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Contents

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Foreword

Since the global financial crisis first erupted in 2008, the IMF has been intensively involved with member countries, as well as in regional and multilateral fora, seeking to address the crisis and restore financial stability. Much of this has necessarily been "fire-fighting"—taking emergency action to contain the crisis. At the same time, we have also had an eye to the future, working with our members and partners to improve the architecture of the international financial system—one that is better able to avoid crises and to handle crises when they occur.

The global financial crisis did not originate in Europe, but it quickly spread there and has lingered there, exposing the fragilities and gaps in Europe's financial stability armor. In nearly all countries, the infrastructure for handling a financial crisis was inadequate or nonexistent, and the regional dimension in Europe has complicated crisis management even more.

During this period, much has been achieved in Europe, using both conventional and novel approaches. The European Commission (EC) and the European Central Bank (ECB)—working with the IMF—have contained the crisis in a number of countries. The ECB's innovative interventions have significantly reduced the "tail risks" from the financial system. Meanwhile, important steps have been taken to create a new financial sector management infrastructure, initially at a national level, but increasingly at the level of the 27-member European Union (EU), and particularly among the 17 members that currently make up the euro area.

Much, however, remains to be done. The vision of where the European partners wish to go is becoming increasingly clear, but the path taking us there is narrow, and in some parts not well defined. It is also not a path on which one wishes to linger. The sooner it takes to get to the destination, the sooner the financial system in Europe—and globally—will be safe.

This book draws together recent work that the IMF has been undertaking to map out the path to safety. For over a decade, the IMF has conducted exercises at the national level, under its Financial Sector Assessment Program (FSAP), assessing vulnerabilities in a country's financial system and providing recommendations on how to address them. For the first time in late 2012, we conducted such an analysis for the EU as a whole, recognizing the region-wide dimension of financial stability in Europe.

Given the ongoing crisis in the EU, this regional FSAP was particularly forward-looking, focusing substantially, although not exclusively, on the institutional infrastructure in the EU and, within it, the euro area. It thus provided an opportunity for the IMF to bring into the spotlight the importance of the ongoing architecture reforms in resolving this crisis.

This book covers the major themes that emerged from that exercise, adds significant related work, and looks forward to the challenges ahead. I hope it will make a useful contribution to the current discussions on these issues in Europe and to the future shape of Europe's financial architecture.

Christine Lagarde
Managing Director
International Monetary Fund

Foreword

The IMF has been conducting Financial Sector Assessment Programs (FSAPs) for our member states since 1999, and all the member states of the European Union (EU) have had this assessment at least once. It became clear, however, in the course of the more recent national FSAPs that the answers to the problems identified at the national level would in many cases require a supranational answer at the European level. EU member states have become highly interconnected, and in many areas are now covered by a common set of laws and regulations determined at the Union level—or for those countries using the euro, at the level of the common currency. Hence, any assessment at a national level needed to be complemented by one covering the EU, and the common institutions of the EU and the euro area, as a whole. This would serve also to complement the regional surveillance that the IMF has conducted for the euro area through its Article IV consultations over the past several years.

The first EU assessment took place against a background of uncertainty and fragility, with the crisis still not resolved in parts of the Union. Banks, in general, are stronger than at the outset of the crisis, and the EU institutional framework has evolved significantly, but some key underlying challenges remain. There remain pockets of bank weakness, and questions in areas where the financial situation remains opaque, while the effectiveness of transmission of monetary policy in the euro area has been impaired. Officials have been laboring over many years, but in some regards the work seems to have only just begun. The inherent but natural tensions in a union of sovereign states, as to the boundary between what is done at the center and what is done in the separate states, continue to complicate decision making.

As the crisis has continued, there have been several examples of difficulties in cross-border coordination and cooperation in the resolution of distressed international banks. Failing banks had to be resolved at a national level, often at cost to taxpayers of the country where the bank is headquartered. Lacking binding ex ante burden-sharing agreements, cross-country supervisory colleges did not alter the fact that supervisors were accountable to national authorities. As a result there has been a substantial reversal from the progressive integration of financial sectors in the EU member states that had been set in train by the EU's single market policy, and the "common passport" arrangement under which a bank license issued in one member state would be recognized in all other member states. As member states have sought to protect themselves, and in particular their taxpayers, from the financial cost of problems arising from cross-border activities, policies of "ring-fencing" were introduced across parts of the EU (as well as elsewhere in the world). This added to the market fragmentation forces unleashed by the crisis and contributed toward reversing many years of progress toward integrated financial markets in Europe and undermining the effectiveness of monetary policy for the currency union. A key concern of policymakers is to reverse this fragmentation.

In this regard, two fundamental changes in paradigm are underway. First, recognizing that EU's problems need, in many regards, to be resolved at a European level, regional institutions are being established and strengthened; a common regulatory framework is in the process of being put in place through an ambitious program of EU directives, regulations, and guidelines; and limited regional financial backstops are being established. Second, measures are being introduced to limit the need for public backstops, whether at a national or regional level, through strengthening banks' capital and liquidity positions, and increasing internal and sectoral sources of finance—the aim being to "bail-in" bank creditors rather than to "bail-out" the bank with taxpayers' money. Achieving both these changes in paradigm is challenging, especially in the midst of an ongoing crisis. Nevertheless, given the fundamental nature of these changes in paradigm, the progress made over the past few years, especially as regards establishing relevant new institutions, has been striking.

This book seeks to take this process further. An FSAP is a comprehensive look at a financial system, and the chapters in this book—reflecting that—cover a great deal of ground. The first chapter provides an overview of the issues central to securing a safer financial system for the EU. Part I of the book looks at issues relating to the crisis, both at the macro level—the pendulum of financial integration and fragmentation—and at a micro level—the institutional reforms that are taking place to address the crisis. Part II covers issues relating to the emerging financial sector management infrastructure, associated with both the prospective Single Supervisory Mechanism (SSM) and other elements of the banking union for the euro area, and the regulatory program under the auspices of the European Commission for the EU as a whole. Part III looks forward at some of the broader challenges.

I would like to extend my thanks to all those responsible for the creation of this book, the members of the FSAP team, others in the Monetary and Capital Markets Department, as well as colleagues in the European, Legal, and Research Departments of the IMF who provided comments and support, and all the counterparts in Brussels, Frankfurt, London, Luxembourg, and Paris who met with the team and offered their perspectives and insights. I hope that this volume provides a valuable resource for policymakers, academics, and private sector participants as we move forward in exiting from crisis and enter a new stage of European financial development.

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