EU as a Framework for action by Member States

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Disclaimer

The views expressed are my own and do not necessarily reflect those of the European Commission

Introduction and Motivation

- Global crisis and many policy responses:
  - Central bank’s liquidity provision and aggressive lowering of interest rates.
  - Extension of guarantees on banks’ liabilities.
  - Capital injections and (in some cases) state-control
  - Treatment of impaired assets.
  - Discretionary fiscal stimulus.
  - A review of the regulatory and supervisory framework in Europe.

In this presentation I concentrate on:

- Global crisis and many policy responses:
  - Central bank's liquidity provision and aggressive lowering of interest rates;
  - **Extension of guarantees on banks' liabilities.**
  - **Capital injections and (in some cases) state-control**
  - **Treatment of impaired assets.**
  - Discretionary fiscal stimulus.
  - **Regulatory & Supervisory Framework.**

Outline

- A/ Common framework for public intervention: linking gains of co-operation to spillovers

- B/ Single Market: Functioning of competition and State Aid Rules
  - è Example: Using the banking crisis to illustrate the risk of negative spillovers and the need for co-ordinated action in the context of the internal market

- C/ A new EU framework for crisis prevention and crisis management

A/ Common framework for public intervention: linking gains of co-operation to spillovers (Berrigan, Gaspar, Pearson, 2008)

- **Standard model of the private provision of public goods** as a benchmark to identify the gains from co-operation (application of the Coase Theorem):

  In an environment with perfect information, well-defined property rights and costless negotiation :

  - Pareto-efficiency will be attained.

  - The outcome contracts with the allocation that would result from a non-cooperative Nash equilibrium.

  - The Nash equilibrium may be improved upon through co-operation or negotiation.

-Coase Theorem and Nash Equilibrium in the Private Provision of Public Goods.

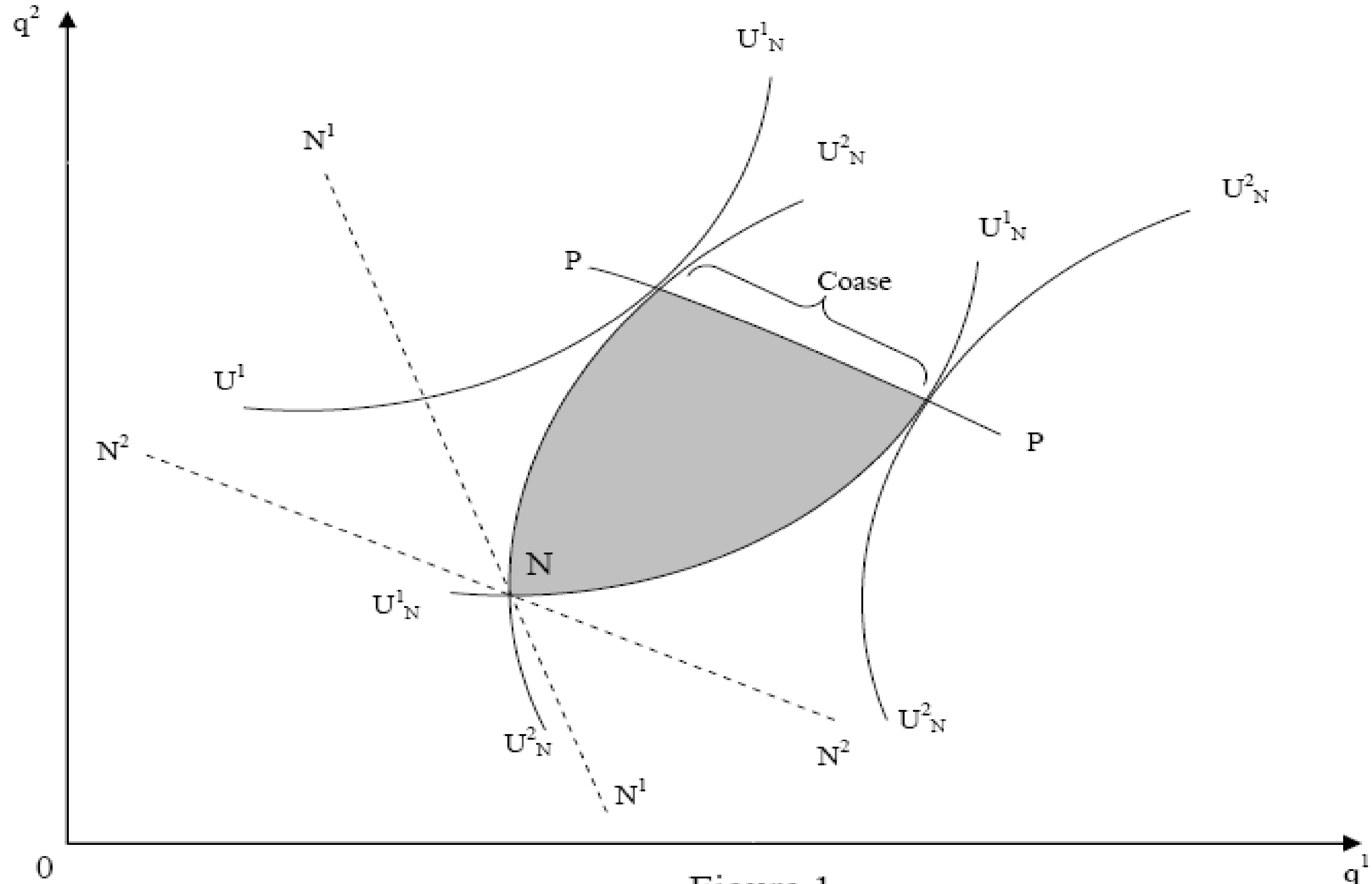


Figure 1

Relevance of this framework in the EU context (Single Market)

- Across the border **spillovers** as a result of public intervention are much clearer when they materialise in the areas in which the European Union has core competence, such as aspects related to competition and trade, including regulation and supervision.

- In times of crisis conditions of the Coase theorem are not met (e.g. costless bargaining, symmetric information,…) and, therefore, there is increased pressure for decentralised and uncoordinated actions. The case for institutional (binding) co-operation becomes stronger.

- Issues of cooperation have led to the framework of the **Single Market** in which Member States have delegated authority to the European Commission, to have legally binding procedures governing the working of the Single Market**.**

- In the context of the theoretical framework, individual and non-coordinated actions by Member States will result in Pareto inefficient outcomes.The legally binding procedures characterising the coordination and cooperation between Member States in the context of the Single Market pushes the Member States to reach Pareto efficient outcomes.

B/ Single Market: Functioning of competition and State Aid Rules – key features

è ***<u>State Aid Rules are not new, the context is new</u>***

Once a process has started Member States have to go through a number of steps, <u>mandatory</u>, in order to preserve the integrity of the Single Market

è ***<u>Internalising negative spillovers</u>***

State aids rules are designed to prevent un-coordinated government interventions to interfere with the functioning of the Single Market and also to improve the effectiveness of public intervention.

è ***<u>Proportionality,non-discriminatory and conditionality of the measures</u>***

The EU framework guarantees that measures taken by Member States comply with the key principles in state aid rules

è ***<u>Reconciling short term imperatives with longer term considerations</u>***

Design of the intervention of the intervention should **<u>reconcile short term imperatives</u>** (safeguarding financial stability, underpinning bank lending) **<u>with longer term considerations</u>** (avoiding fragmentation of the Single Market, distortion of competition, emergence of a structurally weak banking sector, unsustainable public finances)

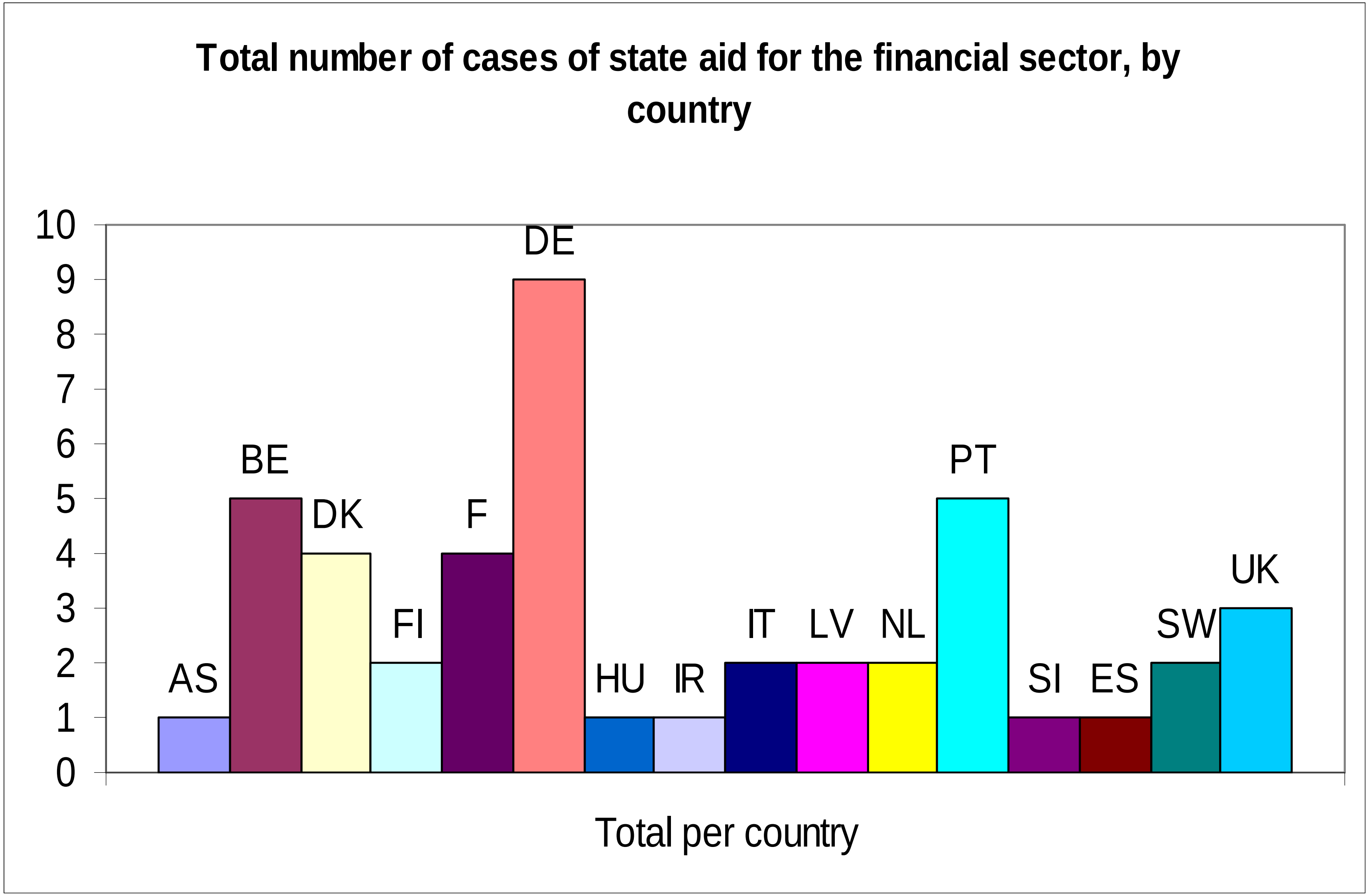
Example: The Banking Sector

- EC provided (ex-ante) **guidelines** on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, in the framework of the **existing state aid rules**.

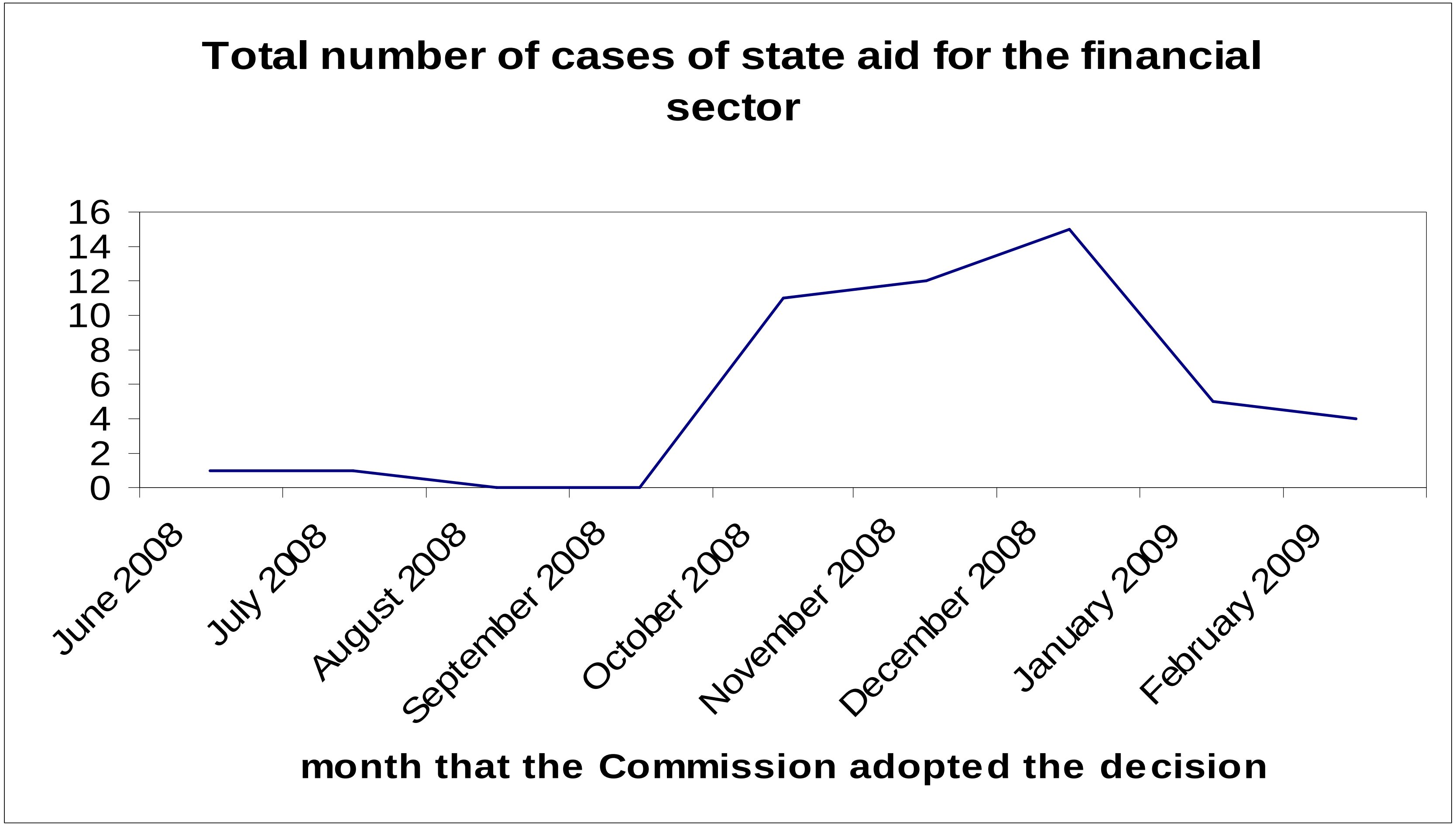
- Guidelines on six classes of measures since the start of the crisis (Com 2008/C 270/02):

è **Guarantees covering the liabilities of financial institutions**
è **Recapitalisation of financial institutions**
è Controlled winding-up of financial institutions
è Provision of other forms of liquidity assistance
è Rapid treatment of state investigations
è **Treatment of impaired assets**

Most member states appealed to the revised guidelines on timely and coordinated state aid in the financial sector since last September



The Irish banking crisis triggered the awareness among the Member States to have a <u>co-ordinated response across Europe</u>, given the potentially large negative spillovers undermining the working of the Single Market



è Economic Rational for Co-ordinated Intervention: **Internalising negative spillovers**

1. ***Guarantees covering the liabilities of financial institutions:***

   In volatile markets, need to reassure depositors that they will not suffer losses and therefore to avoid bank runs.

   Potential negative spillovers:

   - Bank run can cause contamination of healthy banks (systemic risk).

   - If decentralized and uncoordinated national measures are taken, increased risk of inducing artificial distortions on e.g. the ability of healthy institutions to attract funds.

2. Recapitalisation of Financial Institutions

Financial sound institutions may experience distress because of extreme conditions in financial markets (falling asset prices, deposit runs, etc.)

Potential <u>negative spillovers</u>:

- When the compensation scheme does not reflect market prices, banks in other member countries not benefiting from the capital injection are put at a disadvantage.
- Irreversible nature of capital injections can trigger in a later stage expansion of the beneficiary bank at the expense of non-beneficiary banks in the same or other countries

3. *Treatment of impaired assets*

Reducing uncertainty about exposure of banks to financial losses is key to restoring investor confidence (resolving the information problem!)

è Impaired asset relief is required to get credit markets functioning again

Potential <u>negative spillover</u>:

Introducing asset relief measures by a first-mover Member State results in pressure on other member states to follow suit, risking a subsidy race between Member States

C/ Towards a new EU framework for crisis prevention and crisis management

- To have an efficient internal market in financial markets, there is a need for further procedural agreement between the Member States

- de Larosière group formulates recommendations towards (i) a new regulatory agenda, (ii) stronger coordinated supervision and (iii) effective crisis management procedures

- In particular:

è ***European System of Financial Supervision (ESFS)***

create a network of EU financial supervisors, based on the principle of partnership, cooperation and strong coordination at the centre

è ***European Systemic Risk Council (ESRC)***

decide on macro-prudential policy, provide early risk warnings to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues.

è Important Role for the EU in achieving *global* solutions

- Solutions at the European level can only have full effect if they are part of a global effort to improve stability
- Benefits of openness, non-protectionism and the internal market have been clear in the past
- Financial system is global, so the EU must work also with third countries to foster global co-ordination and to obtain the best regulatory framework.
- G20 initiative is essential to enhance regulatory and supervisory standards
- It is therefore important that the Commission is a permanent member of the G20 & the Financial Stability Forum to properly represent EU interests

Conclusions

- The model of the private provision of public goods and the application of the Coase theorem is a useful framework for analysing public intervention. The Single Market is a clear application of this framework.

- Existing EU State-aid rules & ex-ante guidance of the EC have played a major role in ensuring a minimum degree of consistency between the measures taken by Member States and therefore to minimise non-cooperative outcomes. A key moment to come will be the evaluation of the restructuring plans as requested in the context of the State Aid rules.

- Key characteristic of intervention: Reconciliation of short-term and longer-term perspectives of public intervention is crucial to reach a sustainable and competitive banking sector and hence financial sector basis for the real economy.

- But to prevent and manage future crises, further progress in the area of regulation, coordinated supervision and crisis management procedures (as put forward in the **ESRC** & the **ESFS** recommendations) is essential, within a global context (G20)

THANK YOU FOR YOUR ATTENTION!

- You can find more details at:

- http://ec.europa.eu/competition/sectors/financial_services/financial_crisis_news_en.html

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