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NOTE

from:	Council (ECOFIN)
to:	European Council
Subject:	Ecofin Report - Preparation of the European Council on the state of play on measures in the financial sector in response to the crisis

Please find enclosed the Ecofin Report on the Preparation of the European Council on the state of play on measures in the financial sector in response to the crisis, as agreed by Council (ECOFIN) on 8 June 2010.

Enclosure

Ecofin Report
Preparation of the European Council on the state of play on measures in the financial sector in response to the crisis

1. The crisis in global financial markets has been putting the stability of the European financial system to the test during the past two years and, even in more recent weeks, revealed the urgency of strengthening financial regulation and supervision as well as financial stability arrangements, of promoting a more coordinated decision making and of addressing the gaps in regulation and supervision exposed by the crisis. Work in this respect is ongoing, both at EU and international level. This report provides a state of play in respect of the main issues currently addressed in this context at EU level, including in particular the financial exit, the reform of the EU supervisory and crisis management frameworks and financial market infrastructures. Additionally, the Commission has published a Communication setting out its work programme to deliver the majority of the priority measures needed by the end of this year.

I. Financial exit

2. Unprecedented and extraordinary measures were taken by governments to support the financial sector during 2009. These measures have proven to be effective and, in the light of some concrete signs of stabilisation of the banking sector at the end of 2009, it was felt appropriate to start modelling exit strategies from the different forms of support, starting with the **phasing out from government guarantees**. The December European Council invited the Ecofin Council to continue its works and report back by June 2010.

3. In view of this reporting, the May Ecofin Council assessed the current situation based on work carried out by the Commission and ECB, which shows that the use of guarantees has considerably declined since 2009, and this as well in terms of number of issues and volume of guaranteed bank bonds as in terms of number of banks resorting to such guarantees. Evidence confirms that sound banks have largely withdrawn from the use of guarantee schemes.

4. In terms of **pricing conditions**, evidence shows that the cost of guarantee fees is in relative terms considerably below the current cost of funding via unsecured debt, in particular for banks with a lower estimated creditworthiness, which implies that the **risk of distortion of competition between banks issuing guaranteed bonds and those issuing under market conditions has increased**, especially if banks using guarantees are currently not under restructuring obligations.

5. The May Council concluded that it is appropriate under such circumstances to apply an adequate increase of the guarantee fees in order to bring funding costs closer to market conditions and urged the **application of new conditions**, as proposed by the Commission, as **from July 2010**. The Council also agreed that extended use of government guarantees should be monitored and, that banks continuing to heavily rely on government guarantees and not under restructuring obligations should be subject to a **long-term viability tes**t by the Commission.

6. The combination of both measures should incentivise banks to either gradually exit guarantee schemes or address their structural weaknesses, including by going through restructuring procedures if needed. This approach will also allow sufficient flexibility so that the risk of negative spill-over effects, the possibility of setbacks or of renewed stress in financial markets and the diversity of circumstances in individual Member States, can be duly taken into account.

II. Financial supervision

7. The crisis has revealed the shortcomings of both micro- and macro-prudential supervision in Europe. In December 2009, the Council adopted a general approach to a package of proposals for a reform of the EU framework for the supervision of banking, insurance and securities markets. Negotiations with the European Parliament are ongoing with a view to adopt the texts at first reading by mid 2010. Respecting this timing is crucial to ensure that the new EU supervisory framework is operational by 1 January 2011. This would enable a strengthened oversight of cross-border financial groups and provide an appropriate monitoring of risks to financial stability by the new European Supervisory Authorities (ESAs) and by the European Systemic Risk Board (ESRB). Once the texts are adopted, the interaction between the ESAs and ESRB and the existing EU bodies, institutions and committees should be further developed, in line with the policy coordination framework as set out in the Nyberg report, welcomed by the 18 May Ecofin Council; and, the respective regulations setting up the new authorities. From the Council perspective, in particular the efficiency of the interaction between the ESRB and Ecofin Council/Economic and Financial Committee (EFC) in dealing with ESRB assessments and recommendations will be crucial for the further strengthening of the Council's role in crisis prevention and management

III. Crisis management

8. While the Treaty sets out a clear framework for EU-level surveillance and coordination of economic policies, there is no specific mandate for the Ecofin/EFC or Commission to act in a coordinated manner in situations of financial crisis. In the absence of such a more articulated mandate to address financial crisis situations across Member States, in the first phase of the current crisis, decisions were taken at national level and without sufficient ex-ante coordination or exchange of information. In a second phase, actions were guided by an overall EU policy strategy, based on commonly agreed principles and a temporary framework for State aid measures to support access to finance in the crisis.

9. The crisis has thus underscored the urgent need for a better coordination of actions in the case of a cross-border financial crisis, taking into account the interdependence between national financial systems, and ensuring consistency of those reforms with similar measures being considered in the international context. To this end, a holistic approach needs to be pursued that covers all aspects of crisis prevention, management and resolution. Work is ongoing on the three complementary aspects of crisis management: an EU framework for policy coordination in case of crisis (including general principles for burden sharing); a common EU regulatory framework for crisis prevention, management and resolution; and mechanisms to ensure the mitigation of systemic risk and that the financial sector bears the costs associated with resolution measures.

10. Based on proposals included in the Nyberg report[1], the Council has agreed that the current **EU policy coordination framework** should be further enhanced, including as a minimum the following components:

- A strengthened role for the Council in coordinating financial stability policies in an EU-wide systemic crisis and a corresponding revision of the EFC working arrangements;
- The establishment, by mid 2011, of Cross Border Stability Groups (CBSGs) for all large EU cross-border financial groups, as defined in the 2008 MoU, while avoiding overlaps or duplication with the analogous crisis management groups set up under the aegis of the FSB.

[1] EFC AHWG report on a European Policy coordination framework for crisis prevention, management and resolution, including burden sharing arrangement, ECFIN/CEFCPE Ares (2010)190792.

- o Whilst the final responsibility for crisis management and resolution remains national and the general principles and procedures on ex-post burden sharing as included in the 2008 MoU remain fully valid, CBSGs should be provided with common tools to enable effective coordination between the national authorities involved in a crisis (in particular operational criteria for ex-post burden sharing, Recovery and Resolution Plans) and carry out crisis management simulation exercises,
- o An efficient monitoring by the EFC (peer review of the implementation) in order to scrutinise the implementation and to identify specific problems and barriers to coordinated action that may arise in handling severe stress in specific banking institutions.

11. The Commission is developing a legislative proposal for a strengthened EU **regulatory framework for crisis prevention, management and resolution**, which should be comprehensive and cover enhanced prevention measures (including enhanced supervision and a more harmonised approach to supervisory review processes), deposit, investor and policy holder protection, early intervention, resolution and liquidation and explore an EU framework for asset transfers along with the necessary safeguards (in particular in insolvency and company law and in view of ensuring financial stability in all Member States concerned). The Council welcomes the Commission's intentions to come forth with proposals for an enhanced, credible and better harmonised framework for Deposit Guarantee Schemes, Investor Compensation Schemes and similar schemes in the Insurance area as soon as possible this summer; with a Communication setting out a detailed roadmap for an enhanced regulatory framework for crisis management in October; and, with a legislative proposal for that framework in early 2011.

12. The present financial crisis has demonstrated that financial support may be needed to enable an orderly resolution of failing financial institutions. With a view to **reducing the probability of the failure of financial institutions-with systemic impact- in the future, the effect of any such failure on the financial system and the resulting cost to the taxpayer**, further work is needed, at EU and international level, including on i) strengthening the capital base of financial institutions as discussed in the Basel Committee on Banking Supervision (BCBS), ii) on improving market infrastructures, integrity and transparency, iii) on the design of the arrangements to mitigate systemic risk and iv) on ensuring that the financial sector bears an appropriate share of the total costs of any future crisis.

13. As part of an integrated set of requirements in a comprehensive crisis management framework, the introduction of a levy on financial institutions is one of the possible tools to achieve the latter objective. Coherence and consistency between these arrangements and the current prudential supervisory and regulatory reform is needed. Further progress in this area should take due account of the cumulative impact of the various regulatory measures under consideration and implementation of the reforms should be in accordance with an adequate sequencing and timing in order to avoid hampering the economic recovery. It is also important to reach a consensus at EU and, as far as possible at global, level on the main features of such a levy if we want to avoid competitive distortions[2]. To this end, in the short term a global agreement on the objectives, the scope, the size and the basis for this levy would be highly desirable.

14. At the EU level, there is broad agreement that such a levy should help meeting the cost of future crisis, while providing the right incentives for prudent risk taking; that it cannot be considered as an insurance against default; that it should at least be applied across all banks and possibly to all financial institutions; that it should be part of an enhanced resolution framework to avoid any presumption that failing institutions will receive financial support; and that decisions about the application of resolution measures and any supporting funds should be made by public authorities.

15. Efforts at the EU level should also address the need to find a common approach on how to use the proceeds (general budget vs. resolution fund) and on the pros and cons of private funds availability to manage future financial crisis, and also how the different options would be accounted for under the Stability and Growth Pact. On 26th May, the Commission adopted a Communication on bank resolution funds, with a view to including measures on such funds in the legislative proposal for a crisis management framework scheduled for early 2011, which will help in furthering the discussion in this respect at the EU-level. Additionally, acknowledging that further work will be needed in this field, the Council has invited the EFC/FSC to report back, in close cooperation with the Commission, by autumn 2010.

[2] EU common grounds, prepared in view of the upcoming G20 summit, are enclosed in annex.

IV. Market infrastructure: Credit default swaps, OTC derivatives markets and Credit Rating Agencies

Credit default swaps

16. A deep debate about the functioning of Credit default swaps (CDS) markets has arisen in the last few years, especially with regard to the role played by CDS. The debate on CDS is framed within the design of market infrastructure, as one of the main shortcomings of the CDS market is the lack of post-trade transparency. Prices and trading volumes in this type of product are neither disclosed to market participants nor to competent authorities. As a result, the ability of participants and supervisors to analyse the market is hampered, leading to an artificial increase in the uncertainty that naturally follows crises like the current one. Reliable information - periodically updated - on the volume, price, type of counterparty, type of contract, and collateral required, among others, is needed. In the European Union, the upcoming European Market Infrastructure Legislation represents one of the key elements of the framework for transparency requirements. The mandatory registering of CDS, like all OTC derivatives, in trade repositories, laid down in the European Market Infrastructures Legislation will dramatically improve transparency on this market.

17. This will ensure that competent authorities have access to that information, so that abusive conducts in the market can be identified and sanctioned.

18. Finally, taking into account that the CDS market is featured by a high level of counterparty risk, future measures could also focus on making trading on exchanges or on electronic trading platforms and clearing mechanisms for eligible CDS contracts mandatory and ensuring an adequate risk management of non-standardised contracts.

OTC derivatives markets

19. Although derivatives play a useful role in the economy by transferring (all or part of) the risks inherent to economic activity from economic agents who are not willing to bear them to those who are, they also contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants, a fact which went largely unnoticed because of the lack of market transparency, resulting chiefly from the predominant over-the-counter (OTC) market structure. The June 2009 European Council called for "further progress to be made in the regulation of financial markets, notably on transparency and stability of derivatives markets." On 25th September 2009 G-20 leaders agreed that: "All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements".

20. Considerable progress has been made by the Commission since its October 2009 Communication in respect of mandating central counterparty (CCP) clearing for eligible derivatives contracts, mandating reporting of OTC derivatives transactions to trade repositories (TRs) and establishing the requirements CCPs and TRs need to comply with to ensure their safety, soundness and efficiency. Some open issues remain in respect of the reporting obligation to TRs, the institutional arrangements between competent authorities and the location of TRs. We are looking forward to the legislative proposal the Commission will be presenting this summer, which will be addressing all these issues.

Credit rating agencies

21. Credit rating agencies (CRAs) are considered to have failed to reflect properly the risks embedded in structured products as well to reflect early enough the worsening market conditions, and therefore to have contributed significantly to the problems in financial markets. Despite their significant importance for the functioning of the financial markets, they were only to a limited extent subject to Community legislation/oversight before the financial crisis.

22. The European Councils of 20 June and 16 October 2008 called for a legislative proposal to strengthen the rules on credit rating agencies and their supervision at EU level, considering it a priority to restore confidence and proper functioning of the financial sector. In November 2008, the Commission made a legislative proposal for a Regulation focussing on the supervision, integrity, quality and transparency of the activity of CRAs, which was adopted on 16 September 2009. Both regulators and credit rating agencies are getting ready to ensure a smooth implementation of these rules within the prescribed timeframe, i.e. credit rating agencies will have to comply with the new rules by 7 September 2010.All the rules of the Regulation will be applicable as of December 2010.

23. In addition, the Commission recently presented a legislative proposal on centralised EU supervision on credit rating agencies including rules on transparency in order to increase competition and entrusting the European Securities and Markets Authority (ESMA) with exclusive supervisory powers over credit rating agencies registered in the EU.

24. Also in the US, there is currently legislation in both the House of Representatives and Senate that would further enhance regulation of CRAs and would also enhance convergence between the EU and US regulatory framework.

25. Further work would appear necessary in order to analyse the functioning of the market of credit rating agencies. This has become clear in the context of the recent tensions on sovereign debt markets. The role of the CRAs has again come under scrutiny when both the Heads of State and Government of the Euro Area of 7 May and the Ecofin of 9 May mentioned increasing transparency and supervision in dealing with the role of rating agencies as a key priorities for the EU. The Commission is further examining the rules on transparency and conflicts of interest (including the "issuers-pay" model) taking account of the specificities of sovereign debt markets; those rules will if necessary be further enhanced and modified, taking into account the effects of the Regulation on credit rating agencies once it will have started applying. Excessive reliance on credit ratings, namely embedded in European legislation, also needs to be addressed as a matter of urgency.

V. Other financial regulatory measures

Improvement of prudential regulation of financial institutions

26. The reform of the European financial supervisory architecture is not enough even if, with the creation of a new supervisory architecture in Europe, the prudential framework will be reinforced. The financial crisis has shown that the legal prudential framework must increase, on the one hand, the quality of financial regulation and hence its capability of preventing financial crises and to reduce, on the other hand, the undesired procyclical effects it provokes as it is designed now. In fact, the Basel Committee on Banking Supervision has been working thoroughly on the reform of the Basel II framework. The Commission has collected most of its ideas and has turned them into a number of proposals to reform the Capital Requirements Directive (CRD).

27. More concretely, the whole package of CRD improves the assessment of risk exposures, increases the quality of regulatory capital, implements supplementary measures to complement capital requirements, reduces the pro-cyclicality of Basel II framework and aligns remuneration policies to long term profitability to reduce incentives to assume excessive risks.

28. The process of reforming the CRD started with CRD-II, which entered into force on December 2009 and will apply to banks from the end of 2010. It continues with CRD-III, which is currently being considered by the European Parliament and should be agreed swiftly to allow adequate time for transposition; and the future CRD-IV, which has been the subject of recent consultation by the Commission with a view to a legislative proposal by the end of 2010. Both quantitative and macroeconomic impact studies will be developed at European level to ensure that the overall impact of these reforms is sustainable for European economies and that the specificities of the European banking sector are duly taken into account.

Extending regulation and supervision to all significant financial actors

29. Another element of the European Union's response to the financial crisis within the framework of the G20 is the extension of regulation and oversight to **all** financial actors and activities that may pose risks to the stability of the financial system, including those located in non-transparent and non-cooperative jurisdictions. Its relevance is determined by the fact that risks in one sector can be rapidly transmitted around the financial system. Articulating this principle, harmonised rules are currently being developed for alternative investment fund managers (AIFM), including the managers of hedge funds and private equity. It is expected that these rules will enter into force in 2012.

30. The aim of the proposed AIFM Directive is to improve the supervision of the alternative investment sector; to protect investors; and to develop the European Single Market. The transparency requirements are a particularly important feature of this regime. Moreover, a comprehensive and timely flow of information to competent authorities is essential for the effective performance of micro- and macro- supervision. Supervisors will be required to share this information, including with the ESRB, with a view to properly assessing the risks that may destabilise the global financial system. In addition, in order to perform effective due diligence, investors need to be properly informed about the risks associated with their investments, even if they are professional investors.

31. The future Directive will also contribute to restoring confidence in the financial system.

Conclusion:

32. The necessary reforms to restore the soundness and stability of the European financial system must be completed urgently. Progress in the next few months on the actions presented above is essential. Furthermore, the Commission's Communication "Regulating Financial Services for Sustainable Growth" of 2 June 2010 sets out the comprehensive list of initiatives that need to be undertaken and completed before the end of 2011. By taking forward this ambitious programme of reform and by setting clear and differentiated priorities, the European Council would demonstrate Europe's determination to bring about a safer, sounder, more transparent and more responsible financial system which is internationally consistent and in line with the G20 Communiqué of 5 June 2010. It would also reinforce Europe in the G20.

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EU common grounds
on levies for financial institutions
- state of play-

I. Introduction

1. The present financial crisis has demonstrated that governments may find themselves in a position in which they need to provide fiscal support to safeguard financial stability and enable an orderly resolution of financial institutions to limit the costs to society of allowing failure. Work is ongoing at international level (FSB/IMF)[3] on the design of the arrangements to mitigate systemic risk and better anticipate and defray the costs of a possible crisis. At EU-level, the Commission, on 26th May adopted a Communication dedicated to the issue of bank resolution funds.

2. Meanwhile, a number of Member States have introduced or are considering introducing levies[4] on the financial sector, either with a view to allocating the proceeds to the general budget or to a resolution fund. Coordination at EU level and, to an important extent, at global level is critical to limiting competitive distortions. Against this background, **EU common grounds** should be developed in respect of levies on the financial sector ahead of the G20 June Summit.

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[3] The IMF view as expressed in the interim report for G-20: Measures related to levies and taxes should: ensure that the financial sector meets the direct fiscal cost of any future support; make failures less likely and less damaging, most importantly by facilitating an effective resolution scheme; address any existing tax distortions at odds with financial stability concerns; be easy to implement, including in the degree of international coordination required; and, to the extent desired, require an additional fiscal contribution from the financial sector in recognition of the fact that the costs to countries of crises exceed the fiscal cost of direct support.
In their Joint paper on capital and liquidity surcharges and financial levies and taxes, IMF-FSB-BCBS emphasize that any levy should be accompanied by the creation of an effective resolution regime; that it should ideally be designed as a risk-based charge and that an ex-ante levy would avoid survivor bias and be less procyclical than an ex-post measures;

[4] Including the bonus tax in the United Kingdom (temporary measure applying to 2009-2010 bonuses), France (temporary measures applying to 2009-2010 bonuses) and Portugal, the stability fee in Sweden, the financial crisis responsibility levy in the United States, and the recent bank levy in Germany.

3. As a starting point for such EU common grounds, there is broad agreement among Member States on the following **general principles on the way forward**:

- The financial sector should contribute to the cost of crisis, taking into account the risks of the various institutions.
- A levy should be applied to all banks, and possibly to other categories of financial institutions on the grounds that their failure would pose risks to financial stability and/or because they would profit from financial stability. A levy should not be restricted to SIFIs (whether banks or a wider category) since such a restriction could be interpreted as 'insurance' for institutions considered too-big-to-fail and therefore increase moral hazard.
- A levy should, ideally, be designed in such a way as to ensure that financial institutions internalise at least part of the risks their activities pose to the wider economy, while issues of arbitrage, impact, and level playing field on the micro and macro level should also be carefully assessed.
- A levy should be part of a credible resolution framework that allows for the orderly winding down of financial institutions.

A levy is not to be considered as an insurance scheme for bailing out failing financial institutions: there should neither be automaticity between the pay-in and pay-out nor between the existence of financial distress and pay-out, i.e. the individual contributions do not give an automatic right to pay-out.

- Moral hazard needs to be addressed if levies are raised for crisis resolution purposes, in which case it must be made perfectly clear that institutions cannot rely on these funds to bail them out but in principle rather cover the cost of measures designed to minimize the impact on economic and financial stability and ensure continuity of vital operations, without necessarily preserving the failing institution in its current form. In conjunction with such measures, culpable management should be removed, shareholders' equity should be wiped out and uninsured and unsecured creditors should bear appropriate losses.

– Whilst the financial sector should contribute to the cost of financial crisis, the cumulative effect of the envisaged measures on the functioning of the banking sector and the possible macro-economic implications, in particular on credit lending to the economy, should be taken into account. To this end, coherence and consistency between possible funding arrangements for crisis management and the current prudential reform is needed as well as an appropriate sequencing of reforms

4. Based on these principles, there is broad agreement that a first step towards a more coordinated approach at EU level would imply further specification of the base, scope and size of such a levy, while in a second step, the treatment of and then trigger for the disbursement of the proceeds should be further analysed.

II. The pay-in side and the calibration of the levy

5. The levy should be seen as a **useful tool available in combination with a wider set of instruments** currently under development - notably improved quality and quantity of capital (including possible rules on contingent convertible capital), countercyclical capital buffers, possible capital surcharges for certain institutions, quantitative standards for bank liquidity, discouraging excessive leverage, recovery and resolution plans and resolution regimes (which might include an accompanying power to require debt to equity conversions or otherwise write down unsecured debt).

6. As regards addressing (systemic) risk, a levy may share a common rationale with other proposed tools -such as a capital surcharge and regulatory requirements for increased use of contingent convertible capital- namely, to discourage activities that pose systemic risks and impose costs that offset the 'negative externalities' of those risks. Both levies and supplementary capital requirements (including surcharges and contingent convertible capital) have the effects of creating additional buffers of resources. However, an important difference between these policy instruments relates to the **location of the buffer** they create. For surcharges and contingent convertible capital the buffer remains on the balance sheet thus directly increasing, on the one hand, banks' resilience and, on the other hand, leveraging capacity (to the extent that is not controlled). In the case of levies, the buffer is located outside the bank's balance sheet -either in crisis management or resolution funds or government budget- and, therefore improving risk sharing among institutions, between institutions and taxpayers as well as across time.

7. The levy is **determined by two distinct elements**, namely its **rate** and the **base** on which this rate is applied. The choice of a rate and of a base crucially **depends on the objective(s) pursued by the mechanism. The higher the number of objectives** to be pursued with a single instrument, the more complicated such a measure would have to be. Although ideally both the preventative role (lowering the probability of a crisis occurring / addressing systemic externalities) and the resolution role of the levy should ideally be taken into account when defining the basis for the levy, there is broad convergence of views that the primary objective to be pursued with the levy should be to make the industry contribute to the cost of crises. This pleads for **simplicity in the design of the levy**, at least as a starting point. It does not, however, exclude that the levy would also contribute to preventing risk-taking.

The rate

8. The **rate of the levy** can either be **standard and identical for every institution or can be calibrated to the specific circumstances of each institution**. The advantage of a uniform rate (including a very simple progressive rate) is that it is easier to apply. However it will not serve specifically the purpose of preventing risk-taking. A calibrated rate, on the other hand, would allow authorities to discourage certain types of behaviour and better reflect the risks posed by the institution concerned.

The base

9. The **base of the levy** could alternatively cover its (risk weighted) assets, its liabilities, or other elements such as its size, its profits or even off-balance sheet items. Based on a preliminary assessment of the different approaches, most members considered that a **levy** should primarily be **calculated on the basis of the liabilities**, including some off-balance sheet items consistent with the forthcoming BCBS guidelines on the leverage ratio, whilst excluding capital (to encourage capital accumulation) and insured liabilities. Liabilities' duration might also be taken into account as a proxy for greater stability on the liability side. Some members considered that the use of risk weighted assets of an institution as a base for calculating the levy should also be considered as it would provide a more risk-sensitive approach. Considering, however, that the envisaged prudential measures will be addressing the asset side, this could lead to double taxation. A more in depth analysis of the pros and cons of different approaches is needed before drawing any final conclusion.

10. It is crucial to agree on an as **harmonised** a **base** as possible to avoid arbitrage or distortion of competition within the Internal Market. There is broad agreement that the levy should as closely as possible relate to the potential costs linked with bank failures and that it should be applied to all banks[5]. Further consideration is needed as to whether a levy should also apply to other financial institutions that pose a risk to stability or benefit from enhanced financial stability. A wider base would reduce incentives to move activities to other financial sectors that fall outside the scope of the levy (although the risk of this would depend on the size of the levy and other regulatory factors).

11. Given the complexity of the issue, **if there is the political will to introduce a levy very rapidly**, the base and the rate should be determined in a way that it is easy to apply. The easier choice, then, might be to **opt initially for a standard rate** (or a very simple progressive one) to be applied on a **large set of liabilities** (excluding the capital and insured liabilities). This approach would not exclude the possibility – at a later stage - to introduce an element of progressiveness in terms of risk within the scheme.

Appropriate sequencing of reforms

12. Finally, **a gradual phasing in of such a levy** would allow for refining the approach over time so as to better take account of future regulatory developments in the prudential field that try to address the same set of issues. For instance, the interaction of the levy with the proposed binding standards needs to be taken into account. Similarly, the combined impact of the levy and of new regulatory developments on the overall cost of financing with certain instruments, such as e.g. contingent convertible capital or subordinated debt, may require future refinements of the approach. A levy could initially be charged at a very low level, and the level of ambition may then be raised- e.g. by taking into account the riskiness of the different types of funding/business models- once the new regulation becomes clearer, i.e. once the impact assessments currently ongoing at Basel and the Commission are completed, and the resolution framework develops.

[5] The basis for the levy should be defined in a way to avoid relocation of activities within the group or to come to home state taxation.

III. The pay-out side and the appropriation of the levy

13. Opinions in respect of how to allocate the proceeds of such a levy at present vary within the EU as well as at global level, and are mainly based on a number of country specific elements, including whether public funds have been used in the current crisis or not, existing national arrangements -for instance in respect to Deposit Guarantee Schemes- and national legislation. A number of preferred options have been advanced in this context, including absorption into the general budget, earmarking of proceeds within the budget, the establishment of (a) resolution fund(s)[6] or some type of resolution fund / deposit guarantee scheme joint approach.

14. Whatever the option retained in this respect, lack of sufficient harmonisation in the pay-out stage would be a serious cause of concern, as it may raise additional difficulties to the coordination of cross-border crisis management decisions. Further reflection will therefore be needed on a number of issues, including on:

- Which resolution measures would be expected to be covered by a potential pay-out (financing of a bridge bank, a partial or total transfer of assets and/or liabilities, a good bank/bad bank split, administrative costs, legal and advisory fees and recapitalisation).
- How triggers for pay-out could be defined in a harmonised way at EU/international level and be designed in order to avoid moral hazard while the final decision on pay out has to be taken on national level.
- Whether there is scope for convergence (in terms of features as well as governance) with the existing Deposit Guarantee Schemes.

15. Further work is needed on these issues both at G20-level and at EU-level (where further clarifications are expected in the forthcoming Communication on crisis management due in October), in view of preparing more concrete proposals for the autumn G20 meetings

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[6] It may also be important to clarify the concept/the understanding of a fund. Collecting levies that are dedicated for the specific purpose of resolving distressed institutions does not necessarily imply the build up of a tangible fund or reserve, where funds are invested in securities and kept separate from the government budget. It may instead be seen as a “synthetic” fund where the proceeds goes in to the general budget but kept as a liability on (or off) the government balance sheet.