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NOTE

from:	Council (Ecofin)
to:	European Council
Subject:	Annex to the Council (Ecofin) Report to the 18-19 June European Council on the effectiveness of financial support schemes : - Report of the Task Force on reviewing the effectiveness of financial support measures

Delegations will find attached an annex to the Council (Ecofin) report to the 18-19 June European Council on the effectiveness of financial support measures.

Encl.:

ANNEX

Report of the Task Force on reviewing the effectiveness of financial support measures in view of the reporting to the 18-19 June European Council

INTRODUCTION

1. At its meeting of 19-20 March, the European Council invited the Council to assess the effectiveness of the measures taken as well as the overall situation regarding the stability and functioning of financial markets and to report back to the June 2009 European Council.

2. Based on the latest available information, the EFC Task Force reviewed i) the national support measures for the financial sector introduced in the period up to 8 May 2009 and their use; as well as ii) their effectiveness in strengthening the stability of the financial system, the functioning of the financial markets and the credit to the economy.

3. Possible obstacles to the use of national schemes have been identified in the report of the Task Force of 25 March to the Informal Ecofin in Prague. They mainly concern the pricing conditions of the guarantee schemes[1], but also refer to a possible stigma effect and the need to extend and spread the maturity of the guarantees to avoid that all issuance under the guarantee schemes would come to expire at the same time. They remain valid. The ECB and the Commission have been invited to take these issues into consideration when reviewing their guidelines in respect of the guarantees, and explore possible alternatives.

[1] They include i) a difference in pricing between banks of the same rating, depending on guarantor; ii) asymmetry in the pricing methodology between short and medium term issuance and between banks with and without CDS spreads and the add-on fee for operational costs, which seemed to turn out to be more onerous than expected

4. The Commission has prepared its overview and review of the existing national guarantee and recapitalisation schemes with respect to their objectives of ensuring financial stability and restoring lending to the real economy whilst safeguarding the internal market and minimising distortion of competition in its draft note of 25 May 2009. The review in particular aims at ensuring consistency and effectiveness of the schemes when there are re-notified for prolongation after 6 months. In this context, it also addresses the obstacles raised by Member States and delivers preliminary proposals to address those obstacles.

5. The ECB/Eurosystem has also assessed the experience with the provision of government guarantees and reviewed its recommendations in the light of the current market conditions. The ECB /Eurosystem concludes that, even though there is no need for a global overhaul of pricing conditions, a limited adjustment may be warranted, in particular in respect of the add-on fee, to encourage long term bank funding and provision of long term credit to the economy. In order to ensure a level playing field, further work may also be warranted in particular regarding the fact that the pricing scheme does not address the risk of the guarantor.

I. STATE OF PLAY WITH THE FINANCIAL SUPPORT MEASURES

1. AVAILABILITY OF SCHEMES/SUPPORT MEASURES

6. The amount of public resources potentially committed by the support packages varies strongly between Member States but at the aggregate level it is comparable, in terms of GDP, to the efforts made by the US. In a good number of Member States the amounts are quite important in terms of GDP and have contributed to increased bond and CDS spreads and sovereign debt issuance, which will contribute to increasing future debt levels or implicit liabilities. In line with the recently reduced risk aversion, spreads have tentatively started to narrow.

7. The Member States that have not taken public measures in support of the functioning of financial markets include a majority of the more recently acceded Member States (Cyprus, Malta, Slovakia, Estonia, Czech Republic, Poland, Lithuania, Bulgaria and Romania. In a number of Member States that have introduced a guarantee scheme, access to funding and limited exposures to toxic assets may provide part of the explanation for a lack of interest of financial institutions to participate in the scheme and the mere existence of the scheme may act as a safety net and confidence builder.

8. While being consistent with the framework agreed at EU level, the national responses show a considerable degree of variation in the approach (national schemes or ad hoc measures) used and in the combinations of available measures (guarantees on bank liabilities, capital injection and liquidity support, impaired assets relief measures).

9. The type of measures taken so far and their timing clearly reflects the different stages in the management of the crisis. In the acute stage, a large number of Member States introduced measures with respect to the liabilities side of the balance sheet of banks (recapitalizations and credit guarantees[2]). Currently, the responses to the crisis entail that: i) existing guarantee schemes, often with adjusted conditions[3], are being renewed; ii) measures to deal with and enhance the transparency with respect to the asset side of banks' balance sheet (e.g. by introducing impaired asset protection relief measures)[4]. Most of the impaired asset protection measures have been implemented or announced recently and are still under assessment by the Commission. Their use and effectiveness should therefore be reassessed in a near future. The role of the Commission, assisted by panels of experts in ensuring consistent valuation of assets in cases subject to its assessment, is important in this respect. Further guidance by the Commission in this respect could be useful.

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[2] 18 Member States (see annex 1 for detail) have introduced guarantees on bank liabilities, 15 recapitalisation measures, 5 impaired assets relief measures (DE, and IE have announced measures but approval is pending) and 11 have introduced liquidity support measures.

[3] For example the Swedish and Finnish schemes.

[4] UK, DK, BE and NL

10. With a view of providing further information for better evaluating the effectiveness of the national support measures, it will be helpful to build upon the results of the EU-wide stress testing of the European banking system which is currently coordinated by CEBS, with inputs from ECB, Commission and national supervisors. This exercise will help to determine the resilience of the European financial system to further economic shocks, in particular given their potential impact on credit losses and impairment in the balance sheets of major EU banks and, at the same time, provide a clearer picture in terms of overall systemic risks, in particular in respect of large cross-border financial groups. In doing so, CEBS is using a bottom-up approach. In its forthcoming June 2009 Financial Stability Review, to be published on 15 June, the ECB is also conducting a simple bottom-up stress testing exercise on the loan books of a set of large and complex euro area banking groups and carrying out a top-down assessment of further bank losses at the euro area level, following an approach similar to the one the IMF used to determine that impaired assets worldwide amount to USD 4.1trillion.

2. PARTICIPATION IN THE SCHEMES

11. The **use of recapitalisation** measures has been relatively widespread and about 55 % of the amounts available for recapitalisation within and outside the schemes (€311.4 bn for the EU)[5] have been used.

12. The **take-up rate for state guarantees** has been increasing (around 31.7 %) and is generally described to be satisfactory when viewed against the objectives of the scheme although participation varies strongly across Member States and , in a good number of Member States, remains limited to a relatively small number of banks and issues. Only a few Member States still consider participation insufficient for the objective of ensuring an appropriate funding structure of banks and thereby ensuring lending on reasonable terms for all maturities to companies and households.

[5] The figures in annex are based on information provided by Member States with cut-of date 8 May 2009.

13. In Finland and Italy, guarantee schemes have been implemented, but no bank has so far availed itself of such instruments (cut-off date 8 May 2009). In the Italian case, satisfactory access to retail and market funding and the comparatively higher costs of state guaranteed issuance could provide an explanation beyond the possible stigma effect.

14. Some Member States have prolonged or are in the process of prolonging their guarantee schemes as problems with bank financing have not yet been solved. Certainty about this prolongation has previously been signalled as a confidence enhancing factor for the participants to the scheme and would have a positive impact for the market. Both in the Swedish and Finnish case, the maturity has been extended from 3 to 5 years for uncollateralised instruments[6], with an aggregate cap for issuance of instruments with maturities longer than 3 years, in view of helping to smooth the transition from state guarantee to normal market issuance throughout EU financial markets and facilitate the access to long-term funding.

II. MARKET DEVELOPMENTS

15. Even though the level of participation in the schemes is one of the indicators for measuring its effectiveness, it should be considered against the attaining of its objectives, including i) preserving the stability of the financial system; ii) ensuring access to funding for both financial and non-financial institutions and iii) restoring confidence in the financial system. On all three counts, there have been positive developments recently.

[6] In the originally approved schemes, both Swedish and Finnish measures gave the possibility to issue covered bonds with the maturities up to 5 years under the guarantee, also subject to an aggregate limit.

16. Since the onset of the current crisis, problems in the functioning of financial markets have been analysed on the basis of a range of **stress indicators**[7]. As the national support schemes impact on the financial sector, these indicators can be tracked to assess the extent to which there is a coinciding improvement in market functioning and/or investor sentiment.

17. These indicators confirm that the public measures taken since the third quarter of 2008 have contributed to a stabilisation of the extremely tense financial market conditions that were witnessed in the autumn of last year and that public measures continue to be important to support the improvement of market conditions. There are increasing signs of a trend towards a more normal market functioning, although the remaining elevated risk premiums in many parts of the financial markets cautions about the operating environment of the financial institutions, which, in respect of credit losses, is likely to remain challenging.

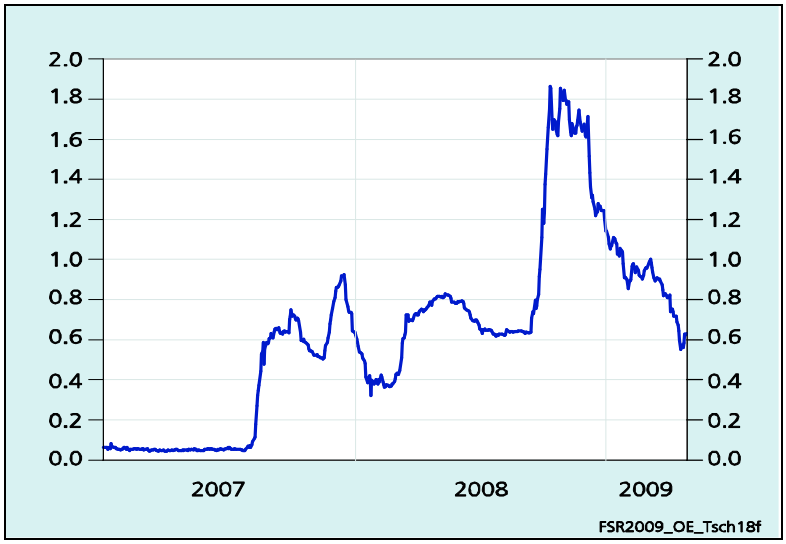
– Money market tensions seem to be easing further. Improved liquidity conditions contributed to a stabilization of EONIA rates at very low levels in a narrow range above 0.50%. In particular the spread between unsecured short-term interbank lending and swap transactions is a widely used indicator of money market distress. These spreads peaked in October 2008 and have fallen thereafter, with only a brief interruption in February, to narrow to 60 bps. Although current spreads in the 3-month maturity are still far from their pre-crisis levels[8], the normalisation process is continuing (see graph below). Market participants interpret this as a sign that the funding stress on the interbank market is slightly easing and that, together with improving financial markets, central banks' efforts to increase liquidity in the markets seem to be working. However, beyond the 3-months maturity the markets remain seriously impaired.

[7] Including inter-bank interest rates and spreads, credit default spreads, indicators of default expectations, issuance volumes and yield spreads in markets for corporate bonds and asset backed securities etc

[8] Currently spreads have returned to levels comparable to those observed during the initial stages of the crisis, before the bankruptcy of Lehman-Brothers, i.e. a reduction of about 70% from the peak.

Chart 1: ***Spread between the three-month Euribor and OIS*** (Overnight Index Swap)[9]

percentages



Source : Thomson Financial Datastream

– *Indicators of default risk have improved substantially, especially for subordinated debt.* They, however, remain at elevated levels and the recent improvements are not yet enough to constitute a reversal of the long-term upward trend. Lower Credit Default Spreads (CDS) signal an easing of investor concerns about possible default and poor earning prospects, and the price of bank equity has seen a strong rebound since mid-March, with higher valuations and an increasing appetite for risk. Despite this strong recovery, bank stocks still have more ground to cover before catching up with the general Eurostoxx stock index. The convergence process continues, and currently volatility is approximately 40% above normal market conditions. At the peak, implied volatility was almost 250% above its long-term average.

[9] Fixed rate paid by the counterparty of an interest rate swap receiving the overnight Eonia rate for a three-month term.

– In particular in those Member States where access to medium to long term capital remains impaired or difficult, high quality assets purchases and *government guarantees* have been providing access to medium term capital. At the same time, direct financing conditions for corporations have eased significantly in recent months, particularly in the euro market for large corporations with a good standing. Although yield spreads for corporate bonds relative to government benchmarks remain high compared to the pre-crisis situation, they have fallen substantially since the peak in October 2008 and the last hike at the beginning of March 2009. Net issuance of debt securities by non-financial corporations has accordingly increased during the first quarter of 2009, and the growth rate has been close to, or even above its long-term average.

– Public capital injections have been instrumental in underpinning the level of *bank capital*. In the absence of these government capital injections, for a total effective amount of € 174.7 bn, there would have been a sharp fall in bank capital with obvious implications for solvency or, for fundamentally sound banks, an even stronger pressure from the market to increase their capital. Balance sheets of both EU and euro-area banks have continued to strengthen under the opposing influences of further asset-write downs and capital injections by governments.

– The aggregate level of bank capital has increased steadily in the euro area, while in the EU a marked increase was registered only in March, after having been broadly stable in the first two months of 2009. The evolution of bank capital going forward will depend on market pressure, further asset write-downs, credit developments and access to capital injections by governments. *CEBS' first risk outlook* [10] points in particular to increasing credit risk but shows that banks expect to be able to meet minimum regulatory requirements in the remainder of 2009

[10] CEBS assessment of risks and vulnerabilities in the EU banking sector – March 2009, CEBS 2009 18 rev 2 of 17 March 2009.

– The lower *cost of debt financing*, which has emerged during the past couple of months, has nevertheless not materialised in a rise in debt financing. On the contrary, after increasing debt issuance during the first two months of 2009, banks' debt issuance has fallen in March. This could reflect a general pursuit for lower leverage in the banking sector or that banks are reducing balance sheets.

III. IMPACT ON THE CREDIT AND LENDING TO THE ECONOMY

18. The effectiveness of the schemes in underpinning the *supply of credit to the private non-financial sectors of the economy* can also be assessed by reference to a range of indicators, including amongst others *data on bank lending volumes, surveys of bank lending standards, data on loan defaults and foreclosures, bank intermediation margins etc.*

19. At the current juncture, the *aggregate volume of bank lending to the corporate sector* is still increasing, but the growth rate is on a sharp downward trajectory, having appeared resilient so far to the financial crisis and economic slowdown until late 2008. There might be significant differences in home and host markets.

20. Bank lending surveys complement this picture with information on *lending standards*. In the euro-area, banks have tightened lending standards significantly since the onset of the crisis, mostly in reaction to the deteriorating economic outlook. Yet, the April 2009 bank lending surveys results show that the speed of tightening abated somewhat in the first quarter of 2009 compared with the second half of 2008, and that expectations for the second quarter point to a further slowdown in the tightening.

21. In addition, the survey results point to persistently hampered access to *wholesale funding of banks* despite government support. Banks indicated that their access to wholesale funding has eased in response to governments' announcements of recapitalisations and guarantees, although there continues to be problems. Only in the case of very short-term funding, a majority of banks reported that access was unrestricted. Reflecting this several Member States have reported that banks are mainly short term funded, which leads to increasing liquidity risks and an unwillingness to extend longer-term loans.

22. A majority of banks also reported that the financial market tensions still adversely affected their capital positions and lending capacity, which indicates some loan *supply constraints* at the current juncture. The relative importance of supply and demand factors remains unclear but a preliminary analysis by the ECB suggests that the decline in lending remains mainly demand-driven but that banks' balance sheet constraints and limited access to medium and long term financing, the high level of risk premiums in many financial markets may also have contributed to this decrease. On the whole, the picture looks similar in the EU.

23. In those countries where commitments to continue extending credit to the economy is a condition for access to government funding, the effectiveness of the support measures may be enhanced.[11] On the other hand, as signalled in CEBS' first risk outlook, this may also imply that banks lose one of their tools to manage credit risk if no safeguards are established to ensure that the committed new lending is on commercial terms and under sound risk management practices.

[11] The UK bank lending survey, for instance, showed that such conditions were successful.

IV. CONCLUSIONS

24. Overall, the situation in financial markets has eased somewhat in the first quarter of 2009. There are some tentatively encouraging signs of improvement in money and corporate bond market developments, although the high level of risk premiums in many financial markets cautions against excessive complacency. The operating environment for banks is likely to remain challenging, in particular in respect of credit losses linked to their loan portfolios.

25. While central banks and governments in Member States continue to provide liquidity, funding and capital support, to financial institutions, an increasing number of Member States is currently also addressing the issue of impaired assets on banks balance sheets. In this context, it is important to:

- Tailor such schemes to the particularities of the banking sector being treated in order to ensure maximum effectiveness and restore lending.
- Further improve transparency with respect to the disclosure of impaired assets on banks' balance sheets in view of effectively separating or removing the assets concerned -combined with relevant public support- and restoring confidence in the banking sector.
- Address negative spillovers and maintain a level playing field within the EU (as well as at global level). In that respect, it is critical that valuation methodologies are applied transparently, objectively and consistently. In this context, further guidance by the Commission would be welcome

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ANNEX 1: National measures in support of the EU banking sector –amounts in €bn

	EU public interventions in the banking sector (in €bn)										
	Capital injections		Guarantees on bank liabilities		Relief of impaired asset		Liquidity and bank funding support		Total for all approved measures	Total effective for all measures	Desposit guarantee scheme (in € unless otherwise indicated)
	Total approved measures	Effective capital injections	Total approved measures	Guarantees granted	Total approved measures	Effective asset relief	Total approved measures	Effective liquidity interventions			
Austria	13,8	4,7	70,6	13,9	1,2	1,2	4,4	4,0	90,0	23,8	100%
Belgium	14,4	19,4	240,8	55,5	15,6	17,1	NA	NR	264,5	126,4	100 000
Bulgaria	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	50 000
Cyprus	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	100 000
Cz Republic	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	50 000
Denmark	13,9	0,6	580,0	NR	0,0	0,0	0,0	0,6	593,9	1,1	100%
Estonia	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	50 000
Finland	0,0	0,0	50,0	0,0	0,0	0,0	0,0	0,0	50,0	0,0	50 000
France	24,0	16,1	319,8	58,8	6,4	6,4	0,0	0,0	350,1	81,2	70 000
Germany	99,4	38,1	445,0	175,2	9,8	9,8	0,0	0,0	554,2	161,7	100%
Greece	5,0	0,0	15,0	1,0	0,0	0,0	8,0	4,3	28,0	5,3	100%
Hungary	1,0	0,1	5,2	0,0	0,0	0,0	0,0	0,0	6,2	0,1	100%
Ireland	8,5	3,5	376,0	376,0	0,0	0,0	0,0	0,0	384,5	379,5	100%
Italy	20,0	0,0	NA	0,0	0,0	0,0	0,0	0,0	20,0	0,0	circa 103 000
Latvia	0,3	0,0	2,1	0,5	0,0	0,0	2,1	1,2	4,5	1,7	50 000
Lithuania	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	100 000
Luxembourg	2,5	2,9	4,5	NR	0,0	0,0	0,0	0,0	7,0	2,9	100 000
Malta	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	100 000
The Netherlands	46,1	46,1	200,0	33,5	28,5	0,0	0,0	34,0	274,5	113,5	100 000
Poland	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	50 000
Portugal	4,0	0,0	20,5	5,0	0,0	0,0	0,0	0,0	24,5	5,0	100 000
Romania	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	50 000
Slovakia	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	100%
Slovenia	0,0	0,0	12,0	0,0	0,0	0,0	0,0	0,0	12,0	0,0	100%
Spain	0,0	0,0	100,0	29,7	0,0	0,0	30,0	19,3	130,0	49,0	100 000
Sweden	4,6	0,5	137,2	24,8	0,0	0,0	0,2	0,0	142,0	25,3	50 000
United-Kingdom	54,0	40,0	337,0	148,0	0,0	0,0	390,2	290,0	781,2	477,9	circa 57 000
Total EU	311,4	171,8	2915,5	921,8	61,5	34,5	435,0	353,4	3723,3	1481,5	
Total EA	237,6	130,6	1854,1	748,5	61,5	34,5	42,4	61,6	2195,5	975,2	

NA - Not Available indicates that the amount is not available in the state aid decisions
NR - Not Reported indicates that the amount was not reported by the Member State in its reply to the EFC questionnaire

ANNEX 2: national measures in support of the EU banking sector (25 MAY update) approved

	EU public interventions in the banking sector						
	Capital injections		Guarantees on bank liabilities		Relief of impaired asset	Liquidity and bank funding support	Desposit guarantee scheme (in € unless otherwise indicated)
	National scheme	Ad hoc interventions	National scheme	Ad hoc interventions			
Austria	✓		✓			✓	100%
Belgium		✓		✓	✓	✓	100 000
Bulgaria							50 000
Cyprus							100 000
Cz Republic							50 000
Denmark	✓		✓		✓	✓	100%
Estonia							50 000
Finland			✓	✓			50 000
France	✓	✓	✓	✓	✓		70 000
Germany	✓	✓	✓	✓	✓	✓	100%
Greece	✓		✓			✓	100%
Hungary	✓		✓				100%
Ireland		✓	✓		✓		100%
Italy	✓		✓			✓	circa 103 000
Latvia		✓	✓	✓		✓	50 000
Lithuania							100 000
Luxembourg		✓		✓			100 000
Malta							100 000
The Netherlands		✓	✓		✓		100 000
Poland							50 000
Portugal	✓	✓	✓				100 000
Romania							50 000
Slovakia							100%
Slovenia			✓			✓	100%
Spain			✓			✓	100 000
Sweden	✓		✓			✓	50 000
United-Kingdom	✓		✓		✓	✓	circa 57 000

Source: Commission based on Member State contributions - Note: impaired asset measures announced for DE, IE, but approval pending