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REPORT

from:	The Council
to:	The European Council
Subject:	Financial Market Stability - Interim report by the Council (ECOFIN) to the European Council

Please find attached the Interim report by the Council (ECOFIN) to the European Council on Financial Market Stability.

Financial Market Stability

Interim report by the ECOFIN to the European Council

This report summarizes the main developments in the financial markets since October 2007 and EU key priorities in enhancing financial stability, taking into account the global context.

I. Recent developments in financial markets and impact on the real economy

1. Conditions in the international financial system remain fragile. Although substantial adjustments have already taken place and actions have been taken by both authorities and financial institutions since last autumn, several financial markets are still disrupted. While ECB and other Central Banks' operations have stabilised liquidity in interbank deposit and asset-backed commercial paper (ABCP) markets since the beginning of the year, these markets have not yet returned to normal functioning.

2. Even though significant de-leveraging has taken place and several financial institutions have taken steps to enhance transparency of their exposures, the uncertainty about the scale and distribution of further losses[1] overall remains. At the same time, indications of contagion have started to appear in other credit markets**.**

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[1] Recent estimates of overall losses are of the order of EUR 130 billions, but could eventually prove to be considerably higher. Part of these losses are likely to be borne by European financial institutions. Mark-to-market valuation revisions can be expected to be reflected in the 2007 earning figures.

3. As defaults in the US markets are spreading to higher quality segments of the US mortgage market and to credit-card debt and automobile loans, credit ratings for Collateralised Debt Obligations (CDOs) have come under renewed pressure. Confidence in CDO credit ratings has been undermined further by concerns about the financial health of bond insurers (monolines)[2], which underwrote much of the credit risk linked to CDOs. Moreover, problems with one or more of these insurers would trigger ratings downgrades not only for CDOs, but also for bonds issued by companies and public institutions and could spread to the market for credit default swaps which provides insurance for an even wider range of bonds. From an EU financial stability point of view, the main concern regarding the monoline insurers are risks of losses for banks and insurers to the extent that they have exposures to the monoline insurers and to the securities wrapped by monolines.

4. Several successive years of strengthening profitability have left most EU banks in a strong financial position to deal with shocks. However, the problems in credit markets have had important implications for the global banking system which has also been reflected in individual institutions within the EU and their balance sheets remain vulnerable to a further deterioration in the credit quality of assets. In the light of the 2007 fourth quarter developments – including the exacerbation of counterparty risk from monoline insurers as well as the updating of various model assumptions for valuing various types of structured credit securities – further and possibly larger mark-to-market valuation losses on securities can be expected for the final quarter of 2007.

[2] Due to the turmoil in credit markets - and in particular the structured credit market - Ambac and MBIA, the two largest monoline insurers, reported a combined loss of USD 5.6 billion for the fourth quarter of 2007 after a more modest loss of USD 400 million in the third quarter of 2007. These losses stand in marked contrast to the steady income earned by these institutions during the 15 previous quarters.

5. At this point, it seems that we are facing a prolonged adjustment and that the risk of a spill-over to **the real economy** is more likely to materialise. The prospect of tighter credit conditions has reinforced investor expectations of a significant slowdown in the US economy and has been reflected in the downward correction in equity prices since the beginning of this year. This is also likely to affect the EU, including through tightening of credit conditions, reduction of the availability of credit and a decline in confidence. Even though the impact on economic confidence is difficult to predict, it is evident that the longer the current problems in credit markets persist, the greater the risk of significant negative spill-over to both consumer and business confidence. Moreover, in emerging markets, the economic implications of the financial turmoil are beginning to be felt. The impact on all parts of the financial system needs to be carefully monitored.

6. Based on these developments, growth in **the EU economy** is expected to moderate in 2008, although the extent of this slowdown should remain limited because of strong fundamentals and the absence of significant macroeconomic and financial imbalances. The Commission has just issued its interim forecast for 2008 of **1.8%** of GDP for the euro area and **2.0%** of GDP for the EU as many of the downside risks identified in autumn 2007 forecast have materialised, including a significant rise in oil prices and a strengthening in the euro exchange ratio.

7. In the current context, **EU economic and financial policies** should be geared towards ensuring macro-economic stability and pursuing structural reform agenda. Our budgetary framework, as defined by the revised Stability and Growth Pact, gives the appropriate tools to cope with the current situation and the automatic stabilizers, which are large in Europe, should play wherever possible.

II. Policy responses to the turmoil

8. In October 2007, the Ecofin Council identified four main priority areas in response to the turmoil, part of which aim at dealing with short term developments while others address long-term challenges. These policy priorities remain fully valid. The developments in financial markets over the past nine months have revealed a number of vulnerabilities and weaknesses that need to be addressed, requiring appropriate and timely reaction as well as close cooperation and exchange of information between supervisors at the EU level. Attention should focus on the key underpinnings of efficient and stable financial markets, i.e. *quality and availability of information and relevant statistics, incentives, robust asset valuation and risk managemen*t. Work is ongoing in different fora on these issues and, for some of them, possible options are emerging and concrete outputs are expected in the coming months. EU fora are working closely together with international bodies, including with the Financial Stability Forum.

9. To restore confidence and promote the functioning of the markets, it is essential that the financial industry comes forth quickly with its own initiatives, including self-regulatory action where appropriate, in particular in view of enhancing transparency, improving asset valuation and the functioning of non-organised debt markets as well as clarifying the role, governance and accountability of credit rating agencies. While timely private sector action is a priority, such initiatives should be properly discussed with the relevant Financial Supervisory Authorities, and authorities in the EU should stand ready to take regulatory and supervisory actions where necessary.

10. Reviewing the four priorities of the Ecofin roadmap, Ecofin Ministers agreed on the following.

(i) Enhance transparency for investors, markets and regulators

11. In the very **short term**, prompt and full disclosure of exposures to distressed assets and off-balance sheet vehicles and/or of losses by banks and other financial institutions is essential to bring back confidence in the markets. Guidance from supervisors and auditors at the EU level could promote consistency in banks disclosure and valuation practices.

12. Preliminary results of a survey by the Committee of European Banking Supervisors (CEBS) on the **disclosure of information by banks** since October 2007 show that the transparency in respect of structured products and vehicles is not fully satisfactory and is very diverse between different financial groups (in particular with regard to the level of detail and description of the nature of the underlying assets). Disclosure on institutions' involvement in or commitments to conduits or Structured Investment Vehicles was also limited. Policy measures for strengthening the systematic disclosure of information by banks should therefore be considered on the basis of an in-depth assessment to be carried out on the forthcoming 2007 last quarter results and/or year-end financial statements of banks and taking into account private sector initiatives mentioned below. So far, the EU supervisory committees (CEBS, CESR and CEIOPS) have been invited to prepare such an assessment by September 2008, to continue their targeted supervisory actions to enhance the level of knowledge on the exposures of institutions.

13. The industry in the EU has already committed to undertake several steps to enhance transparency and disclosure, including: the *development of guidelines* on securitisation disclosure, to be published by the end of June 2008; a periodic reporting of *information to the market* on a range of instruments (e.g. ABS, CDO, ….), focusing on their primary (new issuance) market activity but also including some summary data (spreads, ratings) on secondary market activity; and, *information towards investors*[3]. The efforts aimed at delivering comprehensive data on European debt markets should be continued (by the industry) to give more visibility to investors. The industry's efforts should be closely monitored to ensure delivery by mid-year.

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[3] Including information on public transaction structure and initial portfolio as well as ongoing data on the performance of the pool assets and rating changes.

(ii) Improved valuation standards

14. The analysis conducted by CEBS on the **valuation of and accounting for illiquid assets** shows differences in banks' practices and limited disclosure on valuation issues. This may have contributed to the lack of confidence of market participants and exacerbated the market turbulence. With a view to improve the understanding of banks and other financial institutions' exposures to structured products, supervisors should work with major audit firms and standard setters to ensure that accounting standards relating to valuation are sufficiently clear and robust, particularly in relation to illiquid assets, and that standard setters deliver clear and consistent guidance on valuation. A first assessment by the EU Supervisory Committees (CEBS, CESR and CEIOPS) and the audit and accounting profession on valuation standards should be completed before summer. The Basel Committee on Banking Supervision is also working on these issues.

(iii) Reinforce the prudential framework and risk management in the financial sector

15. The European Commission is reviewing a number of areas of the **Capital Requirements Directive** where the recent financial turbulence has revealed shortcomings (concentration risk, the treatment of hybrid capital instruments, cooperation between supervisors in crisis situations and securitisation rules – in particular the definition of 'significant risk transfer'). Having in mind the EU calendar, it will be key to reach an agreement with the European Parliament before April 2009 (date after which the Parliament will no longer carry out legislative work), and for this reason, the Commission is encouraged to proceed with its consultations and to put forward its proposal by September 2008. Departure from this timeframe would lead to a delay of at least one year.

16. In order to enhance the management of **liquidity risk**, there is a clear need for banks to better estimate the dependence on market liquidity of structured finance instruments, to understand the connections between various types of risks, to ensure an appropriate management of the liquidity risk at the group level as well as to have proper internal governance in place. The work carried on by the ECB in cooperation with the Banking Supervision Committee on banks' stress tests and contingency funding plans, and by supervisors, including in the context of CEBS, to develop stress testing and review the internal governance and management practices of institutions for liquidity risk is of high importance. The Ecofin Council also gives its full support to the ongoing work of the Basel Committee on developing standards to improve the international management of liquidity risk. The EU Member States call for rapid progress in that field at the international level. Special focus should be put on maturity mismatches, whether on or off-balance sheet, as they have appeared as a major source of risk and contagion. At the EU level, progress in convergence of supervisory practices is a priority in the short term.

17. It will also be important to enhance **supervisory cooperation** in crisis situations. This may be achieved by requiring coordination structures to be put in place between supervisors and by appropriate exchange of information in the EU Supervisory Committees as well as arrangements to involve Central Banks and Ministries of Finance where appropriate, to perform their respective tasks.

18. As required by the Capital Requirements Directive, over the medium term, on the basis of a report from the Commission to the Parliament and the Council in 2010, compiled with the assistance of the ECB, consideration should also be given to the possible need for additional improvements in the macro prudential framework, including in the light of the risk of pro-cyclicality.

(iv) Improve market functioning, including the role of rating agencies

19. **Rating agencies** are engaging in a revision of their own practices, to increase transparency about their methodology and the risks actually covered by the rating. Concerning potential conflicts of interest related to their remuneration models, self-regulation should be enhanced and the International Organisation of Securities Commissions (IOSCO) Code of Conduct should be strengthened to take into account these concerns. The Commission will receive advice from Committee on European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME) by mid-year. While preferring market-led solutions, if market participants prove unable or unwilling to rapidly address these issues the EU stands ready to consider regulatory alternatives.

20. By-mid 2008, the **incentive structures** of asset managers and executives of financial entities should be carefully examined. In this context, there is a need to ensure that the incentive structure of the 'originate and distribute' models is appropriate at all stages of the securitisation process. The BSC is already working on this issue.

21. The European Commission, the Financial Services Committee and the CESR have undertaken work on **non-organised debt markets** since October 2007. At this stage, the best course of action is to encourage market participants and industry bodies to seek improvements in the organisation of these markets, inter alia through some degree of **standardisation of instruments; better management systems for counterparty risk**; and **improved transparency**.

III. Strengthening the financial stability framework

22. The recent financial market turmoil underlines the need to ensure that the arrangements for financial stability are fully in line with market developments, so as to ensure the efficiency of crisis prevention, resolution and management. The primary responsibility for managing risk is and must always remain with individual financial institutions and investors. However, Financial Supervisory Authorities must have the capacity to fully understand market developments, to assess whether the management of risks is appropriate and to enforce corrective action respectively. In case of a crisis, public authorities need also to be able to respond in a timely coordinated and credible manner both at national level and in a cross-border context. Independently from the turmoil, the Ecofin Council has been working on these issues for quite some time, and approved in autumn 2007 roadmaps on financial supervision and financial stability arrangements, focusing on the management of cross-border financial crisis situations. On this basis, a number of steps should be taken by May 2008.

(i) Financial supervision

23. Beyond the improvements needed to the prudential framework and risk management of individual institutions, the current turmoil has revealed the new challenges for financial supervision at the national and EU level. In order to deal more efficiently with large cross-border financial groups that are active across financial sectors, enhanced efforts are needed to ensure that the EU decentralised supervisory framework allows sufficient convergence, cooperation and clear decision making process among authorities, while respecting their responsibilities and differences in national markets.

24. Key areas that are being looked at include: convergence of key supervisory rules and standards (including on data sharing among across EU authorities, convergence of regulatory/financial reporting); clarification of relationship between home-host authorities and the role of colleges of supervisors; and improvement of the functioning of the EU Supervisory Committees. Consideration is also being given to the inclusion of an EU dimension in the mandates of national supervisors to facilitate convergence and cooperation.

(ii) Financial Crisis management

25. Tools and procedures for financial crisis management must be enhanced to allow for effective crisis resolution building on **common principles**. To this end, Ecofin Ministers, Central Banks, and Financial Supervisory Authorities are expected, as agreed in the October 2007 Ecofin Roadmap, to sign a **Memorandum of Understanding** in Spring 2008, reflecting the need to strengthen cooperation among authorities across borders and financial sectors, by introducing clear procedures and responsibilities for the coordination of actions within the EU on preserving financial stability.

26. **Deposit Guarantee Schemes** also play an important role in restoring confidence in the banking system. On the basis of further work by the Commission, FSC and EFC by mid-2008, the Ecofin will assess the functioning of the deposit guarantee schemes in the EU (notably coverage, rapidity of payments, communication and financing) and consider different policy options on how to develop systems in order to ensure their efficiency as part of the financial stability arrangements in a cross-border context as well as to the efficient functioning of the internal market.

27. The Commission is also seeking to **improve liquidity** in the markets by putting forward a proposal for extending the scope of the Financial Collateral Arrangements Directive to include credit claims provided as collateral; is examining **possible barriers to the use of key tools in cross-border crisis management**, in particular to the cross-border transfer of assets; and, is analysing the feasibility to review the cross-border winding-up proceedings for banking groups.

(iii) Crisis alert and early warning

28. The experiences from the current turmoil clearly reveal that early warning mechanism should be developed at various levels. In particular:

- At the global level, in order to strengthen the resilience of the financial system, the IMF and the Financial Stability Forum should report on the threats to the global economy from financial sector developments, and enhance their early warning capacities;

- At the EU level the Economic and Financial Committee's Financial Stability Table[4], which reports to the Ecofin on financial stability matters, should assume this role by enhancing the reporting on financial risks to the Ecofin where appropriate, drawing from contributions from all relevant parties, and by providing policy guidance to the Ecofin, with the support of the Financial Services Committee, where needed. The common framework for the assessment of systemic crisis, which is being implemented in 2008 by Central Banks and Financial Supervisory Authorities in the EU, is expected to enhance the readiness of authorities to take joint policy actions in financial crisis situations. Consideration should also be given to the further development of early warning systems on individual institutions.

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[4] For this purpose, the EFC meets in the EFC Financial Stability Table composition which brings together the Finance Ministries, Central Banks, ECB and the Commission at a high level; and involves the Chairpersons of the EU Supervisory Committees (CEBS, CESR and CEIOPS), and the Banking Supervisory Committee of the ESCB. The EFC examination of financial stability is based on up-to-date assessments of these parties from different angles.

IV. Cooperation at global level and follow up

29. Considering the need to reach a global solution for many of the outstanding issues, close cooperation at international level is required especially with international standard setting bodies, in particular the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the International Accounting Standards Committee (IASC), as well as the Financial Stability Forum (FSF). The EU and EU Members States are engaged in discussions at international level in these different fora and, should actively promote European positions as reflected in this report. In this context, the Commission should participate in the FSF as soon as possible.

30. Particular priority by the EU should be given to improving international crisis prevention and management, including strengthening the **role of IMF** in overseeing macro-financial stability and providing, together with the FSF, a better early warning system on the threats to the global economy from financial sector developments; improving the prudential framework, especially on the management of **liquidity risk** of financial groups; improving the understanding and disclosure of banks' and other financial institutions' exposure to off-balance sheet vehicles; ensuring adequate transparency in credit markets and disclosure about how structured products are valued, in such a way that uncertainties around those valuations are lifted and that risks are well managed; and addressing the issues related to **credit rating agencies**.

31. The Ecofin Council will continue to monitor closely the situation. In first instance the informal Ecofin ministers meeting in April 2008 will review delivery of the existing roadmaps, propose further policy actions where appropriate and speed up the process where needed. Ecofin stands ready to report back on progress made on these areas to the European Council as appropriate, and at the latest in **autumn 2008**.