FOR AGENDA

SM/10/26
Correction 1

February 16, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of San Marino—Selected Issues**

The attached corrections to SM/10/26 (2/3/10) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 17, para. 26, line 4: for "context of the 2000 monetary agreement between Italy—on behalf of the European Community—and San Marino currently being renegotiated."
read "context of the monetary agreement between Italy—on behalf of the European Community—and San Marino."

line 5, footnote 11, line 6: for "requirements."
read "requirements; the recommendation does not envisage the possibility for Sammarinese banks to access Eurosystem liquidity."

para. 29, line 3: for "the 2000 Monetary Cooperation with Italy to secure access to Eurosystem liquidity for San Marino banks."
read: "the 2000 Monetary Cooperation agreement with Italy to explore the feasibility to secure access to Eurosystem liquidity for San Marino banks."

Questions may be referred to Mr. Laurens (ext. 36534), Ms. Zoli (ext. 37116), and Ms. Flamini (ext. 38840) in EUR.

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26. **A final option would be for San Marino to secure for its banks full access to Eurosystem liquidity**. That would require either becoming full member of the euro area, or securing access to the Eurosystem monetary policy operations for San Marino banks in the context of the monetary agreement between Italy—on behalf of the European Community—and San Marino.[11] The monetary agreement between France—on behalf of the European Community—and Monaco offers a framework that could be emulated by San Marino.[12]

E. Conclusions and Policy Recommendations

27. **The combination of an unfinished integration of San Marino with the euro area and a large internationally active banking sector has led to macro-financial vulnerabilities**. The CBSM has accumulated some liquidity with which it can provide short-term assistance to individual banks, but it cannot act as an effective LOLR in the event of systemic liquidity shock.

28. **As a first line of defense, the CBSM should take measures to strengthen self insurance mechanisms to help banks cope better with idiosyncratic liquidity shocks**. Banks should be required to hold a substantial stock of liquid assets. To this end, the CBSM should focus on ensuring that banks are properly assessing their own liquidity mismatches and setting appropriate limits for their circumstances. Banks could also be required to secure credit lines from reputable and dependable international banking groups. Currently, two of the banks operating in San Marino are affiliated with international banking groups; enforcing such a policy on these banks would insure about a quarter of total deposits. The other banks should also be asked secure credit lines; those unable to do so could be required to hold a larger stock of liquid assets.

29. **The authorities should also seek ways to strengthen the institutional framework for the LOLR function**. To that effect, they should take advantage of current discussions for the

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[11] In October 2009 the Commission of the European Communities adopted a recommendation for a Council decision on the position to be taken regarding the renegotiation of the monetary agreement with San Marino (European Community, 2009). The recommendation is for the European Community to seek changes in the agreement with a view for San Marino to undertake to adopt measures for the application of all relevant Community legislation relating to the activity and supervision of financial institutions, AML/CFT, and statistical reporting requirements; the recommendation does not envisage the possibility for Sammarinese banks to access Eurosystem liquidity. It is motivated by the size of San Marino banking sector and its close interaction with euro area banks. The ultimate objective is for San Marino to align its banking and financial sector legislation with that applicable in the Community with a view to create a level playing field in San Marino's financial sector. It is recommended that a new monetary should enters into force on January 1, 2010, with a transitional period of 5 years (January 1, 2015) for the introduction in San Marino of all relevant Community banking and financial legislation.

[12] Monaco uses the euro on the basis of a monetary agreement concluded between France (on behalf of the European Community) and Monaco. Banks have access to the euro area payment systems and Eurosystem liquidity through Banque de France. French monetary, banking and balance of payments statistics include Monegasque data. The agreement also stipulates that the EU legal framework governing the activities of banks applies to Monaco, ensuring the principle of a level playing-field in the sector. However, legislative provisions concerning, for example, criminal matters, which are specific to France and do not specifically concern credit institutions, are not applicable in Monaco, which has its own laws in these areas. Hence, Monegasque banks are subject to Monegasque AML/CFT legislation (ECB, 2006, and IMF Country Report No. 03/262).

renegotiation of the 2000 Monetary Cooperation agreement with Italy to explore the feasibility to secure access to Eurosystem liquidity for San Marino banks. Indeed, the point can be made that a natural consequence of creating a level playing field in San Marino's financial sector would also be for its banks to have access to the ECB's monetary policy operations. In the absence of an effective LOLR, a smaller scale financial sector focused on the needs of the economy of San Marino would be prudent.

30. **If the banking sector were better integrated with reputable and dependable international banking groups than is currently the case, this would lessen the need for a LOLR framework, and the financial sector could remain large and internationally active**. This model would be based on the development of a financial sector in which the soundness of locally-licensed banks would depend on that of their parent institutions. The need to maintain strong financial sector regulation and supervision capacities would nevertheless remain, partly because support from parents cannot be taken for granted. In this context, the challenge would be to balance prudential requirements for liquidity and exposure to related parties against business needs that entail high exposures to the parent. This would require close cooperation with home supervisors in order to keep under review the financial health of parent groups and their ability to support their local subsidiaries. Cooperation with home supervisors is particularly important for making contingency plans, to ensure that the interest of the host country are given timely consideration in any intervention by the home country on a bank with operations in the host country.