

## **THE FEDERAL AGENCY FOR FINANCIAL MARKET STABILISATION IN GERMANY: FROM RESCUING TO RESTRUCTURING**

by

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### Abstract

One important element of the response to the crisis in Germany was the establishment of a new institution, the Bundesanstalt für Finanzmarktstabilisierung (Federal Agency for Financial Market Stabilisation, henceforth FMSA). The aim was to supplement the range of tasks performed by the Deutsche Bundesbank and the Bundesanstalt für Finanzdienstleistungsaufsicht (the Federal Financial Supervisory Authority). Neither one of these two institutions nor the legal framework, including especially the insolvency laws, were adequate for rescuing and restructuring stressed banks. While the FMSA was initially conceived as a temporary undertaking, the new German Restructuring Act implies that the FMSA is now a permanent part of the German banking landscape.

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### OECD work on financial-sector guarantees

OECD work on financial-sector guarantees has intensified since the 2008 global financial crisis as most policy responses for achieving and maintaining financial stability have consisted of providing new or extended guarantees for the liabilities of financial institutions. But even before this, guarantees were becoming an instrument of first choice to address a number of financial policy objectives, such as protecting consumers and investors and achieving better credit allocations.

A number of reports have been prepared that analyse financial-sector guarantees in light of ongoing market developments, incoming data, and discussions within the OECD Committee on Financial Markets. The reports show how the perception of the costs and benefits of financial-sector guarantees has been evolving in reaction to financial market developments, including the outlook for financial stability. The reports are available at [www.oecd.org/daf/fin](http://www.oecd.org/daf/fin):

- Financial safety net interactions;
- Deposit insurance;
- Funding systemic crisis resolution;
- Government-guaranteed bank bonds;
- Guarantees to protect consumers and financial stability.

As part of that work, the Symposium on “Financial crisis management and the use of government guarantees”, held at the OECD in Paris on 3 and 4 October 2011, focused on bank failure resolution and crisis management -- in particular, the use of guarantees and the interconnections between banking and sovereign debt. Conclusions from the Symposium are included at the end of this paper. This paper is one of nine prepared for presentation at this Symposium, comprising:

- Managing crises without guarantees?
- Costs and benefits of bank bond guarantees;
- Sovereign and banking debt interconnections through guarantees;
- Impact of banking crises on public finances;
- Fault lines in cross-border banking: Lessons from Iceland;
- The macro-prudential authority: powers, scope and accountability;
- Effective practices in crisis management;
- The Federal Agency for Financial Market Stabilisation in Germany;
- The new EU architecture to avert a sovereign debt crisis.

## 1 Introduction

The financial market crisis has been worsening steadily since summer 2007. Distressed banks, rattled investors, the real economy's need for fresh capital and central banks' attempts to address the most severe needs have led to a bundle of problems, and the situation seemed more or less out of control. All developed economies have been affected, although to varying degrees. The effects of the fall of the US investment bank Lehman Brothers were dramatic for Germany. The order of the day was to act as fast as possible because the survival of the German banking sector was at stake.

A key element of the response to the crisis in Germany was to establish a new institution. The aim was to supplement the range of tasks already performed by the Deutsche Bundesbank and the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the Federal Financial Supervisory Authority. Neither bank-supervision instruments nor German insolvency laws were adequate for rescuing German banks that had gotten into difficulty. It was up to the government: it set up the Bundesanstalt für Finanzmarktstabilisierung (FMSA). The FMSA was initially to be of limited duration.

## 2 Rescue phase: post-Lehman Brothers to the end of 2010

There were several options for reacting to the type of crisis experienced recently. Paying due consideration to free market economics, one option would have been to let individual banks go out of business through an orderly process provided by the State. One could have commenced insolvency proceedings for the stressed banks. Otherwise than is commonly assumed, German insolvency proceedings do not necessarily lead to liquidation. There can indeed be a restructuring on the basis of an insolvency plan with the participation of creditors and shareholders. But this is a long drawn-out process, and whether it will succeed or not is very difficult or impossible to forecast. But in that phase of the crisis, decisions had to meet two preconditions: they had to be fast, and they had to be sustainable. Hence, aspects of timing and confidence played an overriding role when it came to coping with the financial crisis. The legal framework available in Germany at that time was inadequate, however. The German banks that had gotten into difficulty were themselves not in a position to generate the necessary funds.

### *The foundation of the FMSA*

In the third quarter of 2008, the financial crisis peaked with the insolvency of Lehman Brothers. The ensuing loss of confidence in the interbank market and the consequent liquidity and capital problems for banks were the reasons why the FMSA was established on 17 October 2008. Within a week, the German lower house of parliament, the Bundestag, passed the FMStFG, the Act on the Establishment of a Financial Market Stabilisation Fund, which was ratified by the upper house, the Bundesrat. The declared aim was to stabilise the German financial market. Banks that had gotten into difficulty due to the crisis were to be rescued quickly, and banks in an apparently hopeless situation were to be provided with the necessary "help to help themselves"; that is, those banks that the crisis had taken out of the market were to be reintegrated into German banking. The aim was to avoid incalculable consequences for the German banking system and to quickly regain market confidence.

The FMSA and the Financial Market Stabilisation Fund (henceforth referred to as SoFFin) were set up temporarily with that aim in mind. According to the Act on the Establishment of a Financial Market Stabilisation Fund, SoFFin could undertake measures only as requested by the intended recipient of those measures. Hence, as regards the applicant, the recourse to SoFFin measures was on a voluntary basis.

### *SoFFin instruments*

The Act provided for the granting of three support measures for banks:

1. Guarantees: the fund was able to guarantee up to € 400 billion to secure bank refinancing and hence overcome short-term liquidity bottlenecks.
2. Recapitalisation: measures to strengthen the capital base in the form of equity or silent participation. Funds of € 80 billion were available for that.
3. Assumption of risk positions: basically the fund was able to take on, or otherwise secure, limited amounts of banks' risk positions (claims and securities). Only one recipient had recourse to this instrument in 2009 (for some months), until the positions were transferred to a winding-up or resolution agency.

A further aspect of the German rescue package was the Supplementary Act to Stabilise the Financial Market, FMStErgG, of 7 April 2009. It enabled the FMSA in particular to take over banks more easily, *i.e.* expropriation for compensation. This Act originated in the context of the particularly difficult situation characterising Hypo Real Estate Holding AG, a real estate financing company.

In the course of the financial crisis, the FMStFG was supplemented with what was referred to as “bad bank legislation”. The resolution agency model allowed the applicants to move risk positions and business lines that were not part of their core business to an agency set up by SoFFin. The aim of that transfer was to free up capital so as to promote lending to the real economy. At the same time, by using the resolution agency, the bank was enabled to take on a new orientation for the future in the shape of a promising business model.

The FMSA set up two resolution agencies; it supervises both of them under the law. The conditions under which the loss-settlement obligations kick in are governed by the statutes of each respective agency. Basically, the obligation to settle losses and to provide fresh liquidity is incumbent upon the “former owners”, those with a stake in the transferring bank at the time of transfer. The resolution agencies are dissolved after all transferred risk positions and business lines have been wound up.

SoFFin was also able to grant guarantees to special-purpose vehicles, to which a recipient of SoFFin measures could have transferred structured securities in advance. But in practice, that instrument was not used.

The maximum amount of guarantees -- up to € 400 billion -- was not fully drawn down, with the draw-down in peak periods amounting to € 168 billion (42 %), and as of October 2011 to € 28 billion (7%). The guarantees will expire by the start of 2015, at the latest. Much of the assistance made available has never been called on, or is no longer needed. Generally speaking, the taxpayer incurs costs not by the granting of a guarantee but only if the issue suffers a default. In case of such a default, SoFFin would have recourse to the bank's assets. So far, no guarantees have been triggered, and the FSMA is currently assuming that none of the outstanding guarantees are going to be triggered.

In terms of the capital assistance, up to a maximum of € 80 billion, an amount equivalent to about € 30 billion was drawn, of which approximately € 20 billion is currently still outstanding. At a maximum level of 8% of the equity capital of German banks (about € 380 billion as of 12/2008), the capitalisation made available has saved the German banking system from a scenario such as that of Lehman Brothers.

The fees and interest that SoFFin received by the end of 2010 for the guarantees granted were above expenditure. The FMSA had to make valuation adjustments to the participations in 2009 and 2010, leading to loss carryforwards of currently approximately € 8 billion. This equals about 2% of the equity of the

German banking system as of the end of 2008. Given the current situation of the financial markets, the losses carried forward will likely be higher in the annual financial statement for this year. The valuation adjustments/provisions for onerous contracts result from lower receipts expected in the future, and hence do not constitute realised losses for the taxpayer. The exact result as well as the time when SoFFin will present its closing statement (after repayment of all instruments) are still unknown and depend heavily on trends in the capital markets and among banks.

Since January 1, 2011, by law SoFFin has not granted any new stabilisation benefits to credit institutions. However, it continues to discharge responsibilities based on the existing stabilisation measures -- for example, controlling the conditionality of the measures. In addition, under the law, it continues to supervise the resolution agencies. Also, SoFFin may build up beyond 2010 the equity participations it had acquired, with the aim of providing security. By law, it may also replenish the existing resolution agencies and grant them guarantees.

### *FMSA successes*

Looking back, we can see that German banks were rescued successfully. The lines provided by the Federal government did not have to be drawn down entirely, and the banks have been able to repay a high amount of the assistance already. By international comparison, the costs for the stabilisation measures are fairly moderate from a current viewpoint.

A run on deposits by small investors typical for bank crises has been avoided, and the provision of funding to the economy assured. The Deutsche Bundesbank and the European Central Bank have confirmed that there has been no credit squeeze in Germany, and hence no restrictions on the availability of finance. Insurance corporations and the fund industry have been profiting indirectly from the FMSA and its work. The various policy actions taken largely prevented the financial crisis from infecting the real economy in Germany. The problems of the banking sector have not prevented the German economy from recovering.

However, the successful recent stabilisation has not contributed to the necessary adjustment process in the German banking sector. Individual rescue measures stabilise a given bank but weaken the system over the longer term. The crisis has not led to a healthy shakeout because the policy measures have taken a lot of pressure off the banks, as far as restructuring is concerned. In addition, the stabilisation measures were based on the heroic assumption that all the banks had gotten into trouble only because of the crisis. But there has been, and still is, a doubtless long-term need to restructure German banks, irrespective of the financial crisis, as German banks have always suffered from really weak capitalisation and low profitability.

### **3 Restructuring phase: rollout of the Restructuring Act in January 2011**

When the Restructuring Act was passed at the beginning of 2011, it marked a turning point in the conception of the FMSA. From this time on, the focus was to be not only on the short-term rescue and stabilisation of banks; the idea of helping only because of the crisis lost importance. Instead, the aim has become to create the necessary balance between short-term restructuring and the overdue restructuring of the German banking sector, by providing an institutionalised legal framework for winding up banks that are too big to fail. The purpose of the framework is to prevent a bank that is too big to fail from sucking the German banking market into a downward spiral, making a financial crisis even worse. In the event that support measures are necessary, the required funds ought to be provided by the banks themselves and not the taxpayer.

When the Restructuring Act was passed, the FMSA became a permanent element of the architecture of the German financial system.

### ***Instruments of the Restructuring Act***

The German Banking Act, Kreditwesengesetz (KWG), has been amended as a result of the Restructuring Act. The KWG now authorises BaFin to order the transfer of assets relevant to system survival to a new legal entity, if a threatened bank endangers the stability of the system. But assets remaining at the transferring bank, and not classified as relevant to the system as a whole, are normally to be dealt with as part of an orderly wind-up.

The Restructuring Act's toolbox contains the following measures:

1. Restructuring and reorganisation procedures for banks that adopt the insolvency plan process, with the procedures beginning upon application by the banks. This involves a two-stage procedure to support banks that are restructuring on their own account, ahead of any insolvency.
2. Extended instruments for the bank regulator: right to appoint a special commissioner; obligation to submit restructuring plans; and the option to order transfer.
3. Introduction of a bank levy to finance the measures.

When a bank applies to undergo a restructuring process, this does not mean a legal intervention into the rights of shareholders and creditors. The workout plan, its implementation and the appointment of a restructuring consultant are aimed at helping to restructure the bank. The shareholders and creditors can decide on a reorganisation plan, if the reorganisation process would involve more far-reaching interventions. Both of these procedures involve BaFin, but in either case, it is necessary for a bank to apply for them.

The above situation does not describe the stage that involves the most far-reaching intervention: the transfer order. This is decreed officially by BaFin, even against the wishes of the shareholders and creditors. The prerequisite for a transfer order is that the bank's continued existence be threatened, which in turn would endanger the stability of the financial system. Under a transfer order, BaFin is entitled to transfer bank assets that are systemically relevant to a private buyer, or to a bridge bank founded by the Restructuring Fund. Insolvency proceedings are commenced for the remaining parts of the distressed bank that are not systemically relevant. At the end of those proceedings, the distressed bank is either restructured or liquidated. The creditors of the distressed bank are paid off *pro rata*. The law foresees that the financial status of creditors, after the transfer order and wind-up of the distressed bank, should not be worse than without the transfer order.

So as to strengthen market discipline, BaFin decides only at the time of the transfer order which of the assets, liabilities and legal relationships are to be transferred to the bridge bank. Hence, in advance of that transfer order, there is no certainty about which claims or liabilities will remain at the distressed bank and which will get transferred to the bridge bank. This new set of instruments has not had to be used so far. As a purely precautionary measure, the Restructuring Fund has set up three bridge banks without specific purposes. This measure is precautionary; it allows one to be prepared for cases where a transfer order would have to be conducted under extreme time pressure.

The Restructuring Fund is intended to create a solid financial foundation for the orderly wind-up of a bank. The Restructuring Fund aims to protect systemically relevant assets, liabilities and contracts using the measures adopted vis-a-vis the legal entity accepting those assets. Financial means from this fund are available for payments under a transfer order, and especially for the granting of guarantees and providing

recapitalisation funds in the case of a bridge bank. But unlike under the FMStFG, the provision of support to applicant banks is no longer possible.

FMSA manages the fund, and its funds are not unlimited. The law provides for financing through the bank levy, € 100 billion worth of guarantee authorisation, and € 20 billion worth of borrowing for recapitalisation.

Basically, the public sector is to be exempted from paying for bank rescue. This goal is to be achieved through the annual bank levy. The levy is raised, collected and managed by the Restructuring Fund, and banks are required to pay the levy. All banks that have a bank license under the German Banking Act and are subject to reporting requirements are required to pay the levy, except for so-called promotional banks -- that is, the German public banks set up to promote investment activity by granting loans at preferential rates. The bank levy is geared to the size of the bank, and the degree to which it is tied into the financial system. Banks that present less of a threat to the system carry lower charges than systemically relevant banks. In any case, the banks will be bearing the cost of restructuring measures in the future, and the taxpayer is thus relieved of that cost.

The target funding of the Restructuring Fund is € 70 billion, to be achieved by accumulating funds over time. If the funds required during a crisis exceed the financial means accrued under the banking levy, the Federal Republic of Germany will lend the difference, and then recover it subsequently from the Restructuring Fund over time, through the annual levy and a separate contribution rate. This structure ensures that the Fund can go into action as soon as possible, and that it does not depend on how fast financial means actually accrue in the Fund.

Under the Restructuring Act, the FMSA is no longer the saviour of failed banks but the fiduciary of healthy ones. This situation enhances market discipline and increases the pressure on German banks to restructure themselves.

#### **4 Requirements of the European Commission**

The granting of assistance by SoFFin was predicated on meeting various requirements under the law and ordinances, such as a sustainable business model for the core bank or adherence to remuneration standards. Under EU-State aid legislation alone, the banks are to repay the measures undertaken on their behalf at market rates. Further, those drawing on the measures had recourse to recapitalisation or resolution agencies. When accessing these, they had to make wide-ranging adjustments and changes to their business models. The Federal Government has made a commitment to the European Commission to avoid competitive distortions.

At the same time, the European Commission has emphasised the participation of owners and creditors in the costs of the restructuring measures and would like to secure this participation by means of a directive.

#### ***Excursus***

Crises are inherent in market economies as a necessary corrective to events having taken a wrong turn. Corrective measures should be implemented not only by regulators but also by those bearing responsibility in the finance industry. Attempts to regulate can contribute to stabilising financial markets, but regulatory attempts can never replace confidence in responsible practises by market participants. Achieving that confidence requires a change in the attitude of decision-makers in banking, as well as the set of values underlying observed practises. When all is said and done, laws and ordinances cannot replace what a vocational code of conduct must provide. The banking sector must recognise that the discretion that

free markets allow also generates corresponding responsibilities. Only if this connection is fully understood by market participants can the current crisis serve as a genuine turning point for the better.

## **5 Summary and outlook**

Prior to the Lehman crisis, there had not been any concerted State assistance in Germany, but only one-off bank rescues. When Lehman Brothers became insolvent in 2008, the FMSA was established temporarily as a government lifeline to help banks that had become distressed owing to the crisis. Thanks to its cooperation with the Bundesbank, BaFin, the Federal Finance Ministry and the European Commission, the FMSA succeeded in rescuing German banks: no German bank had to be wound up, and Lehman Mark Two was avoided. This has buttressed system stability over the short term. Whereas a one-off rescue of a distressed bank does strengthen it, that rescue saps the overall banking system in the long term. The reason is that the government's measures take a lot of pressure off the banks as far as restructuring is concerned. In addition, it is a big assumption to say that all the banks were debt-free and had gotten into trouble only because of the crisis.

Since the end of 2010, SoFFin is no longer been in a legal position to grant new stabilisation measures. Since that time, Germany has passed a Restructuring Act and hence an institutionalised legal framework for winding up banks too big to fail. That means that the task of FSMA is no longer a temporary one. It is now a permanent pillar of the German banking system and is required to rescue only the systemically relevant parts of a bank, the failure of which would endanger financial system stability. The other operations are wound up. In the future, the banks will be bearing the cost of that restructuring themselves, by paying a bank levy into the Restructuring Fund. In the future, this fund will relieve the taxpayer. Stringent restructuring sacrifices a given bank, while underpinning the banking system over the long term. Propping up unsustainable business models is unjustified. The Restructuring Act thus ensures an appropriate balance between rescue, on the one hand, and overdue restructuring on the other.

When a shock occurs, assistance to the banking system is helpful. Such assistance achieves short-term bank stabilisation and quickly restores confidence in the entire system; the banks concerned are to be restructured by other means. Owing to the current situation in the financial markets, the politicians have already indicated that, if needed, they would be prepared to implement corresponding measures.



## **Symposium on “Financial crisis management and the use of government guarantees”\***

**(OECD, Paris, 3 and 4 October 2011)**

### ***Background***

Almost three years after what many observers had considered the peak of this global financial crisis, we are still waiting for normalcy to prevail. Instead, tensions in funding markets have risen very significantly in recent weeks mainly as a consequence of the sovereign debt crisis in Europe. Currently, we find ourselves once again contemplating guarantees, with some observers calling for the creation of explicit government-supported arrangements for guaranteeing bank debt, such as those temporarily put in place by many governments in 2008/09. In this context, the Symposium on “Financial crisis management and the use of government guarantees” held on 3 and 4 October 2011 turned out to be very topical, certainly more topical than policy makers would have wished.

The Symposium was characterized by an open and frank dialogue between policy makers, policy consultants and other academics on the policy response to the financial crisis, the use of guarantees, failure resolution, banking and sovereign debt interconnections, as well as other financial safety net aspects. The mix of participants from academia and the public and private sector, and both from the economic and the legal profession helped participants appreciate some of the institutional details that get lost in much of the public debate on the topic. Numerous policy suggestions were made as to how to improve the use of government-supported guarantees and the design of the financial safety net, so as to improve existing mechanisms to avert future crises or check them at an early stage. One key message was that guarantees can be a powerful policy tool, but that they need to be employed with limits and priced appropriately.

### ***Costs and benefits of the use of guarantees***

The use of guarantees, where they worked well and where they precipitated other problems, were issues that came up throughout the Symposium. Together with measures to enhance liquidity and capital of financial institutions, sovereigns effectively provided the function of the guarantor of last resort for financial claims in response to the global banking crisis. Despite the rather ad hoc nature of some policy measures, the policy response helped avoid the worst outcome, which could have been a series of failures of systemically important financial institutions, with dire consequences for real activity. Despite their associated problems, guarantees have been an important element in preserving liquidity and restoring market functionality, and it would be difficult to manage financial crises without them. Moreover, other forms of intervention are likely to be more intrusive.

Nonetheless, guarantees were not without cost. Further to administrative costs, they created significant contingent potential liabilities for sovereigns, which was compounded by a failure to charge fees commensurate with the risk which created additional costs. The costs of such underpriced insurance included potential distortions to competition and incentives, which give rise to moral hazard and the potential for additional problems down the road.

### ***Pricing government guarantees***

In principle, pricing structures should be designed in such a way that the premiums paid by beneficiaries of guarantees reflect the costs that they would have incurred if markets had functioned properly. As it turns out, however, pricing was not always appropriate. For example, the case of Ireland has highlighted the risk of underestimating losses from already existing claims, but where the ultimate extent of losses arising from those claims is uncertain. Guarantees have also been introduced for new liabilities, such as bank bonds, in many OECD in an effort to help banks regain access to markets. This effort was generally considered a success. However, fees typically were set as a function of the characteristics of the issue or the issuer and, in practice, were on average broadly flat across countries. In Europe, an effort was undertaken to harmonise fee structures across borders, making them a close function of a measure of the history of credit default swap spreads for the issuer, with the explicit aim being to avoid competitive distortions between banks.

Unfortunately, the costs for banks of issuing such government-guaranteed bonds turned out to be significantly affected by the identity of the guarantor. This is not so surprising, as theory suggests that the market value of a sovereign guarantee is not only a positive function of the weakness of the borrower but also a positive function of the creditworthiness of the sovereign. Thus, to avoid competitive distortions, the strength of the sovereign should be taken into account in the pricing of government-provided guarantees.

### *Crisis management experiences and changes in the financial safety net*

The costs and benefits of guarantees have to be weighed against the alternatives. In Iceland, for example, an all-encompassing guarantee would not have been credible. The more limited guarantee announced together with the resolution approach adopted implied that shareholders were wiped out and that unsecured non-priority creditors bore losses. The link between banks and sovereign was severed. Whether that approach was available elsewhere is questionable. In fact, extensive guarantees were in many cases introduced precisely because alternative tools for resolving severe problems were either not available or not trusted to work smoothly enough to avoid a systemic fallout. In particular, effective failure resolution mechanisms for some types of troubled financial institutions tended to be absent.

In the meantime, special legislation for dealing with stressed financial institutions has been introduced in many countries, which has successfully addressed some issues. For example, new institutions and legal frameworks have been introduced that facilitate the restructuring of stressed banks and the rescue of systemically relevant parts of banks. Other issues prevail, however, including the issue of how to resolve stressed large financial institutions in a cross-border context. For example, further reforms are needed for cross-border banking activities in the European Single Market, where the issue is to match the European passport for banks with a pan-European safety net including deposit insurance and supervision.

While use of guarantees was a central theme, the Symposium also analyzed other aspects of the design of safety nets. There is a need for policymakers to elaborate on the specific roles of the various safety net participants and stakeholders so as to better understand how the financial safety net should work during times of crisis. Moreover, the traditional three-tier safety net, consisting of a lender of last resort, bank deposit insurance, and a (micro-prudential) regulator-supervisor was considered incomplete, which led to calls for the creation of additional players or functions, including:

- a macro-prudential authority, with the power to alter the composition of central bank assets, to adjust capital adequacy and liquidity ratios, and to propose fiscal and structural changes affecting financial intermediaries.
- an institutionalized tiered systemic crisis insurance function, inspired by mechanisms developed for funding resolution of natural or man-made catastrophes. To limit moral hazard, a layered approach with self-insurance as the first layer, private insurance and reinsurance as another layer and the government as a reinsurer of last resort was suggested.
- a bank failure resolution fund, which would be separate from the general government budget and funded through ex ante contributions of financial intermediaries according to their systemic importance, to finance resolution measures that require the rapid availability of funds in systemic crises.
- an institutionalized investor of last resort, which would establish ex ante conditions for providing support and establish credible bounds to the extent of support in systemic crises, thus helping to legitimize future support measures and limit associated moral hazard.

\* OECD Secretariat assessment, facilitated by the rapporteur James McCollum. The opinions expressed here do not necessarily reflect the official views of the Organisation or of the governments of its member countries. For further enquiries please contact Sebastian Schich at [Sebastian.Schich@oecd.org](mailto:Sebastian.Schich@oecd.org).