

Banking crisis management frameworks

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Speeches

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supervisory priorities**

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Cooperation with the AMF and other RFAs

Ladies and gentlemen, good morning. I would like to thank the Arab Monetary Fund and the Bank for International Settlements for the opportunity to speak at this high-level meeting.

The AMF is our peer in the region and a key partner in our collaboration among regional financing arrangements (RFAs), and with the International Monetary Fund (IMF). This cooperation plays an important part in the effort to strengthen the global financial safety net.

Since 2016, the ESM has built stronger interinstitutional ties with the AMF, as well as with other RFAs around the world. We meet regularly at the High-level RFA dialogue and also bilaterally. The RFA cooperation platform facilitates knowledge-sharing about crisis prevention and resolution. It also helps us keep abreast of institutional

and economic developments in the various regions.

In my speech, I will focus on Europe's achievements in strengthening its crisis management frameworks for the banking sector. I will also show how euro area banks are stronger today than a decade ago.

Creation of EFSF and ESM

The global financial crisis and euro sovereign debt crisis exposed the lack of effective tools for addressing financial instability in the euro area. One of these gaps stemmed from the original architecture of the Economic and Monetary Union: There was no lender of last resort for euro area countries.

This gap was filled initially by the creation of the European Financial Stability Facility (EFSF) in 2010, a temporary structure under Luxembourg law. It was the predecessor of the European Stability Mechanism, (ESM), the institution that I manage, which was established as a permanent international financial institution in 2012.

The EFSF and ESM played a crucial role in preserving the integrity of the euro area by providing around €300 billion in loans to five countries (Ireland, Portugal, Greece, Spain, and Cyprus).

ESM tools for the banking sector

It is worth highlighting that the ESM's financial assistance instruments include two dedicated tools for the purpose of bank recapitalisation: the Indirect Recapitalisation Instrument (IRI) and the Direct Recapitalisation Instrument (DRI).

The indirect tool was used for the recapitalisation of Spain's banking sector – via loans to the Spanish government for about €41 billion in 2012-2013. DRI was never used and will be discontinued upon ratification of the new ESM Treaty.

The ESM's involvement in fostering banking sector stability will become even stronger when the ESM reform will become effective. Under the new Treaty, the ESM will perform the role of backstop to the Single Resolution Fund (SRF). This is a fund operated by the Single Resolution Board (SRB), the EU's resolution authority for Europe's Banking Union.

In practice, this means the ESM will provide a credit line to the SRB so that it can carry out its activities in case its own resources are not sufficient. This will reassure financial markets and limit contagion during crises. The ESM is operationally ready to perform this new task.

Banking supervision and resolution at European level

Coming back to the euro's institutional architecture, the next crucial step that ensued from the global financial crisis and the euro sovereign debt crisis was to move the supervision of Europe's systemically important banks from national to European level.

This task was decided in 2012, together with the decision to create the ESM, and has been performed by the European Central Bank since 2014. It is the Single Supervisory Mechanism (SSM). This has enabled the harmonisation of supervisory practices.

In 2015, the resolution of failing banks within the banking union also came under a central European authority (the Single Resolution Board). This protects taxpayers from state bailouts and contributes to financial stability.

Thanks to the creation of these new institutions, we have seen the reduction of pockets of vulnerability that existed in certain national banking sectors.

Euro area banks are more robust today

Apart from strengthening the institutional architecture, the stability of the banking system was boosted by stricter regulation, which imposed much higher regulatory capital ratios on banks. Banks' Common Equity Tier 1 (CTE1) ratio is today on average above 14%, more than double than at the start of the global financial crisis.

In addition, euro area banks hold high-quality liquid buffers, with levels well above the required threshold. Banks' stronger capital and liquidity buffers have enhanced their resilience significantly. Robust capitalisation means that banks are not only better positioned to absorb expected losses, but also well-prepared to manage unexpected losses.

The resilience of euro area banks is more pronounced today than ever before. This is based on quantifiable data, as reflected in the recent stress test, conducted by the European Banking Authority (EBA) and the European Central Bank (ECB). The stress

test results point to the sector's ability to withstand even the most severe scenario to date.

It is noteworthy that during the recent banking turmoil involving the collapse of several US regional banks, as well as that of Credit Suisse — a globally systemically important bank — the euro area banking system continued to function in an orderly way.

Lesson learned for crisis management

The turmoil in the US showed that we should not be overly focused on large banks. The troubled banks in the US were not among the largest. Yet, their size was sufficient to spread concern about the viability of other banks and the safety of deposits elsewhere.

Thus, the line separating “too big to fail” institutions from non-systemically important may be blurred or even meaningless during a crisis. Even institutions that are initially regarded as smaller or less systemically important can be interconnected with larger ones. This may be through various financial instruments, shared counterparties, or exposure to common risks.

Effective coordination and communication

Another lesson we have learned from past financial crises is that they often require a multifaceted and coordinated response. Effective coordination between various authorities, such as central banks, regulatory bodies, and government agencies, is necessary to implement timely and cohesive measures.

This applies to national authorities but should not be limited to national borders. In a globalised financial system, crises can quickly spill across borders. Communication between authorities at the national and international levels is crucial for coordinated responses and preventing the spread of contagion.

We should also keep in mind that financial markets are very sensitive to the flow of information. Coordinated communication by the authorities helps maintain market confidence by providing a unified and reliable narrative about the actions being taken to address a crisis.

Current challenges and necessary responses

The euro area economy and financial system has shown resilience to the string of recent shocks and crises. But now is not the time to be complacent. We live in an increasingly uncertain world where countries are being confronted with new challenges. These are related to factors such as more frequent and extreme climate disasters, demographic changes, and the transition to digital economies.

Crisis management institutions need to be ready to deal with the economic and financial consequences of these developments. For instance, in the digital age, distressed banks may be subject to bank runs that could break out and spread in a matter of hours. The ability to react quickly and in a coordinated way is of key importance.

At the ESM, we are doing our homework. We are reviewing our lending instruments to maintain them “fit for purpose”, given the evolving landscape. We are also integrating climate change considerations into our activities.

At the euro area level, to achieve a high degree of preparedness, it is crucial to complete banking union. We currently have two pillars of banking union in place that I mentioned: European level supervision and resolution.

On the second pillar, beyond the necessity to secure a backstop for the Single Resolution Fund, it is also necessary to make the resolution of smaller and medium-sized banks more effective.

This is the main purpose of the CMDI [Crisis Management and Deposit Insurance] initiative, proposed earlier this year by the European Commission. EU members are also discussing how to implement a third pillar, namely a common European Deposit Insurance Scheme.

Now, each country relies on its national deposit insurance authority. Creating a European scheme would contribute to risk reduction in the financial sector by providing a backstop to national deposit insurance systems. This would boost confidence among depositors and investors, which in turn would increase confidence in the EU banking system as a whole and enhance financial integration.

Conclusion

Ladies and gentlemen, to conclude. The framework for crisis management in the European banking sector is a dynamic and evolving system that has undergone

significant enhancements since the global financial crisis and the euro sovereign debt crisis.

The joint efforts of policymakers, regulatory bodies, central banks, and financial institutions have laid a foundation of resilience. However, more needs to be done to make it even more resilient.

More globally, as we deal with the complexities and uncertainties of the global economy, a strong and well-coordinated global financial safety net is more crucial than ever. In the face of new risks and threats, being prepared means proactively identifying and assessing emerging risks.

To do so, close cooperation among crisis management institutions will be key. It will ensure a comprehensive and timely response to evolving risks, fostering stability and resilience in the face of uncertainties.

Thank you for your attention.

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