



The European Union's Response to the 2007-2009 Financial Crisis

Walter W. Eubanks
Specialist in Financial Economics

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Summary

The purpose of this report is to assess the response of the European Union (EU) to the 2007-2009 financial crisis in terms of the financial regulatory changes the EU has made or is planning to make. The financial crisis began in the United States during the second half of 2006 with a sharp increase in U.S. bank losses due to subprime mortgage foreclosures. Because the U.S. and EU banks were using a similar business model, the EU banks experienced similar distressed financial conditions that U.S. banks faced. Large banks on both sides of the Atlantic found themselves severely undercapitalized and holding insufficient liquidity. However, because in the European Union financial regulations are enforced at the European level as well as the member country level, finding and implementing effective remedies for the causes of the financial crisis have been slower and different than the United States.

Before finding remedies, EU member countries and the U.S. banks were recapitalized through government assistance. The recapitalization approaches taken by the United States were similar for all banks through the Troubled Asset Relief Program (TARP) and the Temporary Liquidity Guarantee Program (TLGP). The EU took several recapitalization approaches ranging from consolidating the savings banks in Spain to the establishment of “a bad bank” in Germany. Banks were nationalized in the United Kingdom and the Netherlands. In all cases, the financial services providers were recapitalized with taxpayer money. On July 21, 2010, the United States enacted the Dodd-Frank Wall Street Financial Reform and Consumer Protection Act (P.L. 111-203), which analysts consider to be a roadmap to remedies of the financial crisis. At the same time, the European Parliament remains deadlocked on a bill that the European Parliament Committee for Economic and Monetary Affairs approved in 2009 that would strengthen the regulatory authorities for banking, securities trade and insurance and pension sectors, and would give the EU the power to overrule member countries on financial issues.

Analysts attribute the European financial crisis to European banks adopting the business model called “originate-to-distribute,” as opposed to the traditional model of originate-to-hold. The model was developed by large U.S. banks. Seeing the record breaking profitability of U.S. banks prior to the crisis, large European banks adopted the model. The originate-to-distribute model allows financial institutions to expand their lending seemingly without violating the underlying capital requirements set by regulators. To exploit weaknesses in the underlying regulatory structures, the model generated financial instruments, including collateralized debt obligations and mortgage-backed and other securities. To garner profits, the model also used poor underwriting of mortgages, regulatory arbitrage among regulators, as well as little coordination among national regulatory authorities. The model contributed to the failure of the regulatory structures on both sides of the Atlantic by undermining the enforcement of capital requirements, which might have mitigated the impact of the financial crisis. Bank losses led to bank undercapitalization, which meant banks did not have enough capital to absorb the losses from housing foreclosures and other asset losses.

This report examines the EU responses to the financial crisis through changes to the financial regulatory structure at the EU level as well as the member country level. The countries examined are Germany and the United Kingdom, which have single financial regulators; the Netherlands, which has a twin peaks regulatory structure; and Spain, which has a functional structure.

This report will be updated as development warrants.

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Introduction

The 2007-2009 financial crisis affected the European Union's (EU)¹ economies mainly because large European financial institutions adopted essentially the same business model as those operating in the United States before the crisis.² The financial crisis began in the United States during the second half of 2006 with a sharp increase in U.S. bank losses due to subprime mortgage foreclosures.³ Because the U.S. and EU large banks were using a similar business model, the EU experienced similar distress financial conditions that U.S. banks faced. Large banks on both sides of the Atlantic found themselves severely undercapitalized and holding insufficient liquidity. EU financial regulations are enforced at the European level as well as the member country level. One of the consequences of this bifurcation of financial services regulations is that finding and implementing effective remedies for the causes of the financial crisis have been slower and different from the U.S. experience.

Almost immediately after the decline in profits began in the United States, the EU's bank profits were similarly negatively affected.⁴ Six months later, in July 2007, the German government and financial regulators asked for and were granted approval by the EU Commission to bailout a German bank, IKB, with a 9 billion euros (\$11.7 billion) recapitalization due to losses suffered for investing in U.S.-subprime mortgage securities.⁵ Other EU member countries' governments injected capital in their financial institutions such as the UK's Northern Rock bank soon after the subprime crisis hit the United States.⁶ The speed of the financial effects on the EU was not surprising because much of the U.S.-securitized debt was originated to be distributed to European institutions and investors.

Analysts attributed the financial crisis to the U.S. banks' business model called "originate-to-distribute."⁷ This model was adopted mostly by large international banks. Originate-to-distribute, as opposed to originate-to-hold, is a process that allows financial institutions to expand their lending seemingly without violating the underlying capital requirements set by regulators. The model generated instruments including collateralized debt obligations, mortgage-backed

¹ The European Union is made up of 27 countries — Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Lithuania, Luxemburg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

² Takafumi Sato, Commissioner, Financial Services Agency, "Current situation of Japan's financial system and FSA's policy response," *Financial Services Agency Speeches*, June 17, 2009, p. 2. <http://www.fsa.go.jp/en/annouce/state/20090617-1.html>.

³ In the first half of 2006, U.S. banks were still reporting record profits. However, profits were falling from \$145.6 billion in 2006 to \$105 at the end of 2007. The industry's profits declined to a net loss of \$3.7 billion in June of 2009, but for the year, profits increased to \$12.5 billion due to government financial assistance. Government assistance to banks was estimated to be about \$600 billion. See *Special Inspector General for the Troubled Assets Relief Program, Quarterly Report for Congress at* http://www.sigtaf.gov/reports/congress/2010/July2010_Quarterly_Report_to_Congress.pdf Jul. 10, 2010, pp. 6, 141.

⁴ CRS was not able to obtain aggregate profits figures for the EU member countries as were obtained for the United States in footnote 3.

⁵ See EU Commission press release at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/314&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁶ See <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/545&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁷ Amiyatosh Purnanandam, "Originate-to-Distribute Model and the Subprime Mortgage Crisis," *Journal of Economic Literature* code g11-G13, September 14, 2009, pp. 1-48.

securities, as well as credit default swaps. These instruments were used to exploit weaknesses in the financial regulatory structures. The regulatory structures were further undermined by poor underwriting of mortgages and other securities, and by regulatory arbitrage among regulators as well as lack of coordination among national regulatory authorities. Not all large financial institutions adopted this model. In Japan, for example, most large institutions did not originate-to-distribute. As a result, the Japanese financial system and economy were less directly affected by the financial crisis. In Germany and Spain, financial institutions used this business model to originate and distribute to investors worldwide financial assets backed by real estate, such as covered bonds,⁸ that were traditionally traded domestically only.

The business model contributed to the failures of the regulatory structures on both sides of the Atlantic to enforce capital requirements, which might have mitigated the impact of the financial crisis. However, because the European Union's financial regulations are enforced on the European level as well as by the member country, finding and implementing effective remedies for the causes of the crisis have taken a longer time in the EU than in the United States. Even though the U.S. financial regulatory structure has its own complexity, the EU structure has more sovereign layers than the United States.⁹ Consequently, there are more opportunities to delay implementing financial reforms.¹⁰ In the United States, federal regulations often preempt states and local financial regulations. In contrast, the European Commission does not have such authority, which tends to lengthen the EU regulatory response.

This report assesses the response of the EU to the 2007-2009 financial crisis in terms of the financial regulatory changes it has made or is planning to make. Even though some EU member countries have consolidated their regulatory structures to speed up regulatory implementation, these regulatory structures are now being changed because they failed to identify the financial crisis, prevent contractions in economic activity, and require government bailout of financial institutions. This report examines the responses to the financial crisis at the EU level and on the member country level by analyzing four member countries with somewhat different financial services regulatory structures. The selected countries are Germany, the United Kingdom, the Netherlands, and Spain.

The European Union's Financial Regulatory Structure

The European Union (headquartered in Brussels) is able to impose its financial regulation only on member countries that accept those regulations.¹¹ The national legislatures of member countries

⁸ Covered bonds are similar to mortgage-backed securities. However, unlike securitization the assets stay on the issuers' balance sheet. Consequently, the buyer of the bonds has recourse against the collateral as well as the issuer in case of default. For further details, see CRS Report R41322, *Covered Bonds: Issues in the 111th Congress*, by Edward V. Murphy.

⁹ See CRS Report R 41176, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis*, by Walter Eubanks.

¹⁰ Joe Kirwin, "Parliament, EU States Deadlock over New Bank Supervision Plan," *BNA Banking Daily*, July 15, 2010, p.1.

¹¹ Guillermo de la Dehesa, Chairman of the Centre for Economic Policy Research, *Financial Crisis Management in the EU and the European Area*, Briefing Paper to the Committee on Economic and Monetary Affairs of the European Parliament for the Monetary Dialogue of December 8, 2008 (hereafter Guillermo de la Dehesa Briefing Paper).

must pass laws to implement most EU financial directives and disputes over their correct implementation are addressed in the courts. The European Court of Justice is the ultimate arbiter. Some European regulations have what is known as “direct effect” across the community and need no implementation of legislation to have the force of law in all 27 member countries of the European Union. Such is not the case for U.S. financial regulatory reform. The legislative basis for the EU crisis management mechanisms are the Capital Requirement Directive and the Financial Conglomerate Directives which were adopted as part of the EU’s Financial Action Plan.¹² There have been no instances where the EU courts were used in implementing an EU financial directive by a member country, even though there have been threats of lawsuits.¹³

The EU’s financial regulations are enforced mainly by the national governments and sometimes by the EU’s supervisory institutions such as the European Central Bank (ECB) and the Committee of European Banking Supervisors (CEBS) for the banking function or the Committee of European Securities Regulators (CESR). National central banks generally supervise banking within the country. However, little more than half of the EU member countries’ central banks are not directly involved in financial institutions supervision. In six member countries, banking, insurance and securities are supervised by one regulatory authority. They are Austria, Denmark, Germany, Ireland, Sweden, and the United Kingdom. Banking supervision in the rest of the member countries is regulated by multiple regulatory agencies. Securities and insurance supervisions are mostly done by other agencies, which run from one agency in Belgium, Finland, Luxemburg, and the Netherlands, two agencies in Greece, Italy, Portugal, and Spain, and three agencies, plus the Ministry of Finance, in France.¹⁴

The Eurozone

The financial regulatory structures of the countries in the Eurozone are economically the most important in the EU, because they include the largest economies in the Union.¹⁵ The Eurozone is made up of countries that use the euro as their national currency. Despite the single currency unifying effects, the 16 countries in the Eurozone have more than 40 financial supervisory authorities with weak coordination among them. This fragmentation slows the EU’s response to the financial crisis. The EU supervision of its financial services industry is based on the principles of home country control and mutual recognition of home control. Cooperation and coordination among these national regulatory authorities is legally binding and is conducted through a network of bilateral memoranda of understanding. Supplementing these memoranda are functional multilateral committees such as the Committee of European Banking Supervisors (CEBS) for the banking function and the Banking Supervision Committee of European System of Central Banks (ESCB). For securities, there is the Committee of European Securities Regulators (CESR) and for

¹² Group of Thirty, *Structure of Financial Supervision: Approaches and challenges in a Global Marketplace*, 2008. p. 230 footnote 3.

¹³ Joe Kirwin, “EC Suit Cites 24 Member States for Failing To Implement Financial Instruments Directive,” *BNA Banking Daily*, April 25, 2007, p. 1. For more information on the MiFID directive see http://www.ec.europa.eu/internatl_market/securities/isd/mifid_implementation_en.htm.

¹⁴Guillermo de la Dehesa Briefing Paper.

¹⁵ Countries currently in the Eurozone are Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, and Finland. The national currency of these countries is the euro. Eventually, all EU member countries are expected to join the zone as their economies and financial systems come into compliance with Euro-zone requirements.

insurance and pension the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

A criticism of the existing EU regulatory framework leading up to the 2007-2009 financial crisis was that some Eurozone country financial supervisors allowed their supervised institutions to use the originate-to-distribute business model that gave their institutions a competitive advantage over other European Union banks. These financially large but poorly supervised institutions developed highly profitable lines of business that took risky assets off their balance sheets without setting aside the appropriate amount of required capital to cushion against institutions' risk exposure.¹⁶ The institutions engaged in these undercapitalized activities suffered most of the losses in the 2008 credit crunch when short-term liquidity disappeared. Even though the countries' central banks bailed out the institutions, the European Central Bank and all the rest of the central banks without such losses in and out of the euro area suffered the consequences of those supervisory failures. The fiscal responsibilities that ultimately accompany such bailouts were paid by EU taxpayers through higher interest on bonds that were sold to finance the bailouts.¹⁷ The next two sections of this report discuss the response to the financial crisis on the EU level (Brussels) and the four selected EU member countries.

European Union Financial Regulatory Reform Plan

The EU has not yet implemented regulatory reform in response to the 2007-2009 financial crisis.¹⁸ The U.S. Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) on July 21, 2010, that is the most extensive financial regulatory reform since the Great Depression. The Dodd-Frank Act includes many of the provisions being discussed by the EU and its member countries. For instance, on May 19, 2010, the European Parliament Committee for Economic and Monetary Affairs approved a version of the bill that would strengthen the regulatory authorities for banking, securities and insurance and pension sectors, and would have the power to overrule national governments on key issues. The Parliament plans called for the establishment of two new funds to which large, cross-border financial institutions would have to contribute. One fund would be a deposit insurance fund and the other would be a stability fund. The amount of the financial institutions' contributions to each fund would be determined by the riskiness of the assets the institutions hold. The more risky the institution's assets, the higher the institution's contribution would be to the funds. The reform plan would also create a European Systemic Risks Board (ESRB) to find and provide analysis of macroeconomic dangers that threaten the economies of the EU. Although these EU provisions are not exactly the same as the Dodd-Frank provisions, the expected outcomes are similar. For example, the ESRB is similar to the Financial Stability Oversight Council provision in the Frank-Dodd Act. The European Parliament as a whole has not yet passed these provision.

The prudential part of the plan would establish a new European System of Financial Supervisors (ESFS) that would consist of three new financial regulatory authorities: the European Banking Authority (EBA), the European Insurance Authority and Occupational Pension Authority (EIOPA), and the European Securities Authority (ESA). In addition, the plan would establish a

¹⁶ Guillermo de la Dehesa Briefing Paper.

¹⁷ *Ibid.*, p. 4.

¹⁸ For an assessment of the United States response to the Crisis, see CRS Report R41176, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis*, by Walter W. Eubanks.

new coordinating committee of these prudential regulators to overcome conflicts or overlapping areas of prudential regulations. The ESFS would be a network of national supervisors that would promote the development of common supervisory approaches to all financial firms and contribute to a single set of harmonized rules. It would ensure consistent application of EU laws and regulations, and help to resolve disputes among supervisors.¹⁹

Of the three EU regulatory authorities mentioned above, the EU Parliament decided to seek the approval of a slightly enhanced version of the European Banking Authority on May 11, 2010. The major enhancement is that the EU Parliament approved amendments that would give the new agencies overriding power of national regulatory authorities of EU member countries. The proposal has triggered intense debate among EU member countries, especially in the United Kingdom with its very highly developed national financial market. The European Commission has a target of January 1, 2011, as the start up date for the new EU banking supervision plan.²⁰

The bank authority is the simplest of the three regulatory structural changes the commission has under consideration. The securities, insurance, and pensions agencies are more difficult because they are uniquely developed by member countries' insurance and pension sectors through historical and traditional practices. Therefore, regulating these financial services would not easily fit into a single European regulatory architecture. Because national supervisors do not have jurisdiction to control financial entities throughout the EU, the important issue of bailouts or winding-downs of cross-border bank, securities, and insurance companies have already led to protracted negotiations. In contrast, the United States' federal financial services regulations have already preempted state regulations of securities and banking. Insurance is regulated by the states. In the Dodd-Frank Wall Street Reform and Consumer Protection Act, state laws trump federal laws when state laws are determined on the federal level to be more appropriate than federal laws in some cases.²¹

Other Regulatory Provisions Under Consideration

There are a number of other financial regulatory reform issues under consideration at various stages of the adoption process. These include the following: corporate governance, hedge fund and private equity regulation, bank tax plan to set up a resolution fund, credit rating agency regulation, and stress test of financial institutions to help build confidence in the European financial system and the euro.

Corporate Governance

To prevent future financial crises, the European Commission is in the process of adopting a range of regulations to enhance shareholder rights by imposing stricter corporate governance requirements on corporations operating in the EU. Under consideration is a proposal that an individual could not belong to three different corporate boards, and restrictions on board

¹⁹ Joe Kirwin, "EC Outline Plan to Revamp EU Financial Service Supervision," *BNA Banking Daily*, May 28, 2009, 9.

²⁰ Joe Kirwin, "Parliament Panel Backs Stiffer EU Bank Reg., New Funds, in Showdown with EU Members," *BNA Banking Daily*, May 11, 2010.

²¹ U.S. Congress, Conference Committee, 2010, *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Conference Report to Accompany H.R. 4173, H.Rept. 111-517, 111th Cong., 2nd sess. (Washington: GPO, 2010), pp.212, 215, 224, 650, 717, 821,836, 868, 875.

compensation. Expertise in some aspect of the corporation's operations would become a requirement to be on a board. The commission would require the boards to regulate a corporation's risk management function, and separate the functions of the chairman and the chief executive officer.²²

Hedge Funds and Private Equity Regulation

Both the European Parliament and the EU member countries simultaneously approved different versions of a plan to require hedge funds and the private equity industry to seek government authorization to operate, hold adequate capital, and make disclosures to regulators and investors. A controversial difference between the proposals involves the treatment of "third country" and the exemption clauses. The third country clause passed by the EU member states in the Council of Economic and Finance Ministers would require hedge funds and private equity groups to seek approval from every EU member country in which they want to operate. These clauses brought objections from the United Kingdom and the United States because they could be faced with multiple and costly requirements from each country. On the exemption clause, the European Parliament would exempt hedge funds and private equity groups from these regulations if they have less than 50 employees. The member countries' proposal would exempt hedge funds and private equity firms if they have more than 250 employees, which is considered more acceptable to the hedge funds and equity groups.²³ The controversy over third country participation caused the EU governments and Parliament to postpone a vote on regulating hedge funds and private equity firm from July to September 2010.²⁴

Bank Tax to Set Up Resolution Fund

On May 26, 2010, the European Commission proposed an outline of a plan for individual EU member countries to impose a tax on banks. The tax would be used to establish a resolution fund to be used in the event that an insolvent financial institution needs funding to lessen its impact on the financial system without taxpayer-financed bailouts. The European Commission called for a series of national funds to be established in all 27 member countries with a future transition to a pan-European fund. The Commission Plan is to assess the tax on all deposit-taking banks and investment firms but it did not decide whether the tax is to be levied on bank assets, liabilities or profits. The EU Commission made it clear that the revenues from the tax would not be used to recapitalize troubled institutions, nor be part of general revenues.²⁵

²² See the report on corporate governance and remuneration policy for financial institutions at http://www.ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf.

²³ Joe Kirwin, "EU Takes Important Step in Finalizing Hedge Fund, Private Equity Regulations," *BNA Banking Daily*, May 19, 2010 [http://news.bna.com/ibdm/IBDMWB/split_display.adp?fedfid=17195117&vname=ibdbulallissues&fn=17195117&jd=a0c3d9c0c4&split=0].

²⁴ Bengt Ljung, "EU Governments, Parliament Deadlock Over Hedge Fund, Private Equities Regulations," *BNA Banking Daily*, June 26, 2010, p. 1.

²⁵ Joe Kirwin, "European Commission Proposes Controversial Bank Tax Plan to Set Up 'Resolution Fund,'" *BNA Banking Daily*, May 27, 2010.

Credit Rating Agencies

In a European Commission proposal put forward in June 2010, credit rating agencies (CRAs) operating in the EU would have to be registered with a central supervision office due to be set up in 2011 and would have to follow new rules designed to improve the transparency among companies requesting ratings, and the CRA making their rating methodology public. The proposal states that the new European Securities Market Authority (ESMA) would take over the supervision of CRAs, centralizing oversight of CRAs in the EU and transferring the current role from member countries.²⁶

Naked Shorts

Even though a member country, Germany, has banned naked short selling of European government debt to stabilize the EU financial system, the European Parliament has not implemented a similar policy. Short selling is when a seller borrows a security and sells it, betting a fall in price will allow the security to be bought back more cheaply and returned to the lender. Naked or uncovered short selling is when the seller makes a sale without borrowing the security. This trading strategy often causes extreme volatility in the security, in this case, government debt of EU countries such as Greece. Member countries and the European Parliament are in discussions about naked shorts of EU government securities under the EU supervisory plan outlined above.²⁷

Stress Tests²⁸

The European Commission announced on June 29, 2010, that it would expand its stress test of European banks to include 70-120 banks, which is considerably more than the 22 large banks the Committee for European Banking Supervisors tested in 2009. Those 22 banks represented 60% of the EU banking sector's assets. The new test is expected to cover more than 75% of the EU banking sector. Stress tests are quantitative surveys to gauge the capital adequacy of financial institutions under different scenarios such as specified declines in several macroeconomic variables. For example, in the EU 2009 stress tests, the scenario was that there was a 5.6 % decline in gross domestic product from peak to trough in 2009 and another -2.7% decline in 2010. The stress test found that the aggregate Tier 1²⁹ capital ratio of these institutions would remain above 8% and these banks' Tier 1 ratios never fell under 6%, which was considered good. Based on Basel II capital adequacy requirements, banks should maintain a minimum Tier 1 ratio of 4%.³⁰

In the recently announced stress test under way, the European Commission's Committee for European Banking Supervision said besides including more banks, the scenario would also be

²⁶ See The Proposal for a Regulation of the European Parliament and of the Council amending (EC) no 1060/2009 on Credit Rating Agencies at http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf.

²⁷ BNA, "Germany Unveils Trading Ban to Hit Sovereign Debt Speculation," *BNA Banking Daily*, May 20, 2010.

²⁸ For more information about stress tests, see Stavros Peristiani et al., *The Informational Value of the Stress Test and Bank Opacity*, Federal Reserve Bank of New York, Staff Report no. 460, July 2010.

²⁹ Tier 1 capital is the book value of an institution's equity plus retained earnings. According to the Basel II capital adequacy requirements, Tier 1 capital must be at least 4% of the institution's risk-weighted assets.

³⁰ Joe Kirwin, "EU Declares Banking Sector Sound after Stress Tests on 22 Large Banks," *BNA Banking Daily*, October 2, 2009.

more comprehensive because it will take into account the deterioration in EU government bond markets causing higher EU interest rates. The macroeconomic variables will include significant declines in economic growth reflected in the EU gross domestic product, unemployment, and consumer price indexes for the different EU member countries.³¹

Four Member Countries Regulatory Structures and Responses

EU member countries have not delegated all financial regulatory authority to the European Union to enable the EU (Brussels) to fully manage the EU response to the 2007-2009 financial crisis. With some EU oversight, each of the 27 member countries had the responsibility to respond. The Congressional Research Service (CRS) selected Four Eurozone countries to illustrate the regulatory changes that have occurred or are planned to occur since the beginning of the 2007-2009 crisis. The countries are Germany, the United Kingdom, the Netherlands, and Spain. These countries provide a variety of financial services regulatory structures through which their national regulatory policies as well as the EU's policies are being implemented. Germany and the United Kingdom have single financial service regulators, BaFin and FSA, respectively. In part as a result of the crisis, their governments have announced plans to eliminate their single financial regulatory structures and redistribute their regulatory authorities back to the central bank, treasury, and finance ministry.³²

Other financial regulatory agencies play different roles in the overall supervision of the financial services industry in each country. The Netherlands has a twin peaks regulatory structure where prudential and enforcement activities are split between two regulatory authorities. In Spain like in the United States, there is a functional regulatory structure, where each financial service function has its own regulator: banking is regulated by the Bank of Spain, insurance is regulated by the General Directorate of Insurance and Pension Funds, and securities are regulated by the National Securities and Exchange Commission.

Germany's Financial Regulatory Structure

The single regulator of financial services in Germany is the German Federal Financial Supervisory Authority (BaFin), which was established in 2002 to improve the functioning, stability and integrity of the German financial system. BaFin is an independent agency governed by public law, run by an administrative Council, and chaired by the Federal Minister of Finance. It does not receive any funding from the German government's budget. It is financed by assessments and fees from the companies it supervises. However, the German central bank retained some supervisory roles in regulating banks including examinations, prudential audits, and financial crisis management. In the area of financial regulatory enforcement, BaFin has wide ranging authority to conduct investigations and the power to immediately call for the cessation and closure of unauthorized activities. It can take appropriate and necessary action to prevent

³¹ Joe Kirwin, "EU Regulators Announce Stress Test Criteria, Dramatically Increase List of Targeted Banks," *BNA Banking Daily*, July 9, 2010, p. 1.

³² Robert J. Steiner, "Deutsche Bundesbank Ready to Integrate BaFin Financial or Bundesanstalt Fur Finanzdienstleistungsaufsicht," *CeoWorld Magazine*, Oct. 4, 2009, p. 1, and Gonzalo Vina, "U.K. Scraps FSA in Biggest Bank Regulation Overhaul Since 1997," *NewsWeek*, June 16, 2010, p.1.

undesirable developments that might harm or threaten the interest of policy holders. BaFin's supervisory responsibilities of the securities industry involve enforcing standards of profession conduct aimed at preserving investors trust in the securities markets. Even though securities exchange supervision is shared with the local governments where they are located, BaFin's investor protection responsibilities of securities exchanges include solvency and disclosure requirements.

BaFin regulatory authority was greatly increased in 2009 to improve its capacity to manage the financial crisis. The act for the Strengthening of the Financial Market and Insurance Supervision became effective August 1, 2009.³³ The law increased the preventive, intervening and supervisory powers of BaFin. Through this act, the German government toughens reporting and information requirements for financial institutions, insurance companies and insurance holding companies. If an institution finds itself in a liquidity crisis, the law gives BaFin the power to prohibit that company from making payments to its foreign parent company. The law gives the regulator the power to increase capital requirements and require equity capital buffers in times of economic slump or under special business circumstances. Under financial institutions governance, the new law mandates that the number of supervisory board members should be limited to no more than two former executive managers. BaFin may prohibit an institution from distributing their profit to shareholders if such distribution could hinder the institution's ability to fulfill its liquidity requirements. The new law also increases professional competence requirements of financial institutions. For example, a supervisory board member must be capable of assessing and supervising the institution taking into account the complexity of the institution. BaFin was authorized to request the dismissal of members of the board, if these criteria are not met.

Germany's 2007-2009 Financial Crisis

Despite BaFin's enhanced authority, BaFin, like U.S. and other EU financial services regulators, failed to anticipate the 2007-2009 financial crisis. As the crisis unfolded several of BaFin supervised institutions were found to be severely undercapitalized because they had adopted the originate-to-distribute business model, which was not directly addressed in the act for the Strengthening of the Financial Market and Insurance Supervision. Instead, government bailout policy in the form of bank recapitalization was implemented because these troubled institutions' balance sheets were heavily burdened with nonperforming securitized assets. The German government allowed these institutions to create a so-called "bad bank" to which banks transferred their securitized non-performing assets. In return the banks received government bonds and debt guarantees as well as lines of credit valued as high as 90% of the securitized debt (toxic assets). The bailout is funded by Germany's Financial Market Stabilization Fund (SoFFin).³⁴ Although the German government took this action in the crisis, the European Commission's approval was also necessary. The EU commission approved all financial assistance programs extended by the German government. Germany's Financial Market Stability Fund provided a guarantee of 152.9 billion euros (\$186 billion) to Hypo Real Estate Holding (HRE); HRE immediately received 103.5 billion euros (\$127 billion).³⁵ In addition, the German government provided financial

³³ The European Group for Investor Protection, "Financial Markets' Regulation in the EU: Overview of issues and developments," *EGIP News*, November 9, 2009, p. 1.

³⁴ Mayer Brown, *Summary of the Government Interventions in Financial Markets Germany* http://www.mayerbrown.com/public_docs/0220fin_Summary_Government_Interventions_Germany.pdf, March 20, 2009, p. 9.

³⁵ IHS Global Insight, "German Government Announces Auto Industry Financial Support Package," *Global Insight* (continued...)

support to: Aareal Bank AG: 0.5 billion euros (\$614 million), Commerzbank AG: 18.2 billion euros (\$22 billion), and West LB AG: 3.0 billion euros (\$3.6 billion). On June 23, 2010, the German Cabinet approved a plan to set up an expert committee to prepare for the government's withdrawal from these partly German-owned banks.³⁶

The financial crisis caused a collapse of the demand for automobiles worldwide, and like the U.S., the German government implemented an auto industry financial support package on January 4, 2009. The plan was to provide 1.5 billion euros (\$1.95 billion) to support the country's automobile industry with measures including tax relief and loan guarantees. The main component of the package was loan guarantees to GM's German Opel unit totaling as much as 1.6 billion euros (\$2.08 billion). The German government also provided incentives for customers to buy new cars. It waved taxes on new car purchases and offered 2,500 euros (\$3,250) payment to any driver who buys a new, low-emission passenger car. In addition, the German government pledged 100 million euros (\$130 million) credit line which provided credit guarantees to banks worried about lending to struggling businesses. The European parliament formally approved these measures.

Other Aspects of the Crisis

German Ban of Naked Swaps

On May 19, 2010, the German government banned the naked short selling of German bank stocks, Eurozone bonds and credit default swaps because the government believed that "the euro is in danger" and warned that if the "euro fails, Europe fails."³⁷ But because other EU members did not join Germany in this ban, investors were able to sell these securities short in other countries. The German ban of naked shorts came right after Germany decided to back the multi-billion euro rescue package for the Euro zone bond market and other support of the Greek financial crisis.³⁸

German Austerity program

In June 2010, the German government announced the largest austerity package since World War II. It included spending cuts and new business tax increases aimed at saving 80.0 billion euros (\$104.0 billion) by 2014. Chancellor Angela Merkel said, "Germany, as the largest economy [in the EU], has a duty to set a good example."³⁹ To reduce the increased government debt caused by the financial crisis, a number of other European nations such as Spain, Greece and the United Kingdom.⁴⁰

(...continued)

Same-Day Analysis, January 14, 2009, p.2.

³⁶ Andrea Schuessler, "Germany Sets Up Panel to Prepare Exit Strategies From Partly State-Owned Banks," *BNA BaInternational Business & Finance Daily*, June 28, 2010, p.1.

³⁷ CNBC, "What will German Short Ban Mean for Investors?"<http://www.CNBC.com/id/37227456>.

³⁸ *Ibid.*

³⁹ Michael Collins, "German Government Agrees to Historic Austerity Program," *The Agonist*, June 7, 2010, p. 1, <http://www.agonist.org/node/65473/print>.

⁴⁰ BBC New Europe, "EU austerity drive country-by-by country," *BBC NEWS EUROPE*, <http://www.bbc.co.uk/news/10162176?print=true>, June 16, 2010, pp. 1-4.

Germany's Stress Tests

It is not known why Germany has not run independent stress test of its banks, but Germany is expected to participate in the European Commission Committee for European Banking Supervision stress tests in which all 27 member countries are expected to participate.

The United Kingdom's Financial Regulatory Structure

The United Kingdom's regulatory response to the 2007- 2009 financial crisis was executed through the Financial Services Authority of the United Kingdom (FSA). In 1997, the United Kingdom's government consolidated financial services regulation in the UK by combining nine regulatory bodies into one new agency. FSA was given the responsibility to regulate virtually every aspect of financial services. To compare with the United States, FSA has the roles played by the federal and state banking agencies, the Securities Exchange Commission, the Commodity, Futures Trade Commission, state insurance and securities commissions, as well as the Self Regulatory Organizations. Over the years, it was given expanded independent enforcement powers enabling it to bring action against violators and impose sanctions. FSA has a single ombudsman to handle complaints by consumers in all financial services. This is in contrast to the numerous hotlines to the various federal and state agencies in the United States. Another provision of the FSA is that it assigns one office to develop policies on capital requirements for all financial sectors. By comparison, in the United States, the assessment of risks and capital requirements are developed separately for insurance, banks, broker-dealers, and futures commission merchants. FSA is organized as a private corporation with a chairman and a chief executive officer and 16-person board of directors. Eleven members of the board are independent. The FSA is answerable to the Treasury and the British Parliament. A practitioner panel and a consumer panel oversee FSA for their respective constituencies. There is also a requirement for consultation on rules and an appeals process for enforcement. FSA's organizational strategy is to focus on the most damaging potential risks to the financial system. Consequently, it generally targets larger financial firms. It is required to furnish cost-benefit analyses for its proposals and report annually on its costs relative to the cost of regulations in other nations.⁴¹

Most financial firms under the FSA, and the International Monetary Fund (IMF) have reported that FSA has been successful in regulating the financial services industry in the United Kingdom.⁴² However, FSA has been criticized for being slower than most financial regulators to respond to prudential failures in the financial services industry it supervises. The so-called "light touch" principal of regulation was attributed to FSA, where regulators were more reactive to prudential developments in the industry and enforcement was on the basis of principles rather than strict rules. This criticism was brought up during the Equitable Life insurance company crisis in 2001⁴³ and the Northern Rock bank nationalization in 2008, which is discussed below.

⁴¹U.S. Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO Report GAO-05-61, October 6, 2004, p. 66.

⁴² International Monetary Fund, United Kingdom: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom, Country Report no. 03/48, February 2003, pp. 31-32.

⁴³ See CRS Report RL33036, *Federal Financial Services Regulatory Consolidation: An Overview*, by Walter W. (continued...)

Not unexpectedly on June 16, 2010, the Chancellor of the Exchequer George Osborne of the newly elected Conservative Party announced that he would abolish the Financial Services Authority over the next two years.⁴⁴ The Conservative Party had made its plan known to abolish the FSA during the election campaign. The Conservatives blamed FSA, which was established by former Labor Prime Minister Brown, for failing to prevent the 2007-2009 financial crisis that caused economic activities to decline into the worse recession since World War II and taxpayers having to bailout a number of large financial institutions. In the next two years, the Chancellor's plan is to create a prudential regulatory authority as a subsidiary of the Bank of England that will work with the UK Treasury. At the Bank of England, there will also be a financial policy committee and a consumer protection and market agency.⁴⁵

UK's 2007-2009 Financial Crisis

In February 2008, the UK government had to nationalize Northern Rock Bank plc⁴⁶, which was the first UK bank failure of the 2007-2009 financial crisis. This originate-to-distribute lender was near collapse in 2007, which caused it to seek emergency funding from the Bank of England after which there was a run on the bank on September 14, 2007 causing it to lose deposits rapidly in the beginning of the liquidity crisis. Northern Rock relied on short-term money market funding of its CDOs and mortgage-backed securities. The run caused Northern Rock to ask for emergency loans from the Bank of England, which totaled 49 billion pounds (\$74 billion) over the five-month period. After FSA and the Bank of England placed a significant amount of taxpayers' money in Northern Rock, these regulators entered an auction process to find a private buyer, but no suitable bids were made. Consequently the government nationalized the bank in order to protect the taxpayers' investment in the bank. The Bank of England plans to attempt selling the bank in the future in more favorable financial conditions. The government also took controlling interest in Royal Bank of Scotland Group Plc and Lloyds Banking Group plc.⁴⁷

The United Kingdom responded to the financial crisis similarly to the United States. The Bank of England and FSA tried to slow the financial turmoil and avert the threat of a deep economic recession by injecting 500 billion pounds (\$750 billion) in the country's eight largest banks and building societies [savings and loan associations].⁴⁸ The government bought "preferred shares" in these banking institutions as the U.S. government bought preferred stocks in large U.S. banks. As part of the bailout, the government announced a 250 billion pound (\$375 billion) credit guarantee program to support lending between banks. The program also included a 100 billion pound (\$150 billion) mortgage-backed securities guarantee.⁴⁹ Many of these provisions in the white paper,

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Eubanks.

⁴⁴ The full text of the announcement is available at http://www.hm-treasury.gov.uk/press_12_10.htm.

⁴⁵ Vina Gonzalo, "U.K. Scraps FSA in Biggest Bank Regulation Overhaul Since 1997," *BusinessWeek*, June 16, 2010, p. 1.

⁴⁶ Plc means a public limited company. It is a limited liability company which is permitted to offer its stocks to the public.

⁴⁷ House of Commons Public Accounts Committee, *Nationalisation of Northern Rock, Thirty-First Report of Session*, June 1, 2009, http://www.voltairenet.org/IMG/pdf/Nationalisation_of_Northern_Rock.pdf, p. 24.

⁴⁸ Mark Kleinman, "Financial Crisis: Government UK unveils bailout of UK banks," *Telegraph.Co.uk*, October 8, 2008, <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3156735/Financial-crisis-Government-UK-unveils-bail-out-of-UK-banks.html>.

⁴⁹ James Kirkup, "Banks bail-out: Taxpayers may take shares in Barclays and HSBC," *Telegraph.Co.uk*, January 18, (continued...)

discussed below, were included in the new Conservative Party government's financial regulatory reform proposals.⁵⁰

UK's White Paper on Financial Regulatory Reform

On July 7, 2009, the UK's Treasury under the Labor Party produced a white paper outlining further reforms of financial markets to ensure that banks and financial markets will be more resilient to any global market shocks like the 2007-2009 financial crisis. The white paper came out before the Conservative Party won the election in June 2010 and announced plans to abolish the FSA. The proposal included tougher regulation of individual firms. It proposed creating a council for financial stability to better monitor and manage systemic risk. It contained provisions to deal with potential failure of institutions and greater protection of depositors. The government planned to introduce legislation in the next 2009-10 parliament session.⁵¹

Had the Labor Party won the elections, the white paper stated the single prudential regulator for financial services in the form of FSA would have been maintained, but would be given more enforcement powers. The Treasury, the Bank of England and the FSA would have made up the Council for Financial Stability to assess systemic risk, increase transparency and accountability. The Council would meet and publish a report published quarterly. FSA would monitor and report on financial firms' compliance with a new code of practice for remuneration. In addition, the white paper proposed ways to resolve failed financial institutions and to protect the taxpayer from paying for future failures. To accomplish this, the white paper would have created a Financial Services Compensation Scheme which would be funded by the financial services industry that should cover the costs of protecting the taxpayers.⁵²

EU Extends UK's Recapitalization and Guarantee Programs

As mentioned above, the UK government set aside 500 billion pounds (\$750 billion) to recapitalize financial institutions as part of a program that included 250 billion pounds (\$375 billion) to guarantee debts and other securities that banks were not able to sell. All EU country aid to their financial sector must be approved by the EU Commission in order to minimize the negative spill-over effects on financial services competition within the Union as a whole. For example, under the commission guidance no insolvent financial institutions should be assisted by the country's recapitalization and credit guarantee programs. Moreover, the program should be targeted for a short amount of time. On October 13, 2008, December 23, 2008, and April 15, 2009, the commission approved and extended the U.K.'s recapitalization and credit guarantee programs. Northern Rock (like Fannie Mae and Freddie Mac in the United States), which would not be counted in the recapitalization and credit guarantee programs, was nationalized and became part of the government.

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2010, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4285088/Banks-bail-out-Taxpayers-may-take-shares-in-Barclays-and-HSBC.html>.

⁵⁰ Shearman and Sterling LLP, *UK Government Proposals for Financial Regulatory Reform*, June 7, 2010, 4 p.

⁵¹ The HM Treasury's "Reforming Financial Markets White Paper," can be found at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf.

⁵² Ali Qassim, "U.K. Chancellor Unveils White Paper to Further Reform Financial Markets," *BNA Banking Report*, July 9, 2009, 2 p.

UK's Bank Liquidity Requirements Rules

In response to the shortage of liquidity in the 2007-2009 financial crisis, on October 5, 2009, the Financial Services Authority issued rules on liquidity requirements for banks. The new rules would prevent banking firms from taking excessive short-term liquidity risk. The new rules would be phased in over time, starting in December 2009. These rules would require British banks, including foreign branches of banks operating in the United Kingdom, to hold higher amounts of government bonds and to diversify their assets less than they have in the recent past. The plan requires banking firms to create liquidity buffers scaled according to the quality of a firm's liquidity risk management. Starting with a two week period, the firm's liquidity would be determined by comparing the firm-specific stresses with the wider market stresses over three months. The rules also require a certain turnover rate of liquid assets through sales and repurchases. The firm's liquidity buffer should consist of an appropriate mix of eligible assets of diversified high quality government bonds.⁵³

The British Banking Association is critical of the rules because they would restrict the ability of banks to lend to businesses and individuals by requiring banks to hold more government securities. These rules also put at risk the attractiveness of the UK as a center for international finance since no other regulators among the world's international banking centers have proposed such strict liquidity requirement.⁵⁴

UK's Tougher Stress Tests

The UK was one of the first EU member countries to require their financial institutions to conduct stress tests to see whether or not the institutions' capitalization would be sufficient to maintain solvency as well as some level of continued lending. The stress tests are quantitative estimates of financial institutions' level of capital given severe but plausible macroeconomic stress scenarios such as a 7.0% decline in the country's gross domestic product (GDP) and a 12.5% rise in the unemployment rate, or a 50% fall in residential property prices. This was the scenario FSA proposed in a late 2008 stress test for 2009-2011.⁵⁵ On March 12, 2010, FSA outlined its scenario for 2010-2012, which is tougher than the previous stress test. The new stress test scenario has unemployment peaking at 13.3% in 2012, and an additional decline of housing prices of 23% with GDP declining by an additional 2.3%. The results of the tests will be used to assess the solvency of the financial services institutions in term of capital requirement. FSA expects these institutions to ensure that their core tier 1 capital ratio remains above 4%.⁵⁶

⁵³ FSA's Policy Statement (PS09/16) "Strengthening liquidity standards" is available at http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf.

⁵⁴ Ali Qassin, "U.K. Financial Regulator Issue Rules On Liquidity Requirements for Banks," *BNA Banking Report*, October 7, 2009, 2. p.

⁵⁵ FSA, "Financial Risk Outlook 2010," is available at http://www/fasa.gov.uk/pubs/plan/financial_risk_2010.pdf.

⁵⁶ Ali Qassin, "U.K.'s FSA Requires Banks to Run Tougher Stress Test for Worst Case Economic Result," *BNA Banking Daily*, March 3, 2010, p. 1

The Netherlands' Financial Regulatory Structure

The twin peaks financial services regulatory structure for all financial institutions in the Netherlands was established in 2004. It is called twin peaks structure because it divides the supervision of financial services providers into two parts—prudential supervision and market conduct supervision. The prudential supervisory agency writes and enforces the prudential requirements on financial services providers. These requirements include licensing, reserve levels, and capital requirements. Providers found not in compliance with these requirements could be ordered to cease operations in the Netherlands. The market conduct supervisory agency regulates the financial market with regard to consumer protection, financial audits, disclosures and the overall integrity of markets. The prudential supervisory agency was placed under the Netherlands national bank, which is the Netherlands' central bank and is a member of the European System of Central Banks. The market conduct supervisor was placed under the newly established Netherlands Authority for Financial Markets (AFM). Both prudential and the market conduct supervisors were placed under the Ministry of Finance⁵⁷ that does no supervision of financial services providers, except mergers and takeovers of any of the five major banks in the Netherlands.

The Netherlands' 2007-2009 Financial Crisis

The Netherlands' financial structure was severely exposed to the 2007-2009 financial crisis and immediately concentrated on recapitalizing its major banks. When the financial crisis began affecting bank profits in the United States in the summer of 2006, the Netherlands had very low unemployment, a large and stable current account surplus, low government debt and a budget surplus. However, at that time, the Netherlands had the largest foreign claims in the Euro-zone. Foreign claims on Dutch financial institutions amounted to 300% of the country's GDP. More importantly, its exposure to the American financial market was also the highest in Europe with an exposure of 66% of GDP compared with the UK's exposure of 40% of GDP. With such a large exposure to the United States, Dutch bank stocks began declining almost immediately after the crisis began in the United States and bank lending in the Netherlands slowed.⁵⁸

The crisis really took hold in Netherlands with the bankruptcy of Lehman Brothers in September 2008. Several Dutch banks had counterparty financial relations with Lehman Brothers. By early October 2008, the Belgian-Dutch bank, Fortis asked for government help because of liquidity problems caused by declining stock value and the acquisition of the Dutch Bank ABN Amro, which depleted Fortis's capital. The finance ministry's response was to fully nationalize the Dutch portion of the bank and insurance division in a 16.8 billion euros (\$21.8 billion) agreement. The Belgian government took a minority interest (49%) in Fortis and the majority interest (51%) was sold to the French Bank BNP Paribas. The Dutch government also guaranteed all bank savings up to 20,000 euros (\$26,000) and drew up plans to guarantee all savings up to 100,000 euros (\$130,000) because there was a run on savings accounts at Fortis.⁵⁹

⁵⁷ The Ministry of Finance is the executive branch of government's comptroller that implements the government's budget. In some countries the Ministry of Finance functions as the treasury. In the United States it is the cabinet position of the Office of Management and Budget.

⁵⁸ Maarten Masselink and Paul Van den Noord, "The Global Financial Crisis and its effects on the Netherlands," *ECFIN Country Focus*, European Commission, December 4, 2009, 7 p.

⁵⁹ Yvette Essen, "Financial Crisis: Fortis Dutch Assts are nationalised," *Telegraph.Co.uk*, <http://www.telegraph.co.uk/> (continued...)

The Netherlands' Legislative Regulatory Response

In the Netherlands, like in all the EU countries affected by the financial crisis, measures to reform the financial system are being considered on the European Union level and on the national level in the member countries. The Ministry of Finance has taken the lead role in proposing financial reform amendments to the Netherlands' Financial Markets Supervision Act (FMSA). The first amendment, the Financial Markets Amendment Act of 2010, has been placed on the list of controversial matters so it is unclear when and if this amendment will take effect. The Financial Markets Amendment Act of 2011 is planned to be submitted to parliament early next year. In the mean time, a number of financial sector reforms are already being discussed in parliament, including

- making changes to the banking code;
- binding remuneration principles [executive compensation];
- reinforcing macro-prudential supervision;
- supervising credit rating agencies;
- reinforcing European wide supervision of financial institutions;
- issuing more stringent capital requirements;
- supervising alternative investment funds such as hedge funds;
- reinforcing financial reporting by financial institutions; and
- supervising over-the-counter derivatives trade.⁶⁰

All these reforms are being negotiated at the EU level as well. Analysts do not expect the Netherlands government to pass legislation and implement these provisions until the European Parliament approves them.⁶¹

Netherlands' Stress Test

The Netherlands has not run independent stress tests on its banks, but is expected to participate in the European Commission, Committee for European Banking Supervision's stress tests in which all 27 member countries are expected to participate.

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finance/financetopics/financialcrisis/3131247/Financial-Crisis-Fortis-Dutch-assets-are-nationalised.html, October 3, 2008.

⁶⁰ De Brauw Blackstone Westbroek, Fracine Schlingmann, Joost Schutte and Marnix Somsen, "Update on (international) financial reform," *Association of Corporate Counsel, Lexology*, <http://www.Lexology.com/library/detail.aspx?g=f1ecbc01-1778-41bc-a7e9-dccee10f2d9e>.

⁶¹ Joe Kirwin, "EC Outlines Tool Box Plans for Crisis Prevention, Management," *BNA International Business and Finance*, April 4, 2010, p. 1.

Spain's Financial Regulatory Structure

Like the United States, the Spanish financial regulatory structure is a modified functional regulatory framework where the functions of banking, insurance, and securities trade are supervised by separate prudential supervisory agencies. The Bank of Spain (BDE), Spain's central bank, writes and enforces Spain's banking laws and regulations. For the securities trade, the National Securities and Exchange Commission (CNMV) is the primary regulator. For insurance, the Ministry of Finance is the insurance industry primary regulator. However, the General Directorate of Insurance and Pension Fund (DGSFP), which is under the auspices of the Ministry of Finance, has no regulatory powers but influences insurance supervision through its influence on the Ministry of Finance. As a member of the European Union since 1986, Spain's financial services regulatory structure is governed by a policy of taking preventive rather than corrective actions in compliance with the EU's harmonizing legislation and international standards. As a member of the European System of Central Banks, Spain's financial markets have become increasingly integrated into the European Markets.⁶²

Spain's 2007-2009 Financial Crisis

Spanish banks are very retail-orientation. Consequently, Spanish banks were not directly affected by the U.S. subprime crisis and ramifications. Even though Spanish commercial banks have had less exposure to mortgage-backed securities and derivatives because of more conservative underwriting regulatory enforcement, the credit crunch of the financial crisis brought the Spanish decade-long real estate and construction boom to an end in 2009 when Spain's GDP fell by 3.9%. Moreover, Spanish banks were less leveraged than their European peers and also more profitable. However, since customer deposits have not kept pace with domestic credit expansion, banks have increasingly tapped international capital markets.⁶³

Between 1997 and the end of 2007, domestic deposits grew at 12 percent, thus financing only part of the credit expansion of 17 percent. As result, the loan to deposit ratio climbed well above the Euro-area average. Securitization facilitated access by credit institutions to foreign savings. Credit institutions have established securitization funds, which in turn have issued their own securitization bonds, mainly covered mortgage bonds. Given the soundness of the issuer, the quality and size of the mortgage portfolio, the level of over collateralization, resulting from sound regulation, these securities were attractive to foreign investors. Outstanding balances of Spanish mortgage bonds went from 18 billion euros [\$23.4 billion] (3 percent of GDP) in 2000 to 350 billion euros [\$455 billion] (33 percent) in 2007.⁶⁴

Between 1997 and 2007, foreign held mortgage bond debt went from 2% of GDP to 33% of GDP. In 2009 Spain's debt as a percentage of GDP went up to 55.2%. Its unemployment rate was 20.05%. Furthermore, because of budget cuts, its estimated economic growth was expected to decline by 0.3% and to decline by 1.3% in 2011. Spain's, like Greece's credit rating, has been declining in 2010, even though Spain has been fiscally much stronger than Greece. For example,

⁶²The Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*, 2008, <http://www.group30.org>.

⁶³International Monetary Fund, *Spain: Selected Issues*, IMF Country Report no.09/129, April 2009, p. 46.

⁶⁴International Monetary Fund, *Spain: Selected Issues*, IMF Country Report no.09/129, April 2009, pp. 40-43.

in 2009, Greece's debt as a percent of GDP was 115.5%. Spain's debt was 55.2%, even though Spain's unemployment rate was higher than Greece's, which was 12.1%. Because Spain introduced economic austerity before Greece, Spain's unemployment rate was higher. The expectation was that Spain would be better able to keep its debt payments current, which they have done so far despite paying higher interest rate on its debt.⁶⁵

Spain's Regulatory Response to the 2007-2009 Financial Crisis

Spain's first most notable response to the 2007-2009 financial crisis came in June 2009 by Royal Decree Law 9/2009, which established a "Fund for Ordered Bank Restructuring (FROB)." The purpose of the fund was to provide a means of "increasing the strength and solvency of the Spanish banking system."⁶⁶ The focus of the financial reform was on consolidating Spain's savings banks, where the exposure to adverse foreign credit conditions was greatest. The reform is being carried out by the Bank of Spain and the Economic Ministry. The reform is expected to require changes in the Organic Act on Savings Bank that is supported by the Spanish Confederation of Savings Banks. However, the government did not specify the nature of the pending legal changes.⁶⁷

The savings bank sector is the focus of Spain's financial reform because savings banks were the issuers of the covered bonds that were purchased by foreign investors. Covered bonds are similar to mortgage-backed securities. However unlike securitization, the assets stay on the issuers' balance sheet.⁶⁸ Covered bonds financed the real estate and construction boom in Spain. The decline in real estate and construction and rising unemployment in Spain have negatively impacted the issuers' ability to pay bond holders. In addition, sovereign debt rating downgrades have not helped covered bonds issuers' credit worthiness. The following show that there could be an implicit government guarantee in the minds of covered bond purchasers:

As seen in 2009, a negative rating action on a sovereign may adversely impact covered bond ratings. Downgrades of sovereign rating may negatively impact covered bonds directly, as financing risk in a market increases, or indirectly, to the extent that downgrade may lead to negative rating pressure on covered bond issuers.⁶⁹

Unlike the United States, Spain's financial regulatory reform began by narrowly focusing on the savings bank sector which had the greatest exposure to the financial crisis worldwide. The reason is that, according to an IMF 2009 country report on Spain, the Spanish financial system was not severely impacted by the initial impact of the American and European financial turmoil. This minimal impact might be due to its conservative regulatory structure, sound supervision, and strong retail-oriented banking activities. Consequently, IMF stress tests showed that the financial

⁶⁵ "Country-by-Country Look at Europe's Debt," *ABC News/Money*, May 30, 2010, <http://abcnews.go.com/Business/wireStory?id=10789213>.

⁶⁶ Royal Decree-Law 9/2009 is available in Spanish at <http://www.boe.es/boe/dias/2009/06/27/pdfs/BOE-A-2009-10575.pdf>.

⁶⁷ Brett Allan King, "Spain to Seed Up Restructuring of Savings Banks in Reform Effort," *BNA International Business & Finance Daily*, May 6, 2010, p. 1.

⁶⁸ Royal Decree-Law 9/2009 is available in Spanish at <http://www.boe.es/boe/dias/2009/06/27/pdfs/BOE-A-2009-10575.pdf>.

⁶⁹ Tracy Alloway, "Next up for Europe, Covered Bond Catastrophe?," *Financial Times.com*, p. 2.

system had weathered the first part of the financial crisis because its institutions had robust capital and with ample capital buffers. In 2010, however, internal and external credit limitations forced the government to bail out some of the savings banks and other issuers of covered bonds. Despite the deteriorating credit conditions, when the Banks of Spain took over these institutions, the securities were able to maintain their credit rating.⁷⁰

Spain's Stress Tests

Under international scrutiny and after there were rumors of a European Union bailout for Spain similar to the one that the EU had to arrange for Greece and which the Spanish government had repeatedly denied, the Bank of Spain announced that the results of its stress tests performed on all its banks would be made public. The Bank of Spain also encouraged the European Commission to make all the stress test results public in order to discourage financial sector speculations on European institutions and government bonds. The Bank of Spain intends to verify that Spanish commercial banks, saving banks and cooperatives have sufficient capital to weather the severe scenarios of the stress tests. The Spanish banking associations argued that two years into the financial crisis, Spanish banks continue to operate profitably with good returns on investment and without public aid.⁷¹

Some Implications

The examination of the European Union and four member countries to find out what financial regulatory changes they have made or plan to make in response to the 2007-2009 financial crisis suggests that, like the United States, most EU members have successfully recapitalized their undercapitalized financial services institutions. However, while there are a number of proposals being debated in the European Union, and the member country level of government, the European Union has yet to legislate the financial services reforms necessary to prevent another financial crisis from occurring. The methods used varied as the selected sample of countries demonstrated. The methods ranged from consolidating the savings banks in Spain to the establishment of “a bad bank” in Germany, while banks were nationalized in the United Kingdom and the Netherlands. In all cases, financial services providers were recapitalized with taxpayer money, a tax subsidy. One of the important consequences is that such tax subsidy created competitive distortion among financial services providers within the European member countries and in the international banking community overall. Yet, the European Commission has continued to extend permission to member countries' governments to continue the subsidies to the financial services industry. By contrast, the United States has moved to sell the preferred stocks the government purchased to recapitalized U.S. banks.

The difficulty in reaching a consensus on regulatory financial reform in the European Union seems to be caused by powerful member countries' unwillingness to turnover certain powers to the European Commission in Brussels. This unwillingness helps to maintain the fragmented

⁷⁰ Diana Golobay, “Rating Safe for Cajasur, despite Government Takeover,” *Housingwire*, May 27, 2010, at <http://www.housingwire.com/2010/05/27/ratings-safe-for-cajasur-spanish-covered-bonds-despite-government-takeover>.

⁷¹ Brett Allan King, “Spain to Publish Stress Test Results, Asks EU to Do the Same Throughout Europe,” *BNA Banking Daily*, June 18, 2010, p. 1.

European financial regulatory structure. For example, as mentioned above, the European finance ministers passed a plan for a new European banking supervision framework. The European Parliament is insisting that the centralized powers of this agency be allowed to overrule national regulators. However, some EU member countries led by the United Kingdom rejected any plan that “could require a national government to bailout with taxpayer money a bank located in another European country.”⁷² This argument puts at risk a significant part of the European Union’s financial regulatory reform plan that included provisions to regulate securities, pensions, and the insurance sectors.

Author Contact Information

Walter W. Eubanks
Specialist in Financial Economics
weubanks@crs.loc.gov, 7-7840

⁷² Joe Kirwin, “Parliament, EU States Deadlock over New Bank Supervision Plan,” *BNA Banking Daily*, July 15, 2010, p.1.