Spotlight on: “Europe : from Fragmentation to Financial Integration”

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From Fragmentation to Financial Integration in Europe

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I. ORIGINS: IMF Mandate

Surveillance Economic Policies

- Mandatory annual consultations with all member countries

Financial Stability Assessment Program

National
- Voluntary since 1999
- Mandatory for 25 systemically important countries since 2010

Supranational
- EU 2012
  - Focus on supranational institutions & reform priorities not on financial institutions
II. Contents

Overview
Securing a Safer Financial System in Europe (chapter 1)
- Summary
- Main conclusions

Part I
From Integration to Crisis Management (chapters 2-8)
- Institutional setup
- Integration before crisis
- Financial, sovereign, and macro risks
- Crisis management
- Risks and vulnerabilities
- Bank restructuring and resolution
- Fragmentation

Part II
Underpinning Financial Stability in EMU and EU (chapters 9-23)
- Banking union Set Up
- Banking union Legal Underpinnings
- SSM
- SRM
- Bank recapitalization
- Deposit Insurance
- Governance and transparency
- Bank regulation and supervision
- Stress testing
- Capital market regulation and supervision
- Insurance regulation and supervision

Part III
Beyond the Crisis (chapter 24-25)
- Structural issues for the new EU architecture
- Some wider challenges
- Macro-prudential policy and the ESRB
- Cross-border clearing and settlement
- Mortgage markets
- Resolving SIFIs
III. KEY FINDINGS

EU and euro area (EA) institutional features and the absence of an EU-wide crisis manager amplified the crisis

EU institutions lacked power/authorities

Contributed to negative sovereign-banking loops and financial fragmentation

Need for a regional approach to financial stability to safeguard the single currency area and achieve EU single market for financial services

Important steps are taken but gaps remain

EU institutions (ESRB, ESAs) face challenges
IV. STABILITY ASSESSMENT

Progress made

• Bank recapitalization
• Liquidity backstops established
• Supranational sovereign support established (EFSF/ESM)
• Roadmap to BU announced, SSM under preparations, SRM negotiations

Significant challenges remain

• Low growth, limited fiscal space, funding risks
• Vulnerability to sovereign-fiscal feedback remains
• Incomplete policies and institutions
• Fragmented financial system
V. INTEGRATION TO FRAGMENTATION

EU Bank Deleveraging

Retail Lending Conditions

Euro Area Corporate Lending Rates (percent)

Note: Unweighted average; MFI lending to corporations over €1 million, 1-5 years. Belgium and Portugal reflect rates on all maturities.
Core: Germany, France, Belgium, Netherlands.
3/ Core excludes Belgium from May 2011.

BIS consolidated banking statistics, immediate risk basis
Note: Ireland and Finland not included due to breaks in data reporting.
VI. SOVEREIGN TO BANK TO SOVEREIGN

**Average Monthly Bank and Sovereign Stress**
(Basis points, 01/2010 to 9/2013)

**Average Monthly Change in Bank Exposures to the Domestic Sovereign**
(billions euros)

*Source: IFS*
VII. BANK BALANCE SHEETS AND REAL ECONOMY

**Impaired Loans / Gross Loans**

(100 = 2008 Q4)

Source: IMF FSI

**Euro Zone: Monthly Interest rates and Banking Stress, 2010-13 (Germany, France, Italy and Spain)**

Interest rates on new loans to NFC (in percent)

Average bank CDS spreads (bps.)
VIII. PRIORITIES TO MANAGE THE CRISIS

- Complete the repair of banks’ balance sheets
- Complete the Banking Union Swiftly
- Coordinate better
Complete the Repair of Banks’ Balance Sheets

Supervisory assessment, asset quality review, stress test

Complete regulatory reforms

Enhance disclosure
### Fast and Sustained Progress Towards the Banking Union

#### ASSIGN ADEQUATE AUTHORITY AND RESOURCES TO THE ECB
- Ability to directly supervise any bank
- High quality resources needed
- Information sharing and cooperation

#### DEFINE A SINGLE RESOLUTION MECHANISM WITH COMMON BACKSTOPS
- Needs requisite powers; e.g. Intervention and bail in
- Swift decisions and least cost resolution
- Burden sharing
- Single Resolution Fund

#### ADDRESS TRANSITION RISKS
- Seamless cooperation with national authorities is critical

#### ESM
- Governance arrangements for direct recapitalization of banks, to weaken bank/sovereign link
- Conditional on BRRD and DGS
Coordinate better

Set up closer collaboration and coordination amongst the various agencies

Set up an integrated crisis management system

Refocus the role of ESAs and ESRB to accommodate the SSM requirements
IX. NEAR TERM CHALLENGES FOR BU

Reach agreement on SRM

- Should be in place by the time the SSM is declared effective
- EC proposal goes in right direction, and negotiations ongoing
  - Mitigate legal risks
  - Need for common backstop and single resolution fund
  - Address conflicts of interest and clarify accountability
  - Ensure level playing field (ins/outs)

Complete credible comprehensive assessment

- Ambitious and appropriate timeline and methodology
- Communication essential given complexity and sequencing with EU stress test
- Clarity on backstops and recapitalization strategies (including bail-ins)
- Independent third party
ESAs

- All agencies need strong independence, resources, access to data, and escape from national bias

Restructuring policy

- EU restructuring linked to competition and state aid policy needs a formal link with financial stability objectives

SSM: Complete BU

- Establish single resolution authority and common DGS
X. STRENGTHEN FINANCIAL STABILITY ARCHITECTURE (Cont.)

Macroprudential Supervision
- ECB to take on role for banks in SSM countries
- ESRB has wider responsibilities: covers nonbanks and systems outside the SSM

Financial Market Infrastructure
- Enhance risk management by centralizing key functions
- Eurosystem infrastructure to be overseen by ECB

Structural Reforms
- Proposals to improve resolvability welcome but the benefits of ring-fencing unclear, possibly at odds with single market

Financial Stability as EU Objective
- Provide robust legal protection, and increase flexibility for future design of the architecture
XI. CHALLENGES AHEAD

*Low growth* will complicate resolution of legacy problems and completion of architecture

*Withdrawal of public sector.* Emphasis on resolvability and bail-ins may modify funding structures and business models

*Variable geometry and single market.* Two-tier institutional framework between EA and others

*Playing field.* Move away from maximum harmonization, specializations will remain
Thank You
Additional slides
STRUCTURE OF FINANCIAL SYSTEM

EU: Overview of Financial Structure in percent of GDP

Note: data are for 2010, except private credit 2008 for Bulgaria, Czech Rep., Denmark and Hungary.

EU: Share of loans booked by foreign-owned banks

Sources: ECB Consolidated EU Banking statistics.
Bail-in as an alternative to (i) bail-out and (ii) disorderly liquidation

Ensure PSI and break the negative sovereign-banking feedback loop

Should be seen as an additional resolution tool

- Crisis calls for expanding resolution powers and tools.
- General corporate insolvency proceedings inadequate in addressing TBTFs
- Should supplement, not replace, other resolution tools that allow institutions to fail orderly

Key design elements/implementation issues

- Ensure legal certainty and “order of priority’ as in liquidation
- Avoid unintended systemic consequences
- Achieve cross-border effectiveness and address group issues