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European Union: Financial System Stability Assessment

In the context of Financial Stability Assessment Program, the following documents have been released and are included in this package:

- The Financial System Stability Assessment. Based on information available at the time of these discussions, the staff report was completed on February 22, 2013. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A PIN and Press Release summarizing the views of the Executive Board as expressed during its March 8, 2013 discussion of the report.

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FINANCIAL SYSTEM STABILITY ASSESSMENT

February 22, 2013

EXECUTIVE SUMMARY

Much has been achieved to address the recent financial crisis in Europe, but vulnerabilities remain, and intensified efforts are needed across a wide front:

- *Bank balance sheet repair. Progress toward strong capital buffers needs to be secured and disclosures enhanced. To reinforce the process, selective asset quality reviews should be conducted by national authorities, coordinated at the EU level.*
- *Fast and sustained progress toward an effective Single Supervisory Mechanism (SSM) and the banking union (BU). This is needed to anchor financial stability in the euro area (EA) and for ongoing crisis management. The European Stability Mechanism (ESM) is to take up its role to directly recapitalize banks as soon as the SSM becomes effective.*
- *Further steps toward a stronger European Union (EU) financial oversight framework. Prompt passage and implementation of various EU directives are needed, as well as enhancing coordination across the various supranational agencies so as to achieve policy consistency, including at the national level.*

Restoring financial stability in the EU has been a major challenge. The initial policy response to the crisis was handicapped by the absence of robust national, EU-wide and EA-wide crisis management frameworks. In a low-growth environment, several EU countries are still struggling to regain competitiveness, fiscal sustainability, and sound private sector balance sheets. Their financial systems are facing funding pressures as a result of excessive leverage, risky business models, and an adverse feedback loop with sovereigns and the real economy.

Much has been done to address these challenges. Banks have boosted their capital adequacy ratios, although partly through deleveraging. Unconventional monetary operations have enhanced liquidity and firewalls have been put in place. Bank supervision has been improved. Agreement was reached last December to establish an SSM for the EA open also to non EA members. New tools for addressing financial stability, including coordinated stress tests have come into play. The newly-established European Supervisory Authorities (ESAs) are making their marks.

Nevertheless, financial stability has not been assured. Recent Financial Sector Assessment Program (FSAP) assessments of individual EU member states have noted remaining vulnerabilities to: stresses and dislocations in wholesale funding markets; a loss of market confidence in sovereign debt; further downward movements in asset prices; and downward shocks to growth. These vulnerabilities are exacerbated by the high degree of concentration in the banking sector; regulatory and policy uncertainty; and the major gaps in the policy framework that still need to be filled.

A key priority, EU-wide, is to complete the framework for financial oversight needed to sustain a currency union and the single market for financial services. The crisis has shown that national decisions, even well-intended ones, have Union-wide repercussions on financial stability, and that there is a need for single frameworks for crisis management, deposit insurance, supervision and resolution, with a common backstop for the banking system, especially for the monetary union. Recent measures taken by national authorities and central banks, together with an EA-wide backstop for sovereigns, have mitigated downside risks. Although progress has been made, the lack of a full embrace of a Union-wide approach to financial stability leaves the system vulnerable to shocks, and generates incentives for national ring-fencing and fragmentation.

In the near term more forceful action is warranted to cement recent gains in market confidence and end the crisis. The priorities are bank balance sheet repair, including addressing impaired assets; fast and sustained progress toward the SSM and the BU; and essential steps toward a stronger EU financial oversight framework. Governance arrangements must be adapted to have a EU (or BU)-wide perspective and also evolve to meet the diverse needs of members of the EA, SSM members not part of the EA, and other members of the EU.

It is critical that the SSM delivers high quality supervision as soon as it becomes effective.

- Operational risk regarding the SSM needs to be guarded against by ensuring that the ECB builds supervisory expertise of the highest quality, and has at its disposal resources commensurate to its supervisory tasks.

- The ECB's effectiveness as a supervisor needs to be safeguarded by giving it powers to maintain general oversight over all banks and to intervene in any bank it deems necessary.

- The ECB's governance and its "will to act" need to be robust, including through ensuring that the SSM avoids "nationality dominance" and that a regional perspective is consistently maintained.

The SSM—while critically important—represents only one of a number of crucial steps that need to be taken to fill key gaps in the EU's financial oversight framework.

- As crisis tensions abate, it is important that the implicit unlimited sovereign guarantees in place for the last several years be effectively removed through affirmation and implementation of the principle that institutions with solvency problems must be resolved.

- The Single Resolution Mechanism (SRM) should become operational at around the same time as the SSM becomes effective. Resolution should aim to minimize costs to taxpayers, as well as to deposit insurance and resolution funds, without disrupting financial stability.

- This should be accompanied by agreement on a time-bound roadmap to set up a single resolution authority, and common deposit guarantee scheme (DGS), with common backstops. Eventually providing an explicit legal underpinning for financial stability arrangements of a fully-fledged BU would further strengthen the framework.

- Guidelines for the ESM to directly recapitalize banks need to be clarified as soon as possible, so that it becomes operational as soon as the SSM is effective.

Proposals by the European Commission (EC) to harmonize capital requirements, resolution, DGS, and insurance supervision frameworks at the EU level should be implemented promptly. While ensuring that the Fourth Capital Requirements Directive and Capital Requirements Regulation (CRD IV/CRR) are in full compliance with Basel III, their swift adoption, as well as that of the directives on resolution, DGS and insurance supervision, are necessary. The resolution directive needs to be enhanced to provide for automatic intervention in the event that a bank's solvency position falls below a certain trigger level, as well as to provide flexibility for intervention in the event of liquidity or other problems. In addition, more effective supervision and resolution arrangements need to be worked out for financial institutions crossing the borders between the SSM and the rest of the EU and beyond.

The ESAs and the European Systemic Risk Board (ESRB) need further strengthening.

- Governance arrangements need to be adapted to avoid potential national biases.

- The European Banking Authority (EBA) can play an important role in ensuring a level playing field between countries inside and outside the SSM. It should be more assertive in cross-border colleges of supervisors and crisis management

groups. Importantly, it should ensure that national authorities are undertaking careful and consistent analysis of the underlying quality of bank assets, to ensure the credibility of its stress tests.

- The ESRB, as the EU systemic risk watchdog, should develop the macroprudential toolkit, analyze macroprudential effects on the cyclical downside and not just the upside, and ensure consistent application of macroprudential policies across the various parts of the financial sector and across the EU. The ECB's macroprudential tools should go beyond those identified in CRD IV.

- For all these agencies their heightened responsibilities would warrant increased resources.

Proposals to separate banks' retail activities from those deemed more risky are no panacea. However, such separation could reduce cross-subsidization of the latter, and make resolvability easier. These proposals are not substitutes for other enhancements in loss absorption capacity, such as capital surcharges, bail-ins, ex ante deposit insurance funds, and common backstops, which should in any case be taken forward. Also, care must be taken to avoid regulatory arbitrage to the extent that EU or national proposals differ.

Significant issues in insurance also require attention. Importantly, a weak economic environment, if it persists, can threaten the financial health of the life insurance and the pensions industries as they have already been adversely affected by exposures to banks and sovereigns, and will need to cope with stricter Solvency II requirements.

Risks related to financial infrastructure seem to be manageable but care will be needed on this front too. TARGET2 functioned well in the crisis although enhanced information sharing with the ECB would be appropriate. The ECB's' capacity and competences should be strengthened as it is moving toward a risk-based oversight approach. Increasing reliance on Central Counterparties (CCPs) and Central Securities Depositories (CSDs) reduces overall risk to the financial sector. Risks in the event of the failure of a CCP or CSD are, however, substantial, and important work is in train to seek to address them.

Strong coordination across the various supranational agencies will be critical, so that decision making can be smooth and policies consistent. Especially for crisis management, establishing a mechanism or a committee that brings in a holistic perspective, integrating the crisis related work of the ESAs, the ESRB, the SSM, the forthcoming resolution authority, EC Directorate General for Competition (DG COMP) and the supranational support facilities would be desirable.

High priority recommendations are shown in Table 1. A risk assessment matrix (RAM) is presented in Appendix Table 2.

The authorities have expressed interest in repeating the EU FSAP on a regular basis. Doing the next assessment within the next three years would allow a timely assessment of progress in setting up the BU and of the revisions to the EU financial oversight framework planned for 2014.

Table 1. High Priority Recommendations				
Area	**Policy Action**	**Authority**	**Paragraph**	**Timing**
Bank Balance sheet repair	Secure strong capital buffers, enhance disclosure, and conduct selective asset quality reviews.	National Authorities, SSM, EBA	14	By end–2013
Progress toward BU	Make SSM operational, providing the ECB with adequate resources, staff of highest professional competence and the authority to directly supervise any bank.	EC, Council, European Parliament (EP)	14	By June 2013
	Initiate preparations for an SRM, to become operational around the same time as the SSM becomes effective.	EC, Council	14	By June 2013
	Agree on a time-bound roadmap to full BU, including a single resolution authority, and a common DGS with common backstops.	EC, Council	14	By June 2013
	Establish modalities and governance arrangements for ESM direct recapitalization of banks.	EC, National Authorities	14	Immediate
Near-term steps toward stronger EU-wide financial oversight	Prompt passage and implementation of directives and regulations of capital requirements (fully in line with Basel III) and resolution (enhanced from current proposals).	EC, Council, EP	14, Box 1	By June 2013
	Modify the roles of EBA and ESRB to accommodate SSM.	EC	14, 41, 42, 62	By June 2013
	Ensure full coordination of crisis management and financial sector policies among all agencies, possibly through a new committee.	EC, Council, EP	14, 22	Immediate
European Supervisory Agencies	Modify governance of ESAs to limit national bias.	EC, Council, EP	37	By end–2013
	Improve access of ESAs to data.	EC, National Authorities	38	Immediate
	Increase resources of ESAs.	EC	36	Immediate
	Strengthen supervisory colleges and crisis management groups by enhancing the roles of EBA and the European Insurance and Occupational Pension Authority (EIOPA).	EBA/EIOPA	42, 46	Immediate

Table 1. High Priority Recommendations (concluded)				
Area	**Policy Action**	**Authority**	**Paragraph**	**Timing**
Policy Framework	DG COMP to continue to improve transparency, and to consider—together with IMF and ECB—methodologies for pricing and deleveraging formulae for banks receiving state aid.	EC, Council	55	Immediate
	Strengthen macroprudential oversight of the EU financial system by enhancing capacity of the ESRB, the SSM, and national authorities, and ensuring their more effective coordination. ECB's macroprudential tools should go beyond those identified in CRD IV.	ESRB, SSM, National Authorities	61, 62	As SSM becomes effective
Regulations	Enhance, adopt and implement the EU DGS Directive.	EC, Council, EP	30	By June 2013
	Adopt and implement Solvency II.	EC, Council, EP	31	By January 1, 2014
Insurance	Plan remedial strategies in advance of possible weakening of pensions and life insurance companies' positions as Solvency II becomes effective.	ESRB, EIOPA	32	By January 1, 2014
Financial Market Infrastructure	Pass EMIR technical standards and CSD Regulation, as well as an EU framework for recovery and resolution of non-bank financial institutions.	EC, ESMA, ESCB, National Authorities	70	Immediate
	Place Euroclear Bank and Clearstream Banking Luxembourg under SSM supervision.	National competent authorities of Belgium and Luxembourg	74	As SSM becomes effective
	Enhance information available to ECB on an ongoing basis on TARGET2 participants' liquidity and collateral positions, and strengthen the capacity and competences of the ECB oversight over payment systems.	Eurosystem, ECB	75, 76	Immediate

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The Economic and Financial Committee of the EU (EFC) and the IMF agreed to conduct a Financial Sector Assessment Program (FSAP) at the level of the EU to assess this EU-wide framework. This report is the outcome of a mission during the period November 27 to December 13, 2012. The team comprised Charles Enoch (mission chief), Luc Everaert (deputy chief), Myrvin Anthony, Ana Carvajal, Heiko Hesse, Nadege Jassaud, Elias Kazarian, Fabiana Melo, Rodolfo Wehrhahn, Froukelien Wendt, and Jianping Zhou (MCM); Scott Roger (EUO); Thierry Tressel (EUR); Alessandro Gullo and Barend Jansen (LEG); Luc Laeven (RES); and Daniel Hardy (expert). On the BU, the report draws significantly on the staff notes on 'A Banking Union for the Euro Area,' IMF Staff Discussion Notes, 13/01. Substantial support was provided by other headquarter staff. Jacky Aluvi (MCM) provided excellent assistance. The mission is grateful to Robert Specterman (DG MARKT) for successful organization of the complicated logistics. In addition to this FSSA, the mission also prepared a range of technical notes that underpin much of the discussion in this document.

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GLOSSARY

AIFMD	Alternative Investment Funds Management Directive
AQR	Asset Quality Review
BU	Banking Union
CCP	Central Counterparty
CRA	Credit Rating Agency
CRA3	Third Credit Rating Agency Directive
CRD IV	Fourth Capital Requirements Directive
CRR	Capital Requirements Regulation
CSD	Central Securities Depository
DG COMP	EC Directorate General for Competition
DGECFIN	EC Directorate General for Economic and Financial Affairs
DG MARKT	EC Directorate General for the Internal Market and Services
DGS	Deposit Guarantee Scheme
EA	Euro Area
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EEE	Emerging Economies in the EU
EFC	Economic and Financial Committee of the EU
EFFE	European Financial Stability Framework Exercise
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pension Authority
EMIR	European Market Infrastructure Regulation
EMU	European Economic and Monetary Union
EP	European Parliament
ESA	European Supervisory Authority
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange Traded Funds
EU	European Union
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GFSR	Global Financial Stability Report
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IMD2	Second Insurance Mediation Directive
IOSCO	International Association of Securities Commissions
LTRO	Long Term Refinancing Operations

MAD	Market Abuse Directive
MiFID	Market in Financial Instruments Directive
MoU	Memorandum of Understanding
NCB	National Central Bank
NSAs	National Supervisory Authorities
OMT	Outright Monetary Transactions
PRIP	Packaged Retail Investment Product
RAM	Risk Assessment Matrix
RTGS	Real Time Gross Settlement
SGP	Stability and Growth Pact
SIFI	Systemically Important Financial Institution
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union
UCITSVI	Sixth Undertakings for Collective Investment in Tradable Securities Directive

MOTIVATION AND SCOPE

1. **The recent financial crises have underscored the need for the EU to take a regional approach to financial stability.** The regional dimension is particularly important, given the single currency that binds many EU countries and the existence of an EU-wide single market for financial services, which have left countries highly interconnected through substantial cross-border exposures, and common money and capital markets.

2. **Preserving financial stability in such an environment requires a supranational oversight framework.** Its construction has been underway for more than a decade, supported by the Lamfalussy process and the follow up to the De Larosiere report, which established the ESAs and the ESRB. However, as flagged in the 2011 European Financial Stability Framework Exercise (EFFE), crisis management and resolution remains an important gap, and it was noted that the new ESAs and ESRB would face challenges to establish their credibility.

3. **Progress has been made toward stronger pan-European approaches.** A number of crisis management tools have been established beyond the national level, such as through the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM). EU institutions, such as the DG COMP have sought to incorporate financial stability considerations in their operations. Meanwhile, central banks engaged in unconventional policies to support macro-financial stability and buy time to address deep-rooted problems. IMF-supported programs were necessary to prevent deeper crises in parts of the Union. The regulatory reform agenda has accelerated and, most fundamentally, the SSM is being established as an element towards the BU.

4. **The focus of this FSAP assessment is on these supranational institutions.** It assesses the effectiveness of the institutions and the possible contributions of the proposed institutional reforms to financial stability. It analyzes how the EU and European Economic and Monetary Union (EMU)-wide institutional setups can complement national financial stability frameworks and how financial stability risks can be further mitigated. It defers to national FSAPs for quantitative analysis to avoid duplication, but draws from them as well as from recent Global Financial Stability Reports (GFSRs) for its financial stability assessment, and from staff papers on the BU for policy recommendations (SDN/13/01).

SYSTEMIC RISK AND VULNERABILITIES IN A CROSS-BORDER SETTING

5. **The current financial turbulence in Europe has multiple causes, with EU and EMU-wide policy frameworks playing an important role.** Financial innovation, deregulation, and soft touch supervision were key factors that led to the global financial crisis. Europe was afflicted and probably hit harder than other parts of the world because of its traditional reliance on bank-based finance and high bank leverage (Figures 1 and 2).

6. EU and euro area (EA) institutional features and the absence of an EU-wide crisis manager amplified the crisis when it hit:

- *Single market in financial services.* The EU's objective to create a single market in financial services, including through passporting and cross-border branching, led to rapid financial integration and sharp increases in cross-border exposure (Figure 3).

- *National approach to supervision.* Countries continued their own supervisory approach and national financial systems varied in size and structure and relative to fiscal capacity (Figures 4).

- *Monetary union.* The elimination of currency risk and interest rate convergence contributed to rising cross-border lending, including to sovereigns. However, mechanisms to instill discipline through the Stability and Growth Pact (SGP) and markets failed.

- *Commitment to euro adoption by the emerging economies in the EU (EEE).* Financial liberalization upon joining the EU led to very large investments in western European banks, while expectations of euro adoption fostered foreign currency borrowing. Together with deep integration came credit booms, especially in countries pegging their currencies to the euro (Figures 5 and 6).

7. EU wide institutions, still in their infancy, lacked the power to respond to the contagion within the Union. Initial policy responses by national and EU authorities sometimes led to adverse policy spillovers (Figure 7). Examples include: the guaranteeing of all liabilities of the Irish banking system and the decision to break up some troubled cross-border institutions along national lines. As a result, central banks, in particular the ECB, were forced to step in with unconventional measures, to buy time to address underlying problems (Table 2).

8. The absence of a robust cross-border crisis management framework in the EU contributed to negative sovereign-banking loops and financial fragmentation. Where sovereigns ran into trouble, the banking system suffered as the value of sovereign backstops fell and funding costs rose. In countries where banking systems had to be supported, the sovereign weakened, in turn reducing the value of its banking system support. In both cases, the real economy suffered, further fueling the adverse loop (Figure 8). This situation led to a reversal of cross-border capital flows and a reduction of cross-border holdings, especially affecting the EA periphery, which was only stemmed with the introduction by the ECB of its Outright Monetary Transactions (OTM) program (Figure 9).

9. Recent FSAP assessments at the national level illustrate that financial stability remains tenuous. Risks include the continued threat of stresses and dislocations in wholesale funding markets; deteriorating or high sustained sovereign risk; and further downward movements in asset prices. Macroeconomic risks are associated with a global recession and protracted slow growth in Europe. Regulatory uncertainty and high concentration in the banking sector in some countries could amplify vulnerabilities (see Appendix I).

Table 2. ECB: Unconventional Measures 2007–To Date	
Decision date	**Measure**
October 8, 2008	Fixed rate, full allotment tenders adopted for weekly main refinancing operations, for as long as needed. Reduction of the corridor between standing facilities to 100 basis points, for as long as needed.
October 15, 2008	Expansion of eligible collateral through end–2009. Enhance longer term refinancing operations through end–Q1 2009. Provision of US dollar liquidity through foreign exchange swaps.
December 18, 2008	Increase of corridor between standing facilities to 200 basis points.
February 5, 2009	Fixed rate, full allotment tenders to continue for as long as needed on all main, special term, supplementary and regular longer term refinancing operations. Supplementary and special term refinancing operations to continue for as long as needed.
May 7, 2009	One year long-term refinancing operations introduced. Covered bond purchase program announced.
March 4, 2010	Return to variable rate tender for three-month long term refinancing.
May 10, 2010	Securities Markets Program (SMP) introduced to intervene in the EA public and private debt securities Markets. Fixed rate, full allotment tenders adopted for regular three-month long-term refinancing, extended through today.
August 4, 2011	Supplementary longer term refinancing operation with a maturity of approximately six months, fixed rate and full allotment introduced—subsequently extended through today.
October 6, 2011	Two longer-term refinancing operations introduced—one with a maturity of approximately 12 months in October 2011, and another with a maturity of approximately 13 months in December 2011. New covered bond purchase program launched.
December 8, 2011	Further non-standard measures introduced, notably: (i) to conduct two longer-term refinancing operations with a maturity of approximately three years; (ii) to increase the availability of collateral; (iii) to reduce the reserve ratio to 1 percent; and (iv) for the time being to discontinue the fine-tuning operations carried out on the last day of each maintenance period.
February 9, 2012	Further collateral easing by approving specific national eligibility criteria and risk control measures for the temporary acceptance in a number of countries of additional credit claims as collateral in Eurosystem credit operations.
September 6, 2012	OMTs introduced to purchase sovereign bonds in the EA in secondary markets.

10. Policy initiatives have helped ease funding pressures, but fragilities and challenges remain. Aggregate capital ratios have increased, but differ considerably between stronger and weaker banks. Banks now face the consequences of the economic slowdown on asset quality, while longer-term market and regulatory forces add to pressure. Together with weak demand, credit growth has become anemic across the region.

11. Fragilities stem from four intertwined vulnerabilities (see Appendix Table 2 and Appendix II):

- *Low growth*. Reflecting deep recessions in the EA periphery, real activity in the EA is projected to decline slightly in 2013 while slowing in most other EU countries. Low growth will put bank profitability at risk, removing an important source of capital growth. Solvency in the insurance sector is under pressure from low returns and the stagnant economy (Figure 10).

- *Fiscal vulnerabilities*. Lackluster growth will hamper efforts to restore fiscal sustainability where needed. Weak confidence in the fiscal sustainability of many EA members—and fiscal crises in some—has severely undermined banks given their large exposures to sovereigns.

- *Funding pressure*. Market funding remains a challenge with wholesale markets segmenting along national borders, and many banks remaining reliant on central bank support. The eventual withdrawal of central bank support operations will be challenging for many banks.

- *Deleveraging*. Since 2008, EU banks have deleveraged considerably, mainly across borders, including outside the EU. Bank deleveraging can be explained by structural and cyclical forces (see GFSRs from 2012): adjustment of business models to new regulatory and economic environments; pressures to build capital; reduction in reliance on unstable market funding; and strained financial conditions and weak demand for credit. Tight lending conditions risk weakening growth and the scope for balance sheet repair.

OVERCOMING THE CRISIS—THE SUPRANATIONAL DIMENSION

12. Moving banks and sovereigns jointly to safety is essential. This should be accomplished by policy combinations that strengthen banks without weakening public sector balance sheets or vice versa. The first set of policies involves raising private capital. The second set involves policies that minimize the potential burden on the taxpayer from too-important-to-fail institutions, for instance through bail-ins. If national capacity is insufficient, support from supranational entities should be deployed in the form of direct support for banks and asset management companies (capital and guarantees); common backstops and safety nets (DGS, resolution funds); borrowing from official sources; or further fiscal integration. Many of these elements will be facilitated for those countries that join the prospective BU.

13. Good progress has been made but gaps and challenges remain:

- *Bank recapitalization.* Banks have raised considerable new capital, both in the context of the EBA recapitalization exercise and national efforts, but pockets of weak banks remain.
- *Banking system restructuring.* During 2007–2012, the number of credit institutions fell by 5 percent: 20 banks were resolved, or are in the process of resolution, and 60 banks have undergone deep restructuring. However, many banks are still excessively dependent on wholesale funding, while others remain exposed to illiquid or impaired assets.
- *Burden sharing with creditors.* Recourse to bail-in may be more difficult during periods of stress, and only a handful of banks have so far made progress in raising liabilities subject to bail-in.
- *National sovereign support.* Financial system support from sovereigns has been large, which has sometimes triggered an adverse loop between banks and some sovereigns.
- *Sovereign adjustment.* Virtually all EU countries have embarked on fiscal adjustment and other reforms to strengthen the sovereign.
- *Supranational support.* The EFSF and ESM have provided support to sovereigns in funding difficulties. A decision has been taken in principle to allow the ESM to directly recapitalize banks; this needs to be made operational as soon as possible.
- *Resolution in systemic situation.* Common fiscal and monetary backstops are essential, alongside bail-ins and resolvability, to cope in an effective and orderly way.

14. More forceful steps to overcome the crisis can and should be undertaken in three areas:

- *Bank balance sheet repair.* Progress towards strong capital buffers needs to be secured. Greater disclosure requirements, especially of impaired assets, would buttress credibility in the improvement in banks' condition. National authorities and the SSM should undertake selective asset quality reviews, coordinated at the EU level. This would add credibility to the stress tests envisaged being undertaken by the SSM and EBA.
- *Fast and sustained progress toward an effective SSM and BU.* This will anchor financial stability and ongoing crisis management, and allow the ESM to directly recapitalize banks, thereby weakening the bank-sovereign link. Interests of member states not in the EA, both those that join the SSM, and those that do not, will need to be protected.
- *Further steps toward a stronger EU financial oversight framework.* Prompt passage and implementation of capital requirements, resolution directives and regulations, as well as strong coordination across various institutions are important to achieve policy consistency, including with national policies:

- With respect to capital requirements (CRD IV/CRR), full consistency with Basel III is essential.

- With weaknesses in national resolution regimes and without an EU-wide common resolution framework, implementation of the resolution directive is essential. Some enhancements are necessary: to allow for strong early intervention powers; provide a full menu of resolution tools, and safeguard taxpayers' money (see Box 1). Meanwhile, national legal frameworks need to be modified to facilitate borrower restructuring and accelerate collateral repossession to free up management resources, capital, and funding to support viable projects and fuel economic activity.

- Realigning the roles of the EBA and the ESRB to accommodate the SSM. With the ECB taking on supervision for a large subset of EU members, safeguards for non-SSM members need to be built into governance arrangements for the other pan-European institutions.

- Coordination across the various supranational agencies will be critical, so that decision making can be smooth and policies consistent. Especially for crisis management, establishing a mechanism or a committee that brings in a holistic perspective, integrating the crisis related work of the ESAs, the ESRB, the SSM, the forthcoming resolution authority, DG COMP and the supranational support facilities would be desirable. Within the EA such enhanced coordination would be essential.

- In addition a statutory mechanism can be considered to provide clarity, powers, responsibility and accountability during systemic situations. Such systemic risk exception would lend clarity and credibility to the bank resolution process. Formal vetting procedures would limit moral hazard and protect resolution funds.[1]

[1] Further discussion is contained in IMF discussion document SDN/13/1, Box 4.

Box 1. Proposed Resolution Directive—Risks and Areas for Enhancements

- Resolution of banks is undermined by the absence of an effective EU-wide framework to fund resolution. Binding mediation powers for the EBA and mutual borrowing arrangements between national funds face inherent constraints (in particular, the EBA cannot impinge on the fiscal responsibilities of EU member states).

- Passage of the directive will substantially enhance the range of tools available to resolution agencies in the EU. But the scope of the directive should be widened to include systemic insurance companies and financial market infrastructures in line with the Financial Stability Board (FSB)'s Key Attributes. All banks should be subject to the regime, without the possibility of ordinary corporate insolvency proceedings.

- The breadth and timing of the triggers for resolution should be enhanced by providing the authority with sufficient flexibility to determine the non-viability of the financial institution (including breaches of liquidity requirements and other serious regulatory failings, not just capital/asset shortfalls). There should be provision for mandatory intervention in the event a specified solvency trigger is crossed.

- The directive affords less flexibility for using certain resolution powers than the key attributes. For instance, it does not permit exercising the mandatory recapitalization power and the asset separation tool on a standalone basis. Also, bail-in safeguards should not prevent departure from pari passu treatment where necessary on grounds of financial stability or to maximize value for creditors as a whole.

- Staff also considers that depositor preference should be established for insured depositors with the right of subrogation for the DGS.

BANKING UNION—IMPLEMENTATION AND RISK MITIGATION

15. The mission fully supports the objectives of the proposed roadmap to a BU. The BU's effectiveness will require that the ultimate financial stability framework includes all elements, such as the SSM, the single resolution authority, and the common financial safety net, underpinned with a strong legal basis. Meanwhile, risks to the design of the SSM and the ongoing transition to a BU need to be mitigated.

A. Single Supervisory Mechanism

16. The Basel Core Principles provide a basis for defining key elements for an effective SSM. These include (i) operational independence; (ii) clarity of objectives and mandates; (iii) legal protection of supervisors; (iv) transparent processes, sound governance and adequate resources;

and (v) accountability. The EU Council agreement by and large is in line with these pre-requisites, but clarity is required, including on resources and responsibilities within the SSM.

17. The December 12 agreement on the establishment of the SSM and announced roadmap toward a BU is appropriately ambitious. It also correctly calls for giving the utmost priority to the adoption of a harmonized regulatory set-up (the CRR/CRD IV), and to reaching agreement on the draft directive for bank recovery and resolution and harmonization of DGS. A proposal for a single resolution mechanism will be put forth by the EC in 2013.

18. Establishing the SSM under the existing EU Treaty has implications for its governance and powers. Given the Treaty requirement that all ECB decisions must be made by the Governing Council that comprises only member states in the EA, a newly created Supervisory Board, comprising representatives from all EMU countries and any other EU member states that join the SSM, will undertake the planning and execution of the supervisory tasks conferred on the ECB, including the proposal to the Governing Council of draft decisions. The Governing Council of the ECB, which comprises of the Governors of EA national central banks (NCBs) and the members of the ECB Executive Board, must formally have the ultimate decision making power for any tasks carried out by the ECB, including supervision.

19. Risks arising from these governance arrangements will need to be guarded against. (see also Appendix II):

- Decisions by the Supervisory Board may not be fully independent from national interests. The ECB functions in a nationality-blind manner, but it will be harder to ignore national interests when taking supervisory decisions, particularly at the outset.

- As the Governing Council of the ECB will be in charge of both supervisory and monetary policy decisions, the ECB will need to establish a comprehensive framework for transparency and accountability for the SSM and Chinese walls between supervision and monetary policy at an operational level. Nonetheless, the setup should still permit synergies between the two functions, for instance from data sharing. Accountability needs to be further safeguarded through appearances of the ECB leadership before the European Parliament, and where relevant also before national parliaments.

- As non-EMU countries cannot vote on the Council, credibility in the maintenance of a level playing field for such countries that join the SSM will need to be achieved through the operation of the envisaged special arrangements.

20. The ECB is to take direct supervisory responsibility for the largest 150 banks, but will have authority to directly supervise any bank it deems necessary. The narrower mandate appears pragmatic, given the resource and other challenges that will be faced by the ECB, and it will be important that the metrics for identifying this set are clear and capture the importance of a bank in cross-border activities, and in domestic and EU significance. However, the crisis has illustrated that problems can emerge also from amongst the smaller banks, especially when

confidence is fragile. According to the EU Council Agreement, the ECB retains the responsibility and scope for oversight over the rest of the banking sector, and has power to quickly exert direct supervisory authority over any bank, or group of banks, if it deems it necessary. To ensure consistent supervision and safeguard against forebearance, the national supervisory authorities (NSAs), which will continue to supervise most banks in the countries covered by the SSM, are required to share information among each other and with the ECB.

21. Transition risks will need to be managed. Initially, the ECB will need to rely on cross-country teams supplied by national authorities and led by an ECB supervisor. It will be critical to avoid mistakes during this start-up period, since these could cause a loss in credibility that would take much time and effort to reverse. Providing support to a bank asset quality review coordinated by the EBA would also help the SSM avoid early difficulties and get a better understanding of the condition of the banks. The ECB has scope to postpone the date when the SSM becomes effective if it feels it is not ready. However this may have knock-on effects; thus every effort is needed to ensure that the ECB has its necessary resources in place by the SSM's March 2014 postulated starting date.

B. Resolution

22. It is essential that a SRM for the countries participating in the SSM be established around the same time that the SSM becomes effective. As banks are too interconnected to be effectively supervised at a national level, national resolution regimes would have difficulty, even under harmonized arrangements, to handle the bigger banks of the EU or cross-border contagion. Moreover, incentives among national resolution authorities for least-cost and rapid action to address problems could remain limited; also, coordination difficulties, especially for large cross-border banks may undermine effectiveness. In addition, there is the danger that—absent a single resolution mechanism—national authorities could be left to bear the fiscal implications of decisions made by others. As crisis tensions abate, it is important that the implicit sovereign bank guarantees in place for the last several years be effectively removed through a reaffirmation and implementation of the principle that institutions with solvency problems must be resolved. To be fully aligned with best practices, the resolution authority should seek to achieve least cost resolution of financial institutions without disrupting financial stability. It should protect insured depositors, and ensure that shareholders and unsecured, uninsured creditors absorb losses. The SRM will need a mandate to intervene before insolvency using well-defined quantitative and qualitative triggers. It will need strong powers and a range of tools to restructure banks' assets and liabilities (for example, bail-in subordinated and senior unsecured creditors; transfer assets and liabilities with "purchase and assumption;" and separate bad assets by setting up asset management vehicles); override shareholder rights; establish bridge banks to maintain essential financial services; and close insolvent banks. Coordination with the SSM should be ensured, particularly when early intervention measures are triggered by the SSM.

23. The SRM will need to coordinate closely with other EU institutions. Coordination with the SSM could be through regular formal meetings with the Chair of the supervisory board of the ECB. Alternatively, the SSM Chair of the supervisory board could serve on the board of the

SRM, together with national representatives and representatives of other EU bodies. Coordination with DG COMP will also be important, as unless and until all EU member states participate in the SRM, its interventions may be subject to State Aid rules. Finally, as most large EA banks have presence outside the BU perimeter, there will need to be coordination between BU resolution authority and those in the remaining EU states and possibly beyond.

24. As with the SSM, use of the existing treaty framework will help determine the structure and operations of the SRM. The SRM will use the framework of the resolution directive, rely in the first place on financing from national authorities, have powers such a bail-ins to reduce likely exposures, and have the ESM as financing backstop. The ESM itself may be adapted to serve as the single resolution authority of the SRM on this basis.

25. In time, a single dedicated resolution authority should be created. This authority should have backstop financing, including through a single resolution fund. It will need to coordinate closely with the national resolution agencies in the member states outside the BU, as well as countries outside the EU.

C. Legal Basis

26. Due care has been given to underpinning the proposed BU with an as strong as possible legal basis under the current treaties. Article 127(6) of the Treaty on the Functioning of the European Union (TFEU) allows the conferral of specific supervisory tasks to the ECB, and is now being used to establish the SSM. Certain elements of an effective safety net such as an SRM can be designed through secondary legislation on the basis of the current treaty.

27. In the medium term, providing an explicit legal underpinning for financial stability arrangements in the treaties could further enhance the legal robustness and transparency of those arrangements. It could be useful to enshrine directly in the treaty, similarly to the approach followed for other EU competences, such as monetary union, competition, and agriculture: (i) explicit financial stability objectives; (ii) the key institutional set up of supervision and the financial safety net; and (iii) the necessary powers. This would ensure that a single resolution authority could stand institutionally at par with the Commission and the ECB, thus facilitating collaboration and mutual checks and balances. Also, a treaty could explicitly provide for the desired allocation of responsibilities between SSM countries and the broader EU. It would also mitigate legal risks that core aspects of the BU are challenged before the European Court of Justice.

STRENGTHENING THE FINANCIAL STABILITY FRAMEWORK OF THE SINGLE MARKET

28. The EU's financial oversight framework will necessarily remain complex. It will need to address the needs of three groups of countries with very different economic and financial governance arrangements: members of the monetary union which will automatically be members

of the BU, non-EA countries that opt in to the BU but retain their own monetary policy frameworks, and EU countries that remain outside the BU. These three groups will retain different degrees of national autonomy, while adhering to (and benefiting from) a single market in financial services.

29. Ring-fencing of domestic banking from foreign operations has been part of the crisis response. This response, while understandable given policymaker's accountability to national taxpayers, has itself contributed to instability, leading to initiatives to prevent disorderly cross-border deleveraging and minimize negative externalities from self-interested national moves (e.g., the Vienna initiative). The benefit of capital and liquidity withdrawal and ring-fencing may be more apparent than real, with adverse feedback effects on the initiator of such measures. If risk is properly assessed, and there are no policy distortions, capital will flow to where it is most productive. Especially at a time when growth in the EU is anemic, which itself poses a risk to financial stability, restricting such potential flows can exacerbate the problems the policy is designed to avoid. Restoring the single market in financial services could thus enhance financial stability.

30. To restore safe functioning of the single market, a continued strengthening of its financial oversight framework is essential. With the non-banking part of the single market functioning comparatively well, measures need to focus on banking, but further strengthening of other parts will be important too. Further measures should be guided by an explicit EU-wide financial stability objective so that actions from national and supranational entities are consistent. Priorities discussed below are: remaining regulatory reforms; strengthening and adapting institutions (ESAs and DG COMP); implementing macroprudential policy; addressing structural issues; and securing safe market infrastructure.

A. Regulatory Reforms

Banking and deposit guarantees

31. Implementing the directive to harmonize deposit guarantee schemes will be a first step towards an EU-wide financial safety net. National DGSs should be aligned not only in terms of quantities (through minimum coverage limits), but also in terms of prices, with premiums adjusted for risk as far as practicable. The length of time to payout should be shortened, likely requiring additional efforts from those member states with the least developed structures. To safeguard depositor confidence and efficient resolution, prefunding of national DGS will be necessary, but may need to be combined with a common backstop should national deposit schemes run out of funds. Agreement is needed on the amount of targeted prefunding and on mutual borrowing agreements across national DGSs. The former can be established on the basis of international practices and phased in over time to modulate pressures on the industry, with transitional arrangements to take account of varying initial conditions.

Insurance

32. Timely implementation of Solvency II would help reduce vulnerabilities in the insurance sector. Implementation is now scheduled for January 2014, but there remain disagreements, mainly around extending the long-term guarantees package. The delay implies that important aspects of supervision, including valuation, disclosure and risk management would remain non-compliant with the International Association of Insurance Supervisors (IAIS) principles (see national FSAPs) in several EU member states, preventing the urgently needed proper assessment of the risks in this sector in the present low interest rate environment.

33. Introducing market-based valuation will likely show insurance companies in a weaker position. Under the market consistent valuation of liabilities required under Solvency II, use of a low interest rate discount curve for the valuation of liabilities will be necessary in the current environment. Such a methodology would likely lead to the solvency positions of insurers being seen as weaker than hitherto presented. Indeed, the situation may throw into question insurance and pensions companies' traditional business models, suggesting that significant refocusing or restructuring may ultimately be called for.

Securities

34. The approval of the Second Markets in Financial Instruments Directive (MiFID2) and reforms to the Market Abuse Directive (MAD) will be key to fostering market resilience and integrity. Although the text still needs refinement, MiFID2 addresses the main concerns brought by market fragmentation and technological innovation.

35. Consumer and investor protection issues should get sufficient priority. In particular, approval of Packaged Retail Investment Products (PRIPs) and reforms to MiFID and the Second Insurance Mediation Directive (IMD2) to ensure cross-sector harmonization in regard to investment-like products are important.

36. Addressing risks from shadow banking should continue to be a priority. Provisions to encourage work on reducing reliance on ratings are part of the Third Credit Rating Agency Directive (CRA3), and the implementation of the Alternative Investment Fund Managers Directive (AIFMD) should bring further transparency to the hedge fund industry. Two areas where further work is warranted vis-à-vis the FSB agenda are (i) money market funds and exchange traded funds (ETFs); and (ii) securities lending and repos. Regarding the former, ESMA has issued guidelines—including in connection to their use of securities lending and repos—which should be the starting point for the reforms to be incorporated in the Undertakings for Collective Investment in Transferable Securities Directive (UCITSVI). Feedback from the consultation of the EU green paper should provide further input as to other areas where additional work is warranted.

B. European Supervisory Agencies

37. The ESAs have undertaken significant work in the two years of their existence, but there is scope to do more in areas including supervisory convergence, risk identification

and consumer protection. The ESAs are performing a critical role for the single market. They are preparing the single rulebooks and are contributing to the implementation of new directives and regulations. But amongst other elements in their remits are fostering supervisory convergence (through creation of centers of expertise, and peer reviews), risk identification, and investor protection. To fulfill these they need additional resources and better governance arrangements.

38. The upcoming review of the ESAs should be an opportunity to sharpen mandates and strengthen governance arrangements. Governance arrangements should be reviewed with the aim of promoting a more supranational orientation of decision making. Providing voting rights to the Chairs of the ESAs, moving fully to a full time board, or delegating more decisions to the management board should be considered.

39. Data transparency is a significant handicap to effective supervision and market discipline. Lack of direct, easy access to institution-specific data creates inefficiencies, and poses reputational risks, and should be replaced by a mechanism allowing joint but still direct and straightforward access**.** Since the ESAs need to go through NSAs to obtain detailed supervisory data, delays and bureaucratic costs arise, which affect work on real-time analysis of risks and crisis-related work. In particular, requiring a vote from the NSAs to provide data for particular studies for an ESA might undermine the timeliness of the ESA's work.

Banking

40. EBA has had high visibility from the moment of its creation. It has significant achievements in its first two years of existence, but the pace and prioritization of its activities have been dictated by the crisis. EBA played a crucial role in securing bank recapitalization, but despite a high level of transparency, the June 2011 stress tests failed to signal some subsequent bank failures. The recapitalization exercise in June 2012 was more effective, and led to substantial infusions of capital into EU banks, although some banks enhanced their capital positions through risk weight optimization. Despite its limited resources and cumbersome governance structure, EBA has made significant progress in the area of rule making, but it needs additional resources and independence, and to seek synergies with ESRB, for instance on cross-sector risk assessment.

41. EBA should continue to prioritize strengthening transparency and the reliability of data. The 2011 stress test exercise showed the value brought by disclosure of detailed information. But now EBA should strive to enhance the quality assurance process, coordinate an asset quality review, standardize NPL definitions, loan classifications and provisioning rules, and promote the timely disclosure of granular asset quality information. EBA should accelerate convergence on Pillar 2 practices (common methodologies for risk assessment), and raise supervisors' awareness on asset quality issues, in particular by issuing guidance for supervisors on best practices for the conduct of asset quality reviews (Box 2).

Box 2. Lessons and Recommendations for EBA Stress Testing

It is important that full transparency about banks' data be obtained, preferably through an asset quality review. A high degree of transparency, including on reference date data, and on sensitivity to differences in data definitions, would strengthen confidence; conversely, further bank failures after passing a stress test would substantially damage the credibility of the process.

In light of these considerations the following are recommended:

- Moving to standardize definitions of NPLs, loan classifications, provisioning etc. while initiating a review of input asset quality data.[2] This review would complement an enhanced system of consistency checks built into the stress testing procedures. Acknowledgement of the concerns, and quantification of possible effects through sensitivity analysis, would be worthwhile.

- Continuing to publish a wide range of detailed information on banks.

- Incorporating as far as possible banks' funding and capitalization plans in the 2013 stress test projections, including the effects of the phase out of the Long Term Refinancing Operations (LTRO). Further efforts could be made to assess the sensitivity of results to likely changes in balance sheet composition.

- Ensuring the consistency and quality of tests run by NSAs and the SSM with its own, and running tests on hitherto relatively neglected topics such as structural issues and funding vulnerabilities. Developing furthering liquidity stress testing, and running stress tests and related simulations to incorporate longer-term and cross-sector factors (for example, using contingent claims analysis) that relate to structural issues are needed.

42. The creation of the SSM will bring a new dimension and urgency to EBA's supervisory convergence role. The ECB will need to implement supervisory procedures and guidance for the operation of the SSM in the established timeframe, which may front run some parts of the envisaged European Supervisory Handbook. While this is unavoidable, it is important that EBA works closely with the new supervisor so that the SSM can build its procedures on best available practice.

43. EBA will have a key role to play in supervisory colleges after the establishment of the SSM. Most large EU banks have activities inside and outside the SSM perimeter. EBA should be assertive in the colleges in ensuring a level playing field, and that practices do not diverge across the two areas. It can have a major role also in the EU's relationships with the outside world.

[2] The definitions should be as consistent as possible while recognizing real differences, for example, in loss given default rates across countries and across time.

44. In the area of consumer protection, EBA has EU-wide responsibility. More staff and building of knowledge are needed. Support may be drawn from the other ESAs, which have been more proactive, issuing guidelines, and reports on good practices and consumer trends.

Insurance

45. EIOPA can point to some significant achievements. In contributing to a common supervisory culture, a soft approach has been taken, based on peer reviews, training, and frequent engagement in the colleges of supervisors. In anticipation of the introduction of Solvency II, EIOPA has been developing regulations and designing technical standards, guidelines and recommendations. Its work on Solvency II equivalence certification has concluded on three countries, and transitional Equivalence measures for several countries are being evaluated. The mutual recognition work with the United States continues. EIOPA has created a common EU voice in insurance and pension matters on selected international topics.

46. Challenges ahead will require EIOPA's realignment, particularly if weaknesses in the industry become apparent. Solvency II is scheduled to be implemented in 2014 and revised legislation for occupational pensions should be soon in force. Shifting from developing technical standards toward monitoring, implementing and enforcement will be necessary. EIOPA will need to prevent delays in Solvency II implementation that could result in regulatory arbitrage. EIOPA's human resources framework as well as its operational processes will need to be realigned to the new challenges.

47. EIOPA's engagement in its oversight role of supervisory colleges has been intense, but much remains to be done. In 2012, colleges of supervisors having at least one actual meeting or teleconference were organized for 69 groups. Important issues like crisis preparedness were introduced and some aspects tested, confidentiality agreement templates were developed, and best practices on group supervision presented. However, work is needed to ensure a harmonized level of group supervision in the EU once the Level 3 legislation is in force. Also, EIOPA's engagement in colleges should go beyond the EU and encompass larger international groups active in Europe, as well as take a leading role in the supervision of the largest EU groups.

48. EIOPA has been proactive in consumer protection. Promoting transparency, simplicity and fairness in the market for consumer financial products and services across the internal market is a stated objective. EIOPA is engaged in the revision of IMD2 and working with ESMA on MiFID2, where EIOPA is in a position to highlight the particular aspects of insurance products and insurance distribution practices.

49. The approval of internal models is a crucial step in evaluating capital levels, and resources need to be allocated to this effort. The level of expertise and amount of work required is imposing severe strain on the NSAs. EIOPA has agreed a work process for the NSAs and insurers. Consideration should be given to centralizing aspects of the approval of internal models, so as to make best use of limited highly-qualified resources.

50. EIOPA's stress tests under a Solvency II regime should focus on EU-wide vulnerabilities and interlinkages. To date, EIOPA's main effort has been to quantify the effect on assets of single factor shocks and traditional insurance factors such as mortality, lapse and market exposures. EIOPA's stress tests should complement national stress testing activity with a special focus on identifying EU-wide risks, spillovers to and from other sectors, and medium term resilience related to, for instance, low profitability in some business lines, and to coordinate with EBA and the ESRB in assessing risks related to bancassurance.

Securities markets

51. Within its resource envelope, ESMA has performed well during its first two years of operation, especially in connection with the single rulebook and credit rating agencies (CRAs) supervision. Technical standards and opinions, and advice to the EC were developed. ESMA has built up its expertise on CRAs and has worked on the development of a risk framework to anchor its supervisory program. Results are more modest in connection with other functions.

52. As it acknowledged, ESMA needs to step up its role in other areas, and in particular on supervisory convergence. It has set up strategic directions for each area, and in many cases has identified concrete actions.

- Supervisory convergence. Reengineering and strengthening peer reviews is essential. Reviews can be made more rigorous by increased onsite work, and their outcomes enhanced by linking reports to the development of best practices and/or guidelines, implementation of which can be monitored; if necessary, for instance for breach of law, stronger actions should be taken. In this context, it is important that the NSAs take the necessary steps to ensure the enforceability of ESMA's opinions and guidelines in their respective jurisdictions.

- Risk identification and crisis management. Projects under way will allow ESMA to make a qualitative jump in its contribution to financial stability and crisis management. To this end, besides needing timely and granular data, ESMA should coordinate simulation exercises amongst the national supervisors, setting out common assumptions to ensure comparability of results.

- Investor protection. ESMA's emphasis on product monitoring is warranted. Effective monitoring of financial innovation should also improve financial stability.

- ESMA is encouraged to acquire skills that enable validation of the complex risk models of CCPs, including for the clearing of OTC derivatives. As the accuracy of these models is essential to safeguard CCPs in extreme market circumstances, the independency of the review of these models should receive attention.

C. DG COMP

53. Competition and State aid policy has served as the de facto coordinating mechanism in bank restructuring during the crisis, as it is the only binding EU framework

available for this purpose. DG COMP has the exclusive mandate and power to ensure that State aid is compatible with the treaty, and that State aid provision is accepted in exchange for strict conditionality. Member states have provided aid through capital injections, guarantees and asset purchases. Compensatory measures required by DG COMP have included divestments, penalty interest rates, management removals, dividend suspensions and burden sharing (shareholder dilutions, and, lately, bail in of subordinated debt).

54. Interventions by DG COMP have been instrumental in imposing restructuring on banks but have on occasion heightened macro-financial concerns. In particular, there have been concerns about the speed of decision making and insufficient transparency, and the impact of compensatory measures on financial stability and economic growth. Since DG COMP could only act in response to national State aid proposals, decisions were taken case-by-case on an individual basis even in the presence of system-wide problems.

55. State aid management is evolving to respond more flexibly to the crisis, but faces fundamental challenges. DG COMP is assigned a difficult task in mitigating competitive distortions, yet preserving financial stability, and limiting the costs to the taxpayers while ensuring the long term viability of the institutions that receive State aid. The design of intervention strategies, therefore, sometimes involves significant trade-offs. Procedures have been accelerated, and sector-wide implications have been taken into account. The ongoing Spanish arrangement, for example, takes a broader approach. The Commission’s powers regarding the resolution of banks have been strengthened further, since ESM support to bank recapitalization is now conditional upon the Commission's approval of those banks' restructuring plans. The new mechanism has given DG COMP greater influence in the restructuring and resolution of banks receiving State aid, and led to a significant acceleration in the approval process. For instance, it took less than six months to approve the restructuring plans of eight Spanish banks, consistent with the timelines of the European program of assistance to Spain. Stronger coordination with other institutions is desirable with a view to achieving the Commission’s objective of “restoring financial stability, ensuring lending to the real economy, and dealing with systemic risk of possible insolvency.”

56. DG COMP’s practices in systemic cases can be further enhanced to ensure consistency with a country’s macro-financial framework. Phasing and composition of bank restructuring is critical to mitigate adverse macroeconomic effects. DG COMP seeks to set the right incentives to make the best use of State aid and withdraw from state protection as soon as possible. A pricing policy has been established based on recommendations of the ECB that seeks to limit moral hazard by ensuring a sufficient degree of burden sharing, although at a level which is still below the remuneration that would, in the absence of State aid, be requested by the market. However, increased transparency in pricing and proposed deleveraging would give added credibility to DG COMP’s efforts, which sometimes appear to be ad hoc. An examination, for instance with the IMF and ECB, of its policy for determining the remuneration of instruments used for capital support would be appropriate, to ensure on the one hand that it is not double-hitting a fragile institution and on the other not simply delaying the institution’s demise, and

thereby undermining financial stability going forward. Similarly, it would be helpful to look again at the methodology for determining the required degree of bank deleveraging.

57. DG COMP's role will change as a dedicated resolution framework for the BU is developed. The challenge will be to find a balance to foster a more integrated approach between the Commission as the guardian of competition and institutions that, concomitant with the BU, will be charged with overseeing bank resolution and safeguarding financial stability at the EU level. One option would be to foster a permanent coordination mechanism between DG COMP and financial stability authorities to deal efficiently with the competition and State aid aspects of future resolution cases. Moreover, as most large EA banks have presence outside the likely BU perimeter, there is likely to be an important role in coordinating between the BU resolution authority and those in the remaining EU member states using the framework of the prospective resolution directive.

D. Macroprudential Policies and the ESRB

58. The role of macroprudential supervision is to identify and reduce risks to financial stability. Macroprudential policy relies on instruments to i) limit the buildup of financial imbalances; ii) address market failures to assess risk externalities among financial institutions; and iii) dampen the procyclicality of the financial system. It can apply both at the peak of a cycle "taking away the punchbowl," as well as at the trough, to ensure that procyclicality on the downside does not prevent a revival of growth after a downturn.

59. Currently national authorities in the EU are responsible for macroprudential oversight, although adequate frameworks are still lacking in some countries. Coordination and internalization of cross-border spillovers is achieved at the EU level by the ESRB through a (non-binding) "act or explain" mechanism for member countries in response to its warnings and recommendations. In December 2011, the ESRB issued recommendations on the macroprudential mandates of national authorities. As national authorities establish institutional arrangements, guidance for establishing common macroprudential toolkits is being developed. Some harmonization of tools is required to facilitate coordination and reciprocity of those policies with cross-border effects, but flexibility must be allowed to tailor responses to local conditions.

60. Coordination of national macroprudential policies is especially important in the EU, given its highly integrated markets, as well as constraints on the use of monetary policy in the EMU. National authorities may not have power over all lending within their territory, including by foreign bank branches. The use of macroprudential instruments over a particular activity could be referred by national authorities to the ESRB for approval so that all EU banks regardless of origin are covered. Such coordination is important to minimize negative spillover effects of national policies, reduce the possibility of regulatory arbitrage, and foster policy effectiveness. The last is particularly relevant for EEEs with a high degree of cross-border banking activities and direct cross-border lending. The ESRB has announced its intention to establish coordination procedures when considered appropriate.

61. The ESRB currently lacks binding legal authority, so relies on "soft" power, and is also handicapped by its very limited resources, and burdensome governance structure. Nevertheless, it has established itself as an important body. Its first warning, over foreign currency lending in EEE, was effective, although the ESRB will achieve further credibility once it issues warnings to major "core" economies and obtains a positive response. Further work on the downside of the cycle, looking for instance at the aggregate effects of deleveraging or of asset sales, would be particularly relevant at the present juncture.[3]

62. Within the countries of the SSM, the ECB will have a role in macroprudential policy, as well as the national authorities, as it takes on its microprudential responsibilities. There are synergies with microprudential policies; also, the ECB already has good understanding of European financial markets, and its deep knowledge of the monetary transmission mechanism will be helpful in assessing the transmission mechanism of macroprudential policies. Moreover, a key challenge for macroprudential supervision will be to design and calibrate macroprudential instruments and implement them against political interference. The established independence of the ECB would help in this regard; the national macroprudential authorities too need adequate independence. Since monetary union prevents participating member states at different points of the cycle from having divergent monetary policies, macroprudential instruments may be particularly important for these countries. The ECB should cooperate closely with national authorities to benefit from their local knowledge, as well as with the ESRB in the oversight of non-EMU countries and the non-bank financial sector. It should be responsible for a wide range of instruments going beyond those included in CRD IV/CRR

63. The ESRB will continue to have an important role, and will continue to be responsible for macroprudential oversight over the financial sector at the EU level. While the ECB only has authority over banks, the ESRB covers the entire financial system, including insurance and occupational pensions, as well as market infrastructure, financial markets and products. The ESRB would be well suited for effective identification, analysis and monitoring of EU-wide systemic risks, and for assessing the array of instruments potentially available to address them. The ESRB should interact with the ECB on macroprudential toolkits when the ECB takes on macroprudential responsibilities, as it does with national agencies. It must be able to exercise its powers and issue the same kind of recommendation to the ECB as it does to any NCB or bank supervisor—this would require a substantial revision to the ESRB legal framework, a detachment from the ECB "umbrella" and a clear delineation with the mandate of the latter.

E. Structural Reforms

64. High level working groups chaired respectively by Vickers and Governor Liikanen of the Bank of Finland assessed the need for additional banking reforms. These could be targeted at individual banks to reduce the probability and impact of failure, ensure the

[3] Recommendations on money market funds and bank funding were approved by the ESRB General Board in February 2013.

continuation of vital economic functions in the event of failure, and better protect vulnerable retail clients. One conclusion was that the experience of the crisis showed that no one type of bank performed systematically better than the others, and no one type did systematically worse.

65. The Liikanen group recommended the mandatory separation of the investment banking business. This type of business was deemed riskiest, and that separation would limit danger of contagion to core functions such as deposit-taking and payments, and hence reduce taxpayers' contingent liabilities. It would also limit the scope for cross-subsidization, improve the scope for effective monitoring and risk management, and facilitate resolution. This proposal is in the spirit of others elsewhere, including the Volcker Rule in the U.S. and the Vickers group's recommendations for ring-fencing of retail banking.[4] More recently, the French authorities proposed that banks separate the same businesses that are prohibited by the Volcker rule, albeit banks would be allowed to run these businesses in a separate subsidiary.

66. The Liikanen proposal allows the preservation of the universal banking model, characteristic of much of Europe. It mandates that businesses to be placed in a stand-alone subsidiary include proprietary trading, market making, and investments in hedge funds and private equity funds. The trading subsidiary and the subsidiary housing deposits and payments would need to meet capital and other regulatory requirements on a stand-alone basis. The report argues that any increased costs from the removal of synergies between the two may simply reflect the withdrawal of the hidden taxpayer subsidy for the implicit saving of the institution.

67. Proposed measures to enhance resolvability are welcome. The Liikanen group argues for enhancing the bank resolution regime, developing a comprehensive system of bail-ins, applying more robust weights in the determination of minimum capital, more consistent treatment of internal risk models, and governance reforms. It recommends higher loss absorbency requirement for the trading subsidiaries engaging in separated businesses via a leverage ratio.

68. However, separation of banking activities would not have helped address some of the most serious problems of the crisis. Lehman Brothers, for example, was not a retail deposit taking institution. Also, many banking sector difficulties derived from the "plain vanilla" side of the bank, most particularly lending for residential real estate. And now the sovereign-bank linkage is causing difficulties particularly for those banks that invested in their countries' government bonds, notionally the most conservative of strategies. Most importantly, from the

[4] Amongst the differences of the Vickers proposal from Liikanen are: (i) Vickers pushes almost all investment banking activities out of the deposit bank, while Liikanen allows the deposit bank to retain underwriting and client facing hedging services; (ii) Vickers would apply to almost all banks, while Liikanen would apply only to the largest banking groups; and (iii) Vickers applies the ring-fencing only to the U.K. business while Liikanen would apply to all affiliates of an EU banking group. Both the Vickers and the Liikanen proposals differ from the Volcker proposal for the U.S. in that retail and investment banking would be allowed to remain within the same legal entity.

perspectives of ease of resolution and minimizing contingent fiscal liabilities, separation may not work as intended as trading subsidiaries may remain systemically important, especially since they will house market making operations of the largest banks.

69. Consistency with structural reform proposals in comparable jurisdictions, at least insofar as application to internationally active banks is concerned, is important.

- There is a danger that the major international banks may optimize across different structural constraints by moving operations, changing corporate structures, and redesigning products in ways that could weaken policy effectiveness. This would put further pressure on cross-border supervision and resolution.
- It will be important to manage differences across the proposals so that they do not result in mutually inconsistent structural constraints on internationally active banks.
- A level playing field will need to be developed vis-à-vis banks from outside the EU that are competing within the EU.[5]

F. Financial Market Infrastructure

Regulation

70. The adoption of the European Market Infrastructure Regulation (EMIR) and the legislative work on the draft Central Securities Depositories (CSD) Regulation are important for the creation of a single market for CCPs and CSDs. The regulations significantly reduce sources of risks related to the cross-border offering of clearing and settlement services, and provide for a level playing field, enhancing fair and efficient competition between CCPs and CSDs. The intention of the Commission to further centralize supervisory responsibilities in the medium term is appropriate.

71. Measures are needed to ensure that recovery and resolution plans for CCPs and CSDs will work across borders in case of large market disruptions. With national competent authorities bearing the primary supervisory responsibilities, the framework does not provide safeguards to ensure that the national interest may sometimes prevail over the general interest to have safe and efficient CCPs and CSDs. The active participation of ESMA in the CCP colleges should contribute significantly to supervisory consistency and oversight. Access rights of CCPs and CSDs for other markets and infrastructures should be further developed in line with international standards. The establishment of a comprehensive framework for cooperation between national supervisors of CSDs is needed too, given the increased cross-border nature of CSDs. The supervision and oversight of the two international CSDs in the EU should be enhanced,

[5] Further discussion of this topic with be provided in a forthcoming IMF SDN "Making Banks Safer: What Role Can Structural Measures Play?" IMF Staff Discussion Note (forthcoming).

in cooperation with the ECB in its responsibility for financial stability and by participation in the SSM, as competitive pressures may encourage competition on risk management frameworks.

72. Regulatory risks arise due to differences in the legal and regulatory frameworks in the EU, the U.S. and elsewhere to handle the mandatory clearing obligation for standardized derivative contracts. Globally operating OTC derivative CCPs face regulatory uncertainty and inefficiencies. Regulators should continue ongoing joint work to give priority to the identification and mitigation of conflicts, inconsistencies and gaps between EMIR and other non-EU frameworks through bilateral and multilateral coordination. The EU has drafted flexible arrangements for the identification and recognition of third country CCPs that limit the risks of conflicts of laws by ensuring that foreign CCPs remain subject to their home regulation.

73. EU crisis management procedures for financial market infrastructures should be further developed and tested. A notification regime should be in place that allows for immediate information sharing between all relevant authorities, CCPs, CSDs and other systems and market participants. Central monitoring of potential market wide disruptions should be enforced, for example in relation to the quality of collateral kept by CCPs and international CSDs.

Euroclear's soundness and efficiency

74. Euroclear Bank is a securities settlement system that contributes to the safety and efficiency of global markets for government bonds and other international securities but also concentrates systemic risk. It is one of the largest securities settlement systems worldwide with a daily average settlement value of around €1.1 trillion, providing settlement services for securities from 44 markets in 53 currencies. In particular, Euroclear Bank services the largest, global banks with triparty repo arrangements to secure their interbank financing.

75. Important risk measures have been taken to reduce systemic risk, but some of the risk management frameworks need to be further improved to fully observe the recently adopted international standards.[6] Euroclear Bank should in particular prepare measures to be operationally ready for the implementation of its recovery plans and plans for the orderly winding down of its operations. In addition, it should upgrade some risk management policies and practices to reduce its (potential unsecured) credit exposures to participants and other linked securities settlement systems. It has recently made important improvements to its collateral and its liquidity management frameworks.

76. Euroclear Bank is subject to effective regulation, supervision and oversight of the NBB and FSMA, but cooperation with the Luxembourg authorities should be improved. The legal framework provides the Belgian authorities with sufficient powers to obtain timely information and induce change. However, as Euroclear Bank is in competition with the Luxembourg based Clearstream Banking Luxembourg—which offers similar settlement and

[6] CPSS-IOSCO Principles for Financial Market Infrastructures.

banking services—close cooperation with the Luxembourg authorities is needed to avoid any competition on risk management frameworks. As both entities are highly relevant for the global financial stability the Belgian and Luxembourg authorities should evolve from the existing cooperation towards a cooperative framework that would allow them to take common decisions and implement these simultaneously in both entities. The plans to include Euroclear Bank on the list of eligible banks for the SSM may further contribute to a level playing field.

77. The national securities depositories of Belgium, France, and the Netherlands, that share a common IT platform provided by the Euroclear Group, are subject to effective regulation, supervision, and oversight of the Belgian, Dutch, and French authorities, despite the fact that the legal frameworks differ substantially between the three countries. The cooperation between the different authorities is effective and contributes to the financial stability in Belgium, France, and the Netherlands. Crisis management frameworks are in place that are regularly tested and updated.

TARGET2's soundness and efficiency

78. TARGET2 displays a high level of observance of international standards. The system has a sound, coherent, and transparent legal basis. It has developed an adequate risk management framework to address financial and operational risks. As a real time gross settlement (RTGS) system, credit risk is minimized. Liquidity risk is mitigated by participants having access to central bank intraday liquidity based on adequate collateral and the liquidity saving mechanism offered by the system. TARGET2 business continuity arrangements are well developed and comprehensive, covering operational as well as communication network aspects.

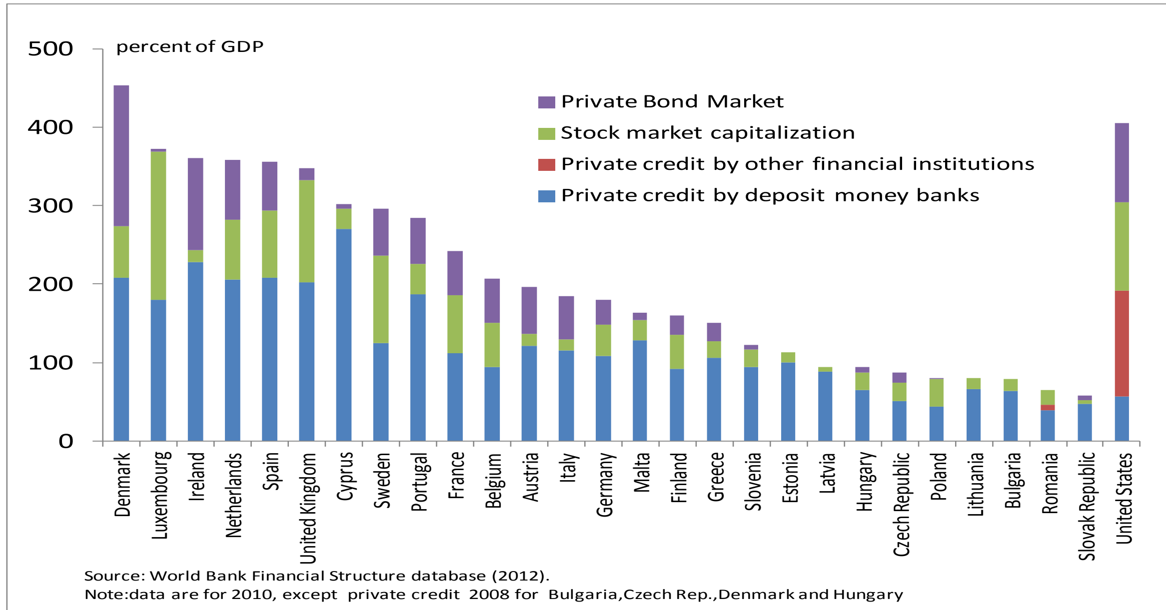
79. Nevertheless, TARGET2 crisis management and risk communication procedures can be enhanced by giving the ECB direct access to information on participants' liquidity as well as collateral positions. For most large participants, liquidity positions are maintained in several countries, and NCBs can only monitor positions maintained on their own account system. Furthermore, the collateralization process and securities holding are decentralized. Centralizing the monitoring of participants' liquidity and, where possible, collateral positions at the level of the ECB is crucial in order to allow the Eurosystem to maintain financial stability across the EA by acting quickly and effectively in the event of financial distress.

Eurosystem's oversight framework for payments

80. The ECB's oversight capacity should be strengthened. The ECB is in the process of moving from a rule-based to risk-based and forward looking oversight approach. In particular, it is developing more dynamic oversight tools such as interdependencies analysis, stress testing, and early warning system. The ECB oversight team has the responsibility to define the Eurosystem's strategy and policy, develop rules and guidance, coordinate the Eurosystem, and contribute to international fora. In addition, the ECB will soon participate in several EMIR colleges for CCPs. In order to implement the new risk-based approach credibly, the ECB needs to access to confidential bank-by-bank data which is within the remit of the NCBs and to strengthen the

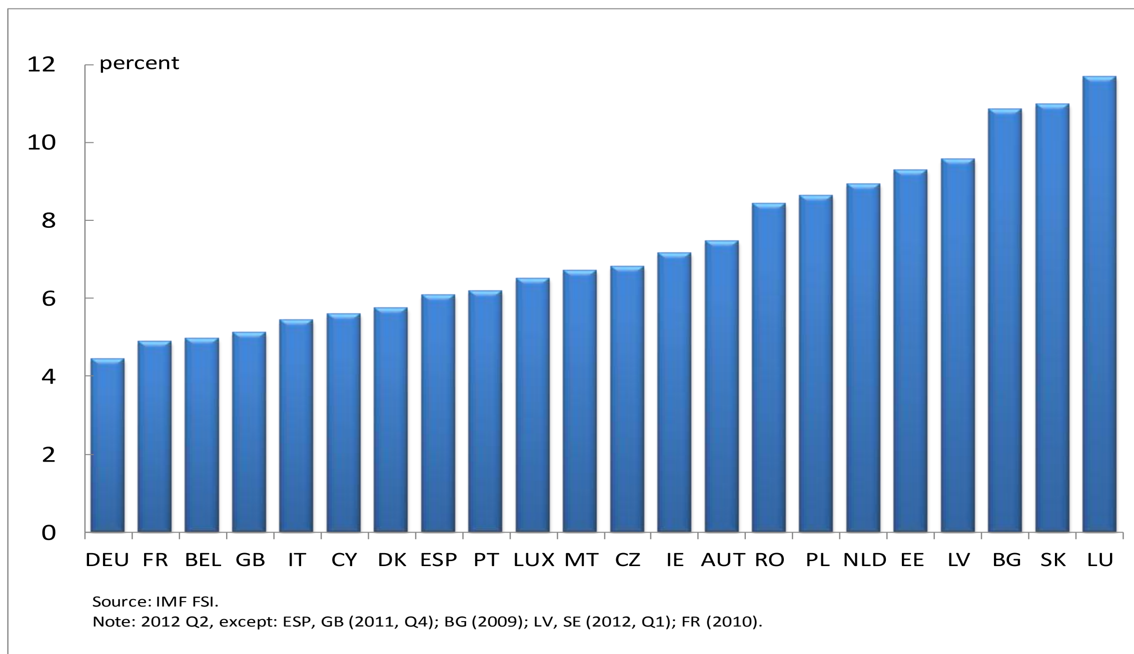
capacity and the skill of its staff. ECB oversight staff should be significantly increased, and their work organized in cluster modules, focusing on overseeing individual entities as well as on specific risks across entities. They need the right skills, and continuity in running critical areas such as interdependencies and stress testing.

Figure 1. 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

Figure 2: EU: Capital-to-Asset Ratio (in percent)



Source: IMF FSI.
Note: 2012 Q2, except: ESP, GB (2011, Q4); BG (2009); LV, SE (2012, Q1); FR (2010).

Figure 3. EU: Total Intra-EU Foreign Exposure
(In EUR bn.)

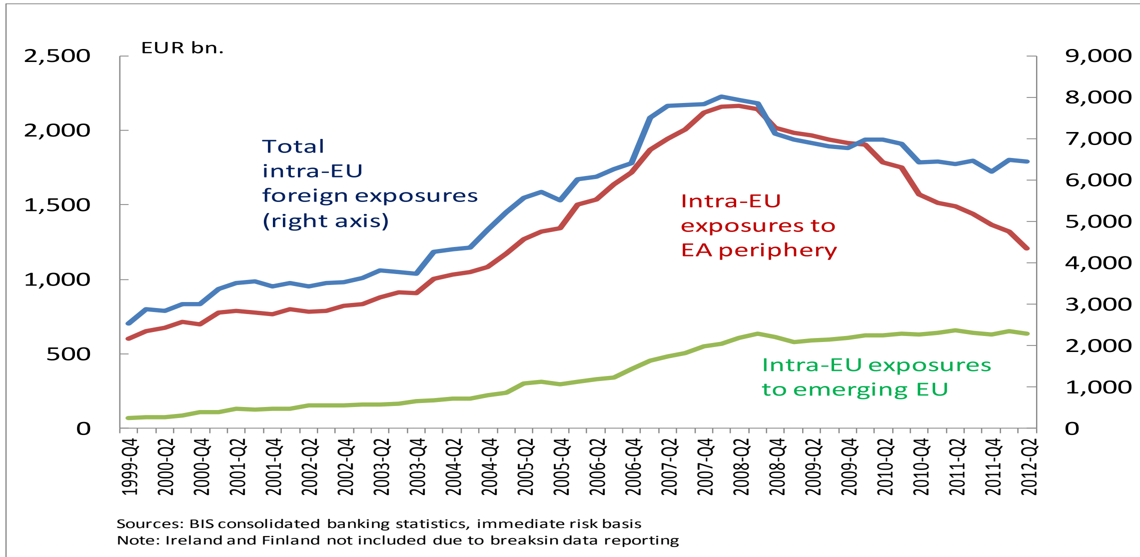


Figure 4. EU: Selected Advanced Economies—Assets of Four Largest Banks/GBP
(In percent)

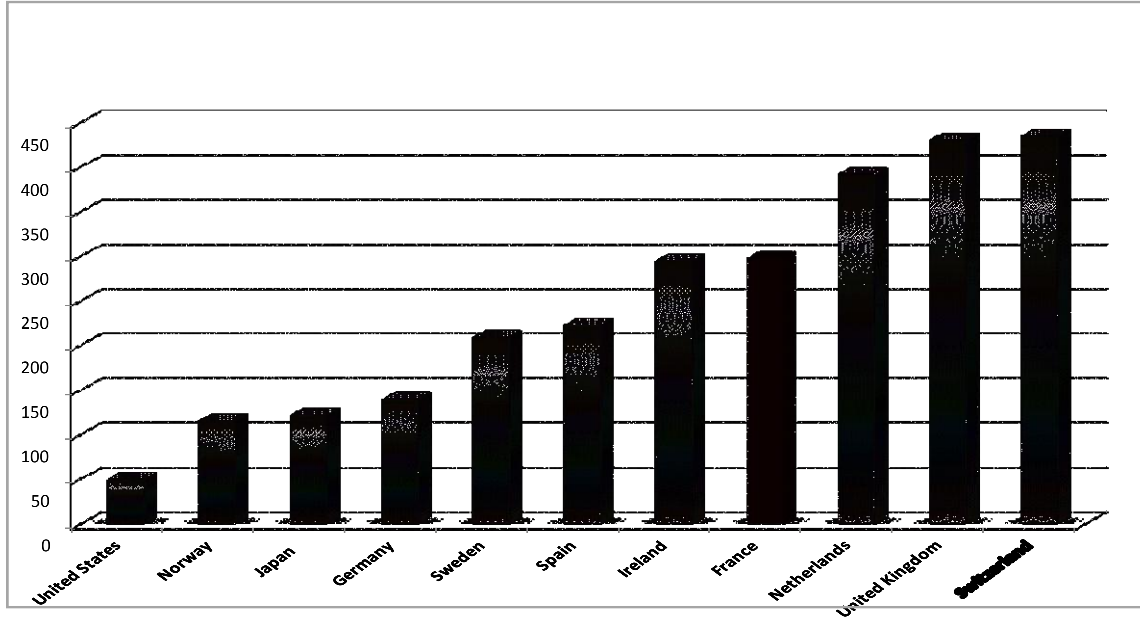


Figure 5. EU: Market Shares of Foreign Banks in EU Member States (2011, in percent)

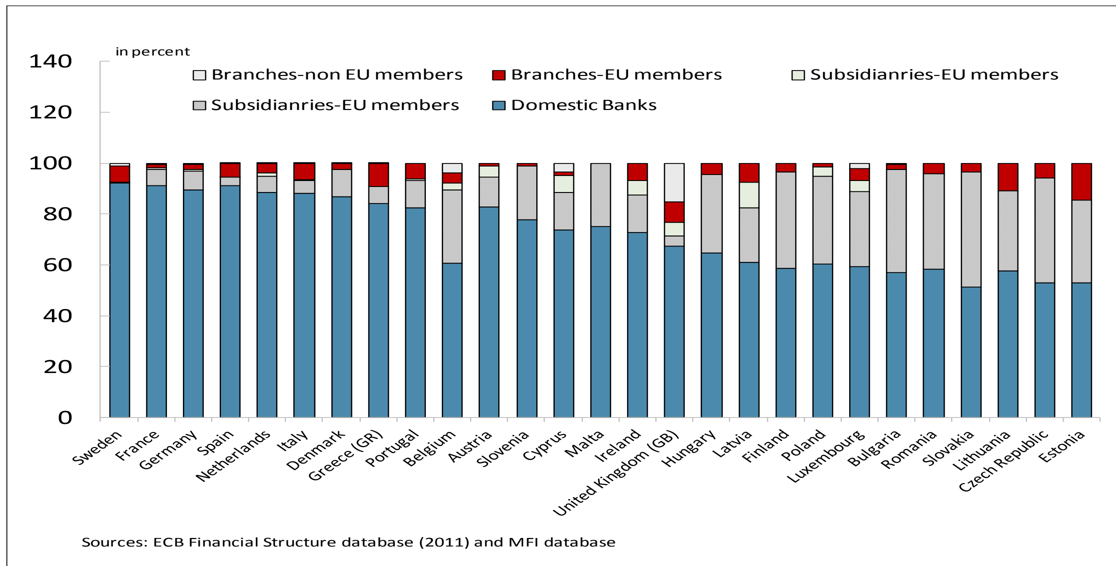


Figure 6. EU: Selected Emerging European Countries—Real Private Credit (Index January 2008 = 100)

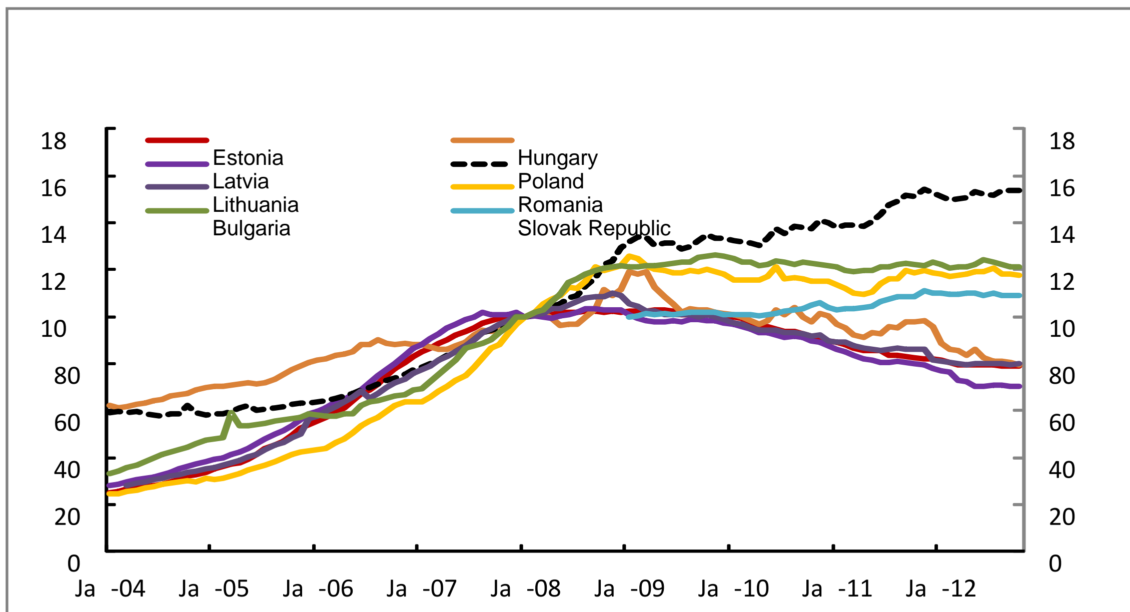


Figure 7. EU: Spillover Coefficient Country Groups

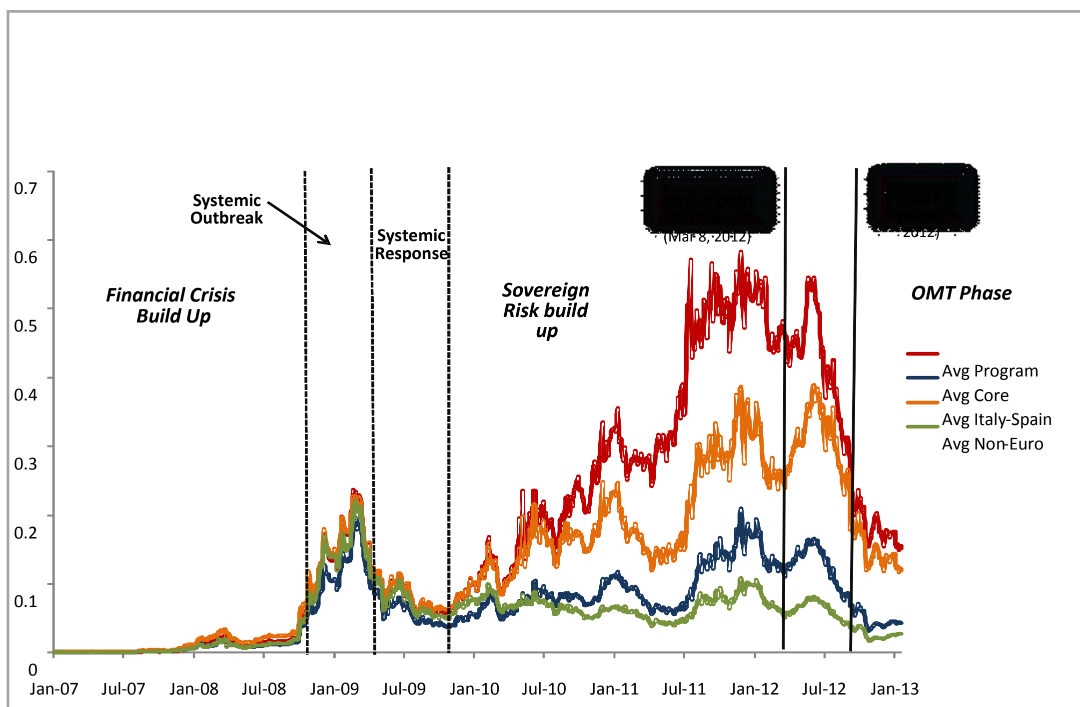


Chart Technical Explanation:

The Spillover Coefficient (SC)—is estimated in order to quantify the role that contagion plays in driving sovereign spreads. The SC characterizes the probability of distress of a country conditional on other countries becoming distressed. The SC embeds sovereigns' distress dependence, and how such dependence changes along different periods of the economic cycle, reflecting that dependence increases in periods of distress.

For each country A_i, the SC is computed using the formula: $SC(A_i) = \sum P(A_i/A_j) \cdot P(A_j)$ for all $j \neq I$, which is essentially the weighted sum of the probability of distress of country A_i given a default in each of the other countries in the sample. This measure of distress dependence is appropriately weighed by the probability of each of these events to occur.

The probability of sovereign distress in country A_i given a default by country A_j, referred here as the probability of A_i given A_j, denoted by $P(A_i/A_j)$, is obtained in three steps: (i) the marginal probabilities of default for countries A_i and A_j, $P(A_i)$ and $P(A_j)$ respectively, are extracted from the individual CDS spreads for these countries; (ii) then, the joint probability of default of A_i and A_j, $P(A_i, A_j)$, is obtained using the CIMDO methodology* (Segoviano, 2006), which embeds sovereigns' distress dependence, and its changes at different points of the economic cycle.(iii) Finally, the conditional probability of default $P(A_i/A_j)$ is obtained by using the Bayes' law: $P(A_i/A_j) = P(A_i,A_j) / P(A_j)$.

* CIMDO methodology is used to estimate the multivariate empirical distribution (CIMDO-distribution) that characterizes the probabilities of distress of each of the sovereigns under analysis, their distress dependence, and how such dependence changes along the economic cycle. The CIMDO methodology is a nonparametric methodology, based on the Kullback (1959) cross-entropy approach.

Figure 8. EU: Correlations of Sovereign and Bank CDS Spreads (January 2010–October 2012)

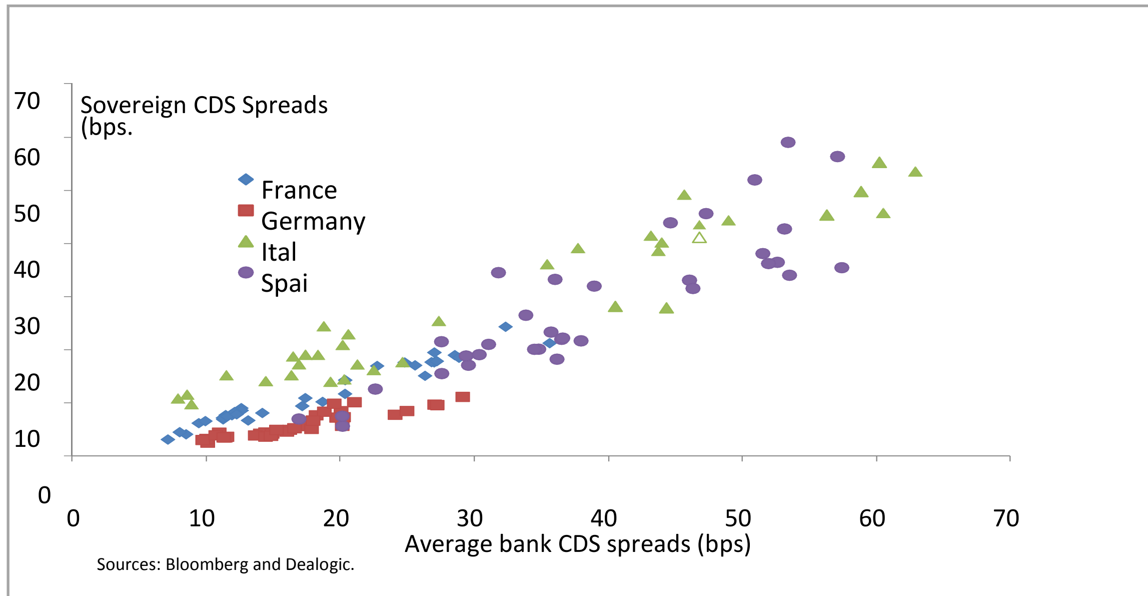


Figure 9. EU: Deleveraging by EA Banks—Domestic and Cross-Border (September 2008–September 2012)

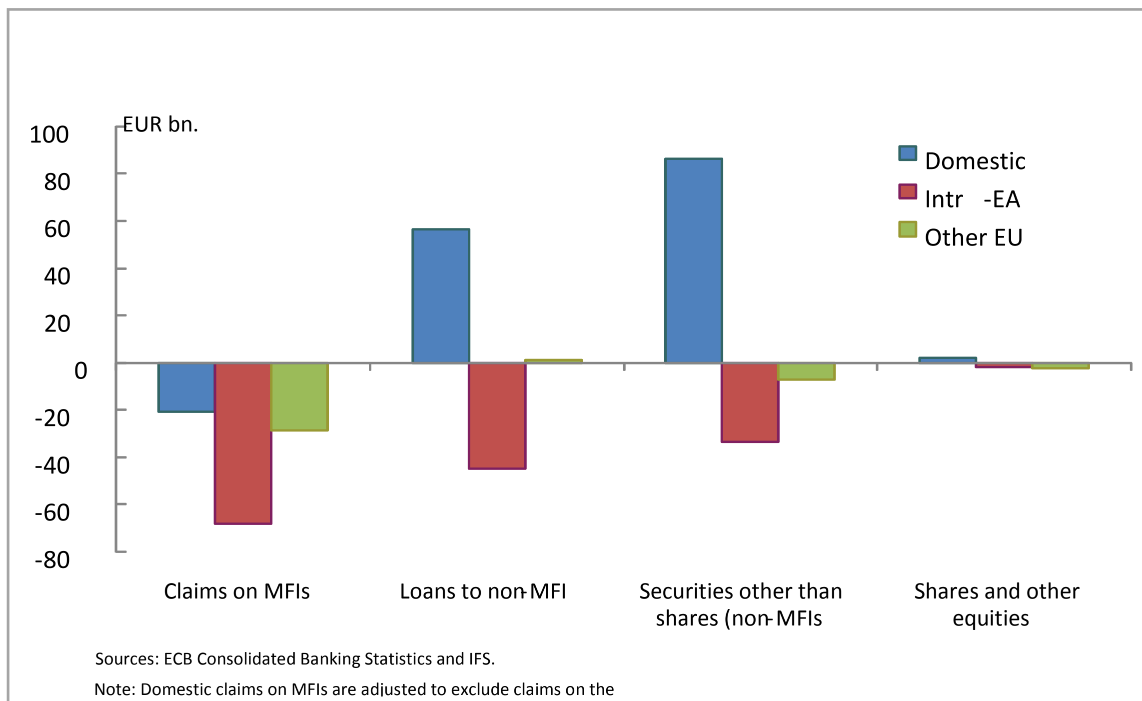
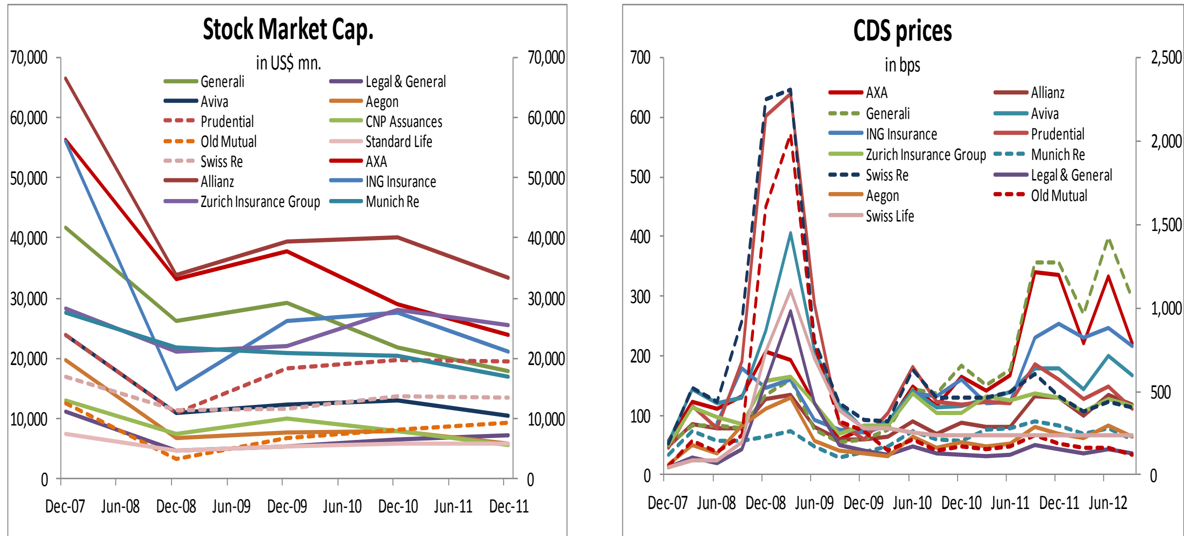


Figure 10. EU: Insurance Market Capitalization in EUR bn and CDS Spreads (In bps 2007–2012)



Appendix I. Risks and Vulnerabilities in EU Countries—Lessons from National FSAPs[7]

The overstatement of asset quality has been one major cause of the banking crisis experienced by some EU countries. Medium-term financial and macroeconomic risks, common across the region, could further impair asset quality and damage banking sector balance sheets. Stress tests, however, suggest that capital buffers appear broadly adequate. Against liquidity shocks, the availability of official facilities help protect the banking system, but central banks in smaller countries may face difficulties shoring up foreign currency shortages, especially in U.S. dollars. Safeguarding against tail risk scenarios requires continuing building up capital and liquidity buffers to meet the Basel III targets. Enhancing financial sector oversight and macroprudential supervision will also help reducing balance sheet risks.

81. The experience of EU crisis countries underscores the importance of an adequate assessment of asset quality in banks' balance sheets. In Greece and Portugal, domestic banks suffered substantial losses mainly from their domestic sovereign debt holdings. In Ireland and Spain, losses in the banking system were triggered by the burst of domestic real estate bubbles. Capital buffers and provision regimes, including dynamic provisions, as in the case of Spain, were not designed to withstand the massive losses entailed by the downgrade of risk-free assets to junk status and the large downward price corrections when asset price bubbles burst. Markets concerns about banks' creditworthiness also led to funding shortages, reducing their ability to continue funding their domestic economies and sovereigns.

82. Recent FSAPs in EU countries highlight a number of common financial and macroeconomic risks across the region. These risks emerged in the aftermath of the global financial crisis and the sovereign debt crisis in the EA (Appendix II). The main financial risks are stresses and dislocations in wholesale funding markets that could lead to adverse liquidity and refinancing conditions; deteriorating or sustained high sovereign risk if the EA crisis intensifies; and a major further downward correction of asset prices. The main macroeconomic risks are associated with the scenarios of a global double dip recession and a protracted slow growth in Europe. Uncertainty about the regulatory environment and the burden it may place on banks and financial institutions is also viewed as a source of risk in jurisdictions hosting systemic banking systems and financial institutions. In several EU countries, the high degree of concentration in the banking sector creates too-big-to-fail problems that could amplify the country's vulnerability were the risks to materialize.

83. These risks could materialize in further deterioration of asset quality in banks' balance sheets, a contraction of credit to the real economy, and rising stress in funding markets. Rising sovereign risk could affect banks still holding substantial claims on EA periphery sovereigns and corporates, raising their funding costs and encouraging further deleveraging that

[7] Prepared by Jorge A. Chan-Lau.

could shrink credit supply in the banks' home and host jurisdictions. Given the strong trade and financial linkages within the EU, adverse global macroeconomic scenarios characterized by slow and/or negative growth and rising unemployment would lead to higher NPLs and declining profits, reducing the scope for bank recapitalization without inducing further deleveraging. Banks in the region that rely heavily on market funding would face liquidity problems in the face of declining capital buffers, increasing impaired assets, and a weak earnings outlook. While official measures adopted by the ECB have helped to restore some normalcy to funding markets, central banks in smaller countries may face difficulties providing liquidity in foreign currency. Finally, the recent FSAPs in EU countries note that these risks contribute to reinforcing the bank-sovereign linkage, with weaknesses in the banking sector contributing to increased sovereign risk, and vice-versa.

84. Notwithstanding these risks, FSAP stress tests suggest that capital buffers in EU countries appear mostly adequate to withstand severe macroeconomic shocks but there are some caveats. The resilience of the banking sector to macroeconomic shocks follows from efforts to repair balance sheets in the banking system, including the divestment of non-core assets. These efforts contributed to an earnings recovery for some large internationally diversified banks. However, legacy assets remain a problem in many EU countries, and there are concerns in some cases that reported NPLs and provisions could understate losses. Contrary to the crisis countries, comprehensive asset quality reviews have not been conducted with the exception of Spain. Absent such reviews, the loss estimates may not reflect the underlying quality of the banks' balance sheet. Banking, by nature, builds up on leverage which magnifies asset losses. Even though capital buffers relative to assets will increase under Basel III, assessing asset quality is a must.

85. FSAP recommendations point towards the need to continue building up buffers and strengthening financial sector oversight and macroprudential supervision. The need for larger and better quality buffers has been highlighted by recent experience, with Basel III providing the roadmap and timelines. FSAP recommendations related to financial sector oversight and macroprudential supervision aimed mainly at improving the legal framework, enhancing the review, supervisory and crisis management processes, and improving the quality of the data used to monitor and measure risks. The proposed BU could help anchoring oversight and supervision within a macroprudential perspective emphasizing the proper assessment of asset quality.

Appendix Table 1. Risks and Vulnerabilities in EU Countries Identified by Recent FSAPs

	France **FSAP Completion Date:** **July 2012**	**Germany** **FSAP Completion Date:** **July 2011**	**Luxembourg** **FSAP Completion Date:** **May 2011**
Main Source of Risk	**Vulnerabilities**	**Vulnerabilities**	**Vulnerabilities**
Stresses and dislocations in wholesale funding markets; adverse liquidity and refinancing conditions.	• Likelihood: medium; impact: high. • Bank refinancing needs in 2013–4 are significant and heavily reliant on wholesale funding. • Domestic interbank market frozen as of end-October 2012. • Vulnerable to systemic liquidity shocks owing to cross-border interbank exposures and derivatives positions.	• Likelihood: medium; impact: medium. • Some banks may face distressed U.S. dollar funding conditions. • Certain banks rely heavily on market funding including through interbank borrowing, securitization, and covered bond issuance. • Landesbanken seem to be more vulnerable than other banks; retail banks exhibit more resilience.	• Likelihood: medium; impact: medium to high. • Liquidity pressures on local bank subsidiaries could materialize if parent bank is under severe stress; the failure of the parent bank would likely lead to the failure of the subsidiary.
Deteriorating or sustained high sovereign risk; intensification of the EA crisis.	• Likelihood: medium; impact: medium to high. • Large exposure of systemically important financial institutions (SIFIs) to peripheral Europe could translate into losses from deteriorating loan quality and sovereign bond values. • Bank deleveraging may lower returns and profitability. • Downgrade of own sovereign could impact negatively banks' ratings, funding costs, and ability to support derivatives operations.	• Likelihood: medium; impact: medium to high. • Financial institutions' holdings of foreign sovereign, sovereign-linked, and sub-national government claims are substantial.	• Likelihood: high; impact: high. • EA periphery exposures amount to half of the aggregate bank capital in the jurisdiction. • EA periphery-related losses of parent groups could lead to additional losses through indirect exposures arising from solvency and liquidity pressures. These exposures are difficult to quantify though.
Declining or sharp downward correction to asset prices.	• Likelihood: medium; impact: medium to low. • LTV ratios are high but the risks to banks from a downward house price correction appear limited owing to households' comparatively low debt levels and sound lending standards. • A housing price correction could still have an indirect impact on banks through its impact on real GDP.	• N.A.	• Likelihood: low to medium; impact: medium (domestically), high (globally). • Turbulence in bond and asset markets could lead to large scale fund redemptions, damaging the domestic and European fund industry. • Run on funds could depress asset market prices further, forcing fund sponsors, depository and custodian banks to provide liquidity. • Linkages to domestic banks appear limited; similarly, the direct impact on European bank funding through fire sale of assets is also limited.

Appendix Table 1. Risks and Vulnerabilities in EU Countries Identified by Recent FSAPs (continued)			
	France **FSAP Completion Date:** **July 2012**	**Germany** **FSAP Completion Date:** **July 2011**	**Luxembourg** **FSAP Completion Date:** **May 2011**
Main Source of Risk	**Vulnerabilities**	**Vulnerabilities**	**Vulnerabilities**
Double dip recession.	• Likelihood: medium; impact: high. • Bank asset quality would be affected; NPLs likely to rise; lower earnings from lower interest margins and higher provisioning needs. • Increased financial distress and heightened risk aversion could dampen growth by widening spreads and reduced credit supply.	• Likelihood: low; impact: medium. • Credit quality deterioration. • Reduced bank profitability from an inversion of the yield curve. • Non-bank financial institutions affected by market losses on securities; losses in pension funds and insurance companies from the impact of low rates on long-term liabilities. • A short recession is unlikely to generate systemic risk.	• Likelihood: medium; impact: medium to high. • Strong capital buffers make banks resilience as long as the parent bank does not fail.
Slow growth in Europe; low interest rate environment	• N.A.	• Likelihood: medium; impact: high. • Reduced profitability and ability to meet higher capital requirements. • Losses in pension funds and insurance companies from the impact of low rates on long-term liabilities.	• N.A.
Regulatory uncertainty and regulatory burden.	• N.A.	• Likelihood: high; impact: low. • Money market banks and large financial groups will be the most affected, having to increase core capital and decrease leverage.	• Likelihood: low to medium; impact: high.

Appendix Table 1. Risks and Vulnerabilities in EU Countries Identified by Recent FSAPs (continued)

Main Source of Risk	The Netherlands FSAP Completion Date: March 2011 Vulnerabilities	Spain FSAP Completion Date: May 2012 Vulnerabilities	Sweden FSAP Completion Date: July 2011 Vulnerabilities
Stresses and dislocations in wholesale funding markets; adverse liquidity and refinancing conditions.	• Likelihood: medium; impact: medium. • Banks reliant on interbank borrowing, securitization and covered bond issuance would be the most affected. • Increased competition for retail deposits could squeeze profitability further; "safe haven" concerns could reduce the returns for banks with funding surpluses.	• Likelihood: medium to high; impact: high. • Substantial bank refinancing needs in • 2012–13. • Despite comfortable buffers of ECB instruments that could be used as repo collateral worsening market conditions could impose higher haircuts to banks' collateral. • Refinancing difficulties could prevent and orderly deleveraging in the banking sector.	• Likelihood: medium; impact: high. • Banks could face refinancing risks, including higher funding rates. • The central bank has limited ability to offset foreign currency liquidity shortages.
Deteriorating or sustained high sovereign risk; intensification of the EA crisis.	• Likelihood: medium; impact: low. • Banks appear less exposed to EA periphery countries than are some in neighboring countries. • Spillovers from the periphery to the core raise concerns.	• Likelihood: high; impact: high. • Limited direct exposure of the banking system to peripheral countries, but exposure to domestic sovereign is high, amounting to 150 percent of core Tier 1 capital. • Trading book and mark-to-market value of the AFS book only minimally affected by valuation haircuts.	• N.A.
Declining or sharp downward correction to asset prices.	• Likelihood: medium; impact: high. • Banks are heavily exposed to the residential housing market; falling prices and lending arrears would have a negative impact on banks' balance sheets.	• Likelihood: high; impact: high. • Since real estate exposures are large, recapitalization needs will further increase. • About one out of four banks in the stress test sample would face severe capital losses.	• Likelihood: medium; impact: high. • Falling housing prices would lead to direct losses in the banking system and indirect losses from weaker economic growth and higher unemployment.
Double dip recession in advanced economies.	• Likelihood: medium; impact: medium. • Bank solvency affected by high and/or rising unemployment rates; sharp housing price corrections; rising NPLs from corporate and households. • Difficulties of foreign subsidiaries would impact parent banks negatively.	• N.A.	• Likelihood: medium; impact: medium. • Bank asset quality would be adversely affected through various transmission channels including increased unemployment, deteriorating corporate earnings, and a sharp correction in real estate prices.
Slow growth in Europe; low interest rate environment.	• Likelihood: medium; impact: medium to high. • Impact considerations largely in line with the realization of the double dip recession risk. • Scenario not included in stress test.	• Impact similar to 2 above but scenario not included in stress test.	• N.A.
Regulatory uncertainty and regulatory burden.	• N.A.	• N.A.	• Likelihood: medium; impact: high. • Banks need to extend their funding maturity to comply with new liquidity regulations, leading to higher lending rates, reduced lending and/or lower bank profitability.

Appendix Table 1. Risks and Vulnerabilities in EU Countries Identified by Recent FSAPs (continued)			
	Czech Republic FSAP Completion Date: December 2011	**Slovenia FSAP Completion Date: October 2012**	**United Kingdom FSAP Completion Date: May 2011**
Main Source of Risk	**Vulnerabilities**	**Vulnerabilities**	**Vulnerabilities**
Stresses and dislocations in wholesale funding markets; adverse liquidity and refinancing conditions.	• N.A	• LTROs have contributed to alleviate banks' funding pressures but the loan to deposit ratio for the system is high. • Foreign-owned banks are more reliant on wholesale funding than domestic banks.	• Likelihood: medium and rising; impact: high. • Stable funding in the banking sector beyond six months is inadequate.
Deteriorating or sustained high sovereign risk; intensification of the EA crisis.	• Likelihood: medium; impact: high. • The transmission channel would be the failure of a foreign parent bank as the direct exposure of Czech banks to euro area sovereigns is very low. • Upstreaming capital and/or liquidity to parent may limit the operational scope of the subsidiaries. • Reputational risk would pressure liquidity and funding costs; and encourage deleveraging.	• Impact: low. • EA periphery exposures are small.	• Likelihood: medium and rising; impact: low. • Extreme tail risk losses in the banking sector could amount to about 6 percent of 2010 GDP. • Rising sovereign risk could expose banks to funding disruptions.
Declining or sharp downward correction to asset prices.	• See 4 below on housing prices and commercial real estate prices.	• Housing and commercial real estate prices have remained relatively stable since the price correction experienced in 2008; however, the inventory of foreclosed properties and NPLs in the sector has increased. • Further declines in CRE and housing prices are likely to accelerate foreclosures and NPLs in the banking sector, resulting in impairments. • Protracted bankruptcy procedures suggest increased foreclosures would affect prices only after a substantial lag of about 2–3 years.	• Likelihood: medium; impact: medium. • Commercial real estate loans account for a substantial share of corporate loans, putting banks at risk if CRE prices decline sharply. • Housing loans to low income households are more sensitive to housing price declines and real interest rate shocks. • Lender forbearance practices could be masking increased risks in housing and CRE markets. • Two large U.K. banks have very large exposures to Asia, which has experienced rapid asset price increases on the back of strong capital inflows.

Appendix Table 1. Risks and Vulnerabilities in EU Countries Identified by Recent FSAPs (concluded)			
	Czech Republic **FSAP Completion Date: December 2011**	**Slovenia** **FSAP Completion Date: October 2012**	**United Kingdom** **FSAP Completion Date: May 2011**
Main Source of Risk	**Vulnerabilities**	**Vulnerabilities**	**Vulnerabilities**
Double dip recession in advanced economies.	• Likelihood: medium; impact: medium to high. • Unfavorable export markets; slower domestic growth; drop in asset prices; reversal of capital flows. • Negative effects on banks' asset quality leading to a substantial drop in capitalization. • Heavy concentration of bank loans in commercial real estate and mortgages makes banks especially sensitive to a severe macroeconomic shock.	• Likelihood: high; impact: high. • Negative impact through trade and financial channels. • Further recapitalization needs required for the largest domestic bank.	• Likelihood: medium; impact: medium. • Major banks would be able to absorb losses, with extreme tail risk losses amounting to about 2½ percent of 2010 GDP.
Slow growth in Europe; low interest rate environment.	• Likelihood: high; impact: medium. • Negative impact on economy through main trading partners, especially Germany; asset quality and income deterioration in the banking sector. • Higher funding costs resulting from competition for deposits and the adoption of Basel III to a certain degree. • Higher exchange rate volatility could amplify stress conditions.	• N.A.	• Likelihood: medium; impact: low. • The insurance sector exhibits resilience to low interest rates; extreme tail risk losses in the banking system could be as high as 5 percent of 2010 GDP.
Regulatory uncertainty and regulatory burden.	• N.A.	• N.A.	• Likelihood: medium; impact: medium. • Basel III could have a significant impact on banks; Core Tier 1 capital reduced by half for six largest banks under new definition; new liquidity requirements will affect short-term wholesale funding practices; SIFIs profitability adversely affected. • Solvency II, which becomes effective January 1, 2013, could encourage search for yield among insurers.

Appendix Table 2. Risk Assessment Matrix		
Nature/Source of Main Threats	**Overall Level of Concern**	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
Protracted slow growth in Europe	***Staff assessment: Medium*** • Deep recessions in the southern periphery EA countries have spilled over to the rest of the EA and affect the emerging economies of the EU. • 2013 growth is projected to be below 1 percent in the EA and the U.K., and is slowing in many countries.	***Staff assessment: High*** • The real economy and the financial system become locked in an unstable low-quality equilibrium. • Banks' NPLs are likely to rise, leading to higher provisions, which would hurt bank profitability and could lead to a capital shortfall in some banks. • Weak growth would reduce already limited fiscal space and hamper efforts to restore fiscal sustainability.
Stresses in wholesale funding markets	***Staff assessment: Medium*** • EU banks rely heavily on wholesale funding. • Risks mitigated as funding conditions are eased as the announcement of OMT programs reduced tail-risk perceptions. • But funding costs of periphery banks are still high and exit from LTROs is uncertain. • High sovereign yields from slowed fiscal consolidation could raise funding costs.	***Staff assessment: Medium/High*** • Funding difficulties could prevent orderly deleveraging. • Increased competition for retail deposits could squeeze bank profits and entrench market fragmentation, as national authorities would be prompted to limit liquidity transfers between parent banks and their subsidiaries. • High asset encumbrance lowers bank access to secured funding, increases costs of unsecured funding, thus reduces banks' resilience to funding shocks.
Policy risks	***Staff assessment: Medium*** • Possibility of slippage in the main steps toward completing the EU financial oversight framework (the agreement on the SSM, the roadmap toward BU, regulatory reforms) that are needed to anchor long-term expectations. • OMT announcement removed tail risks and stabilized markets, but its credibility yet to be tested.	***Staff assessment: High*** • Lack of agreement on ESM direct recapitalization could reignite investors' concerns about sovereign contingent liabilities in the periphery. • Delay in completing the BU, including putting in place a single resolution authority and a resolution fund with credible common backstops, or in concluding and implementing the EC's proposed directives and associated regulations would weaken the EU financial stability framework.
Operational risk of the SSM	***Staff assessment: Medium*** • ECB needs to build capacity, expertise, and requires resources to directly supervise "significant" banks and identify risks throughout the banking system at an early stage. • Incentives need to be aligned so that ECB and NCBs share information fully.	***Staff assessment: Medium/High*** • Regulatory forbearance could build-up in the EA financial system. • Bank solvency problems may remain unaddressed. • An ineffective SSM will undermine market confidence.

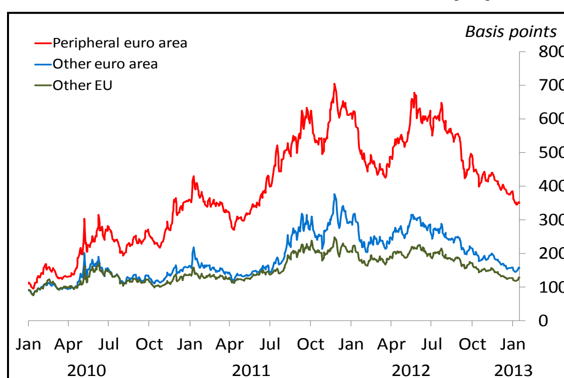
Appendix Table 2. Risk Assessment Matrix (concluded)

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
Deleveraging risk	***Staff assessment: Low/ Medium*** • Pressures to deleverage could rise as a result of cyclical and structural factors (Basel III, and other structural changes). • The risk is contained with the final form of the Basel III liquidity rules and the relatively stable sovereign and bank funding market in the EA. • Some countries have shifted toward ring-fencing strategies, reflecting "home bias."	***Staff assessment: Medium/High*** • Further fragmentation of the EU financial system and retrenchment of cross-border lending could hinder effective monetary policy transmission. • Curtailed credit supply in the periphery and in the core could reignite adverse amplification loops between the banks and the real economy and jeopardize fiscal consolidation efforts.

Appendix II. Recent Developments and Challenges Facing EU Banks

86. Market pressures on EU banks have eased in recent months, bank bond issuance has picked-up, and customer deposit levels have stabilized. Banks have increased their capital ratios, but the dispersion between institutions remains high.

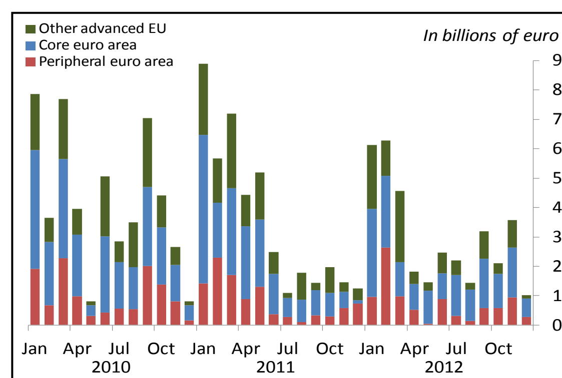
Chart 1. Five-Year Bank Credit Default Swap Spreads



Sources: Bloomberg; and IMF staff calculations.
Note: The chart shows asset-weighted averages for each region.

- Credit default swap spreads have come down from high levels, though they still remain elevated for peripheral EA banks.
- The cost of issuance remains high, keeping financial conditions tight in these economies.

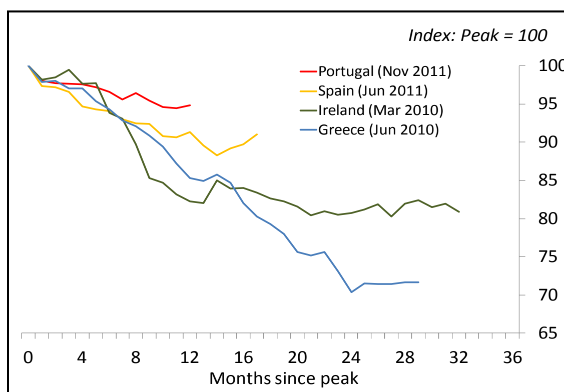
Chart 2. Bank Bond Issuance



Sources: Dealogic; and IMF staff calculations.
Note: Excludes self-funded issuance, where the issuer is the sole underwriter.

- Issuance by the core EA and other advanced EU banks increased moderately in late 2012 relative to the same months a year before.
- Banks benefited from central bank liquidity support, and bank deleveraging reduced funding needs.

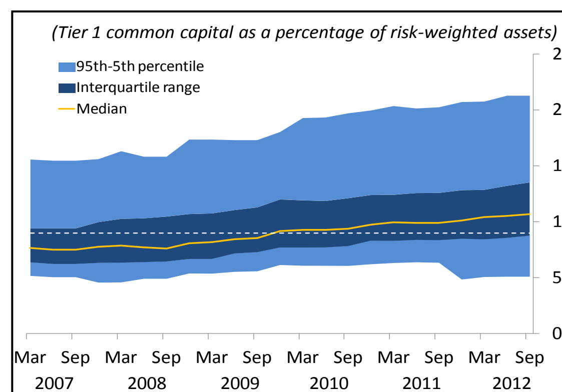
Chart 3. Customer Deposits



Sources: ECB; Haver Analytics; and IMF staff calculations.
Note: The date of each peak is shown in parenthesis. Excludes repos and deposits greater than two years from other EA financial institutions. The data for Spain are also adjusted for the increase in retail debt from October 2011.

- Deposit in Greece, Ireland, Portugal and Spain stabilized in recent months.

Chart 4. Individual EU Bank Core Tier 1 Ratios

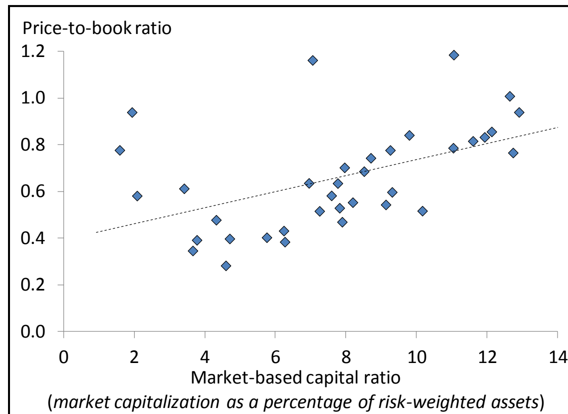


Sources: SNL Financial; and IMF staff calculations.
Note: Based on consolidated data from a sample of around 220 EU banks.

- Core Tier 1 ratios are trending up as banks raise capital, shrink balance sheets, reduce risk, and optimize risk models.

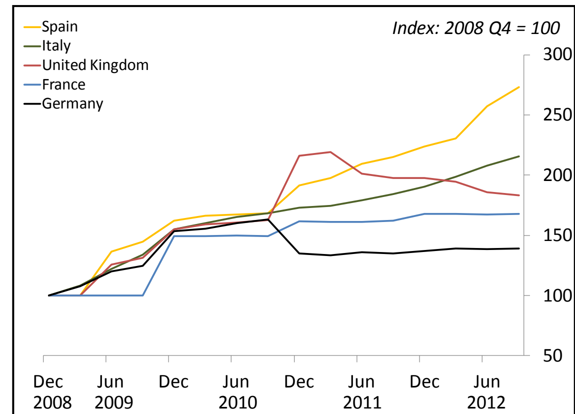
87. Capital could nonetheless come under pressure from rising nonperforming loans and bank exposure to weak economies. Balance sheet pressures have contributed to a deceleration in credit growth, unmet demand from SMEs in some economies in the region and a divergence in interest rates on SME loans.

Chart 5. Individual EU Bank Market Indicators



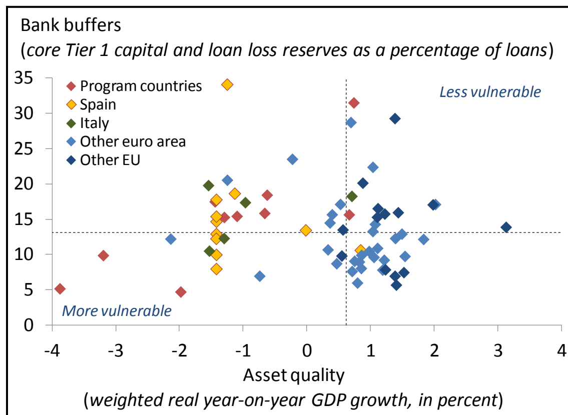
Source: Bloomberg LP; and IMF staff calculations.
Note: The price-to-book ratios and market capitalization are based on daily data from January 2013, while risk-weighted assets are for 2012 Q3.

Chart 6. Nonperforming Loans in Selected EU Countries



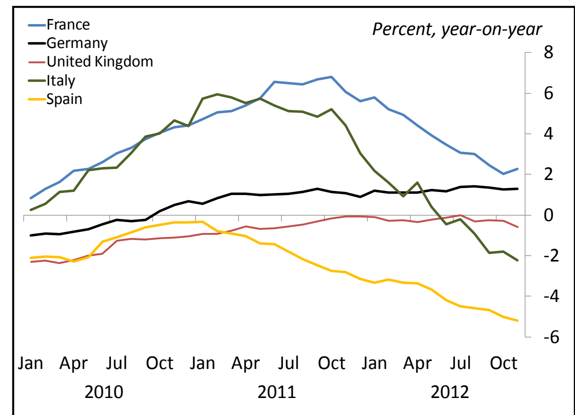
Sources: SNL Financial; and IMF staff calculations.
Note: The nonperforming loan ratio is the stock of impaired loans to the stock of gross loans. The definition of impaired loans differs across countries.

Chart 7. Individual EU Bank Buffers



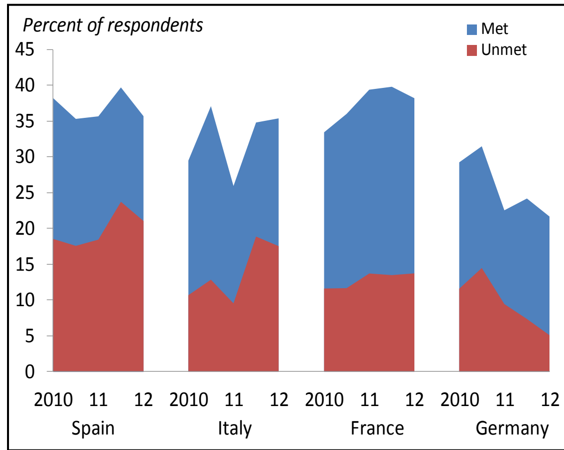
Sources: BIS; EBA; SNL Financial; and IMF staff estimates.
Note: The asset quality indicator is a weighted average of real GDP forecasts for 2012 and 2013, weighted by a bank's exposure to each economy. The exposures are taken from data published by the EBA and updated using BIS consolidated banking data.

Chart 8. Bank lending in selected EU Countries



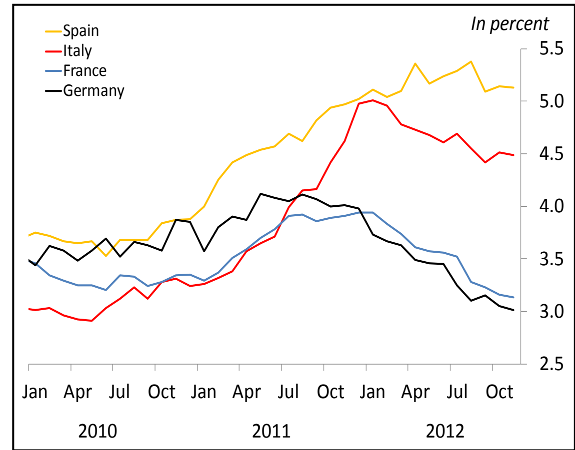
Sources: Bank of England; Haver Analytics; and IMF staff calculations.
Note: Adjusted for securitizations.

Chart 9. Met and Unmet Demand for Bank Credit from SMEs



Source: ECB SAFE survey; and IMF staff calculations.
Note: Unmet demand is the percentage of respondents that applied for a loan and did not get all or most of the loan.

Chart 10. Interest Rate on New Loans to SMEs



Source: ECB.
Note: Chart shows the interest rate on new loans to non-financial corporations up to and including €1 million in value.

Appendix III. Going Ahead With the SSM—Identifying and Mitigating the Risks

ESTABLISHING THE SSM

88. At the June 2012 summit of the EU, EA leaders decided that, as a step to break the vicious circle between banks and sovereigns, once an SSM involving the ECB was in place for banks in the EA, and in other member states that wished to join, the ESM could have the possibility to recapitalize banks directly.

89. The Council of the EU reached agreement on the SSM regulation, and on a roadmap toward BU, on December 13, 2012. The SSM will come into operation in March 2014 or one year after the SSM legislation enters into force, whichever is later, and the ECB can postpone the date if it feels that it is not ready. The Council noted that adoption of a harmonized regulatory infrastructure (including CRR/CRD IV) should be accelerated and called for the adoption of the draft directive for bank recovery and resolution and for harmonization of deposit guarantee schemes (DGS) by June 2013. It affirmed that the SSM requires a single resolution mechanism with adequate powers and tools, and financed by financial sector contributions and backstop arrangements that recoup taxpayer support over the medium term. The EC will make a proposal for such a mechanism to be examined as a matter of priority by the co-legislators. Lastly, an operational framework for the possibility of direct bank recapitalization by the ESM, including the definition of legacy assets, should be agreed by June 2013.

90. The progress being made towards BU through the establishment of the SSM and the ancillary proposals is impressive and welcome, but there are challenges and risks. To safeguard the project it is important that these risks are identified at the outset, so that they can be addressed at an early stage. This appendix examines some of the risks.

ESTABLISHING THE SSM IN A TIME OF CRISIS

A. Design Features of the EU and Treaty Constraints

91. A range of risks can be ascribed to the design features of EU that constrain the construction of the SSM:

- *The EU setup*. The EU can act only in those areas where it has exclusive or shared competences, or can support the actions of the member states, as provided under the treaty. When competences are shared with EU member states (such as the single market for financial services), under the principle of subsidiarity the EU may act only insofar as its objectives can be better achieved at the EU level, rather than at member states level.

- *Legal contours of the SSM*. As regards the supervisory sphere, Article 127 (6) of the Treaty on Functioning of the European Union (TFEU) provides that specific supervisory tasks may be

conferred upon the ECB, and presumes therefore the continued existence of "competent authorities of member states." This implies a division of responsibilities between the ECB and national competent authorities and ipso facto constraints on the design of the SSM.

- *Governance.* The governance arrangements of the ECB are not designed for a supervisory function, and country coverage is restricted to EA member states. The Governing Council is the ultimate decision making body of the ECB, as enshrined in the TFEU, including for any supervisory tasks conferred upon the ECB under Article 127 (6). The governance structure of the ECB hinges on its monetary mandate, as the Governing Council comprises the Governors of the NCBs and the members of the Executive Board; heads of other national supervisory agencies cannot be part of the Governing Council. Given such predetermined design, a number of constraints, as well as legal, reputational and implementation risks, may arise from the assumption by the ECB of supervisory tasks.

- *Any ECB internal body established for supervisory task, as foreseen under the draft SSM regulations, cannot have decision-making powers, which are ultimately vested with the Governing Council.* Any delegation of activities to a supervisory board—composed of national and ECB representatives—cannot override such setup.

- *The Governing Council will have to process a wealth of information on short deadlines.* While being accountable for all supervisory decisions, the Governing Council will scarcely have the capacity to analyze each case brought to its attention., The Governing Council will "validate" the decisions prepared by the Supervisory Board, following a "silent procedure," i.e., they will be deemed adopted unless the Governing Council objects within a short period (10 days in normal times, and two days in stressful times).

- *There is a risk that, within the supervisory board or Governing Council, decision-makers may not be fully independent from national interests.*

- *There is a risk of conflicts of interest between the monetary policy function and the supervisory function.* Given that the ECB Governing Council must pursue its primary objective of price stability, it may take decisions that from a supervisory perspective are not optimal.

- *Member states not part of the EA but joining the SSM cannot be represented in the Governing Council, which will nonetheless take decisions affecting them.* This may open the door to conflicts and accountability problems within the SSM. If they have the possibility to opt out from decisions taken by the Governing Council, the level playing field of the single market may be tilted.

B. Transitional Risks

92. Bringing all EA banks under the supervision of the ECB is a major task, and entails many practical difficulties and risks. A swift transition to covering all banks would reduce risks of entrenchment of regulatory forbearance between the announcement of the decision to create an SSM and the actual transfer of supervisory responsibilities. An "effective" SSM would also provide the possibility of starting direct ESM recapitalization of banks; on the other hand, there is a possibility that specific banks in need of direct recapitalization by the ESM may be brought under the SSM ahead of the date of general effectiveness of the SSM. Unless supervisory capacity at the center is put in place quickly, and incentives at the national and central levels are well aligned, there would be risks of information losses, and supervisory drift and regulatory forbearance. The challenge of putting in place an effective capacity at the center should however not be underestimated, which puts greater emphasis on urgent efforts to plan for and ensure success under a realistic but ambitious timeline.

93. Taking on responsibilities in the crisis carries its own risks. By definition, in a crisis banks are likely to be weak, and credibility in institutions low. While it would be desirable for the ECB to conduct a re-licensing exercise before taking responsibility for a bank, this will not be possible. Thus it may have to take early action against problem banks while its own expertise in not fully established and its credibility in supervision not assured.

C. Risks Inherent in the Division between the Center and the National Authorities

94. Important risks may derive from the division of responsibilities between the ECB and the national authorities, also perhaps particularly during the transition.

- *Banks under direct ECB supervision.* To ensure stability, it is essential that the ECB is able to identify risks at an early stage, including for banks that will not be under its direct supervision. The draft regulation of the SSM specifies a set of criteria to identify which banks are "significant" for the EA and should therefore be directly supervised by the ECB, and which banks should remain under the direct supervision of national authorities. These criteria relate to importance of cross-border activities, domestic and EU significance, and size. Moreover, the ECB will be able to designate as "significant" and bring under its direct oversight institutions (or groups of institutions) that could jeopardize the stability of the EA financial system—for instance through their impact on the balance sheet of the respective sovereign. The draft regulation safeguards the capacity of the ECB to investigate all credit institutions, and bring them under its direct oversight at any time. Nevertheless, at least during the transition stage, the process of taking over credit institutions from national authorities may be lengthy and unwieldy, and may therefore allow risks to build-up.

- *Identification of macroprudential risks.* The ECB will have to be able to identify pockets of growing systemic risks and take action at an early stage. A purely micro-supervisory approach is insufficient when banks are interconnected or take correlated exposures, and

when localized macroeconomic conditions affect a specific region or a specific type of institution. Thus, microprudential analysis will need to be complemented with a macroprudential approach to risk assessment.

- *Incentives under a decentralized system of supervision.* National authorities may be biased toward favoring the national banking system. Risk-based supervision will always rely, to some extent, on supervisory judgment, and the ECB may rely on such qualitative assessment by national authorities. Yet, national authorities may tend to be too optimistic about their respective banks, thus increasing the risk of supervisory slippages also at the SSM level. The accountability mechanisms may reinforce these incentives to the extent that the ECB will be responsible for the effective and consistent functioning of the SSM, and for the supervision of "significant banks," while the NCAs under the instruction of the ECB will be responsible for the direct supervision of all other banks. The risk may be compounded during the transition because of the very limited resources available to the ECB, including resources to control actions at the national level and in its ability to reach its own supervisory judgment on the soundness of institutions' risk management.

- *National supervisory practices and frameworks, and enforcement regimes.* The ECB will need in practice to operate with recourse to the national supervisors for ongoing supervision and especially on-site supervision. Moreover, in order to apply non-pecuniary administrative sanctions—different than the remedial measures provided under the draft SSM regulation—the ECB will need to instruct national authorities, which will implement the sanctioning action according to national laws. Recent FSAPs in EU countries have identified supervisory laws and practices—and especially enforcement practices—that differ from country to country and diverge from international best practice and standards. Thus ensuring uniformity of treatment may be difficult.

- *National resolution regimes.* The ECB will be given powers to withdraw a license, but until a single resolution authority is established, the SSM will have to operate with multiple regimes and authorities. This will entail additional operational complexity because the ECB, local supervisors, resolution agencies and deposit guarantee schemes will have to interact in the preparation and validation of recovery and resolution plans for SIFIs, and in decisions leading to the possible withdrawal of a bank license.

D. Operational Risks

95. Perhaps most immediately, the authorities need to be alert to operational risks. Establishing a critical new authority over the EA and beyond without providing sufficient resources, both financial and human, would be self-defeating, and jeopardize the entire exercise.

- *Capacity, expertise and resources of the ECB.* Currently, the ECB has impressive human capital to conduct monetary policy and monitor financial stability in the EA, but has no supervisory expertise. Overall supervisory resources in the EA are fixed in the near term; it will take time to build supervisory resources, skills and expertise at the center without depleting the local

level from needed experts. Although the dates for being operationally ready have been reasonably set in the draft SSM Regulation, there is a risk that the ECB may be pressured to operate as a single supervisor before being adequately resourced.

- *Data management and information sharing.* To operate, the ECB system and staff will have to be able to receive, store and analyze large amounts of (confidential) information, and translating this analysis into supervisory operations and decisions. Establishing systems and internal mechanisms to handle these tasks will be demanding.

RISK MITIGATION

96. As the SSM is put into effect, comprehensive risk mitigation should be a central complement.

- *Swift agreement and adoption of harmonized legislations and transposition into national laws. If a fully integrated substantive law across the concerned 17 or more jurisdictions were to be in place, the ECB could exercise its powers under a uniform regime.* From this perspective, not only the adoption of the CRR/CRD IV, but building a uniform single supervisory rule-book in the EU is important, going beyond the harmonization prompted by the CRD IV and the resolution and deposit insurance directives. The EBA can play a positive role here in ensuring harmonization of supervisory practices.

- *Governance.* A steering committee, supporting the work of the Supervisory Board, could play a useful role in the chain of supervisory tasks that could avoid cumbersome processes at the higher level. The establishment of internal and external monitoring mechanisms or "watchdogs" could also enhance checks and balances, contribute to better scrutiny, and incentivize the effectiveness of the ECB supervision. Effectiveness could also be enhanced by a more significant representation of permanent, full-time officials or independent experts at the Supervisory Board not linked to national interests. In time, the governance structure could be buttressed by measures that would require a treaty change—for instance, also allowing representation of non-EA countries in the Governing Council when deciding supervisory matters.

- *Accountability.* Additional accountability mechanisms, such as the possibility of reporting to national parliaments in addition to the European parliament, are provided in the draft SSM Regulation. The respective responsibilities of the ECB and the NCAs should be clarified to help make the system of decentralization incentive compatible, given the ultimate responsibility of the ECB in ensuring the effectiveness of the SSM.

- *Allocate resources, to build capacity and expertise at the ECB.* The off-site supervisory structure should be established as soon as possible at the ECB. Specialist expertise should be hired externally and also obtained by secondments from national authorities. Cross-country teams led by an ECB supervisor should be in place as soon as possible for the most systemic or fragile banks (including those requiring ESM direct recapitalization). Funding of the ECB's

supervisory activities should not be derived only from transfers from the national supervisory authorities, but also from additional revenues, in part to minimize potential adverse effects on national supervisory resources.

- *Specify the respective roles of national authorities and ECB, and how cooperation under the SSM will be performed.* The SSM hinges on a division of labor between the ECB and the national authorities. Clear, precise and transparent rules defining such division of labor, and the attribution of tasks given by the ECB to the national authorities, will be important to prevent overlaps, gaps, or conflicts. For this purpose, the ECB should, as soon as possible, prepare a supervisory manual.

- *Risk mapping exercise.* The ECB should receive from the national supervisors the risk assessment and local risk classification of the local banks as soon as possible. Based on this information, the ECB would map banking risks and target supervisory actions accordingly—for instance, by requiring national supervisors to undertake additional due diligence on specific portfolios and capital planning, or to provide information on the availability of additional shareholders resources.

- *Asset quality assessment.* The ECB may initiate asset quality assessments for a set of banks as they are brought under the SSM. The exercise, which will need to be conducted with the involvement of the national supervisors and perhaps third parties, should follow harmonized guidance on conduction of such assessments, to be issued by EBA, and in coordination with other efforts to review data and relevant definitions (e.g., of nonperforming loans).

- *Initiate the possibility of ESM recapitalization, and agree its investment mandate to advance the restructuring of the banking system.* The possibility of direct recapitalization of banks would provide incentives to make progress in addressing solvency issues in countries by relieving pressures on weak sovereigns. The interpretation given to the ESM Treaty is that it is flexible enough to enable the ESM to recapitalize banks directly—subject to political agreement and unanimous consent of the ESM membership. Indeed, under Article 19 of the ESM Treaty, the Board of Governors may also review and change the range of financial assistance instruments that can be made available by the ESM. The Board of Directors may adopt guidelines for implementing financial assistance through recapitalization or loans. Ultimately, the breadth of the investment decisions that can be made by the ESM rests upon the decision of its member states, in due consideration of the risks and potential upside or downside inherent in such investments. It will be important to agree and clarify the investment mandate of the ESM, as well as the specifics of ESM recapitalization, including the definition of legacy assets, the pricing of assets, the role of bail-ins, the principle for access, and the design of instruments. Moreover, if the ESM were to inject ordinary equity into banks, governance arrangements and ownership policies would need to be carefully elaborated. Possible conflicts arising from concurrent significant stakes in competing institutions would need to be dealt with, and disclosure requirements strengthened. Lastly, it would be important to ensure that the ESM has adequate capital, not only to allay any investor concerns about ESM credit quality, with resulting rating implications, but also so it

can leverage its capital to play a potential role of a common backstop for bank recapitalization.

- *Define a clear roadmap and steps toward a single resolution authority and common backstops, and meanwhile enhance national mechanisms.* Pending the establishment of an EU-wide resolution framework, it is welcome that the prompt update of national resolution regimes has been agreed to be a priority. It is essential that the EC announces steps toward the creation of strong single resolution authority with a common backstop and a fully integrated resolution regime.

- *Develop the ECB's macroprudential powers and oversight.* The ECB should identify systemic risks, take early actions, and use macroprudential instruments when deemed necessary, in coordination with national authorities and the ESRB.

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FOR IMMEDIATE RELEASE
March 15, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Financial System Stability Assessment with the European Union

On March 8, 2013, the Executive Board of the International Monetary Fund (IMF) discussed the Financial System Stability Assessment (FSSA) with the European Union (EU).

Background

Restoring financial stability in the EU has proven to be a challenge. Following the global financial crisis, the EU's banking system came under severe pressure. Economic growth has been low and is projected to continue to be weak. This will put bank profitability at risk, limiting an important source of growth and putting solvency in the insurance sector under pressure. In several EU countries, fiscal sustainability is proving difficult to achieve and exposure to weak sovereigns has undermined banks. Market funding has been a challenge with wholesale markets segmented along national borders, requiring banks to rely on central bank support. Recently, however, banks reduced their reliance on central bank funding. Finally, structural forces contribute to deleveraging pressure on banks, leaving some economies with little support from the financial system.

Much has been done to address these challenges. Banks have raised considerable new capital both in the context of European Banking Authority (EBA) recapitalization exercise and national efforts but pockets of weakness in the banking sector remain. After the resolution and winding-down of several institutions, the number of credit institutions fell and a large number of banks have undergone deep restructuring. Still, dependence on wholesale funding remains high, as does exposure to illiquid or impaired assets in some cases. In response, a few countries have set up asset management companies.

The supranational dimension of crisis management has gained importance and significant progress has been made in recent months in laying the groundwork for strengthening the EU financial architecture. Initially problems in EU member states were dealt with primarily at the national level through sovereign support to the financial system, the parameters of which were coordinated at the EU level and subject to the EU competition regulation. However, national fiscal capacity turned out to be insufficient in some cases, triggering the setting up of mutual support mechanism among sovereigns. The European Stability Mechanism became a permanent crisis management facility. The possibility to involve it directly in the recapitalization of euro area banks to help limit the adverse feedback loop

between sovereigns and banks is under consideration, and an operational framework should be finalized in the coming months.

To anchor crisis management, major institutional reforms are being implemented. The EU authorities have announced the establishment of a Single Supervisory Mechanism (SSM) at the European Central Bank (ECB), mandatory for EMU members but open to other EU members. It is the first step in the setting up of a banking union, which is proposed to have a single resolution mechanism with appropriate and effective backstop arrangements. Ensuring proper governance and building up supervisory capacity will take time, with the new institutions expected to be fully operational in 2014.

Meanwhile, the financial oversight framework for the single market is being built further. Directives and regulations are under consideration to harmonize capital requirements, resolution frameworks, deposit guarantee systems, and insurance supervision frameworks. A single rulebook for the EU is being built by the European Supervisory Authorities and cross-border supervisory colleges and crisis management groups set up for the large banks. Information sharing among all institutions involved is a challenge and the system remains complex as it covers different groups of countries with different degrees of monetary and supervisory autonomy. Several initiatives are underway to adapt the regulation of financial market infrastructure to the requirements of the single market.

Executive Board Assessment

Executive Directors welcomed the first FSSA for the EU, which, with its focus on supra-national institutions, complements recent national-level assessments for EU member states. They broadly shared the main findings and recommendations in the report.

Directors noted that much has been achieved to restore financial stability: bank capitalization has increased; funding conditions have improved; and countries under stress have been adjusting under programs supported by the EU and the IMF. Nevertheless, risks remain elevated, especially in a context of low growth and fiscal retrenchment. Some financial systems still face pressures from excessive leverage, risky business models, and adverse feedback loops between sovereign and bank balance sheets. Regulatory and policy uncertainty, and gaps in policy frameworks also continue to pose vulnerabilities. Further ambitious steps are thus necessary to rebuild confidence and achieve long-lasting financial stability in the region.

Directors agreed that repair of banks' balance sheets remains a key priority. This should be complemented by reviews of the quality of banks' assets, based on harmonized definitions of forbearance and nonperforming loans. Directors supported the announced path toward a banking union, underpinned by robust governance. They welcomed the recent agreement to establish a SSM at the ECB. Directors stressed the need to ensure that the SSM maintains broad oversight over all banks in countries participating in the mechanism and has powers to intervene if necessary, and that its resources are commensurate with this task.

Directors underscored the importance of creating without undue delay a Single Resolution Mechanism. In this context, many saw merit in the staff's recommendation to

develop a time-bound roadmap toward establishing a single resolution authority and a deposit guarantee scheme with common backstops. A few Directors considered that progress on this front depends on greater fiscal integration in the EU. Directors looked forward to early agreement on operational guidelines for bank recapitalization by the European Stability Mechanism.

Directors urged sustained efforts to strengthen the EU framework for financial oversight, including through prompt implementation of the European Commission proposals to harmonize capital requirements, resolution, deposit guarantee schemes, and insurance supervision frameworks. They stressed in particular the importance of full compliance with Basel III on capital requirements, and a trigger for automatic intervention in insolvent banks. Directors also emphasized the need for more effective supervision and resolution for financial institutions with cross-border activities.

Directors commended the European Supervisory Authorities for their achievements in the first two years of existence. They nonetheless saw scope for further improvements in areas such as data transparency, information sharing, and operational independence.

Directors also welcomed the work of the European Systemic Risk Board in developing the macroprudential toolkit, noting that flexible implementation should be allowed in response to different conditions. Close coordination with national supervisors and the SSM would be crucial.

Directors noted ongoing plans to separate banks' retail activities from those deemed more risky. They noted that while separation could reduce cross-subsidization and facilitate resolvability, it should not substitute for other enhancements in loss-absorption capacity. It is also important to avoid regulatory arbitrage.

Directors took note of the staff's view that the life insurance and pensions industries would face stricter supervisory requirements under Solvency II. This calls for a refocusing of the regulatory authority's role toward monitoring, implementing, and enforcing the new standards.

Noting the complexity and potential overlaps of responsibilities, Directors underlined the importance of close collaboration among the various supra-national agencies, as well as with national authorities. In this regard, consideration could be given to establishing a mechanism or committee to integrate crisis-related work and bring to bear an all-inclusive perspective.

Directors welcomed the authorities' interest in repeating the Financial Sector Assessment Program for the EU regularly every few years.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Financial System Stability Assessment Report (use the free Adobe Acrobat Reader to view this pdf file) for the 2013 Financial Sector Assessment Program with European Union is also available.

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IMF Assessment of Financial Stability in Europe: Much Achieved to Address the Crisis but Vulnerabilities Remain and Intensified Efforts Needed

In its first-ever overall assessment of the soundness and stability of the European Union's financial sector, under its Financial Sector Assessment Program (FSAP), International Monetary Fund (IMF) says that much has been achieved to address financial crisis in Europe but vulnerabilities remain and intensified efforts are needed across a wide front:

- **Bank balance sheet repair.** Progress toward strong capital buffers needs to be secured and disclosures enhanced. To reinforce the process, selective asset quality reviews should be conducted by national authorities, coordinated at the EU level.
- **Fast and sustained progress toward making the Single Supervisory Mechanism** (SSM) effective as a stage towards banking union (BU). Such progress is essential to anchor financial stability and ongoing crisis management in the euro area. A single resolution mechanism needs to become operational as the SSM becomes effective. Agreement on the modalities for the European Stability Mechanism to take up its role to directly recapitalize banks needs to be reached quickly.
- **Further strengthening of the European Union's financial oversight framework.** Prompt passage and implementation of various EU directives are needed, as well as enhancing coordination across the various supranational agencies so as to achieve policy consistency, including at a national level. Further progress towards a full embrace of a Union-wide approach to financial stability— crisis management, deposit insurance, supervision and resolution, with a common backstop for the banking system, especially for the monetary union is needed to strengthen the ability of the system to avert and withstand shocks

Much has been done to address the recent financial crisis in Europe. Banks have boosted their capital adequacy ratios, although partly through deleveraging. Unconventional monetary operations have enhanced liquidity and firewalls have been put in place. Bank

supervision has been improved. Agreement was reached last December to establish an SSM for the euro area, open also to non euro area members. New tools for addressing financial stability, including coordinated stress tests have come into play. The newly-established European Supervisory Authorities (ESAs) are making their marks.

Nevertheless, financial stability remains fragile. Recent Financial Sector Assessment Program (FSAP) assessments of individual EU member states have noted remaining vulnerabilities: stresses and dislocations in wholesale funding markets; a loss of market confidence in sovereign debt; further downward movements in asset prices; and downward shocks to growth. These vulnerabilities are exacerbated by the high degree of concentration in the banking sector; regulatory and policy uncertainty; and the major gaps in the policy framework that still need to be filled.

In the near term more forceful action is warranted to cement recent gains in market confidence and end the crisis. The priorities are bank balance sheet repair, including addressing impaired assets; fast and sustained progress toward the SSM and the BU; and essential steps toward a stronger EU financial oversight framework. Governance arrangements of existing pan-EU institutions must be adapted to have a EU (or BU)-wide perspective and also evolve to meet the diverse needs of members of the euro area, SSM members not part of the euro area, and other members of the EU.

The ESAs and the European Systemic Risk Board (ESRB) need further strengthening. The ESRB, as the EU systemic risk watchdog, should develop the macroprudential toolkit, analyze macroprudential effects on the cyclical downside and not just the upside, and ensure consistent application of macroprudential policies across the various parts of the financial sector and across the EU. Governance arrangements need to be adapted to avoid potential national biases.

Proposals by the European Commission to harmonize capital requirements, resolution, DGS, and insurance supervision frameworks should be implemented promptly. While ensuring that the Fourth Capital Requirements Directive and Capital Requirements Regulation are in full compliance with Basel III, their swift adoption, as well as that of the directives on resolution, DGS and insurance supervision, are necessary. The resolution directive needs to be enhanced to provide for automatic intervention in the event that a bank's solvency position falls below a certain trigger level, as well as to provide flexibility for intervention in the event of liquidity or other problems. In addition, more effective supervision and resolution arrangements need to be worked out for financial institutions crossing the borders between the SSM and the rest of the EU and beyond.