

Brussels, 14 October 2008

FAQs on Europe's response to the Financial Crisis

Europe's immediate response to the crisis

What is Europe doing to respond to the crisis?

The immediate priorities are to restore confidence and to protect ordinary citizens. Europe has achieved an unprecedented level of coordination in dealing with this unprecedented crisis.

This coordination was deepened at the euro area summit on 12 October in Paris, where the UK Prime Minister was also present. The euro area member states agreed a detailed programme of action to restore liquidity, recapitalize the banking system (including through government's taking shares in banks where appropriate) and protect savers' deposits.

The principles underpinning the programme aim to ensure that action taken by Member States is effective and mutually reinforcing, so that what is done in one does not cause problems for its partners.

The common declaration made by the leaders present, including Commission President Barroso can be found at:

http://www.ue2008.fr/PFUE/lang/en/accueil/PFUE-10_2008/PFUE-12.10.2008/sommet_pays_zone_euro_declaration_plan_action_concertee

The following day several Member States took concrete action at national level to implement the programme.

The European Council on 15-16 October will now work further to reinforce coordination across the whole EU.

What is Member States' role?

Member States - unlike the Commission - have the legal power and the funds to commit large sums of taxpayers' money to, for example, implement generalized "rescue plans", to intervene directly in individual financial institutions in trouble and to provide guarantees for inter-bank lending.

They are doing so, in close coordination with each other and with the Commission, and in line with the detailed principles agreed at the euro area summit on 12 October (see above).

Member States have also agreed to the Commission's suggestion to raise the minimum deposit guarantee at European level and have taken action at national level to reinforce such guarantees.

The Commission will bring forward a proposal on 15 October to implement a higher guarantee formally in EU law (see below)/

What are central banks doing?

The main roles of central banks are to adapt monetary policy and to provide liquidity, without which the financial market cannot operate and credit – including home loans and loans to small business - dries up or becomes much more expensive.

The European Central Bank has done both. Its move on 8 October to cut interest rates, in coordination with other major central banks, demonstrates their collective will to act together decisively.

What is the Commission's role?

The Commission's has three distinct roles. It is playing them to the full.

The first is to apply EU law, notably on competition and state aids. State aids rules fully allow for exceptional measures in the exceptional circumstances we are living through and the Commission is applying those rules flexibly and fast.

For example, the Commission has approved plans by some Member States to restore liquidity and confidence within 24 hours of their notification in final form (e.g. the Irish and UK schemes – see [IP/08/1497](#) and [IP/08/1496](#)). It also approved state aid for Bradford and Bingley (see [IP/08/1437](#)) and Hypo Real Estate (see [IP/08/1453](#)) within 24 hours of notification. It will respond as speedily as possible also to all other measures taken by Member States, once the full details are decided and notified.

To help Member States to put in place coordinated concrete measures to restore confidence in financial markets, the Commission has issued guidance (see [IP/08/1495](#)) on how Member States can best support financial institutions in the current financial crisis whilst respecting EU state aid rules and so avoiding excessive distortions of competition. The guidance is based in particular on EC Treaty rules allowing for aid to remedy a serious disturbance in the economy of a Member State (Article 87.3.b of the EC Treaty). EU state aid rules require that measures taken do not give rise to disproportionate distortions of competition, for example by discriminating against financial institutions based in other Member States and/or allowing beneficiary banks to unfairly attract new additional business solely as a result of the government support. Other requirements include that measures must be limited in time and foresee adequate contributions from the private sector. The Commission will aim to approve schemes that comply with this guidance very quickly (within 24 hours, if possible). In all cases the Commission has been available for informal guidance to Member States before they bring forward proposals. See MEMO/08/618 for an overview of measures taken by Member States and of decisions taken so far by the Commission.

The Commission's second role is to propose adjustments to EU law where necessary, with the rapidity demanded by the circumstances.

The Commission will bring forward on 15 October a proposal for a Directive to put into EU law a higher minimum than the current €20 000 euros for national deposit guarantee schemes. This will build on the national actions mentioned above and on the agreement reached by Finance Ministers on 7 October, so that depositors throughout the EU will benefit from additional protection and to bolster confidence in retail level financial institutions.

The Commission has already launched fast-track procedures to adjust accounting rules in order to be sure that assets are not undervalued, confidence is not unnecessarily undermined and EU financial institutions not disadvantaged vis-à-vis their international competitors. Provided Member States and the European Parliament approve these changes quickly, this will allow the rules to be applied for the third quarter, from 1 July 2008.

The Commission's third and equally important role is to work, often "behind the scenes, as a 'bridge', facilitating agreement and ensuring coherence between national action and European action; between Member States within the euro zone and outside it; between all the institutions of the EU and the Member States. The Commission President and the responsible Commissioners are in continuous contact with their national counterparts.

As a concrete example, the Commission played an extensive role in cooperation with the French Presidency and Member States in preparing the programme agreed at the euro area summit.

For steps the Commission is taking to promote stability in the longer-term, see "Building for the future" below.

Why has a single, European scale "rescue fund" on US lines not been put in place? Why did the Commission not propose European legislation to do this?

Europe is 27 states, not one. And the financial market situations and the nature of the banking system in each are different.

A one-size fits all plan would make no sense.

In any case, there is a division of responsibilities. The Commission is playing its own role with vigour but it cannot commit taxpayers' money to "bail out" financial markets as the US has done. The Treaties do not provide for European legislation in this regard. It would be illegal for the Commission to use funds for this purpose.

What is important is that large-scale and decisive action is taken at the right level and in a coordinated and mutually reinforcing way.

That is precisely what is happening, based on the agreement at the euro area summit on 12 October., which builds significantly on action already taken. The Commission welcomes the resolve and rapidity demonstrated by the Member States.

How can Member States intervene financially on a sufficient scale, without risking falling foul of the stability and Growth Pact, which requires them to keep government deficits below 3%?

There is no need to change or suspend the Stability and Growth Pact. It is not an obstacle to recapitalisation (which incidentally would be likely to affect debt, not the government deficit) or to any other form of proportionate intervention.

The Commission – backed by EU G8 leaders and by Finance Ministers - has made clear that it considers the current situation to be "exceptional".

The existence of exceptional circumstances allows a deficit temporarily above but close to 3% of GDP not to be considered as excessive.

What is more in cases where the excessive deficit procedure (EDP) is opened, the Pact allows for flexibility with respect to the correction deadline, the annual correction effort required and the decision whether or not to move on to subsequent steps under the EDP.

This flexibility in the Pact makes sense. Doing nothing could end up being much more expensive for taxpayers for many years to come. And the current rescue plans may also ultimately be of limited cost for taxpayers if confidence and normality is quickly restored to the financial markets and governments recoup the money invested in financial institutions.

At the same time, adherence to the rules of the Pact is an asset, not a liability. They provide a guarantee that public deficits will not spiral out of control. That situation can itself lead to major economic crises and taxpayers could end up paying the interest bill for many years to come.

Background

The Pact allows for greater flexibility in "exceptional circumstances", defined as an unusual event outside the control of one or several Member States that has a major impact on the budgetary situation of the Member State(s) concerned, or a severe economic downturn.

Do state aids rules prevent Member States taking necessary action to support financial institutions?

Absolutely not. State aids rules are part of the solution, not part of the problem. They allow effective and proportionate intervention to support banks, while providing the very conditions for such intervention to enjoy lasting success to the benefit of citizens and businesses. They also ensure that one Member State's measures do not make matters worse for the other Member States' financial institutions.

State aid rules allow for exceptional measures in the exceptional circumstances we are living through - including the possibility for aid measures to be deemed compatible because they would remedy a serious disturbance in the economy of a Member State. The rules do not need to be changed or suspended, they need to be applied, in line with the exceptional circumstances, and guaranteeing a level playing field and the future viability and stability of companies concerned.

The Commission will continue to apply state aid and other competition rules flexibly and in real time, while taking into account the developments on the ground. To assist Member States, we have also issued further guidance on their application in the current circumstances (see [IP/08/1495](#)).

At a point where people say that stricter regulation is needed to prevent market abuse, it would be highly inconsistent NOT to apply a set of rules which is precisely designed for that purpose.

What are the changes being introduced to accounting rules, how is that being done and how will these changes help?

No primary legislation is needed to amend accounting rules – the Accounting Regulatory Committee must endorse a proposal then validated by the Council and Parliament before formal adoption by the Commission.

The Commission has brought forward the next meeting of the Committee and has already sent a draft to the Committee to alter the mark to market requirement for assets to be valued at the current market price, allowing a valuation more closely reflecting their intrinsic value over time. This will avoid assets being undervalued and bring EU rules into line with those now applying in the US and some other jurisdictions, thus avoiding any competitive disadvantage for EU banks.

If the Member States and the European Parliament can deal with this to the timescale the Commission proposes, the Commission will adopt the amended rules in time for them to apply to the third quarter, that is from July 2008.

What is the Commission's view of the US rescue plan?

The Commission welcomes the plan, which shows that the US is taking responsibility over the turmoil which originated primarily in the US but has now become a global problem.

The Commission notes that the Plan, like Europe's own response, is evolving as circumstances change and we hope that the Plan, as it begins to operate, will gradually increase market confidence in a lasting way.

As to the specifics, this is a US plan for US markets and the US authorities are best placed to judge what is needed. The action needed in Europe must in turn be adapted to European conditions.

What action is the EU taking to ensure coordination at international level?

First, the Commission is fully behind the French Presidency's call for an international conference this autumn. The Commission has long been calling for more international regulatory cooperation and for streamlined representation of the EU and the euro area in international bodies. The Commission is a full member of the G8. It is now represented at the Financial Stability Forum.

Of course, central banks are also working together closely at international level, as the coordinated interest cut on 8 October demonstrates.

On 10 and 11 October Commissioner Almunia attended the G7 Finance Ministers and the Annual Meetings of the International Monetary Fund (IMF) and the World Bank (WB) in Washington, D.C.

Discussions among Ministers from both the advanced and the emerging market economies focused on the need to take coordinated, adequate, and swift actions with the aim to reassure the markets and the general public.

The G7 Finance Ministers on Friday 10 October, issued the "G-7 Finance Ministers and Central Bank Governors Plan of Action", (see <http://www.treas.gov/press/releases/hp1198.htm>)

This built upon the principles agreed by the ECOFIN Ministers earlier in the week and notably included agreement at international level on recapitalisation of banks through government participation in equity, as a tool to restore liquidity and confidence. This is a significant element in European action.

In turn the programme agreed at the euro area summit on 12 October, and now being implemented, fleshed out the G7 agreement with a concrete action plan for Europe, fully consistent with the international approach.

The International Monetary and Financial Committee (IMFC) of the Board of Governors of the International Monetary Fund has endorsed the G7 plan of action and called on the IMF to take the lead in drawing the necessary policy lessons from the current crisis and recommending effective actions to restore confidence and stability. (see <http://www.imf.org/external/np/sec/pr/2008/pr08240.htm>).

An extraordinary meeting of the G20 Finance Ministers was also held on 11 October. G20 Ministers agreed that they would communicate to each other about national actions to avoid "beggar-thy-neighbour" policies (see <http://www.imf.org/external/np/tr/2008/tr081011.htm>).

The IMFC welcomed the development of the Generally Accepted Principles and Practices (GAPP) by the International Working Group on Sovereign Wealth Funds. (see <http://www.iwg-swf.org/pr/swfpr0806.htm>, [IP/08/313](#)). The EU contribution to this work was based on the Commission's contribution endorsed by the Spring European Council.

Building stability in the future

What new steps is the Commission taking to stop this kind of crisis happening again?

The Commission believes Europe must learn lessons from the crisis and comprehensively rethink regulatory and supervision rules for financial markets, including banks, other lenders, hedge funds and private equity.

So in parallel with its immediate response to the current crisis, the Commission is taking decisive action to reinforce the regulatory framework for the future. This already began in autumn 2007, as soon as Finance Ministers agreed on a road map of actions and has now been accelerated.

There are two main strands to the work underway.

First, imposing more responsible and ethical behaviour. The Commission has already presented a proposal to reinforce capital requirements for financial institutions, to rein in reckless speculation based on borrowed money (see [IP/08/1433](#)). It will introduce this month further proposals to improve regulation of credit rating agencies. The Commission also intends to make proposals on remuneration, to improve transparency and help tackle short-term-ism and excessive risk taking.

The second key task is to improve supervision structures, notably in order to remove the mismatch between European financial markets on the one hand, and largely national supervision on the other.

The proposal on capital requirements already includes steps forward in this respect for banking markets, including setting up "colleges" of supervisors led by the authority from the country where a cross-border institution is primarily based. Similar steps are proposed for the insurance market in the Solvency II package adopted already by the Commission in and now being finalised in the Council and Parliament.

President Barroso is setting up a high level group chaired by Jacques de Larosière, former managing director of the IMF, to look in more detail at cross-border supervision issues (see below).

It is never possible to completely rule out difficulties in financial markets arising from unforeseen circumstances, as to function efficiently and provide the services businesses and consumers need, these markets cannot eliminate risk. But the steps being taken will significantly reinforce stability in the longer-term and reduce the effects of shocks where they occur.

How can European supervisory coordination be improved ?

It has already been improved. The implementation of the proposals of the high-level group chaired by Alexandre Lamfalussy in 2001 for example led among other things to the creation of the Committee of European Securities Regulators, which has become a very important contact point for supervisors.

However, more is clearly needed and the high-level group set up by President Barroso and chaired by Jacques de Larosière will report in detail.

But the basic problem is obvious. There are more than 8 000 banks in the EU but two-thirds of total bank assets are held in 44 cross-border institutions, operating in up to 15 Member States.

But obviously a situation where markets are integrated, and supervision fragmented among national supervisors, gives rise to extra risk and makes cross-border intervention difficult. The Commission has proposed in the Capital Requirements Directive, and in the Solvency II package for insurance companies, steps to improve the situation by creating "colleges" of supervisors.

There has been resistance from some Member States until now.

Yet the current crisis shows that Europe may need to go further. When a cross-border bank active in a few Member States is in trouble (Fortis, Dexia), it has proved possible, though not easy, to find solutions. This could be even more difficult in the case of a bank active in many Member States.

So a European solution is needed to a challenge with a European dimension, so that we are better placed to deal with crisis situations, but also to ensure that the single market provides maximum benefits to citizens and businesses in more normal times.

Work on better coordination of supervision will also extend to the global level. The Commission will continue to seek to improve international cooperation notably through the IMF, the Financial Stability Forum and in the Transatlantic Economic Council.

How will this crisis affect the real economy?

Businesses depend on credit to expand and create growth and employment and families need affordable loans to buy homes. Confidence is also a significant factor in the health of the real economy, and in particular in terms of consumer demand, just as it is in financial markets.

So there has already been a significant effect on the real economy, as recent economic data and forecasts show. In 2008 economic growth will be less than half that of 2007. And there will be no or little 'carry over' entering 2009, as forecast in the September 10 interim forecasts. The Commission will issue on November 3 its autumn economic forecast for 2008-2010.

However, the crisis can be contained, the effect on purchasing power and employment contained and growth relaunched, if confidence in financial markets and the flow of credit to business can be restored quickly. That is the immediate aim of the EU response to the crisis.

What is being done to help small businesses deal with the crisis?

Small and Medium Sized Enterprises are of prime importance for our economy and its growth, as 80 percent of all new jobs are created in small companies. So the Commission is committed to supporting them, continuing with the EU's reform policy within the Lisbon partnership for growth and jobs and to doing everything possible to stimulate growth via small businesses.

The Commission is therefore asking for quick adoption of the Small Business Act (SBA), which it tabled in June (see [IP/08/1003](#)) and which proposes concrete actions to unlock the growth potential of small businesses. It will continue to work to cut unnecessary administrative burdens, which can hamper particularly smaller enterprises.

To facilitate the growth of small businesses the European Investment Bank (EIB) has doubled the amount of money for loans to Small and Medium Sized Enterprises to 30 billion euro, for the period until 2011.

Can Europe weather the storm?

Europe faces an unprecedented challenge. But it is extremely important to resist excessive pessimism which would make the situation worse. There are very good reasons to be confident Europe can emerge stronger, as it often has done from previous crises.

First, there is more coordination within Europe than ever before. The Commission has made clear that it would like this to be even further enhanced. But Europe is working very closely together and with international partners to restore confidence and to limit damage to our "real" economies".

The agreement reached at the euro area summit on 12 October clearly demonstrates Europe's capacity to act decisively and together. The coordinated – and unprecedented - move to cut interest rates, taken on 8 October by six major central banks including the European central Bank is a clear demonstration of international cooperation.

Second, the euro greatly reinforces Europe's resilience, provides stability for businesses and guards against speculative runs on national currencies that have occurred in crisis situations in the past.

Third, there is an unprecedented European and global consensus that we must act together to solve this global problem, applying lessons from previous crises and then learning lessons from this one.

There is consensus that laissez-faire inaction, protectionism, or reckless steps leading to spirals of debt and inflation are not the answer.

There is consensus that the right response in the short-term is extensive but measured, targeted and coordinated intervention. And that the right approach in the longer-term is to reinforce regulation of financial markets where necessary and to continue with economic reforms to improve the underlying competitiveness of European businesses and the skills of Europe's labour force.

Background to the crisis

What is the root cause of this situation?

The root causes lie in the US, where banks and other mortgage lenders lent large amounts of money whose ultimate recipients were house buyers who proved unable to repay the loans (the so-called "subprime" market).

The lenders themselves had often borrowed very large amounts of money to make these loans – in other words they were heavily "leveraged".

Many banks and other institutional investors bought, often in complex packages and again using leverage (borrowed money), so-called collateralised debt obligations (CDOs) or other financial instruments based on those bad loans. These instruments carried, on the face of it, higher interest rates than competing investments and were therefore attractive.

But they were dependent for their value on sub-prime loans being repaid – which in many cases did not happen as defaults spiralled.

How did the sub-prime situation undermine the whole financial market edifice?

When defaults on sub-prime loans started to increase in 2007, and as the value of the CDOs plunged as a result, both mortgage lenders themselves and financial institutions which had bought CDOs feared becoming unable to repay their own creditors – usually other financial institutions. The complexity of the CDOs was also in many cases such that even calculating the losses and identifying where they lay was extremely difficult.

Excessive optimism and in some cases irresponsible risk taking, partly based on the previous period of sustained growth and low interest rates and inflation, was then quickly replaced by a rapid downward spiral in confidence – and by a strong aversion to risk, with banks restricting credit to each other and to other businesses and consumers.

This loss of confidence was significantly exacerbated when high profile institutions such as Freddie Mac and Fannie May, Lehman Brothers and AIG got into trouble in mid-2008.

Among the results worldwide have been that the lending which usually oils the working of financial markets has seized up and share prices have plunged - thus cutting still further the capital available to financial institutions to lend to each other and to other businesses and to consumers.

In other words, a particularly vicious circle has been operating. Excessive optimism in the markets has turned to fear and to extreme pessimism. And in market terms, extreme pessimism is a self-fulfilling prophecy. This has threatened the viability of more and more financial institutions. That is why governments have stepped in to support them.

Why has Europe been so badly affected?

First, CDOs were traded world wide and financial institutions all over the world, including many in Europe, became exposed to them and to other instruments whose value directly or indirectly fell as a result of the sub-prime loan defaults in the US.

Second, although there has been very little real "sub-prime" lending in Europe, some Member States have also seen significant downturns in their own housing markets.

Third, given that financial markets are global and financial institutions trade with each other worldwide, EU financial institutions are directly affected when US institutions get into trouble. Sentiment also plays an important part - the extreme crisis of confidence in the US financial markets in recent weeks immediately spread elsewhere – as is always the case in such circumstances.

Fourth, all this has coincided with other global shocks, particularly soaring oil and commodity prices, resulting in rising inflation, and with exchange rate volatility. Those factors too have led to an economic downturn everywhere and have also had a negative affect on stock markets and therefore on the amount of capital available to banks to resist the current pressures.

What has Europe been doing already over the last few years to get the financial markets under control?

It is important to be clear that the current crisis originated in the US, therefore outside the EU's jurisdiction. However, the Commission, the other EU institutions and Member States have expressed their determination to learn lessons and to make Europe as resistant as possible to this kind of financial market shock.

This further action is indeed building on measures already taken over a long period. The Financial Services Action Plan 1999-2005 ([FSAP](#)) laid the foundations for a stronger financial market in the EU. But efforts have continued.

The Commission has focussed notably on strengthening the EU prudential framework. Work on the revision of the Capital Requirements Directive (see [IP/08/1433](#)) was already underway before the emergence of the crisis. The Commission tabled the Solvency II proposal (see [IP/07/1060](#)), which aims at streamlining the way that insurance groups are supervised, ensuring that group-wide risks are not overlooked, and demanding greater cooperation between supervisors from different Member States;

The Commission has in all areas of financial services tried to clarify and optimise the division of responsibilities between "home" Member State and "host" Member State supervisors and to stimulate the development of a pan-European supervisory culture. The "level three" committees that were established in the Lamfalussy system (see [IP/07/1731](#)) did a lot of practical work on fostering supervisory cooperation in the banking, insurance and securities fields;

However, views between Member States still diverge and progress has not been fully satisfactory. The high level group chaired by Jacques de Larosière will now look at this issue.

On securities and investment funds, the Markets in Financial Instruments Directive (MiFID) has been implemented (see [IP/07/1625](#)) and amendments presented to the UCITS legislative framework ([IP/08/1161](#)).

As for trading and post-trading infrastructures the Commission, Member States, infrastructure providers and users – have been working together to enable a more efficient and safe post-trading market in the EU. This has resulted in the Code of Conduct on clearing and settlement (see [IP/06/1517](#)).

In the field of payments, the Payments Services Directive (see [IP/07/1914](#)) has been adopted in 2007 and work continues on the industry-led Single Euro Payments Area (SEPA).

The Commission has been working on a range of measures aimed at creating a real single market for retail financial services – to bring tangible benefits to European consumers. A White Paper on Mortgages has been published. We have also been actively promoting financial education.

The Commission has also worked to deepen relations with other global financial marketplaces and to strengthen European influence globally.