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

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From Fragmentation to Financial Integration in Europe

**IMF Staff Book Launch
(December 11–17, 2013)**

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OUTLINE

- I. Origins**
- II. Book**
- III. Key Findings**
- IV. Stability Assessment**
- V. Fragmented Financial System**
- VI. Sovereign-Bank Links**
- VII. Bank Balance Sheets and Real Economy**
- VIII. Priorities to Manage the Crisis**
- IX. Near Term Challenges for the BU**
- X. Strengthen Financial Stability Architecture**
- XI. Challenges Ahead**

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)	Part I From Integration to Crisis Management (chapters 2-8)	Part II Underpinning Financial Stability in EMU and EU (chapters 9-23)	Part III Beyond the Crisis (chapter 24-25)
<ul style="list-style-type: none">▪ Summary▪ Main conclusions	<ul style="list-style-type: none">▪ Institutional setup▪ Integration before crisis▪ Financial, sovereign, and macro risks▪ Crisis management▪ Risks and vulnerabilities▪ Bank restructuring and resolution▪ Fragmentation	<ul style="list-style-type: none">▪ 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	<ul style="list-style-type: none">▪ Structural issues for the new EU architecture▪ Some wider challenges <ul style="list-style-type: none">▪ 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

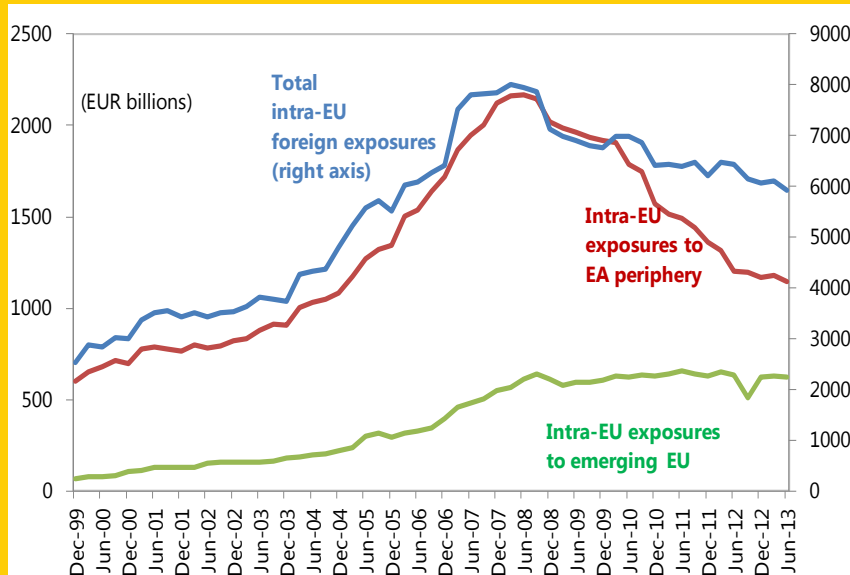
- Bank recapitalization
- Liquidity backstops established
- Supranational sovereign support established (EFSF/ESM)
- Roadmap to BU announced, SSM under preparations, SRM negotiations

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

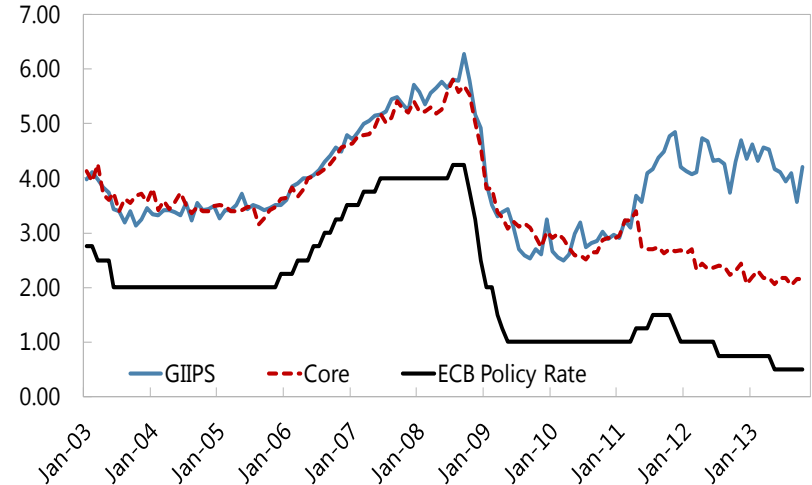


BIS consolidated banking statistics, immediate risk basis

Note: Ireland and Finland not included due to breaks in data reporting

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.

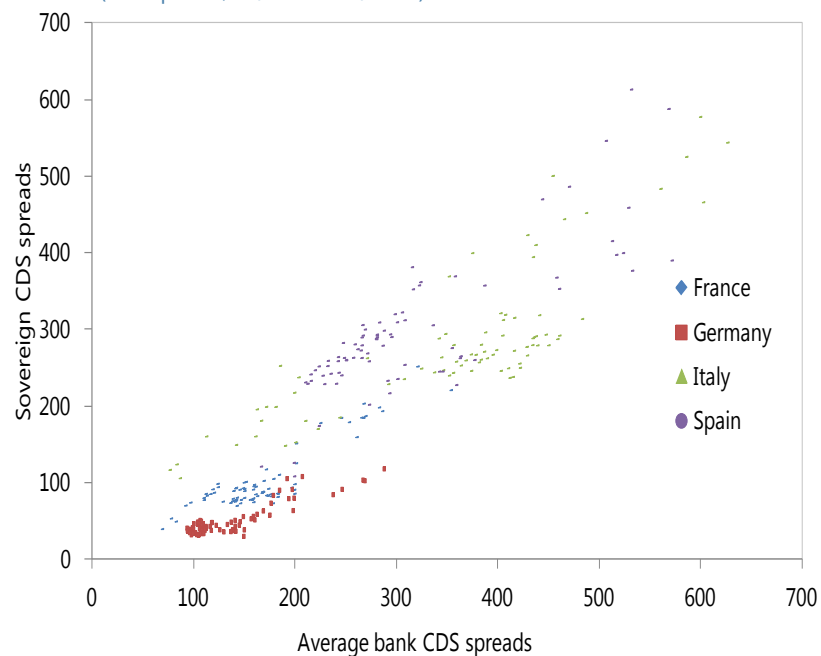
2/ GIIPS excludes Greece from October 2008, and Ireland from May 2011.

3/ Core excludes Belgium from May 2011.

VI. SOVEREIGN TO BANK TO SOVEREIGN

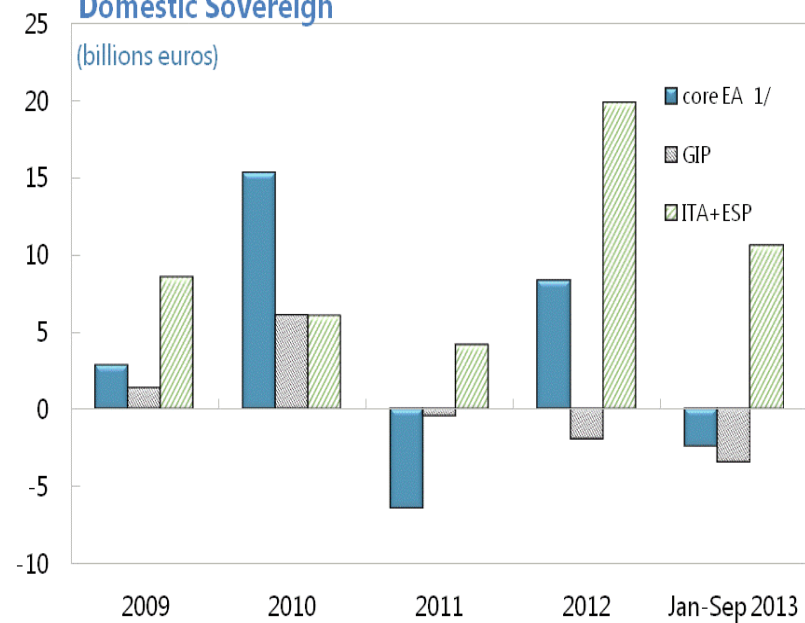
Average Monthly Bank and Sovereign Stress

(Basis points, 01/2010 to 9/2013)



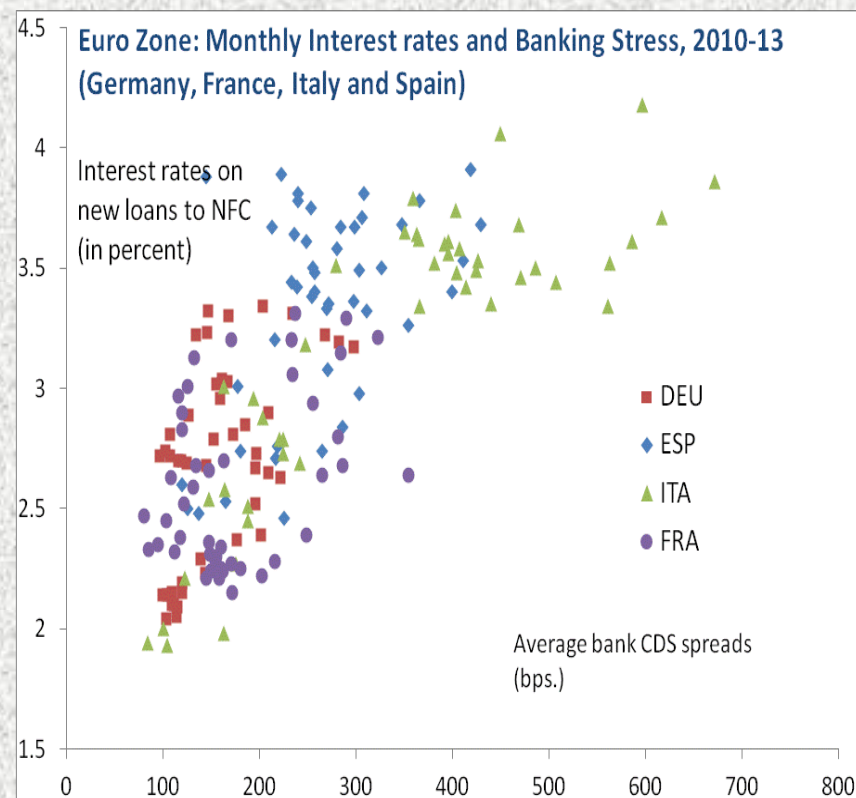
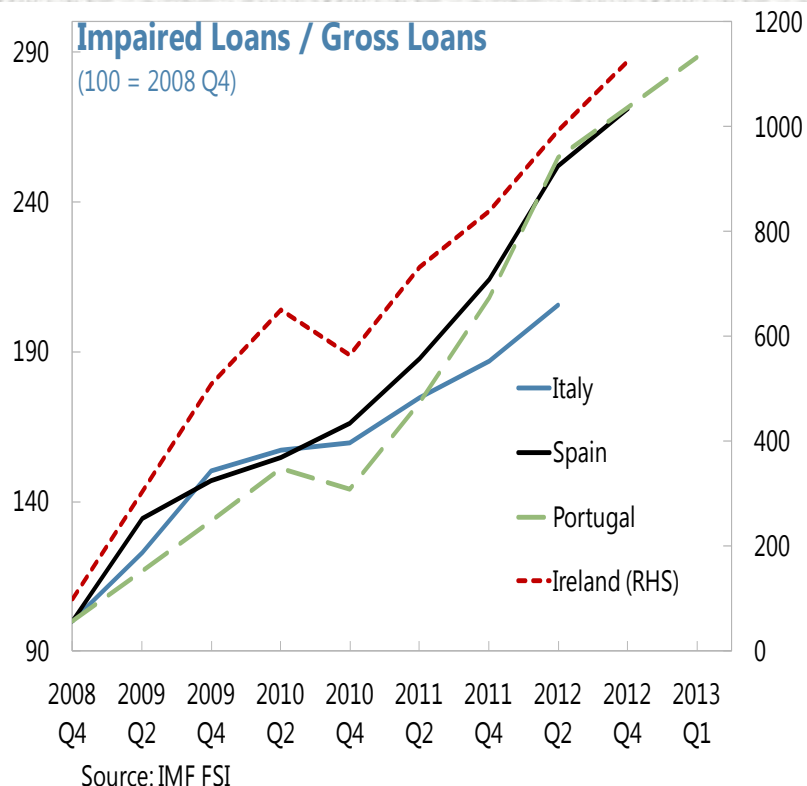
Average Monthly Change in Bank Exposures to the Domestic Sovereign

(billions euros)



Source: IFS

VII. BANK BALANCE SHEETS AND REAL ECONOMY



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

X. STRENGTHEN FINANCIAL STABILITY ARCHITECTURE

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

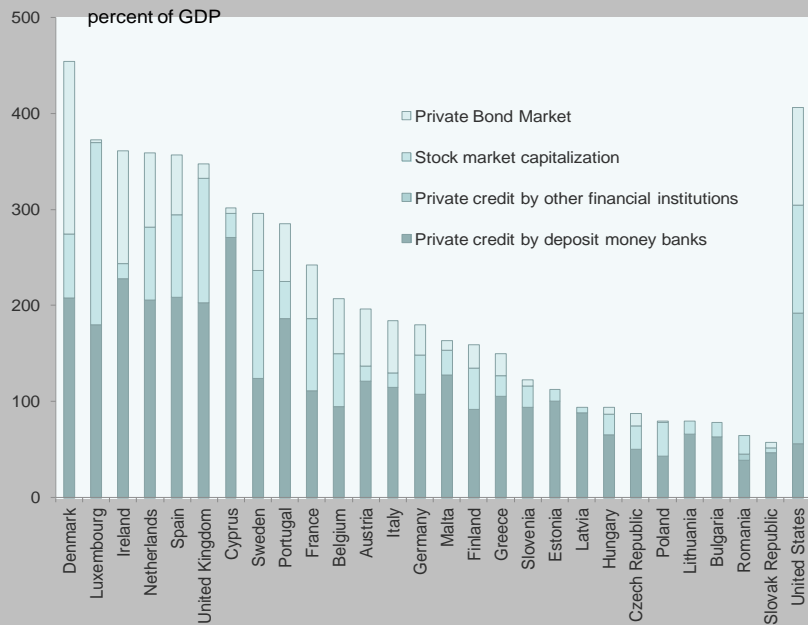
Playing field. Move away from maximum harmonization, specializations will remain

Thank You

Additional slides

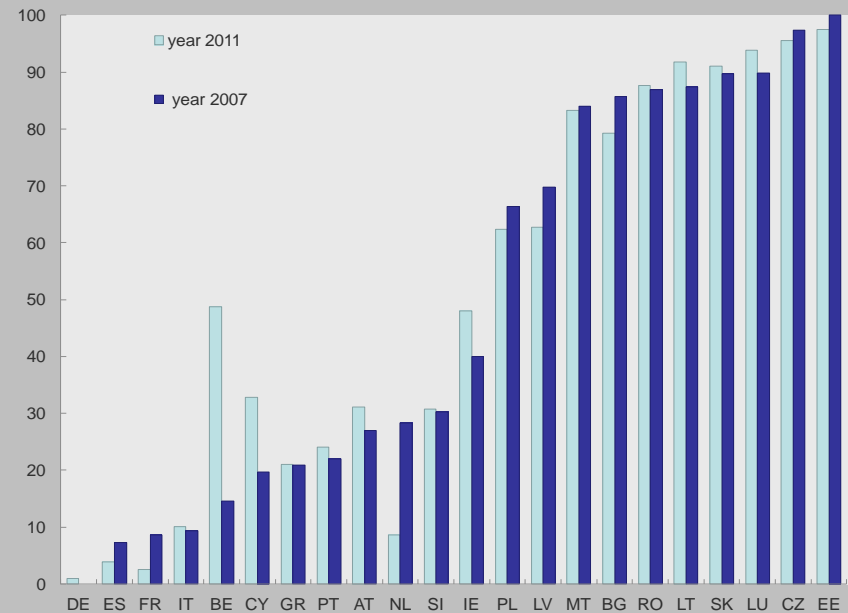
STRUCTURE OF FINANCIAL SYSTEM

EU: Overview of Financial Structure
in percent of GDP



Source: World Bank Financial Structure database (2012).
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

FROM BAIL-OUT TO BAIL-IN

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