International Monetary Fund

European Union: Financial Sector Assessment, Preliminary Conclusions by the IMF Staff

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A Financial Sector Assessment Program (FSAP) team led by the Monetary and Capital Markets Department of the International Monetary Fund (IMF) visited the European Union (EU) during November 27–December 13, 2012, to conduct a first-ever overall EU-wide assessment of the soundness and stability of the EU's financial sector (EU FSAP). The EU FSAP builds on the 2011 European Financial Stability Exercise (EFFE) and on recent national FSAPs in EU member states.

The mission arrived at the following preliminary conclusions, which are subject to review and consultation with European institutions and national authorities:

The EU is facing great challenges, with continuing banking and sovereign debt crises in some parts of the Union. Significant progress has been made in recent months in laying the groundwork for strengthening the EU's financial sector. Implementation of policy decisions is needed. Although the breadth of the necessary agenda is significant, the details of the agreed frameworks need to be put in place to avoid delays in reaching consensus on key issues.

The present conjuncture makes management of the situation particularly difficult. The crisis reveals that handling financial system problems at the national level has been costly, calling for a Europe-wide approach. Interlinkages among the countries of the EU are particularly pronounced, and the need to provide more certainty on the health of banks has led to proposals for establishing a single supervisory mechanism (SSM) associated with the European Central Bank (ECB), initially for the euro area but potentially more widely in the EU.

The missionï¿½s recommendations include the following:

Steps toward banking union

The December 13 EU Council agreement on the SSM is a strong achievement. It needs to be followed up with a structure that has as few gaps as possible, including with regard to the interaction of the SSM with national authorities under the prospective harmonized resolution and deposit guarantee arrangements. The SSM is only an initial step toward an effective Banking Union—actions toward a single resolution authority with common backstops, a deposit guarantee scheme, and a single rulebook, will also be essential.

Reinvigorating the single financial market in Europe

Harmonization of the regulatory structure across Europe needs to be expedited. EU institutions should accelerate passage of the Fourth Capital Requirements Directive, the Capital Requirements Regulation, the directives for harmonizing resolution and deposit insurance, as well as the regulatory regime for insurance Solvency II at the latest by mid–2013, thus enabling the issuance of single rulebooks for banking, insurance, and securities. Moreover, the European Commission should increase the resources and powers of the European Supervisory Authorities as needed to successfully achieve those mandates, while also enhancing their operational independence.

Improved and expanded stress testing

European stress testing needs to go beyond microprudential solvency, and increasingly serve to identify other vulnerabilities, such as liquidity risks and structural weaknesses. Confidence in the results of stress tests can be enhanced by an asset quality review, harmonized definitions of non-performing loans, and standardized loan classification, while maintaining a high level of disclosure. Experience suggests that the benefits of a bold approach outweigh the risks.

Splitting bank and sovereign risk

Measures must be pursued to separate bank and sovereign risk, including by making the ESM operational expeditiously for bank recapitalizations. Strong capital buffers will be important for the banks to perform their intermediating role effectively, to stimulate growth, and so safeguard financial stability.

Effective crisis management framework to minimize costs to taxpayers

Taxpayers' potential liability following bank failures can be reduced by resolution regimes that include statutory bail-in powers. A common deposit insurance fund, preferably financed ex ante by levies on the banking sector, could also reduce the cost to taxpayers, even if it takes time to build up reserves. Granting preferential rights to depositor guarantee schemes in the creditor hierarchy could also reduce costs, particularly while guarantee funds are being built.

The European Commission and member states should assess the costs and benefits of the various plans for structural measures aimed at reducing banks' complexity and potential taxpayer liability with a view towards formulating a coordinated proposal. If adopted, it would be important to ensure that such measures are complementary to the international reform agenda, not cause distortions in the single market, and not lead to regulatory arbitrage.

Lastly, the mission would like to extend their thanks to European institutions for close cooperation and assistance in completing this FSAP analysis.

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