ECONOMIC MEASURES ADOPTED AT EU LEVEL IN CONNECTION WITH ECONOMIC AND FINANCIAL CRISIS

Petr Zahradník

EU Office of Česká spořitelna

EU OFFICE
Česká spořitelna, a.s.
Olbrachtova 1929/62
140 00 Praha 4
tel.: +420 956 718 012
fax: +420 224 641 301
EU_office@csas.cz
http://www.csas.cz/eu

Jan Jedlička
+420 956 718 014
jjedlicka@csas.cz

Iva Dlouhá
+420 956 718 015
idlouha@csas.cz

Helena Chamerová
+420 956 718 012
hchamerova@csas.cz

Tomáš Kozelský
+420 956 718 013
tkozelsky@csas.cz

ČESKÁ SPOŘITELNA

Summary:

Six-pack measures ... 3
A Regulation amending the legislative underpinning of the preventive part of the Stability and Growth Pact (Regulation 1466/97) ... 3
A Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact (Regulation 1467/97) ... 3
A Regulation on the effective enforcement of budgetary surveillance in the euro area ... 3
A New Directive on requirements for the budgetary framework of the Member States ... 3
A New Regulation on the prevention and correction of macroeconomic imbalances ... 3
A Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area ... 4
Other measures adopted ... 4
1. Reinforcing common economic agenda and closer EU surveillance ... 4
1.1. Economic priorities for the EU have been agreed ... 4
1.2. Tighter EU surveillance of economic and fiscal policies is being implemented ... 6
1.3. Economic priorities and budgetary policy priorities will be discussed on a coordinated basis at the same time every year: ... 7
2. Safeguarding the stability of the euro area ... 9
3. Repairing the financial sector ... 11

EU OFFICE ČS, E-MAIL: EU_OFFICE@CSAS.CZ, TEL.: +420 956 718 012

Six-pack measures

The six legal documents include:

A Regulation amending the legislative underpinning of the preventive part of the Stability and Growth Pact (Regulation 1466/97)

The preventive part of the Stability and Growth Pact is meant to ensure that EU Member States follow prudent fiscal policies in good times to build up the necessary buffer for bad times. To break off with past complacency in good economic times, the monitoring of public finances will be based on the new concept of prudent fiscal policy-making that should ensure convergence towards the Medium-Term Objective. The European Commission may issue a warning in case of significant deviation from prudent fiscal policy for the euro area Member States.

A Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact (Regulation 1467/97)

The corrective part of the Stability and Growth Pact is meant to avoid gross errors in budgetary policies. The regulation is amended so that debt developments are followed more closely and put on an equal footing with deficit developments as regards decisions linked to the excessive deficit procedure. Member States whose debt exceed 60% of GDP should take steps to reduce it at a satisfactory pace, defined as a reduction of 1/20 of the difference with the 60% threshold over the last three years.

A Regulation on the effective enforcement of budgetary surveillance in the euro area

Changes in both the preventive and corrective part of the Stability and Growth Pact are backed up by a new set of gradual financial sanctions for euro-area Member States. As to the preventive part, an interest-bearing deposit should be the consequence of significant deviations from prudent fiscal policy making. In the corrective part, a non-interest bearing deposit amounting to 0.2% of GDP would apply upon a decision to place a country in excessive deficit. This would be converted into a fine in the event of non-compliance with the recommendation to correct the excessive deficit.

Interests earned on deposits and fines will be distributed among euro-area Member States neither in excessive deficit nor in excessive imbalance. The changes are devised so that they should facilitate the eventual move to a system of enforcement linked to the EU budget as foreseen in the Commission communication of 30 June 2010.

A New Directive on requirements for the budgetary framework of the Member States

Since fiscal policy-making and responsibility are dominated by the Member State, it is essential that the objectives of the Stability and Growth Pact are reflected in the national budgetary frameworks, i.e. the set of elements and tools that form the basis of national fiscal governance (accounting systems, statistics, forecasting practices, fiscal rules, budgetary procedures and fiscal relations with other entities). The directive sets out minimum requirements to be followed by Member States.

A New Regulation on the prevention and correction of macroeconomic imbalances

The Excessive Imbalance Procedure is a new element of the EU's economic surveillance framework. It comprises a regular assessment of the risks of imbalances based on an overview of economic indicators and their trends. For Member States with severe imbalances or imbalances that put at risk the functioning of EMU, the EU Council may adopt recommendations and open an excessive imbalance procedure. A Member State under an excessive imbalance procedure would have to present a corrective action plan that will be vetted by the EU Council, which will set deadlines for corrective action. Repeated failure to take corrective action will expose the euro area Member State concerned to sanctions (see next point).

A Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area

Like in the fiscal field, if a euro-area Member State repeatedly fails to act on the EU Council's recommendations to address excessive imbalances, it will have to pay a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a qualified majority vote, with only euro-area Member States voting.

Other measures adopted

Besides measures associated solely or dominantly with correcting fiscal policies and adopting preventive tools to reduce future susceptibility to crisis, other crucial steps have been taken during the past period of nearly two years; giving an overview of them is useful also because those measures represent a significant exogenous factor underlying the Multiannual Financial Framework as well as the future cohesion policy after 2013. Generally specified, the measures can be represented as three key areas:

1. Reinforcing common economic agenda and closer EU surveillance

A common framework is essential for the EU to tackle its economic challenges and return to a stronger growth path. In the past, the lack of a clear system of economic governance between Member States led to imbalances and lost opportunities, and made the EU more vulnerable when the crisis hit. To establish conditions limiting the susceptibility and vulnerability, the Commission proposed the Europe 2020 strategy, which was endorsed by the European Council in June 2010. The common economic agenda strategy brings together:

- a common economic agenda;
- a stronger EU surveillance framework; and
- its monitoring using a synchronized model.

1.1. Economic priorities for the EU have been agreed

The Europe 2020 strategy is the EU's common economic agenda, a plan to move beyond the crisis and boost smart, sustainable and inclusive growth over this decade. It deals both with short-term challenges linked to the crisis and the need for structural reforms and measures enhancing economic growth and development that are needed to help Europe and its economy recover from the crisis and be more resilient to economic shocks. Europe 2020 is based on a simple and effective delivery mechanism, made up of targets, concrete priority actions and monitoring. It consists of:

Five targets for 2020

Five targets have been set for 2020 to focus efforts on areas critical for the EU's future in terms of its competitiveness: employment, innovation, climate and energy, education and social inclusion. These targets have been agreed for the EU as a whole and have also now been translated into national targets by each Member State:

- 75% of the population aged 20-64 should be employed
- 3% of the EU's GDP should be invested in Research & Development
- The EU should reduce its CO^2 emissions by 20%, increase its energy efficiency by 20% and raise the share of renewable energies in overall energy consumption to 20%
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a degree or diploma
- 20 million fewer people should be at risk of poverty

Seven flagship initiatives

In order to drive progress towards the Europe 2020 goals, the Commission has come forward with a set of these seven flagship initiatives:

- A Digital Agenda for Europe
- Innovation Union
- Youth on the Move
- Resource Efficient Europe
- An Industrial Policy for a Globalisation Era
- An Agenda for New Skills and Jobs
- The European Platform Against Poverty

The adoption of the Single Market Act is a further example of the Commission's action to support Europe 2020.

Ten concrete priorities for 2011

In January 2011, the Commission further detailed the expected future development in its Annual Growth Survey by setting out more immediate actions for the next eighteen months:

Three priorities to guarantee macro-economic stability:

1. putting public finances in order;
2. taking action where there are large deficits (or surpluses) on the current account of the balance of payments;
3. ensuring the stability of the financial sector;

An example: in 2011, all Member States are implementing fiscal consolidation plans, which set strict deficit targets to be met as of this year and which will help the Member States bring their budget deficits below 3% of GDP within an agreed timeframe.

Four priorities to enhance structural reforms:

1. helping people get back to work or find new jobs by making work more financially attractive;
2. urgently reforming pension systems;
3. making sure that unemployment benefits provide an incentive to work;
4. better balancing flexibility and security in the labour market;

This does not mean abandoning the common European social model; it means bringing in those who are currently excluded from the labour market.

Three priorities to frontload measures that boost growth:

1. abolishing barriers that still hamper the Single Market;
2. increasing investment in energy, transport and IT infrastructures, partially through innovative financing (including, for example, EU project bonds);
3. creating cost-efficient access to energy;

Speeding up growth will also help to accelerate fiscal consolidation and support structural reforms.

A complementary agenda with additional reform measures and tools – called the Euro+ Pact – has been agreed among euro area Member States, as a reflection of their deeper interdependence, as well as six non-euro area Member States that have chosen to sign up (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania); the only EU Member States remaining outside are the Czech Republic as well as the United Kingdom, Sweden and Hungary. The Euro+ Pact focuses on four areas:

- competitiveness;
- employment;
- sustainability of public finances;
- reinforcing financial stability.
- reinforcing financial stability.

The Pact was endorsed at the 2011 Spring European Council on 24/25 March 2011. All 23 signatories are committed to implementing the reforms the Pact details; the remaining four Member States are free to decide whether and when they sign up. The Euro+ Pact is fully embedded in the new European Economic Governance framework and the commitments taken therein are included in the National Reform Programmes of the concerned Member States.

Competitiveness-enhancing measures are part of one integrated delivery mechanism ensuring that EU commitments are effectively implemented at the level of national states and the reforms they implement. Member States are committed to:

- Setting national targets to be met and achieved by 2020, committing themselves to contribute to the overall EU effort. This commitment was made in 2010 and their implementation has been underway since 2011. The Commission is monitoring the fulfilment of the commitments;
- Spelling out in their National Reform Programmes and Stability or Convergence Programmes the measures they intend to take domestically to contribute to the achievement of the overall EU targets. This should cover both the Annual Growth Survey and the key areas included in the Euro+ Pact. The Member States send their National Reform Programmes and Stability or Convergence Programmes to the European Commission on a regular basis;
- Translating these measures into concrete economy policy actions through their budgets, laws and other activities, approved and adopted at the level of the national legislatures and executives.

1.2. Tighter EU surveillance of economic and fiscal policies is being implemented

The Commission has proposed giving the EU better, more functional tools to prevent unsustainable development of public finances and major competitiveness imbalances between Member States. The system includes sanctions applicable to euro area countries not respecting the rules, which face better enforceable fines.

Over the past few years, the EU has not been able to fulfil and respect key, crucial, long (or rather permanently) applicable goals it set itself on economic and fiscal policies, partly because of a surveillance mechanism that was not stringent enough. To address this, on 29 September 2010 the Commission presented six legislative proposals (the so-called Six-Pack; see above). The Parliament and the Council gave their agreement to the package in June 2011. The package of these proposals has three main objectives:

Stronger preventive action through a reinforced Stability and Growth Pact

Member States must avoid excessive public deficits (beyond 3% of GDP) and excessive debt (beyond 60% of GDP), so as not to put fiscal sustainability at risk. These rules are enshrined in the Treaties and detailed in the Stability and Growth Pact.

This is achieved both through surveillance of national budgets and surveillance and coordination of economic policies (based on Article 121 of the Treaty). To this effect, each year Member States set out the structural reforms and other activities needed to achieve and maintain fiscal sustainability in their Stability or Convergence Programmes.

The new system for achieving this objective introduces three key changes:

- **greater transparency** – Member States should ensure that their fiscal frameworks reflect the EU budgetary framework at all administrative levels (national, regional and local). This means bringing all elements – such as national public accounting systems, statistics and forecasting practices – into line with EU standards, allowing for more clarity and peer pressure;
- **stricter rules** – Member States with unsustainable public finances will be required to make significant progress towards medium-term budgetary objectives to respect the 3% deficit criterion. Expenditure growth should be linked to the mid-term GDP growth rate, so that any extra revenue leads to increased savings rather than higher expenditure. A faster adjustment path towards the mid-term budgetary objective will be expected from countries with a debt ratio above 60%, countries with a strongly rising debt level or countries facing risks to long-term sustainability;
- **better enforcement** – failure to respect the agreed principles will make the concerned Member State liable to a warning from the Commission, even in the preventive phase. In case of a persistent and/or particularly serious failure to respect the rules, the Commission will draft a recommendation to the Member State to take corrective action. The recommendation will be adopted by the Council unless a qualified majority of Member States vote against it (the so-called reverse qualified majority voting procedure). For euro area Member States, the recommendation will be backed by an enforcement mechanism (based on Article 136 of the Treaty) in the form of an interest-bearing deposit amounting to 0.2% of GDP. This preventive arm of the Stability and Growth Pact has been further strengthened by the Euro+ Pact, with euro area and the six other Member States committed to translating EU fiscal rules as set out in the Stability and Growth Pact into national legislation through a specific national legal vehicle of their choice. This should have a sufficiently strong binding and durable nature (e.g. a constitutional or framework law).

Stronger corrective action through a reinforced Stability and Growth Pact

When Member States do not respect the thresholds laid down in the Treaty, the Excessive Deficit Procedure is triggered. However, the current fiscal situation in almost all Member States, and the sovereign debt problems in some, show that the existing Excessive Deficit Procedure was not effective. The European Commission has proposed giving teeth to the Stability and Growth Pact through better enforcement and the ability to fine Member States (as outlined above). The two key changes are:

- **stricter rules** – debt reduction will now be a criterion in the assessment of public finances. Member States with debt in excess of 60% of GDP must reduce the amount by which their debt exceeds the threshold by at least 1/20 per year over three years. If they do not, they will be placed in an Excessive Deficit Procedure. All relevant factors should be taken into account, as outlined in the European Commission proposal, when assessing the satisfactory pace of debt reduction;
- **better enforcement** – a non-interest-bearing deposit of 0.2% of GDP will be requested from a euro area Member State that is placed in an Excessive Deficit Procedure. The Commission will draft a recommendation to the Member State to take corrective action. The recommendation will be adopted by the Council unless a qualified majority of Member States vote against it (the so-called reverse qualified majority voting procedure again; see above). In case of non-compliance with the initial recommendation for corrective action, this non-interest-bearing deposit will be converted into a fine. The fine will be increased in case of repeated non-respect of the recommendations.

Reducing macro-economic and competitiveness imbalances

Over the past decade, Member States have made divergent economic choices, leading to competitiveness gaps and to major macroeconomic imbalances within the EU. A new surveillance mechanism will be set up to identify and correct such issues much earlier. It will rely on the following new elements:

- **Clear alert system** – based on a scoreboard of external and internal indicators (around ten) to detect imbalances emerging in different parts of the economy. The composition of indicators may evolve over time. Thresholds will be identified and announced. The assessment of such indicators will not be mechanical but will be done by the Commission based on in-depth reviews, Stability and Convergence Programmes and National Reform Programmes;
- **Stricter rules** – a new Excessive Imbalance Procedure will now be created, based on Article 121 of the Treaty. This mirrors the Excessive Deficit Procedure for public finances. If the European Commission considers that macroeconomic imbalances (or the risk thereof) exist, it will propose that the Council open an Excessive Imbalance Procedure and recommend that the Member State concerned adopt a corrective action plan with a clear roadmap of implementing measures and a deadline. Progress made will be reviewed on a regular basis;
- **Better enforcement** – for euro area countries, the enforcement mechanisms will include both fines (0.1% of GDP) and non-financial measures in case the imbalances are not corrected.

1.3. Economic priorities and budgetary policy priorities will be discussed on a coordinated basis at the same time every year:

The new coordination device to monitor commitments at EU level is called the European Semester. Over the first half of each year, discussions take place both on the EU's economic agenda, on the basis of the Annual Growth Survey presented by the European Commission in January (2011 is the first year this procedure is followed), and on Member States' priorities, presented in their national programmes in the spring. Country-specific recommendations are issued in June, giving time for these to be incorporated into national budgets and economic policies for the following year.

In the past, the EU Institutions looked at economic policy in the spring and fiscal frameworks in the autumn, with the implementation by Member States of commitments made at EU level only reviewed retrospectively.

Basically, decisions on economic objectives were made without necessarily knowing how much money could be mobilised. From now on, Member States and the Commission discuss structural reforms, growth-enhancing measures and fiscal surveillance at the same time. Beginning this year, these discussions will occur at EU level every year from January to June and are called the European Semester.

How does the European Semester work?

January: steer by the European Commission – the Commission will launch each cycle by presenting its Annual Growth Survey (AGS) in January, with a clear assessment of the EU economic situation and guidance for further priority actions to be delivered at both EU and national levels. The Survey will encompass three economic policy components: macro-economic and fiscal policy, structural reforms and growth-enhancing measures;

March: political endorsement by the European Council – the Spring European Council will discuss and endorse this menu for economic reform and fiscal policy in one single set of conclusions. Heads of State and Government will thus take ownership of this common economic agenda and budgetary surveillance framework, and will be committed to proper implementation in their respective countries;

April/May: presentation of national programmes – Member States will then submit to the Commission and their peers their National Reform Programmes and Stability (for euro area countries) or Convergence (for non-euro area countries) Programmes. The National Reform Programmes set out Member States' agendas for structural reform and measures to boost growth and jobs and move towards the achievement of the Europe 2020 targets. They also include the short-term commitments made under the Euro+ Pact by the countries that have signed up to it. The Stability and Convergence Programmes on the other hand set out national plans for sound and sustainable public finances. The synchronisation of the preparation of these two programmes will ensure the streamlining of processes and reflect the virtuous course and/or upturn in the development of public finances and structural reform;

June: recommendations by the European Commission – after due assessment of these national reports, the Commission will present in June draft country-specific recommendations to the EU Council, flagging the progress and shortcomings of each Member State in delivering the agreed actions. The June European Council will discuss these recommendations, and the EU Council will subsequently adopt them. Member States will take into account the guidance received from the EU Council when drawing up their budgets for the following year. Draft budgets will continue to be sent from governments to national parliaments for debate in the second half of the year, since they continue to exercise fully their right to decide on the budget. Thus, the new framework in no way represents a limit to the sovereignty of national parliaments.

	European Commission	EU Council	European Parliament	European Council	Member States
January	Annual Growth Survey (AGS) presented				
February		AGS debated ahead of European Council	AGS debated ahead of European Council		
March				Endorsement of reform priorities for EU and Member States	
April					National Reform Programmes (NRPs) and Stability / Convergence Programmes (SCPs) sent to Commission
May	Assessment of NRPs and SCPs				
June	Recommendations to Member States based on NRPs and SCPs			Debate and endorsement of recommendations to Member States	
July		Recommendations to Member States formally adopted			
Throughout the year	Peer review of Member States' compliance with recommendations including consideration of possible further enforcement measures (Excessive Deficit Procedure / Excessive Imbalance Procedure)				
Autumn	Governments present draft budgets to national parliaments for debate in line with established national practice				

2. Safeguarding the stability of the euro area

In 2010, the EU responded to the sovereign debt crisis by setting up temporary support mechanisms, which will be replaced by the permanent European Stability Mechanism (ESM) in 2013. These support measures are helping to safeguard the financial stability of the euro area. They are conditional on rigorous fiscal consolidation and reform programmes, and are developed in close cooperation with the International Monetary Fund (IMF).

The economic crisis has put great pressure on public finances, increasing levels of deficits and public debt in all Member States. Three non-euro area Member States have been granted financial assistance (through the balance of payments corrective mechanism) by the EU, IMF and World Bank, in exchange for agreeing to implement programmes of fiscal consolidation and structural reforms:

- The first was agreed with Hungary, which received disbursements of €5.5bn between October 2008 and November 2010.
- A second programme was approved for Latvia in January 2009, in exchange for assistance of up to €7.5bn.
- And a third programme was agreed with Romania for €5bn in May 2009.

The Romanian and Latvian programmes are currently ongoing.

To guarantee the stability of the euro area as a whole and assist individual Member States in financial difficulties and/or under serious market pressure, temporary mechanisms have been set up as a backstop of last resort. An agreement has also been reached on a permanent mechanism to be put in place as of 1 July 2013.

Financial assistance can be provided to a euro area Member State which requests it, subject to strong conditionality reflected in an economic adjustment programme to be negotiated by the Commission and the IMF, in liaison with the European Central Bank (ECB). With such mechanisms, the Commission has the capacity to act to defend the euro, even in the most stressed scenarios. They are a clear reflection of the common interest and solidarity within the euro area, as well as the individual responsibility of each Member State of the EU before its peers.

Mechanism of bilateral loans (for Greece)

An ad hoc mechanism was set up on 2 May 2010 to face the imminent threat of Greek insolvency. The euro area Member States agreed to provide, together with the IMF, €110bn of financial assistance to Greece in the form of bilateral loans, with specific interest rates, for a period of three years. These loans were made conditional on a strict fiscal consolidation programme, and were discussed with the Commission, the ECB and the IMF. The Commission monitors progress through quarterly missions and reports to Finance Ministers.

The agreement of 11 March 2011 aligned the maturities of both the future and already disbursed tranches of the loans to Greece with those of the loan to Ireland (seven-and-a-half years on average). Furthermore, it was decided to reduce the pricing of both the future and already disbursed tranches of the loans of the Greek facility by 100 basis points.

Due to Greece’s difficulty to meet the conditions, this situation was fundamentally changed by the Council’s decision to further loosen up the timeframe for providing financial resources to Greece, which was modified by a more radical approach, consisting in a significant write-off of a major portion of Greece’s debts, at the end of October.

Temporary mechanisms worth up to €500bn (2010-2013)

In the face of persistent pressure on the sovereign debt markets, the euro area Member States and the Commission decided on 10 May 2010 to set up two temporary financial backstop mechanisms worth up to €500bn to support any other euro area countries which could need financial support. These are the European Financial Stabilisation Mechanism (EFSM), based on guarantees from the EU budget up to €60bn, and the European Financial Stability Facility (EFSF), an inter-governmental body providing up to €440bn in guarantees from the euro area Member States. The IMF decided to complement these mechanisms with a potential financial support to euro area countries of up to €250bn.

In November 2010, Ireland requested €85bn in assistance from these newly set up mechanisms, following a sharp deterioration in its fiscal position due to extraordinary banking problems. A programme was negotiated by the Commission, the IMF and the European Central Bank. The United Kingdom, Denmark and Sweden decided to complement this assistance mechanism with bilateral loans.

In light of the Irish experience and in order to face any other request before 2013, the 24-25 March European Council further improved key elements of these temporary mechanisms. The pricing of the EFSF’s loans (and subsequently

ČESKÁ SPOŘITELNA

those of the EFSM) has been lowered to better take into account the debt sustainability of the assisted countries, while remaining above the funding costs of the facility, in line with the IMF's pricing principles.

The EFSF's scope of activities has also been made more flexible: it may, as an exception, intervene in the primary debt market (i.e. buying newly issued sovereign bonds) in the context of a programme with strict conditionality. Finally, the agreed lending capacity of the EFSF of €440bn will be made fully effective, as recommended by the Commission.

In May 2011, financial assistance of €78bn was also granted to Portugal to enable the country to deal with its financing difficulties. Two thirds of the assistance will come from EU sources: €26bn from the EFSF and €26bn from the EFSM, with the remaining €26bn provided by the IMF. The assistance will be disbursed over three years, conditional on the outcome of quarterly assessments of Portugal's implementation of the agreed programme, comprising an ambitious fiscal adjustment, a wide range of reforms to enhance growth and competitiveness and measures to reinforce the stability of the financial sector.

European Stability Mechanism (as of 1 July 2013)

In the autumn of 2010, euro area Member States decided to set up a permanent mechanism, enshrined in the Treaty, as a structural response to any future request for financial assistance beyond 2013.

The ESM will provide a permanent crisis resolution framework and will assume the role of both the EFSF and the EFSM in providing external financial assistance to euro area Member States from 1 July 2013. Access to ESM financial assistance will be provided on the basis of strict policy conditionality under a macro-economic adjustment programme and a rigorous analysis of public-debt sustainability, which will be conducted by the Commission together with the IMF and in liaison with the ECB. The beneficiary Member State will be required to put in place an appropriate form of private-sector involvement, according to the specific circumstances and in a manner fully consistent with IMF practices. Non-euro area Member States may decide to participate in operations conducted by the ESM on an ad hoc basis.

The terms of the ESM, including its governance, capital structure and repartition, location, instruments and IMF involvement, were agreed by the euro area summit on 11 March 2011 and confirmed by the European Council two weeks later. The ESM will have an effective lending capacity of €500bn (a total subscribed capital of €700bn, from which €80bn will be in the form of paid-in capital and €620bn in a combination of committed callable capital and of guarantees from euro area Member States).

The Treaty on the Functioning of the EU (Article 136) will be amended to set up the ESM. After the Commission and the European Parliament gave their positive opinions, the European Council agreed on this change in February and March 2011, paving the way for national ratifications.

3. Repairing the financial sector

The EU has established new rules and agencies to address comprehensively defined problems that may be faced by the financial sector earlier and make sure all financial players are properly regulated and supervised. Further work is carried out, including the more systematic and rigorous bank stress tests taking place regularly.

Since the outbreak of the financial crisis in 2008, EU action has focused on filling in the gaps in financial sector regulation and strengthening the supervision of this sector, with a view to improving stability, transparency and confidence.

- A new financial supervision architecture with real teeth was set up in January 2011 with a European Systemic Risk Board (ESRB) to ensure that macro-economic risks are detected sufficiently early. This is complemented by three sectoral European supervisory authorities:
  - the European Banking Authority (London),
  - the European Insurance and Occupational Pensions Authority (Frankfurt),
  - the European Securities and Markets Authority (Paris).
- Strengthened rules on capital requirements for banks, investment firms and insurance companies are being defined: a fourth revision of the Capital Requirements Directive for banks and investment firms, and a Solvency II Directive for insurance companies (this enters into force in 2013). Better risk management in financial institutions will be facilitated by existing and new rules on governing remuneration and bonuses in financial institutions and reducing incentives for short-term risk-taking. A global approach is being implemented to ensure that no financial actor, market or product escapes appropriate regulation and effective supervision. Action has already been taken to create a framework for hedge funds and private equity and some rules governing credit rating agencies. More initiatives are under negotiation or coming up in the near future, including on derivatives, short-selling, financial markets and market abuse.
- It is also essential to move away from the current state of moral hazard where banks de facto rely on governments to step in if they face serious difficulties. That is why the Commission will propose in the next few months a comprehensive framework for the resolution of failing banks – to ensure that banks can fail, in an orderly manner, and that taxpayers don't have to pay when there are difficulties.

In parallel, work is ongoing to ensure the viability of the banking sector and overcome the crisis.

- Bank stress tests are one of the supervisory tools used at EU level to detect potential weaknesses and prevent bankruptcy or system failure. The tests assess the overall resilience of the EU banking sector and individual banks' solvency in the face of hypothetical adverse events. This work is led by the European Banking Authority. The other stakeholders are the ECB, the Commission, and national supervisors, who are responsible for conducting the tests at national levels.
- Two rounds of stress tests have been conducted since 2008. The European Banking Authority started a new round of stress tests on a broad sample of EU banks in March. A rigorous peer review and quality control were carried out and the results were published in June 2011. Full transparency regarding banks' exposures must be ensured. Any banks identified as vulnerable and possibly undercapitalised under the stress test are expected to take the necessary action. Member States will release, ahead of the publication of the new stress test results, specific remedial plans for the restructuring of vulnerable institutions, including potential market-based solutions such as direct financing on the markets or asset sales, but also solid frameworks for the recapitalisation of individual institutions and the acceleration of bank restructuring where needed, within the framework of EU state aid rules. The stress scenarios, developed by the European Banking Authority in close collaboration with the ECB, the ESRB and the Commission, are rigorous and address market concerns regarding the degree of severity and the scope of the test. As to sovereign risk, shocks will be applied to exposures in banks' trading books.
- Separately, the European Banking Authority is carrying out a review of banks' funding structures and the liquidity of their portfolios.