## Editorial

# The EFSF: A lender of last resort for member States and their banks?

The sovereign debt crisis in the Eurozone bears resemblance to the currency crisis preceding the creation of the euro, to the extent that they both served as catalysts for further European integration. At this point in time, by putting pressure on debt-ridden economies, market forces are giving a decisive boost to the economic governance of the Eurozone.

The package of measures currently under discussion aims at ensuring that no Eurozone member will default. The no bail-out clauses will remain in the Treaty, but a new provision will allow for the establishment of a permanent stability mechanism. This revamped European Financial Stability Fund (the "EFSF") will amount to a lender of last resort, able, however, to attach strict conditionalities to its lending operations. Moreover, stringent rules, aimed at containing public deficits are to be introduced in the Stability and Growth Pact, and possibly, in the Constitutions of the Eurozone members. Additional commitments on competitiveness are also likely to be introduced, covering direct taxation and social security expenditure which, although excluded from EU regulation, due to the unanimity requirement, have been part of the conditionalities attached to the Greek loan facility.

The ECB which, in its role as defender of the euro, has been buying government bonds from the secondary market in order to reduce pressure on the debt-ridden economies, will revert to its original duties under the Treaty.

The mandate and terms of lending of the revamped EFSF are still under discussion. It has emerged, however, that it will be entrusted with the refinancing of sovereign debt of Eurozone members in distress; it would either buy itself bonds which are not finding buyers in the markets, thereby reducing spreads, or it would provide low-interest loans to Eurozone members in distress, who would then redeem high-interest bonds in the primary or secondary markets.

Greece could start by redeeming the high-interest bonds bought last year by the ECB, amounting to approximately 50 billion euros and then offer attractive terms to private bondholders. Greece would also have to deal with the fact that Greek government bonds are recorded in their full nominal value, rather than their current market value, at least in the portfolios of Greek banks. Although the EFSF would be in a position to recapitalize Greek banks, such a situation is unlikely to occur. Greek banks have been successful at raising capital from the market and, if they found themselves in need, a 10 billion euros financial stability mechanism is already in place, under the 110 billion euros financial package to Greece.

Constantine Stephanou
Jean Monnet Chair, Panteion University
Director of ECEFIL


# The implementation of the de Larosière Report has taken place: the European System of Financial Supervision is functional

In December 2010, the European Parliament and the Council adopted the basic legal acts (five Regulations and an “omnibus” Directive) for the creation of the European System of Financial Supervision (the “ESFS”), based on the proposals of the de Larosière Report. The latter was commissioned in 2009 by the European Commission to investigate the causes of the recent (2007-2009) international financial crisis and propose the adequate institutional amendments mainly in the supervisory structure of the European financial system.

The ESFS consists of:

- the European Systemic Risk Board (the “ESRB”), responsible for the macro-prudential oversight of the European financial system,
- the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority, responsible with regard to the micro-prudential regulation and supervision of the three main sectors of the financial system,
- the Joint Committee of the just abovementioned three European Supervisory Authorities, and
- the competent supervisory authorities in the financial sector of the member states of the European Union, which remain ultimately responsible for the supervision of financial firms in the European Union.

The ESFS is a network of the “so-called” European Supervisory Authorities but also the national supervisory authorities in the financial sector, reflecting the decision not to adopt fully fledged, “genuine” European supervisory authorities by activating the relevant provision of article 127, para. 6, of the Treaty on the Functioning of the European Union. In the words of the de Larosière Report: *“In the absence of a genuine single market in financial services, it was judged necessary in the interests of savers and taxpayers (...) to operate an essentially national system of supervision”.*

Within this context, the following deserve special attention:

(a) The main task of the ESRB is the issuance of warnings and recommendations for action in response to identified macroeconomic risks. These can be addressed to the EU as a whole, to EU member states, to the European Supervisory Authorities or to national supervisory authorities. The ESRB may decide on a case-by-case basis, after consulting the Council, whether a warning or a recommendation should be made public. The addressees must either communicate the action undertaken in response to the recommendations or provide adequate justification in the event of inaction, according to the “comply or explain principle”.

In order to fulfil its tasks, the ESRB has the power to collect and analyse relevant information, as well as to identify systemic risks to financial stability. To this end, the ESRB may request the European Supervisory Authorities to provide information on macro-prudential issues. Furthermore, the ESRB is entrusted with the power to cooperate with international organisations and *fora,* such as the International Monetary Fund and the Financial Stability Board.

(b) On the other hand, the powers of the European Supervisory Authorities consist in:

- the development of technical standards, which will be proposed for adoption by the Commission (in the form of binding legal acts, under the procedure provided for in article 290 TFEU on the delegation of powers to the Commission); these standards will be related to the fields mentioned in the abovementioned “omnibus” Directive;
- the adoption of non legally binding guidelines and recommendations;
- the adoption of decisions addressed to the competent authorities with regard to the consistent application of the European Union’s financial law among its member states, and in case of emergency for the settlement of disputes among authorities; and
- the adoption of decisions directly addressed to financial institutions requiring the necessary action to comply with their obligations under EU financial law, including the cessation of any non-compliant practice.

The efficiency of the enhanced work of the newly-established ESRB and the European Supervisory Authorities is an issue to be assessed in the coming months during their operation. The ECEFIL *Reporter* will continue to address this issue on a regular basis.

Professor Christos Gortsos

## Credit rating agencies: regulatory intervention at European level after the recent financial cirsis

Credit rating agencies (CRAs) play a significant role in the financial markets. Their ratings are used both by market participants as part of making informed investment and financing decisions as well as by financial intermediaries as a reference for the calculation of their capital requirements or for calculating risks. During the crisis CRAs are considered to have failed to reflect early enough the worsening market conditions and to adjust their ratings timely following the deepening market crisis.

It was therefore considered necessary to establish a common regulatory approach at European level in order to ensure that they consistently provide high quality, independent and objective credit ratings. This was the main purpose of the Regulation (EC) 1060/2009 of the European Parliament and the Council which (with the exception of certain provisions) is in force since December 2010.

The Regulation lays down rigorous and detailed rules, among others, on:

- the avoidance of conflicts of interest,
- the requirements which should be met by rating analysts and persons involved in the issuing of credit ratings,
- the disclosure of CRAs' methodologies, models and credit ratings, and
- credit ratings issued by CRAs established in third countries.

Moreover, in June 2010 a proposal for a Regulation was submitted by the EC on amending the above Regulation in order to introduce centralised oversight of CRAs operating in the EU. The European Securities and Markets Authority (ESMA) is to assume general competence in matters relating to the registration and on-going supervision of CRAs that operate in the EU. The ESMA will be empowered with all necessary powers to exercise its duties, including the possibility to conduct on-site-inspections and to take supervisory measures in case of a breach committed by a CRA.

Finally, in November 2010, the EC issued for public consultation a working document in order to address certain additional issues related to CRAs' and, especially, the risk of overreliance on credit ratings by financial market participants, the high degree of concentration in this sector, the civil liability of CRAs and the remuneration models used by them.

Dr. Christina Livada

## Draft Regulation concerning SEPA end-dates

On December 16, 2010 posted the European Commission's proposal for a Regulation establishing technical requirements for credit transfers and direct debits in euros and amending Regulation (EC) No 924/2009 (COM (2010), 775 final) (also known as SEPA end-date Regulation).

The Single Euro Payments Area (SEPA) is the area where citizens, business and public authorities can make and receive payments in euro under the same basic conditions, rights and obligations, regardless of their location.

SEPA is an initiative of the European Banking Industry and is strongly supported by the European Commission and the European Central Bank. In SEPA, there is no differentiation between national and cross-border euro payments and the whole of the 27 EU Member States plus Iceland, Liechtenstein, Norway, Switzerland and Monaco are considered as a single area for making electronic payments in euro (credit transfers, direct debits and card payments).

According to the European Commission the self-regulatory efforts have proven not to be sufficient to drive forward concerted migration to SEPA. According to available European Central Bank (ECB) data, as of November 2010, only 10.4 % of all credit transfers in the euro area were executed using a pan-European payment instrument (SEPA credit transfer-SCT). European Commission's view is that only rapid migration to pan-European, i.e. SEPA credit transfers and direct debits, will generate the full benefits of an integrated payments market.

The proposal for a Regulation clarifies that full integration of the payment market will only be achieved once Union-wide credit transfers and direct debits replace completely the respectively national legacy instruments. Card payments, money remittances and cheques are out of scope of the Regulation.

The European Banking Industry welcomes that this proposal minimises the risk that existing national schemes for euro credit transfers and direct debits could become compliant with the technical requirements of the Regulation; i.e. a scenario where domestic euro transactions would still be handled by national schemes whilst Union-wide schemes would be used exclusively for cross-border euro transactions.

Vasilis Panagiotidis

## The resolution of SIFIs

Following the recent Communication from the Commission on "an EU Framework for Crisis Management in the Financial Sector" of 20.10.2010, the DG Internal Market and Services published a working document on the technical details of that framework, which takes a step further towards the end of enabling the resolution of Systemically Important Financial Institutions (SIFIs) in an orderly manner. The working document suggests the extension of the framework's scope so as to include credit institutions, systemically important investment firms and EU bank holding companies. The envisaged framework is organized in three stages: preparation and prevention, early intervention and, finally, resolution.

Main elements of the first stage are the recovery and resolution plans that will be prepared by every institution concerned, in close cooperation with the competent supervisory authorities. Conditions and procedures for the transfer of assets to distressed but not yet insolvent entities of a cross-border banking group are also set out.

It is suggested that powers of early intervention (second stage) be granted to the supervisors, whenever an institution fails or is likely to fail to meet the requirements of the Capital Requirements Directive (CRD) as it currently stands. Already existing early intervention powers under art. 136 (1) CRD will be expanded to include, among other things, the implementation of the recovery plan, the appointment of special management, the preparation of a plan for negotiation on restructuring of debt with some or all of the creditors e.t.c.

Finally, the stage of resolution will be triggered before the point of balance-sheet insolvency has been reached, once the institution fails or is likely to fail. Resolution authorities will have the competence to apply ordinary insolvency proceedings or, if necessary, resolution tools that enable the continuity of vital banking functions while maintaining the going concern value of the institution. The alternatives to ordinary insolvency proceedings include, on a stand-alone-basis or in conjunction with one another, the following tools: the sale of business, a bridge bank tool, the separation of assets (bad bank) and the conversion of debt (debt write down or debt conversion into equity).

The Commission's formal proposal, which will take into account the results of the ongoing consultation, will be submitted in spring 2011.

Irini Parasyri

## Basel III and its implementation in the EU

The new regulatory framework from Basel Committee on Banking Supervision (Basel III) is designed on two separate but closely interlinked approaches, the micro-and the macro-prudential approach.

From the micro-prudential approach Basel III touches upon the basic elements of supervision of the banking sector. The new regulatory framework increases the amount of capital requirements both for the Common Equity and the Tier 1 capital. Moreover, Basel III introduces a whole new notion of convertibility of capital, the loss absorbing capacity of Tier 2 and the contingent capital mechanism which transforms debt into common equity.

In the same micro aspect the framework introduced the risk coverage, liquidity standards and a number of monitoring tools. The standards will closely follow the stock of highly liquid assets of each bank in order to maintain a fixed amount of liquidity and funding so as the banking sector is able to withstand an acute stress scenario for a period of 30 days.

The Liquidity Coverage Ratio will follow the liquid assets of the bank according to its outflows and the Net Stable Funding Ratio will track the stability of the funding available to the bank based on lines of credit and other daily operational funding lines.

From the macro-prudential point, the framework introduced the capital buffers (the capital conservation buffer and the counter cyclical capital buffer) in addition of the raised capital requirements in order to ensure that banking sector capital requirements take account of the macro-financial environment.

The Capital Requirement's Directive IV (CRD IV), which amends the Directives 2006/48/EC and 2006/49/EC, is expected to be published in mid March. According to the European Commission's staff working document, CRD IV will implement the micro and macro area of the Basel III framework. In accordance with the above, Capital Requirement's Directive IV will also apply the concept of contingent capital and the loss absorbency of Tier 2 as mentioned in the Basel III framework.

Anastasios Pisimisis

## European Semester: EU new governance architecture

The recent financial and economic crisis, and the subsequent, for some countries, debt crisis not only highlighted the interlinkages among the European economies, but also revealed the weaknesses and gaps of the current EU governance system. Thus, on September 7th, 2010, the member States of the EU introduced the new governance architecture for the coordination of budgetary and fiscal policy of the EU and euro zone, in line with both the Stability and Growth Pact and the "Europe 2020" strategy, for putting Europe's economy on a path to sustainable growth.

The cornerstone of this new governance architecture is the *European Semester* as it introduces an ex-ante dimension of EU budgetary and economic surveillance. Specifically, the *European Semester* includes a six-month cycle with two phases:

- The first phase starts each year on January, when the Commission publishes the Annual Growth Survey (AGS), to be concluded by March at the European Council. The AGS provides a review of the economic challenges for the EU and the euro area as a whole and outlines priority actions to be taken by the member States. After discussions by the various council formations and the European Parliament, the Spring Council defines the main challenges and adopts the guidelines that member States should consider when drafting their Stability and Convergence Programmes (SCPs) and their National Reform Programmes (NRPs).
- At that point the second phase begins, with the Member States preparing by mid April their finalised SCPs and NRPs to be submitted to the European Commission for assessment. In June, the European Council issues country-specific guidance and possible country-specific guidance to countries whose policies and budgets are out of line, signaling the completion of the *European Semester.*

At that point, member States have at their disposal a period of another six months to finalise their national budgets and bring them for approval to their national parliaments.

It is believed that the effective implementation of the *European Semester* is in the common interest of all EU members and pivotal to set the path to a more integrated and sustainable Europe. The current Hungarian Presidency of the Council is committed to implement this new endeavour.

Dr. Sophia Ziakou

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