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Banking Crisis Management in the EU: An Interim Assessment

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Introduction

It would certainly not be an overstatement to say that the European Union (EU) was institutionally ill-prepared to manage a financial crisis, especially one involving systemic cross-border institutions. Well before the 2007/2008 crisis, many authors, both from academia and policy circles, warned that the architecture for resolving problems within the European single financial market was deficient.

There were worries about the ability to manage either liquidity or solvency difficulties. On the liquidity side, concern focused on the absence of clear guidelines for implementing the EU lender-of-last-resort function in situations when pan-European banks would experience problems (see, in particular, Prati and Schinasi, 1998 and 1999, Schinasi and Teixeira, 2006 and Nieto and Schinasi, 2007). On the solvency side, there was equal concern about the lack of clear arrangements for the resolution of cross-border banking crises, in particular fiscal burden-sharing mechanisms (see, in particular, Goodhart, 2004, Goodhart and Schoenmaker, 2006, Mayes, Nieto and Wall, 2007, and Nieto and Schinasi, 2007).[2] Even Alexandre Lamfalussy, the former managing director of the Bank of International Settlement and former president of the European Monetary Institute, deemed existing European arrangements “suboptimal” (Lamfalussy, 2004).

Against this background, this paper assesses the actual response of EU and national authorities to the financial crisis. Our main finding is that, so far, their policy performance has been better than may have been expected prior to the crisis, but only because institutional arrangements were so sub-optimal.

The paper is organised as follows. Section 1 describes the pre-crisis EU banking landscape in terms of both market integration and crisis management arrangements. Section 2 describes the main banking events and the policy responses since the start of the crisis. Section 3 presents our assessment of the management of the crisis using first the pre-crisis institutional arrangements and then the EU arrangements deemed desirable by the literature as benchmarks. Section 4 concludes with a discussion of policy lessons and the choices ahead.

1. The pre-crisis EU banking landscape

Financial and specifically banking integration has been regarded by EU policymakers as a goal in itself since the early days of the single European market. The cross-border provision of financial services was envisaged very much in the same way as the provision of any other service, and emphasis was put on the efficiency gains a more integrated market would provide. This meant relying on the home country principle that allowed a financial institution legally established in any member state to provide banking services cross-border.

The single market for banking was slow to take-off and the pure cross-border provision of consumer-oriented services proved to be an illusion – largely because tax and regulatory differences make financial products differ across countries. What remained of the single market was the predominance of the home country principle. Banks are supervised by the authorities of the countries were they are headquartered, and only the fiscal authorities of that country are in a position to bail them out.

1.1 The internationalisation of the EU banking sector

European banking witnessed important changes after the liberalisation of capital movements in the early 1990s, the introduction of the euro in 1999 and the enlargements to the new member states (NMS) in 2004 and 2007.

The creation of a single market for financial services and the introduction of the single currency produced conditions for greater consolidation and internationalisation in EU banking. Kleimeier and Sandler (2007) summarise the main evidence found in the existing literature, while the ECB (2006 and 2008) and the European Commission (2006 and 2007) provide additional information:

- There was extensive mergers and acquisitions (M&A) activity. Mode ba merger. They conclude that "the long expected cross-border merger wave in Europe has started. European banking is finally arriving" (Schoenmaker and van Laecke, 2007, p. 61).

- The European Commission (2007) finds that, indeed, one the new features of the European financial landscape was the emergence of major pan-European financial institutions and groups. Moreover, the ECB (2006) identified 46 systemically important banking groups that accounted for 68% of EU banking assets, of which about half with significant cross-border activity.
- The national presence of foreign banks, measured by their asset share in domestic markets, varies a great deal across EU member states. In 2004, it was less than 10 percent in France, Germany and the United Kingdom, but more than 90 percent in the Czech Republic, Estonia, Lithuania, Luxembourg and Slovakia. In general, foreign presence is much larger in the new member states than in the old ones. According to ECB (2008), in 2007, foreign entities in the NMS accounted for 70 percent of total banking assets, while the corresponding figure for the EU-15 was slightly below 30 percent.
- Persson (2007) calculates a cross-border banking index defined as the sum of the share of domestic banks' total assets held in EU-25 countries outside the home country and the foreign banks' share of the domestic bank market. In 2005, EU member states fell into four categories: those with an index of more than 75 percent (the Czech Republic, Estonia, Hungary and Slovakia), those with an index between 50 and 75 percent (the three Benelux countries, the three Scandinavian countries, Cyprus, Italia, Lithuania and Poland), those with an index between 25 and 50 percent (Austria, Germany, Ireland, Latvia, Malta, Portugal, Spain and the UK) and those wit

1.2 Crisis prevention:

fundamental tension in the EU between home country responsibility for the supervision of financial *institutions* as a subsidiary on its territory. Since banking supervision is also national, with the main responsibility for cross-border institutions assigned to the home country, there is a distinct risk of insufficient flow of information and too little cooperation between in case of market stress.

The situation is similar in the euro area, where the European Central Bank (ECB) has not been formally assigned lender-of-last-resort responsibility by the Maastricht treaty. Liquidity assistance is decentralised. Furthermore the ECB has no supervisory authority, nor privileged access to information from national supervisors.

There are, however, two caveats to this. First, mechanisms have been in place since 1999 to ensure an adequate flow of information *within the Eurosystem* in case a national central bank takes the decision to provide emergency liquidity assistance (ELA) to an institution operating within its jurisdiction. The purpose is to ensure that the provision of ELA is consistent with the maintenance of the appropriate single monetary stance (ECB, 2000). Second, although the ECB is not the lender-of-last-resort in charge of providing liquidity to individual banks, it is, at least implicitly, responsible for providing liquidity to the euro area system as a whole, since no other institution is capable of assuming such task (Walter and Bergheim, 2008).

Cooperation within the EU concerns the exchange of information in crisis situations. Here cooperation is based on a Memorandum of Understanding (MoU) of March 2003 on high-level principles of cooperation between the banking supervisors and central banks of the EU in crisis management situations. The text of the MoU has not been made public. According to the press release, it consists of a set of principles and procedures for cross-border cooperation that deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides for the setting-up of a logistical infrastructure to support the enhanced cross-border cooperation between authorities.[3]

Crisis resolution

When solvency becomes an issue, responsibility for crisis resolution shifts from central banks to treasuries. Since there is no EU or even euro area treasury or common pool of resources available for this purpose, crisis resolution is entirely the responsibility of national treasuries and there are no specific provision for crisis resolution affecting pan-European banks.

Cooperation among treasuries and between treasuries and central banks takes place at the level of ministers and central bank governors through the ECOFIN Council. The decisions of the ECOFIN in all matters, including crisis management, are prepared by the Economic and Financial

[3] See press release at http://www.ecb.int/press/pr/date/2003/html/pr030310_3.en.html.

Committee (EFC), which comprises of deputy finance ministers and deputy central bank governors.

The only *ex ante* crisis management arrangement that existed at the EU level prior to the crisis was a MoU of May 2005 on cooperation between the banking supervisors, central banks and finance ministries of the European Union in financial crisis situations. Like the previous one, the text of this MoU has not been made public. According to the press release, it consists of a set of principles and procedures that deal specifically with the sharing of information, views and assessments among the authorities potentially involved in a crisis situation, the appropriate procedures for such sharing of information and the conditions for cooperation and information flow at the national and cross-border level.

1.3 Conclusion

Two conclusions emerge from the previous discussion. First, the years before the 2007/2008 crisis witnessed a rapid internationalisation of the EU banking sector, with the development of large cross-border groups. Second, although the EU's institutional architecture for financial crisis management was nominally based on both decentralisation and cooperation, the latter clearly relied on weak procedures if not mere declarations of intent. As summarised in Table 1, actual competence essentially rested with national authorities.

As already stated, the deficiencies of the system were well identified prior to the crisis. Frustration with the lack of progress was also clearly expressed in the literature and at policy conferences. For instance, Eisenbeis and Kaufman (2007) had "identified a number of issues and concerns about the present system design that are likely to result in higher than necessary costs of insolvencies in cross-border banking. To date, little progress appears to have been made in the EU in dealing with them. Indeed, as both cross-border branches and subsidiaries increase in importance in host EU countries, the resulting potential dangers of the current structure are likely to become large and may not only reduce aggregate welfare in the affected countries substantially when foreign banks with domestic branches or subsidiaries approach insolvency, but also threaten financial stability. Serious doubts are cast about the longer-term viability of the single passport concept for cross-border branch banking under the existing institutional environment" (Eisenbeis and Kaufman, 2007, p. 43).

The deficiencies of the system had also become known to the EFC, which in April 2006 ran a simulation exercise which took place at the ECB premises and involved the participation of banking supervisors, central banks and finance ministries from all EU-25 countries. The simulation clearly pointed to basic problems in cooperation for managing cross-border crises, a situation which prompted the ECOFIN to set up a special working group on crisis management under the auspices of the EFC.

The reason for this clearly suboptimal situation is that EU policy had been to put market integration first and to build policy integration only as a response to market integration. This strategy had been implemented with success in other fields and it was essentially replicated: the logic was to enlist market forces at the service of the integration process and to proceed with the next step of policy integration when rendered necessary by the advance of market integration and supported by participants in it.

2. The management of the crisis

So far, the crisis has gone through two phases. The first phase, starting in August 2007, started with a general liquidity strain affecting all EU countries (and nearly all other industrial countries) and gradually morphed into a crisis of securitisation and leverage. Tensions on money markets as measured by the EURIBOR-OIS spread had ups and downs during this phase but remained consistently above pre-crisis levels (Figure 2). There were also some solvency problems affecting specific institutions, but none of them with (significant) cross-border activities. The second phase, which started in September 2008 and could be considered over by summer 2009, witnessed both a general loss of confidence and institution-specific solvency crises affecting some major cross-border banks[5]. The EURIBOR-OIS spread jumped markedly in September 2008 and abated only gradually.

2.1 The first phase of the crisis: from August 2007 to August 2008

The first sign of a financial crisis appeared in August 2007 in the EU, when BNP Paribas froze redemption for three investment funds, citing its inability to value structured products due to the rise of delinquencies on US subprime mortgages. As a result, counterparty risk between banks increased sharply and liquidity evaporated from the interbank market, forcing central banks to provide massive liquidity to their banking systems. In the euro area, this general liquidity crisis was handled, as foreseen in the literature on financial stability (Goodhart, 2000 and Schoenmaker, 2003), by the ECB, without the need of detailed supervisory information on individual institutions.

Unlike the Federal Reserve, which had to introduce new facilities to provide liquidity to financial institutions, the ECB was able to perform this role without significant reform of its procedures and operational framework (ECB, 2009). The range of collaterals it was able to accept in repo lending was already very wide because it has been set on the basis of existing practices in euro area countries. The diversity of these practices resulted in giving considerable flexibility to the Eurosystem and this proved to be an asset. The ECB therefore essentially fine-tuned the provision of liquidity to the banking sector.[6] In December 2007, it also entered into a swap agreement with the Federal Reserve and other major central banks in order to be able to provide foreign currency liquidity to European banks experiencing difficulty in accessing it on the markets.

Given the propensity of general liquidity crises to turn into solvency crises for weaker institutions and given the increased risk that some of these institutions might be cross-border ones, it was timely for the EFC ad hoc group to have launched its work the previous year. By September 2007, the Economic and Financial Committee was able to issue a report containing basic principles for crisis management in the EU.[7] Besides basic principl Besidesnciples 015.4(fo Chr)]Tlog27

During this period, member states intervened with rescue measures aimed at preventing insolvency of several banks, none with (substantial) cross-border activities.[8] These state measures were handled by the EU competition authority, the European Commission, on the basis of the standard rules on rescue and restructuring aid.[9]

In June 2008, a new Memorandum of Understanding on cooperation between the banking

2.2 The second phase of the crisis: since September 2008

The crisis of confidence among banks dramatically worsened in mid-September 2008 with the bankruptcy of Lehman Brothers. The insolvency of Lehman Brothers not only reduced sharply the already deficient liquidity in various markets, but unleashed serious solvency problems of several major European banks. On 27 September, the Belgo-Dutch bank Fortis became the first systemic EU ban to be rescued by governments. The intervention by the governments of Belgium, Luxembourg and the Netherlands was followed on 30 September by the intervention by the governments of Belgium, France and Luxembourg to rescue the Belgo-French bank Dexia, another major institution. The same day, the Irish Minister of Finance announced a unilateral government decision to guarantee all deposits and debts of six Irish banks and their subsidiaries located abroad. This move, which was sharply criticised in other EU countries, was just the beginning in terms of national rescue packages with cross-border implications and potential risk for the entire EU banking system.

In view of the systemic nature of the crisis and the response by national governments, it became clear that the R&R Guidelines were no more providing an appropriate framework to handle state aid to the banking sector. On 4 October 2008 a meeting of the heads of state and government of France, Germany, and Italy failed to deliver a meaningful result and at the Eurogroup and ECOFIN meetings on 6-7 October, Finance Ministers agreed that the economic situation "calls for a coordinated response at the EU level", but apart from a decision to increase guarantees on deposits to a minimum of 50,000 euros, it failed to adopt anything beyond broad principles and a declaration of intent that "negative spillover effects should be avoided" (Council of the European Union, 2008, p. 1).

The ECB acted on its side with a change of procedure for refinancing operations. Instead of its variable rate tender, which involved both variability in the cost of liquidity and uncertainty about the amount available to individual institutions, the move to a fixed rate procedure with full allotment was announced on 8 October 2008. With this new procedure, the banks could be certain that their bids for liquidity would be satisfied in full at the rate set by the ECB. This resulted both in removing uncertainty and in lowering the cost of liquidity (since the central bank rate de facto became a ceiling for the EONIA).[12] The same procedure was applied to US dollars operations, which developed significantly to reach almost USD 300bn in December 2008. Quasi-simultaneously the list of assets eligible as collateral was temporarily expanded (the rating threshold was lowered from A- to BBB- and debt instruments denominated in foreign currency became eligible). In contrast with the first period, the ECB therefore went much

[12] Details of the new procedure are provided by ECB (2009).

beyond the fine-tuning of existing procedures and introduced genuinely innovative operations.[13]

At the end of the week of 6 October markets throughout the world suffered one of their worst days in history, prompting the French Presidency of the European Union to convene the first-ever meeting of the heads of state or government of the euro area. This emergency summit, held in Paris on 12 October, is generally viewed as the turning point in the efforts to bring about a concerted European response to the financial crisis.

The Paris Declaration[14] on ‘A concerted European action plan for the euro area countries’, endorsed by all EU countries at the European Council meeting of 15-16 October, provided an plan for concerted action. On substance, it was largely inspired by the British plan of 8 October 2008[15] and included the same ingredients: a commitment to further liquidity provision by the central bank; a commitment to the public recapitalisation of banking institutions in need for capital; and public guarantees for bank borrowing. It also committed signatories to enhanced cooperation.

The Paris Declaration paved the way for three important Commission documents that provided a consistent framework for the rescue and restructuring of EU banks aimed at minimising negative spillover effects:

- The ‘Banking Communication’ of 13 October 2008 focused mainly on conditions that national guarantees covering bank liabilities have to fulfil to be in compliance with EU state aid rules.[16] The main purpose of these conditions was to cut the danger of large amounts of funds flowing between member states in search for the highest level of protection and to avoid massive distortions to competition. The Banking Communication was accompanied by ECB recommendations on the pricing of guarantees[17], also with the aim of avoiding competition distortions resulting from different pricing practices across member states.

[13] Further innovations were introduced in June 2009 with the creation of 12-months fixed-rate, full allotment refinancing operations.
[14] See http://www.eu2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE-12.10.2008/sommet_pays_zone_euro_declaration_plan_action_concertee.html.
[15] HM Treasury, “Financial support to the banking industry”, http://www.hm-treasury.gov.uk/press_100_08.htm.
[16] Communication from the Commission on ‘The application of the State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis’, OJ C 270, 5.10.2008.
[17] “Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt”, of 20 October 2008, http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf.

- The 'Recapitalisation Communication' of 5 December 2008 provided the set of conditions relative national funds to recapitalise banks in order to ensure adequate levels of lending to the economy.[18]
- Finally, the 'Impaired Assets Communication' of 25 February 2009 provided the framework for the clean-up phase of financial institutions' balance sheets by removing toxic assets and underperforming loans.[19]

Furthermore, the Commission call of October 2008 to lift the minimum level of deposit guarantees was followed on 11 March 2009 by a Directive setting a new minimum level at 100.000 euros and shortening the maximum payout delay from nine months to twenty working days (with a view to shortening it further to ten working days).[20]

In summary, EU authorities moved swiftly during the fourth quarter of 2008 and in 2009 to put in place a framework to respond to the crisis.

Implementation was also swift. During the period from October 2008 to July 2009, the Commission approved a total of over three and a half trillion euros of state aid to financial institutions, of which one and half trillion had effectively been used. The support measures fall under four main headings: capital injections (recapitalisation); guarantees on bank liabilities; relief of impaired assets; and liquidity and bank funding support. Table 2 reproduced from European Commission (2009) provides the details of both approved and actual state

3.1 Information sharing

The policymakers' primary responsibility in a financial crisis is to determine whether and how to provide assistance to institutions in distress. This is first and foremost a matter of information on the nature of the problem a particular institution and possibly the financial system as a whole are facing. As illustrated by the sequence of events in 2007-2008 worldwide, effective crisis management requires that authorities in charge have as accurate as possible information

it will establish and manage a central database accessible to colleges of supervisors.[23] On the second question, the Commission proposal for the establishment of the ESRB states that it should have access to all necessary information “while preserving the confidentiality of these data”. In case this information would not be made available, the ESRB would even be entrusted with the right to “request data directly from national supervisory authorities, national central banks or other authorities of Member States”.[24] Implementation of this legislation would be a significant step forward in access to information.

3.2 Liquidity support

As indicated in Section 1, there was concern among scholars and practitioners that the Eurosystem would not be able to provide effective liquidity support in time of crisis. The fear was that the absence of a strong, explicit lender of last resort mandate for the ECB, information asymmetries between the ECB and the national central banks of the Eurosystem, and the resulting coordination problems would hamper swift and sufficient liquidity provision.

Those fears proved unfounded. As indicated the ECB was in fact the first central bank to act on the evidence of a drying-up of liquidity on the interbank market and throughout the crisis there has been no evidence of coordination difficulties between the ECB and the national banks belonging to the Eurosystem. Furthermore, there has been close coordination with major central banks – especially but not only with the Federal Reserve – resulting in the extraordinary innovation of liquidity provision in another currency and the acceptance as collateral of assets denominated in another currency.

This achievement is to be compared to prior assessments. Writing in 1999 on the basis of the provisions of the treaty and secondary legislation, Prati and Schinasi found that “there [was] uncertainty about whether, in the event of a banking crisis across pan-European markets, there will be a central provider or coordinator of emergency liquidity” and that it was “unclear how a fast-breaking liquidity crisis will be handled”. The ability of European central banks to distribute tasks within the Eurosystem in spite of unclear treaty provision and to coordinate across currency zones in spite of the absence of any preexisting formal agreement must be considered a significant achievement.

The only caveat – an important, but specific one – concerns the handling of cross-border externalities vis-à-vis the new member states. As already indicated we do not address the issue in this paper, but it deserves to be mentioned.

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[23] ‘Proposal for a regulation establishing a European Banking Authority (EBA), COM(2009) 501 final, 23 September 2009.

[24] ‘Proposal for a regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and

3.3 Deposit guarantees

As already mentioned in Section 1, deposit guarantee schemes are national in scope and were loosely harmonised as regards levels, payout delays and procedures to ensure the continuity of banking services. Lack of coordination in this regard involved two potential spillover effects:

- Possible deposit flows across countries in search of better guarantees.
- Possible deposit flows within countries from banks headquartered in countries with

As the EU had no legal power to foster a coordinated response, its definition and the Member States' commitment to implement it were entirely an exercise in ad-hoc coordination. The Paris Declaration was a declaration of intent, only precise enough to elicit market confidence until it

3.5 The treatment of pan-European banks

Third, the better-than expected performance of the EU, so far, ought to give rise to no illusion. It is only because EU financial stability arrangements are so sub-optimal that a rather positive assessment of their functioning can be provided.

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Figure 1: Comparative internationalisation of large banks

Table 1: Essential features of the pre-crisis state of play