example, risk correlation between asset holdings of different institutions and the contagious effects of the crush of certain financial products markets needs to be taken into account in calculating risk and regulatory capital. Strong political initiatives at national, regional, and international levels help enforce tighter regulations in consideration of the impacts of individual financial institutions' investments on macro-financial market stability.

Second, closer international cooperation in financial supervision can help tackle financial market vulnerability and volatility that spread across the countries through international banking and investments. In order to assess the risk of an entire financial group that has many foreign branches/subsidiaries, cross-national supervisory cooperation is necessary. In addition, financial supervisory cooperation and regulatory harmonization promote a level playing field to prevent regulatory arbitrage from occurring.

Third, cross-national cooperation in crisis management is necessary to get damaged financial markets back on the path toward recovery. Moreover, closer cross-national cooperation in financial crisis management can facilitate cross-national supervisory cooperation. When the costs of failures of financial institutions fall only onto host countries, home countries could lose an incentive to tightly supervise their

foreign branches. In a modified crisis management framework, failure costs need to be linked with supervisory responsibility.

To overcome the regulatory pitfalls, regulatory capacity and resources in financial markets governance need to be enhanced, not only at national but also at global levels. In order to shed light on policy issues and agendas in international financial policy cooperation, this paper focuses on the case of European financial integration and regulations. The analysis of policy developments at the European level in coordinating differing national interests, supervisory systems, and practices among EU member states highlights fundamental elements of global financial regulatory cooperation.

## **2. Cross-National Cooperation in Financial Supervision in Europe**

The first part of the section overviews the impacts of a European framework on national financial supervision, in reference to a German case. Since the late 1980s, the EU has prompted member states to adopt tighter financial supervisory policies and strengthen resources and capacities of central financial supervisory agencies. The latter part of the section examines recent legal and policy developments before and after

financial crisis, including a post-crisis proposal called the de Larosière Report. It became apparent that the existing European cooperation framework needed to be reformed when it was unable to prevent or effectively mitigate the 2007 global financial crisis.

### *2-1. Euro-Passport Policy and Minimum Regulatory Harmonization*

Europe has facilitated its single market policy in financial services through the following measures: 1) lowering regulatory barriers for global business expansions of financial institutions through adopting a Euro-Passport policy, 2) introducing a home country principle and mutual recognition, and 3) enhancing regulatory and enforcement capacities of national financial supervisors to meet minimum requirements and ensure a level playing field. These policies enabled member countries to tighten and centralize the financial market supervisory functions.

### *Euro-Passport Policy and a Home Country Principle*

In December 1991, the European Council agreed on the Maastricht Treaty that mandated a path toward the European Economic and Monetary Union (EMU). As a first step, the European Monetary Institute (EMI) was established to promote cooperation

among central banks. It was replaced by the European Central Bank (ECB), which had a mandate to lay out a single monetary policy and maintain a single currency. The ECB and the European System of Central Banks (ESCB) that were composed of the ECB and the national central banks (NCBs) of all 27 EU Member States were established in accordance with Maastricht Treaty Article 4a (ESCB Statute Article 1).<sup>1</sup>

According to Article 2 of the ESCB Statute, "the primary objective of the ESCB shall be to maintain price stability." Article 2 further states that "without prejudice to the objective of price stability, it shall support the general economic policies in the Community." Basic tasks of the ESCB are itemized under Article 3.1: 1) implementing monetary policies, 2) conducting foreign exchange operations, 3) managing official foreign reserves, and 4) promoting the smooth operation of payment systems. According to the ESCB Statute, neither financial supervisory authority nor the role of lender of last resort (LOLR) is explicitly assigned to the ECB, although there is still room for interpretation to give an increasing role for the ECB, as will be discussed in the following sections.

Through the Second Banking Co-ordination Directive in 1992, Europe adopted a "Euro-Passport" model in financial supervision. This means that financial institutions

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1. See Official Journal of the European Communities, No C 191/ 68, 29. July 1992  
[http://www.ecb.int/ecb/legal/pdf/en\\_protocol\\_18.pdf](http://www.ecb.int/ecb/legal/pdf/en_protocol_18.pdf)

can conduct their businesses in other European countries (host countries) through establishing branches or subsidiaries, based on the license given by their home countries. They can offer the same financial services as they do in their home countries. The same principle was applied to investment firms and investment funds through the Investment Services Directive (ISD) of 1993 that was replaced by the Markets in Financial Instruments Directive (MiFIDs) of 2007, and the Undertakings for Collective Investment in Transferable Securities (UCITS).

The principle of Euro-Passport is based on mutual recognition of home country rules. This concept is distinguished from international harmonization. Whereas international harmonization aims at establishing uniformity of rules across countries, mutual recognition aims at preserving each country's national laws to a certain extent, which reflect their respective market needs and various stages of development.<sup>2</sup> According to this concept in the Second Banking Co-ordination Directive, credit institutions' branches that are located in other member states are subject to supervision by home supervisors.

However, in order to apply mutual recognition, minimal regulatory requirements need to be met. For example, the Own Funds Directive of 1989 laid out a common

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2. Kubota, Takashi, (2008). "International Harmonization and Mutual Recognition in the Global Financial Regulation," In *Waseda Hogaku*, 83-3, pp 6-10.



concept of "own funds," harmonized supervisory techniques, and set minimum solvency ratios. Similarly, the ISD laid out a concept of the "regulated market" where securities transactions occur and service providers are subject to detailed disclosure requirements. These EU Directives prompted member countries to strengthen supervisory resources and enhance market disclosure.

#### *The Impacts on National Financial Supervisory Systems*

Long before European integration proceeded, each nation developed its own legal structure in financial supervision. For example, in Germany, in response to the world economic crisis in 1931, the German Banking Act (Kreditwesengesetz: KWG) came into force on January 1, 1935 and gave a legal basis for national financial supervision. In 1962, the KWG was fundamentally revised, and financial supervisory functions were centralized from the state to the national level. The Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen: BAKred) gained the main supervisory authority in cooperation with the Deutsche Bundesbank.

As European integration deepened, each nation was obligated to transpose European Directives into national laws. In Germany, financial supervision was tightened through the creation of a new federal supervisor and implementation of EU

Directives. The impacts of EU Directives on the German financial supervisory system were especially prominent in securities market regulations.

In Germany, supervisory authority over securities was held by states (Länder). The self-regulatory features resulted in fewer regulations. Underdeveloped capital markets led to a smaller pool of investment, thus raising funding costs and driving German companies out of domestic markets. To tighten securities regulations and coordinate fragmented securities supervisory authorities, the second Financial Market Promotion Act established the federal securities supervisory office (Das Bundesaufsichtsamt für den Wertpapierhandel: BaWe) that started its operation in 1995. The same law banned insider trading, extended disclosure requirements, and instituted other investor protection measures by implementing European directives such as the Insider Directive, the Transparency Directive, and the ISD.<sup>3</sup>

Parallel to cross-national integration of financial services in Europe through Euro-Passport Policy, cross-sectoral integration across banking, securities, and insurance has proceeded, which is typically represented by the emergence of "bankassurance." In response to cross-sectoral integration, the federal financial

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3. Baum, Harald, (2005). "Change of Governance in Historic Perspective: The German Experience," In *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US*, Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum (Eds.) 20-21.

supervisory office (Die Bundesanstalt für Finanzdienstleistungsaufsicht: BaFin) was created in Germany based on the Law on Integrated Financial Services Supervision (Finanzdienstleistungsaufsichtsgesetz: FinDAG), and started its operation in 2002. BaFin integrated the supervisory functions over all financial services. It was created under a policy aimed at achieving more effective supervision of financial conglomerates and enhancing German presence in regional and international financial policy meetings through a single representative entity.

#### *Summary*

Thus, as illustrated by a German case, the European framework has enhanced the effectiveness of financial supervision as well as promoted a single-market policy. A policy of mutual recognition led not only to lowering barriers to the activities of pan-European financial institutions but also to imposing mandatory minimum regulatory requirements on those activities. Development of a European framework fundamentally affected the national financial supervisory structure.

A single market policy has facilitated financial market integration in Europe parallel to global financial integration, thus leading to the growth of pan-European and global financial conglomerates. Accordingly, systemic risk has been amplified and

spread beyond national borders. To assess risk and ensure overall financial stability under such situations, consistent supervisory standards and practices among countries have become increasingly important. Closer cross-national coordination is needed in standard-setting, law-making, and enforcement stages.

## *2-2. Financial Supervisory Cooperation at an Enforcement Stage: Some Issues*

A major initiative toward financial supervisory integration started even before the 2007 financial crisis. Recommendations by the Committee of Wise Men on the Regulation of the European Securities Markets (Chairman Alexandre Lamfalussy) led to creation of the Level 3 committees that played certain roles in financial supervisory convergence. International agreements such as the Basel Accords as well as the CRD provided common supervisory standards across nations, thus facilitating a path to regulatory harmonization.

### *The Level 3 Committees*

To enhance cooperation in financial supervision and enforcement, the EU established regional supervisory agencies that strengthened policy coordination among

national financial supervisory authorities. Such institutions are the Level 3 committees: the Committee of European Banking Supervisor (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Securities Regulators (CESR). The Level 3 committees support legislative initiatives in financial regulations, enhance legal enforcement, and promote cross-national supervisory information exchanges. These committees were instituted under a four-level cooperative financial governance scheme (legislative, regulatory, supervisory convergence, and enforcement), called the Lamfalussy framework.

The Level 3 committees played a role in laying out standard rules and practices in accordance with minimum regulatory standards agreed upon at European and global levels. Examples include their roles in implementing the CRD by way of issuing guidelines, as will be discussed below. The CRD was introduced in October 2005 to implement Basel II in Europe as agreed upon by the global community. Europe implemented the Basel Accords with extended application of rules to nonbank financial services.

*Basel II and the CRD*

Basel II was approved in 2004 after four consultation stages and laid out three pillars: 1) minimum capital requirement (Pillar I), 2) supervisory review process (Pillar II), and 3) market discipline (Pillar III). In Pillar I, risk-sensitive measures were introduced, and some weights were given to internal risk assessment.<sup>4</sup> Financial institutions that developed an advanced risk management capacity were allowed to use their own internal risk-based assessments (IRB approach). The adoption of IRB led to an expanded role of self-regulation in financial supervision. The definition of risk was expanded, to include credit risk, market risk, and operational risk.<sup>5</sup>

Pillar II of Basel II is composed of two elements: 1) the International Capital Adequacy Assessment Process (ICAAP) and 2) Supervisory Review and Evaluation Process (SREP). ICAAP guides banks to organize an internal risk and capital management system. In addition, according to Pillar II of Basel II, individual banks' internal risk management process needs to be subject to scrutiny by financial

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4. A risk-sensitive approach caused a problem of pro-cyclicality. Financial institutions were obliged to hold less capital in an economic upturn and more capital in an economic downturn. As a result, capital requirements did not help calm the financial bubble or restore economic growth during economic recession. Although this paper does not address this issue, a solution to the problem of pro-cyclicality is one of the major policy agendas that would ensure financial stability.

5. In Basel I, neither market risk nor operational risk was taken into account. Market risk was incorporated for the first time in the "Amendment to the Capital Accord to Incorporate Market Risks" that was published in January 1996 and amended Basel I. Market risk includes interest rate risk, currency risk, and counterparty risk, whereas operational risk means human errors in logistics and illegal activities.

supervisors. Thus, SREP provides the guidelines on how financial supervisors evaluate a bank's internal risk management system.

### *CEBS's Guidelines*

In accordance with Basel II and the CRD, the CEBS developed an integrated guideline on the supervisory review process (SRP) of European banks and investment firms in January 2006 after two rounds of public consultation.<sup>6</sup> In combination with two other CEBS guidelines on cooperation between consolidating and host supervisors and on stress testing,<sup>7</sup> the guideline for SRP provides a basic framework of financial supervisory practices and cross-national cooperation in Europe. To capture the overall risk profile of and impose adequate capital requirements on pan-European financial institutions, cooperation between consolidating and host supervisors has increasingly become critical.

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6. CEBS. (2006), "Guidelines on the Application of the Supervisory Review Process under Pillar 2" published on 25 January 2006, available at <http://www.c-eps.org/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx>.

7. CEBS. (2006), "Guidelines for Co-operation between Consolidating Supervisors and Host Supervisors" published on 25 January 2006, available at: <http://www.c-eps.org/getdoc/cb2b33ce-c043-444e-90b2-1e61a5354173/GL09.aspx>. CEBS, "Technical Aspects of Stress Testing under the Supervisory Review Process" published on 14 December 2006, available at: <http://www.c-eps.org/getdoc/e68d361e-eb02-4e28-baf8-0e77efe5728e/GL03stresstesting.aspx>.

Financial institutions need to adjust their risk assessment and capital requirements according to the suggestions from supervisors. Importantly, the guideline on SRP mandates that supervisors take into account not only quantitative but also qualitative risk. In addition, the guideline on stress testing requires that financial supervisors conduct stress tests as part of assessment process, the results of which need to be incorporated into the calculation of capital. The stress test measures the extent to which financial institutions can withstand macroeconomic or financial market shocks.

Moreover, the guideline on cooperation between consolidating (home) and host supervisors addresses the lack of supervisory information of an entire financial group due to cross-national activities of each financial institution and segmentation of financial supervisory authorities. This guideline mandates that consolidating and host supervisors work in close cooperation while identifying and monitoring financial institutions' branches/subsidiaries of systemic relevance for a whole group. An exchange of supervisory information on these institutions' foreign offices is necessary to assess risk and capital requirements of an entire group.

#### *Financial Supervisory Cooperation*



A home country principle has capacity limitations and incentive problems regarding supervision of cross-national financial conglomerates. Based on a home country principle, foreign subsidiaries are supervised by host supervisors, whereas foreign branches are supervised by consolidating (home) supervisors. Host supervisors do not have primary responsibility over the financial health of branches of foreign banks, which are located within their national borders. Problematically, consolidating supervisors do not often have access to detailed supervisory information about the foreign branches of their financial institutions.

In addition, consolidating supervisors might not have an incentive to tightly supervise them, since resolution costs often fall onto a host country in case of insolvency. This could lead to moral hazard, as seen in an Icelandic case. In this case, the expansion of branches continued without a sufficient amount of deposit guarantee funds and adequate financial supervision. This resulted in accumulated costs ex post imposed on the host countries.<sup>8</sup>

An institutional framework to strengthen cooperation in financial supervision in Europe came to the fore in a reform proposal that was launched in response to the 2007

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8. The de Larosière Group, "The High-Level Group on Financial Supervision in the EU" Chaired by Jacques de Larosière Report 25 February 2009, p35; Also see House of Commons Treasury Committee, (2009). "Banking Crisis: The impact of the failure of the Icelandic banks" on 31 March 2009, Available from <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/402.pdf>

global financial crisis. Closer cooperation can enhance financial stability in Europe through understanding accurate risk features of pan-European financial institutions.

### *3-3. Reform Proposals in Response to the 2007 Global Financial Crisis*

After Europe was hit by the 2007 global financial crisis, the European Parliament approved the amendments of the CRD on May 6, 2009. This amendment aimed at enforcing stricter financial supervision over a cross-national banking group and improving quality of capital adequacy and risk management over securitized products.

In response to suggestions from the European Parliament, the EU Commission is required to submit detailed proposals by the end of 2009 based on the following points: 1) minimum 5% equity holding against financial institutions' investment in securitized products, 2) tightened regulations over the most frequently used derivatives instruments such as Credit Default Swap (CDS) and over-the-counter (OTC) market products, 3) establishment of the central clearing house to reduce the risk of derivatives instruments, and 4) cross-country integration of financial supervision over pan-European financial institutions.<sup>9</sup> As discussed above, the last point, integration of financial supervision, can

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9. Redaktion beck-aktuell, Verlag C. H. Beck, May 8, 2009, "EU verschärft Eigenkapitalvorschriften für Banken."

play a large role in enhancing financial market stability and mitigating negative effects of financial crises.

Detailed policy measures to enhance supervisory integration under the lead of European institutions were contained in the de Larosière Report that proposed a new financial supervisory architecture in Europe on February 25, 2009. This proposal was written by an expert group that was formed in October 2008 under former International Monetary Fund (IMF) president Jacques de Larosière.

*The de Larosière Report: Assessment*

According to the de Larosière Report, a new European institution, called the European Systemic Risk Council (ESRC), needs to be instituted and presided over by the ECB. Such an institution would replace the existing Banking Supervision Committee (BSC) within the ECB and would be assigned a new legal mandate of macro-supervision and early warning. Macro-supervision concerns overall financial market stability and economy as opposed to micro-supervision that concerns solvency of individual financial institutions. This proposal also suggests fuller regulatory harmonization of a European financial market.<sup>10</sup>

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10. The de Larosière Group, "The High-Level Group on Financial Supervision in the EU" Chaired by Jacques de Larosière Report 25 February 2009, pp. 38-39, Also see Neue Zeitschrift für

The proposal mandates that national financial supervisory authorities maintain their monitoring power in their jurisdictions in cooperation with reformed Level 3 committees. These committees renamed the European Banking Authority, the European Insurance Authority, and the European Securities Authority, will be assigned enforcement power and increased regulatory competence. These three new authorities would replace the existing CEBS, CEIOPS, and CESR, respectively, and have representation at the ESRC that decides on macro-prudential policies and provides early warning.<sup>11</sup>

Establishing the ESRC can improve the risk assessment process as well as cross-national cooperation in financial supervision. One of the lessons learned from the current financial crisis is that the overall risk can be much larger than an aggregated amount of risk stemming from all individual financial institutions. As the de Larosière Report points out, "regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the macro-systemic risks of a contagion of correlated horizontal shocks."<sup>12</sup> Financial supervision is

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Gesellschaftsrecht 2009 Heft 9, 337, Fischer zu Cramburg "Finanzmarktaufsicht I: Bericht der de Larosière-Gruppe."

11. The de Larosière Group 2009, p57.

12. The de Larosière Group 2009, p11.

essential not only from a "micro-prudential" point of view to reduce the risk of individual banks' failures to an acceptable level, but also from "macro-prudential" and "macroeconomic perspectives" to ensure the overall financial market stability.<sup>13</sup>

Moreover, the ESRC could facilitate cross-national cooperation in financial supervision. To understand the overall systemic risk across countries and maintain the financial market stability, supervisory information needs to be shared cross-nationally. The proposed European framework ensures that supervisory information will be transmitted from national supervisors to the ESRC. In consideration of the impacts upon the overall European financial stability, the ESRC can mandate corrective actions to national supervisors.

Such new pan-European institutional arrangements could also benefit non-European countries, since this could make a European financial system more transparent and facilitate supervisory informational exchange, not only within Europe but also between European and non-European countries. The de Larosière Report recommends that when changes of global rules become necessary, Europe should "speak with one

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13. The de Larosière Group 2009, p 17.

voice," whereas harmonization of minimum core standards needs to be achieved at a European level with consistent national transposition of directives.<sup>14</sup>

### *Summary*

The 2007 global financial crisis revealed that existing European financial supervisory schemes were ineffective for preventing or mitigating financial crises. Existing schemes of financial supervisory cooperation did not help gauge the risk features of financial conglomerates. To overcome lack of supervision, a new policy proposal gave the European authorities, including the ESRC, enforcement power to coordinate and intervene in national supervisory policies based on a macro-prudential perspective.

When the ESRC is instituted in Europe, it could lead to more effective intervention on the part of financial supervisors with respect to risk exposures and capital holdings of pan-European financial conglomerates. The 2007 global financial crisis underscored the necessity of enhancing financial supervisory offices' enforcement capabilities. Financial supervisory offices should be able to grasp the overall risk features of financial institutions with systemic relevance and exercise cross-nationally

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14. The de Larosière Group 2009, p 29.

coordinated supervisory actions in accordance with ever-changing economic and financial situations. In addition, such institutional reforms need to be combined with improved regulation of investment funds and transparency of financial products and transactions. Moreover, pro-cyclicality issues resulting from risk-sensitive capital requirements need to be addressed.

### **3. Cooperation in Financial Crisis Management in Europe**

Parallel to cooperation in financial supervision, cooperation in financial crisis management is necessary to get the damaged financial markets back on a path toward recovery. This section discusses the lack of a regional cooperation framework for financial crisis management in Europe. This issue drew a high degree of attention through the 2007 global financial crisis. Coordinated and smooth investigation of troubled financial institutions and fiscal responses are often necessary in a case of the disposal of troubled pan-European financial institutions. The first part of this section contrasts the global nature of the 2007 financial crisis with the national crisis responses, illustrated by the case of Germany. Germany was one of the countries that were most

severely hit by the 2007 financial crisis. The latter part of this section examines issues and recent agendas involving financial crisis management in Europe.

### *3-1. Global Financial Losses and National Crisis Responses*

Financial losses due to the 2007 financial crisis spread around the world. Europe was not an exception and it was one of the regions hit most severely by the crisis. Large financial losses resulted from subprime loans and subprime-related investments. Financial losses also resulted from securitized products, other structured products, non-subprime mortgage and corporate loans, and market illiquidity in a crisis period. Securitized products experiencing losses included collateralized debt obligations (CDOs), residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and leveraged loans. In addition, losses spread through banks as well as insurance companies, investment funds, and government-sponsored enterprises (GSEs).

Hit by the 2007 global financial crisis, total estimates of potential banks' losses stemming from securitized products (including both subprime and non-subprime ones) amounted to \$470-530 billion in October 2008 at a global level. When other financial sectors' estimated losses, such as those in insurance, pensions, GSEs, and hedge funds,



are included, the total estimated losses stemming from securitized products are \$980 billion out of the exposure of \$10.840 trillion to those products.<sup>15</sup> At a European level, net European banks' exposures to U.S. subprime mortgage markets are reported as \$279 billion as of March 2008. Estimated losses on these subprime-related products are reported as \$123 billion, including reported losses of \$80 billion.<sup>16</sup> The majority portion of losses due to the 2007 financial crisis comes from banking sector and subprime-related products.

Financial and fiscal responses to the financial crisis have been made mainly on a country-by-country basis, although national central banks and the ECB exercised coordinated quantitative easing in order to increase financial market liquidity and stimulate the economy. Europe has not developed a detailed agreement on crisis management schemes and measures. Only ad-hoc cross-border solutions and informal guidance through Memoranda of Understanding (MOUs) exist. In addition, a potential candidate for that role, the ECB, does not have a clear legal mandate to function as LOLR, as discussed in the next section.

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15. International Monetary Fund, "Global Financial Stability Report: Financial Stress and Deleveraging, Macrofinancial Implications and Policy" World Economic and Financial Surveys, October 2008, p. 15.

16. IMF "Regional Economic Outlook: Europe Reassessing Risks," World Economic and Financial Surveys April 2008, p25, <http://www.imf.org/external/pubs/ft/reo/2008/eur/eng/ereo0408.pdf>, p. 25

In Germany, in response to the 2007 financial global crisis, its government announced the enactment of measures to stabilize financial markets and regulatory reforms on October 13, 2008. This plan proposed the use of about €470 billion for recapitalization by the end of 2009, with €400 billion for credit guarantee, and €70 billion for direct capital injection. At the same time, the government promised balanced budget by 2011. Financial market stabilization funds will be established to strengthen capital adequacy of troubled banks and purchase risk assets including derivatives.<sup>17</sup>

Accordingly, Financial Market Stability Law (Finanzmarktstabilisierungsgesetz: FMStG) was approved by Bundestag and Bundesrat on October 17, 2008. This law allowed public funds to be used for the following three purposes in order to stabilize financial markets: 1) to guarantee risk when financial institutions give new credits to businesses, 2) to recapitalize the troubled financial institutions that are relevant to the federal state, and 3) to acquire bad assets from troubled financial institutions.<sup>18</sup> The troubled financial institutions received guarantee from this fund as follows: €30 billion for the HSH Nordbank, €15 billion for the Bayerische Landesbank, €30 billion for the

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17. beck-aktuell Redaktion, Verlag C. H. Beck, October 13, 2008, "Europäische Strategie zur Stabilisierung der Finanzmärkte beschlossen - Gesetzentwurf der Bundesregierung für deutsche Maßnahmen - Paket steht."

18. Zeitschrift für Bank- und Kapitalmarktrecht 2008, Heft 11, 452, Norbert Horn, "Das Finanzmarktstabilisierungsgesetz und das Risikomanagement zur globalen Finanzkrise."

Hypo Real Estate (HRE), €15 billion for the Commerzbank, and €5 billion for the IKB Deutsche.<sup>19</sup>

Fiscal responses were made nationally, and the timing and measures varied across countries. The domestic nature of crisis responses contrasted with the global and regional nature of the 2007 financial crisis. Most of the financial institutions that were severely hit by the financial crisis were internationally active ones with foreign branches and subsidiaries. In addition, European banks' major losses came from the bursting of the U.S. asset bubbles and subprime-related investments.

There are a series of discussions on domestic remedial actions and reforms. For example, in Germany, mergers or reforms of Landesbank became a major reform agenda. Landesbank were given an excessive credit supply based on its government guarantee and made an enormous investment in complicated financial products. In addition, German financial supervisory authorities lacked regulatory tools and access to information for monitoring accurate risk profiles of foreign branches/subsidiaries of

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19. beck-aktuell Redaktion, Verlag C. H., Beck, February 6, 2009, "BaFin prüft Banken seit Beginn der Finanzkrise schärfer." Until June 2009, IKB received public money of a total of €9.2 billion to cover losses from their investment in toxic U.S. assets (See Newsweek, June 22, 2009, International Edition, "The Germans are toxic too: claims of safer banks now ring false").

German banks whose management was highly exposed to a maturity mismatch problem, as seen in a case of HRE.

However, given the regional or global nature of financial crises and financial institutions, some tasks of crisis management need to be handled regionally or globally. As seen in a case of the resolution of Fortis, a major pan-European financial institution, ex-post negotiation of a share of burden takes longer. The resolution costs tend to become higher when the states wait for their fiscal remedies. As an initial step in the design of a cooperative framework, issues and agendas relevant to European cooperation in financial crisis management are described in the next section.

### *3-2. A Potential Role of the European Authority in Financial Crisis Management*

The lack of coordinated financial crisis management schemes at a European level fundamentally stems from nonexistence of a pan-European treasury department or equivalent. This leads to inevitable difficulty in cooperating in crisis management that often involves the use of a large pool of funds, including taxpayers' money. A basic principle that was adopted in the Maastricht Treaty was separation between fiscal and monetary authorities, assigning the former to a national level and the latter to a European level. Modifications to this principle could be politically difficult.

Lack of coordinated crisis management at the European level led to slow responses to the resolution of pan-European banks in the 2007 financial crisis. To overcome such negative policy consequences, several institutional alternatives need to be considered. Alternative options include a potential role of the ECB as LOLR and the creation of a privately funded deposit insurance scheme.

Given that the ESCB has responsibility for the smooth operation of payment systems, the ECB can provide liquidity in the case of the payment system lock-up. However, the ECB does not have a clear mandate for liquidity provision to specific troubled banks that are illiquid but solvent. Article 2 of the ESCB Statute allows the ECB to support general economic policies as long as it does not contradict with price stability. Since liquidity provision will lead to inflation, an expanded ECB role in a case of financial crisis based on Article 2 could be problematic.<sup>20</sup>

Instead, Article 3.3 of the ESCB Statute describing ESCB's supplementary role in financial supervision provides possible justification for an expanded ECB role as LOLR. Article 3.3 states that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system." ESCB's contribution to

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20. Steven R. Blau, (2008) "The Federal Reserve and European Central Bank as Lenders of Last-Resort: different needles in their compasses," *New York International Law Review* 39.

national supervisory policies is defined only as supplementary tasks under Article 3.3 that are assigned separately from the basic tasks defined under Article 3.1. This could potentially justify the ECBs' role as LOLR as long as it is compatible with financial supervisory policies conducted by national supervisors.<sup>21</sup> Thus, a well-coordinated national financial supervisory policy at a European level, as was discussed in the previous section, could facilitate an increasing role of the ECB in financial crisis management.

In addition, the de Larosière Report suggests that Europe develop deposit guarantee schemes (DGS) that are harmonized and pre-funded by the private sector.<sup>22</sup> The public EU fund for crisis management was not supported due to political reasons. "The idea of a pooled EU fund, composed of the national deposit guarantee funds, has been discussed by the Group, but has not been supported. The setting-up and management of such a fund would raise numerous political and practical problems."<sup>23</sup>

When crisis management schemes are set up, they need to avoid moral hazards that can result from the existence of public guarantees. For example, in the case of

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21. Steven R. Blau, 2008, pp. 19-20.

22. The de Larosière Group 2009, p 36.

23. The de Larosière Group 2009, p 35.

failures of some Landesbank in Germany, the oversupply of credit gained through government guarantees led to excessive investments in structured products with unknown risk and unfamiliar financial techniques.

In order to achieve prompt and effective crisis management without ex-post negotiation and to avoid moral hazards at the same time, a clear resolution scheme for troubled financial institutions needs to be achieved on a general level, not on an individual financial institution level. The de Larosière Report emphasizes that, although "a clear and consistent framework for crisis management is required with full transparency and certainty," "constructive ambiguity and uncertainty is appropriate in the application of these arrangements in future individual cases of distressed banks."<sup>24</sup>

### *3-3. Summary*

Regional cooperation in financial crisis management could be more politically difficult than supervisory integration, due to its direct link to the use of taxpayers' money. To promptly relieve the European economy from the turmoil of financial crises, detailed schemes for disposing of troubled pan-European financial conglomerates and dealing with ongoing financial crises need to be developed at the European level. Strict

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24. The de Larosière Group 2009, p 33.

application of a principle of separation between fiscal and monetary authorities and delegation of only the latter at the European level would limit cross-national cooperation for smooth disposal of troubled financial institutions.

Several policy options were discussed to strengthen cooperative function in financial crisis management. Progress in financial supervisory cooperation could facilitate cooperation in financial crisis management in Europe through an enhanced role of the ECB. In addition, a pool of funding for a deposit insurance scheme and a cross-national burden sharing rule could provide alternative measures. A rule for burden sharing needs to be determined and agreed ex-ante in order to mitigate ex-post collective action problems that arise when crises become a reality and lead to subsequent financial losses.<sup>25</sup>

#### **4. Conclusion: An Analysis from a Political Economy Perspective**

The 2007 financial crisis triggered a shift in the boundaries between states and markets as well as between states and regional/global authorities. Public skepticism arose against ever-expanding freedom of financial conglomerates with world-wide

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25. This point owes to the discussions at the Center for Financial Studies (CFS) Research Conference, "A New Supervisory Architecture for Europe's Banking System" on June 5, 2009, in Frankfurt.



branches/subsidiaries to innovate, arrange, and sell complicated financial products, including structured and securitized ones. Post-crisis momentum has become in favor of pre-emptive actions by regulators and states based on their assessments of the risk features of such institutions and transactions.

Financial institutions of systemic relevance warrant tightened financial supervision due to the impact of their financial losses and bankruptcies. As most of such large financial institutions adopt an internal risk model to calculate risk and regulatory capital, according to the current Basel II and CRD frameworks, institutional resources and capacities of financial supervisors need to further develop in order to monitor and mandate remedial actions against flaws in the internal risk models through SRP. The cooperative functions between consolidating and host supervisors need to be strengthened along with enhanced supervisory authorities at the European level.

Whereas the 2007 financial crisis revealed the limitations of self-regulation, it also underscored government failures, including moral hazard issues that stemmed from state guarantees and deposit insurance. Examples include excess liquidity held by Landesbank in Germany. Although government failures did not draw as much attention as did market failures in the context of the 2007 financial crisis, both are important aspects in designing market governance.

Thus, the 2007 financial crisis seems to have had mixed effects on the direction of power shifts between states and markets. A new financial governance design needs to give sufficient resources and authorities to the states that enable them to enforce necessary regulatory actions as well as prevent the states from providing arbitrary privileges to certain financial institutions and providing too much liquidity to the markets.

The same financial crisis led to discussions on the rearrangement of political resources and regulatory capacities that were allocated across multi-level governance to achieve more effective financial supervision. Due to a global feature of financial transactions, markets, and institutions, strengthening regulatory capacities at a supra-national level has become a more important policy goal. In a European context, concrete institutional reform proposals were put into an agenda to enhance regulatory power of European institutions.

Such institutions at the European level should promote coordinated enforcement of corrective measures, based on their monitoring of the distribution of systemic risk. Closer coordination in financial supervision can facilitate further cooperation in financial crisis management. However, safety-net measures to mitigate the negative shocks of the financial crisis should not lead to depriving financial institutions of their

own incentives for self-restraint and self-regulation. Again, a question of balancing power between states and markets needs to be addressed in the process of setting up a new financial architecture at the supra-national level.

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safer banks now ring false."

### **List of Acronyms**

BaFin: The federal financial supervisory office (Die Bundesanstalt für

Finanzdienstleistungsaufsicht)

BAKred: The Federal Banking Supervisory Office (Bundesaufsichtsamt für das

Kreditwesen)

BaWe: The federal securities supervisory office (Das Bundesaufsichtsamt für den

Wertpapierhandel)

BSC: Banking Supervision Committee

CDOs: collateralized debt obligations

CDS: Credit Default Swap



CEBS: The Committee of European Banking Supervisor

CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors

CESR: The Committee of European Securities Regulators

CMBS: commercial mortgage-backed securities

CRD: The Capital Requirements Directive

DGS: deposit guarantee schemes

ECB: The European Central Bank

EMI: The European Monetary Institute

EMU: The European Economic and Monetary Union

ESCB: The European System of Central Banks

ESRC: The European Systemic Risk Council

EU: European Union

FinDAG: The Law on Integrated Financial Services Supervision

(Finanzdienstleistungsaufsichtsgesetz)

FMStG: Financial Market Stability Law (Finanzmarktstabilisierungsgesetz)

GSEs: government-sponsored enterprises

HRE: Hypo Real Estate

ICAAP: The International Capital Adequacy Assessment Process

IMF: International Monetary Fund

IRB: internal risk-based

ISD: The Investment Services Directive

KWG: The German Banking Act (Kreditwesengesetz)

LOLR: lender of last resort

MiFIDs: The Markets in Financial Instruments Directive

MOUs: Memoranda of Understanding

NCBs: The national central banks

OTC: over-the-counter

RMBS: residential mortgage-backed securities

SREP: Supervisory Review and Evaluation Process

SRP: The supervisory review process

UCITS: The Undertakings for Collective Investment in Transferable Securities

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### **Bibliographical Notes**

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