“Strengthening the Financial Stability Framework of the EU”

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Introduction

I would like to thank the conference organizers for offering me the opportunity to talk about how the financial stability framework of the EU could be strengthened.

Much has happened since July when I accepted this invitation to speak and selected this topic. The euro area crisis has reached new heights and a more virulent phase. Sovereign and bank funding pressure persists despite ECB intervention. Market tensions are fueled by a perceived lack of cohesion by European policy makers and concerns about the resilience of banks and the speed of adjustment at the country level. The softening global growth outlook adds to uncertainty.

Given this backdrop, you might ask: why talk about the future financial stability framework of the EU? Aren’t there more immediate matters that need to be addressed? Yes, there are. European leaders recognize this and are working on strengthening the immediate crisis management response. As the IMF’s Managing Director Christine Lagarde has stressed, implementation is now key to remove the cloud of uncertainty hanging over banks and sovereigns. But she has also highlighted that Europe needs to articulate a common vision for its future that looks beyond the crisis and addresses its root causes. A clear demonstration of unity behind the project of economic and monetary union is needed to reduce market uncertainty. Otherwise economic tension will persist. Establishing a common approach to the banking system within the single market is a critical element of the vision of how the euro area and the EU ought to function in the future. There are other aspects, notably on economic governance and fiscal integration, but today I will focus my remarks on the financial system.

I will start by reviewing how we got to where we are and elaborating on the case for reforming the EU’s financial stability framework. I will then describe the key elements of a more robust, resilient, and integrated future financial stability framework. The elements I will outline are not new proposals by IMF staff. They draw on work done by a number of IMF experts over the last several years and the ideas I will present have featured in our published documents, including our annual euro area consultation reports and more recently in the October 2011 *Regional Economic Outlook* for Europe. Furthermore, over the years IMF staff have had a constructive dialogue with European counterparts on these issues. We are partners on these matters.

The case for reform

It is well accepted that the financial crisis that started in 2007-2008 was rooted in a combination of common global factors and vulnerabilities in individual countries. In the decade that preceded the crisis, global financial markets were characterized by high liquidity and low risk premia in a stable economic environment. Financial integration in the euro area was accelerating. European banks,

including Irish ones, expanded their balance sheets through unprecedented access to wholesale funding. The new funding structures created deep fragilities that came to the fore when liquidity dried up.

Ideology also played a role. There was a belief that "light-touch" regulation and market discipline would suffice to ensure efficient and stable financial markets. The crisis proved this belief was wrong. Mechanisms of self-regulation and market discipline—such as corporate governance, internal risk management, private audits, and discipline by creditors—failed to prevent the build-up of risk. Market players also anticipated bailouts of "too big to fail" institutions. In addition, in many countries including Ireland, authorities wrongly considered that macroeconomic risks and unsound bank behavior were not sufficiently alarming to require assertive policy responses.

Europe is now at a critical juncture. Earlier this week ECB President Jean-Claude Trichet told the European Parliament that the euro area crisis had reached "a systemic dimension" threatening the stability of the entire euro area. What has proved so damaging to financial stability is the deep intertwining between sovereigns and domestic banks' balance sheets. Let me explain why. Because many European banks are large and global, but remain the responsibility of their home country when they fail, bank failures potentially threaten the sovereign where the bank is domiciled. The Irish case has many of these features. But weak sovereigns have also damaged domestic banks' balance sheets, because of their large exposure to domestic sovereign debt. Here Greece is a case in point.

This intertwining creates a dangerous amplification mechanism when weak banks curtail credit to the economy, which adversely affects economic growth and reduces tax revenue. A weaker sovereign, in turn, damages the capital position of banks, which creates the risk of dangerous bank runs. These vicious feedback loops that can lead to a crippling downward spiral are painfully evident here in Ireland.

The task for EU policy-makers is to convince market participants that they are determined to undo this Gordian knot between weak sovereigns and domestic banks. Reform of the European financial stability framework is thus an important complement to immediate short-term action. The required immediate crisis management steps are not the focus of my talk today, but suffice it to say that they include a strengthening of capital buffers of banks, ideally from private sources, and flexible and efficient use of the EFSF as needed. Provision of liquidity by the ECB is also necessary until sovereign and bank funding pressures ease. Building on the steps taken over the last eighteen months, European leaders have recently reaffirmed their commitment to reach consensus soon on such steps, including a pan-European approach to ensure that banks have adequate capital buffers, and to implement these steps on an ambitious timetable.

Looking beyond these crisis management policies, the EU needs a truly integrated financial system. To help restore strong economic growth, European businesses must be able to access credit from healthy financial institutions, regardless of local circumstances. If an individual state or province in the United States, Canada or Australia faces a budget crunch or bank failures or a combination of both, businesses in that state do not necessarily find that their access to credit has dried up or become more expensive. European banks must be able to allocate credit to the most productive activities in the region independently of the strength of the sovereign. To support such as pan European financial system, an integrated framework for crisis prevention, management and

resolution is essential. Such reforms will enhance confidence and growth and are now more urgent than ever.

I will now describe the key elements of the future EU financial stability framework. I am going to focus on four related elements: first, an EU-wide deposit insurance scheme; second, a common bank crisis management and resolution regime; third, a new EU supervisory regime for cross-border groups; and fourth, financial regulation and macroprudential oversight. I will also touch briefly on issues such as proposals for Eurobonds and European Safe Bonds. But before I turn to these specifics, two points need to be borne in mind.

- First, although I will discuss the four elements separately they are not separate. Rather, they are related and mutually reinforcing. Integrated insurance and resolution require integrated regulation and supervision, which would need to come first.

- Second, these are difficult steps. They are highly complex in several dimensions, including technical, legal, and political. My intention is to outline some key principles, and no doubt details will need to be fleshed out. Careful design and attention to coordination and transition issues will be important to ensure smooth operation of new centralized structures.

EU-wide deposit insurance scheme

Establishing an EU-wide deposit insurance scheme would help ensure that sovereign problems do not trigger destabilizing bank runs. The deposit base of countries with weak sovereigns can become fragile because depositors are able to easily and abruptly shift deposits to institutions based in other countries, in particular in the common currency euro area.

Two steps are needed to prevent destabilizing cross-border movements of deposits. First, further cross-country harmonization of deposit insurance schemes is necessary to prevent deposit shifts driven by remaining differences in insurance coverage. But this is not sufficient. Deposit guarantee schemes are unfunded in many countries, and the fiscal position could be affected significantly by the failure of a large institution. Second, member countries should aim for a pan EU-scheme and reach common agreements on the conditions that would need to be met in terms of coordination, cooperation and fiscal harmonization to make such a scheme work. There would need to be collective backing by all member countries. Such a scheme, complemented with a resolution component, would also help deal efficiently with the failure of cross-border banks within the EU.

A pan EU- deposit guarantee scheme could be pre-funded by a harmonized bank levy on selected bank liabilities or a financial activity tax (FAT). A FAT, where the base is the sum of profits and remuneration paid by banks, comes close to mimicking a VAT on financial services. A financial transaction tax, as recently proposed by the Commission, would be less attractive because of its potential distortionary effects and scope for evasion. In addition, the EU-scheme could borrow on financial markets—with appropriate backing from member countries—to finance depositor payouts. For the euro area, consideration should be given to embedding this in the general permanent crisis management toolkit envisaged with the forthcoming European Stability Mechanism, which is in the process of being finalized, with clear rules on the circumstances under which the funds could be used.

Common bank crisis management and resolution regime

Efficient resolution of banks with activities across many EU-countries would be greatly assisted by the creation of a common bank crisis management and resolution regime that would be binding to all member states. In this respect, we fully support efforts of the Commission to establish a harmonized framework that would provide EU supervisors with strong powers to take remedial actions at an early stage, and a with a resolution toolkit to deal efficiently with bank failures while minimizing costs to taxpayers. But the Commission proposals are not sufficiently ambitious and coordination problems and reaching efficient outcomes may remain difficult.

As we have argued in the past, a better solution in the medium-to-long term would be to establish a European Resolution Authority covering all banks and backed by a common backstop at the EU level that ends the need for national financing. A common pan-European backstop would help break the link from the balance sheet of banks to the balance sheet of the sovereign. Hence, when a bank fails, the cost should not fall exclusively on the taxpayer of the home country, but should be borne by an EU-wide resolution fund. Experience has also shown that in a crisis situation involving cross-border banks, cross-border cooperation between governments may not work as smoothly as one would hope. Hence, ex ante rather than ex post burden sharing solutions are required. Such a resolution authority would need to have decision making structures that allow for effective and rapid intervention as bank instability can evolve rapidly, while balancing collective interest among member states. It would require a high degree of coordination and harmonization with regard to sovereign fiscal and financial stability issues to operate effectively.

Cost-effectiveness of the resolution regime should be a major objective. Thus, the new resolution regime should ensure that losses are borne, first, by shareholders and holders of equity-like instruments, and second by uninsured creditors, including senior creditors. For this reason, we support a framework that provides the resolution authority with statutory power to bail-in defined liability holders as part of the resolution process along the lines proposed by the Financial Stability Board. Further, to minimize costs to taxpayers, the new resolution system should be pre-financed by the industry as much as possible, potentially through the EU deposit insurance scheme I just described.

A new EU supervisory regime for cross-border groups

Supervision of cross-border groups remains mainly the responsibility of the home country supervisors. To obtain a global, yet detailed view of the activities of banking groups, and make optimal decisions when a restructuring is required, lead supervisors must cooperate effectively with the supervisors of countries where the group operates. The establishment of colleges of supervisors has been a key tool to achieve effective supervision of financial groups operating across border.

But supervisory colleges are an incomplete approach to the supervision of cross-border groups. Home and host authorities sometimes have conflicting incentives to share information. For instance, because of concerns about ring-fencing, some national authorities may refrain from sharing information. Or they may have different priorities, such as when the activities of a group may be systemic from the point of view of the host country, but not for the group as a whole. Participation in colleges is also resource intensive, and reaching joint agreement may be unwieldy when many countries are involved. There may also be legal constraints on the sharing of information that

impede effective cross-border supervision. Lastly, national supervisory authorities may have a tendency to be lenient with "national champions," which may lower supervision quality.

For these reasons, a pan-EU supervisory regime is better to ensure effective supervision of financial groups with cross-border activities. The supra-national framework could build on the newly created European Supervisory Authorities. For instance, the European Banking Authority may be granted supervisory authority, and potentially resolution authority, over all EU banks with cross-border activities.

Financial regulations and macroprudential oversight

The European banking system needs an effective regulatory regime. The EU Commission is working on a new Capital Requirements Directive—known as CRD4—to implement the Basel III agreements through a new EU-wide legislation that would fully harmonize capital and liquidity regulations in the EU.

It is commendable that the EU is the first region to take active steps towards the implementation of Basel III. However, the proposal falls short of the needed reforms in two key dimensions.

First, the common capital requirements in the CRD4, set at the level of the Basel III minimum requirements, are too low given conjunctural and structural characteristics of European banking systems. The principle of a single market based on a common rule book is important and one we endorse, but we have argued in several recent reports that harmonized capital requirements should be set ambitiously high—above the Basel III requirement. Further, the next iteration of the CRD4 proposals should include the topped up capital requirements for systemically important financial institutions as was recently put forward by the Basel Committee. High capital buffers are needed to address the high prevailing balance sheet uncertainties, and to minimize the contribution of European taxpayers to bank failures. Having high buffers in place is particularly important during the potentially long transition towards an effective EU-wide supervisory and resolution regime with a common backstop. The Basel III minimum is too low for European banks also because sovereign exposure and intra-EU exposure still represent significant risks to EU banks. More generally, the international regulatory community will need to examine the appropriate treatment of risk classes that have traditionally been regarded as low or zero risk.

In connection with this discussion of the appropriate capital threshold for banks, it is worthwhile to recall that in Ireland the threshold has been set at 10.5 percent for core tier 1 capital in the base case. The Irish regulator's insistence on these high capital buffers, together with a stringent external assessment of likely losses, has been a key ingredient in the improved market sentiment toward Ireland.

Second, the CRD4 proposal might restrict flexibility at the national level for the implementation of macroprudential policies. The proposed legislation grants new power to the Commission to tighten capital requirements for particular activities and exposures. National authorities can set higher capital requirements for individual banks through pillar II supervisory review, but system-wide increases in capital requirements are restricted to real estate exposure and the Basel III countercyclical capital buffer.

Instead, in view of the uncertainty regarding the effectiveness of macroprudential instruments in general, more flexibility is needed to allow national authorities to introduce various macroprudential tools, including liquidity rules and varying risk weighs to address emerging systemic risks. To prevent regulatory arbitrage and ensure effectiveness of macroprudential measures, the new EU-rules should also ensure that reciprocity of application of macroprudential tools is not restricted to a small set of instruments. In this respect, a clear drawback of an approach based on Pillar II measures is that reciprocity is not mandated.

We have also argued in our euro area consultation reports that the European Systemic Risk Board should play a prominent role in the calibration of macroprudential instruments. For example, the ESRB could issue guidelines on the design of an effective macroprudential toolkit. Given the high interconnectedness between national financial systems, the ESRB should also ensure coordination of macroprudential instruments in the EU, including on key aspects of home-host coordination and reciprocity, and finding a balance between rules and discretion.

A last point on macroprudential tools. It is interesting to do the following thought experiment in the case of Ireland—if they had existed at the time, what recommendation could the ESRB or a national macroprudential body have made during the boom to temper the surge in credit to the property sector? Establishing a relatively low ceiling for the loan-to-value ratio would have been a good candidate. Another would have been requiring a capital buffer specific to property lending, which has the advantage of being more targeted than a general counter-cyclical capital buffer. Tightening limits on sector exposure and concentration are additional candidates.

Elements of the future architecture of the euro area: ensuring effective market discipline with strengthened governance

Let me finish with a few remarks on the proposals to establish bonds common to all euro area countries. The Eurobond proposal would require “joint and several” guarantees from all euro area countries. The European Safe Bond (or ESBie) proposal—as you might know, Philip Lane was a part of the team that made this proposal—is based on risk pooling and the creation of senior and junior tranches.

These are interesting ideas that may help strengthen the architecture of the euro area. Indeed, the monetary union at present does not have the mechanisms to buffer sovereigns from speculative attacks, including exchange rate adjustment that shifts losses to creditors, and, in theory at least, a central bank that could support the sovereign. These proposals should be assessed along two dimensions. First, they must provide financing to euro area sovereigns at reasonable interest rates without creating distortions such as moral hazard and expectations of bailouts. Second, the reform must be feasible under potentially severe political constraints. Transitional issues from the current system with national sovereign bonds to a common bond should not be overlooked, including how to adjust sovereign risk weights of bank capital buffers.

These proposals for pooling of risks make the need for fiscal governance even stronger. Strong fiscal frameworks must be in place at national levels to guarantee fiscal sustainability. This may require some delegation of sovereignty to a federal entity. The new framework could also require alternative mechanisms of ex-ante risk sharing such as those that are prominent in other federal states such as the U.S. or Germany.

Conclusion

A fundamental overhaul of Europe's financial stability architecture is a priority. Citizens of Europe stand to benefit greatly from financial integration. But their trust in the financial system needs to be restored and they need to be protected from the twin fiscal-financial crises that many countries are facing. Much work is underway globally to learn and apply the lessons from this crisis. In Europe, financial integration has proceeded apace, but developing a corresponding integrated financial stability framework has lagged. Steps to build the EU framework I have described are underway, but the steps taken and contemplated do not go far enough. Modest reforms are not sufficient in the current environment. The crisis requires convincing skeptical markets that Europe can make bold and unified decisions. The issues involved are exceedingly complex, but clarity about the goal of establishing an integrated EU crisis management and resolution framework, supported by a more effective supervisory and regulatory regime, will make it easier to deal with these complexities. As the Roman philosopher Seneca said, "If one does not know to which port one is sailing, no wind is favorable."