Risk-sharing in the EU - speech by Nicoletta Mascher

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"Risk-sharing in the EU: how to ensure common ground on adequate instruments, institutional framework and appropriate procedures"
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(Please check against delivery)

Good afternoon Ladies and Gentlemen,

I want to thank the organisers for having me on this panel to talk about risk-sharing and its implication for financial stability.

First, it is important to understand what type of risk-sharing we want to talk about.

In formal terms, (international) risk-sharing is risk absorption (realised through different channels) which enables a country to insulate disposable income from regional shocks.

In the euro area, it is estimated that 80% of local shocks remain unsmoothed and therefore specific economic shocks end up having an impact on people’s income and consumption of a specific country (compared to 20% in the USA).

In more pragmatic terms, you can look at risk-sharing from two main angles:

- one is the level of integration in a concerned market: how freely investors can move their resources and savers choose their investments; it is risk diversification with the related income flows from investment and labour;
- another angle is public redistribution; today this is measured only by general government transfers across countries and is relatively small;

If we look at ex-post public risk-sharing, after a crisis has already hit a country, than we can also consider public crisis management tools, like the European Stability Mechanism.

For this panel discussion, I will specifically take the angle of financial integration to briefly mention loopholes in the institutional framework and possible steps ahead; I will conclude with the role of the ESM.

The main idea is that the more private risk-sharing, the less public interventions will be necessary; therefore we need more financial integration and for that a complete banking union and a Capital Markets Union.

Conversely, fragmentation and risk segregation may reduce contagion from local risks but also the risk absorption capacity; in the end this increases instability and weakens growth.

Risk-sharing connected to financial integration

Let’s ask ourselves where we currently stand in the euro area in terms of integration.

Have you ever tried to pay your utility bills with a debit order on your domestic account when relocating within banking union? Who, as an expat, has never had difficulty opening a bank account in the European Union or, even worse, getting a mortgage?

Since the last financial crisis, Europe has come a long way and we are better prepared for a potential new crisis. However, euro area financial integration is very low compared to other jurisdictions; this results in less risk-sharing, lower profitability, and higher instability.

In fact, an integrated financial sector with free cross-border services would make the economies less vulnerable to idiosyncratic shocks and financial entities themselves less exposed to their business in a specific country or region.

Banks could compete better not only within the euro area, but also on a global scale. Customers could benefit from lower bank service costs. Companies could obtain easier financing even in periods of local financial distress.

Therefore, financial integration is a centrepiece for enhancing risk-sharing.

Where we see room for improvement in banking union in terms of financial integration

What does this concretely imply in terms of improvements for banking union?

We have recently published a discussion paper where we outline a number of elements needed to complete banking union to achieve three many objectives: safety, profitability and integration of the banking sector.

A European common deposit insurance is, after appropriate risk reduction, in our staff view necessary to ensure a truly integrated banking market.

Currently, the level of deposit protection still depends on national resources and conditions, which leaves banks and customers vulnerable to local shocks. A large common insurance would reassure all euro area customers and dissipate the risk of bank runs. It would loosen the link between banks and sovereigns and reduce its amplifying effect in a crisis.

In terms of priorities to get there, we see merit in focussing the attention on the crisis management framework since this has a direct link with the risk of pay-outs from a common deposit insurance and on the overall credibility of banking union.

But fragmentation needs to be tackled at different junctures: options and national discretions in banking regulation and lack of an equivalence regimes for non-banks (same risks – same rules) contribute to an unlevel playing field, affect credibility and spur the build-up of vulnerabilities in other corners of the financial sector that can spread to banks in a crisis.

Fostering an integrated banking sector requires the removal of barriers to capital and liquidity movements for subsidiaries across borders. But because of the loopholes we see in banking union and the uneven level of risk, fears of contagion across national borders surmount the perceived benefits from operating in a large single market.

In the attempt to find the right balance between further risk reduction and more risk-sharing, risk-sharing instruments, like a common deposit insurance, should be used as a tool to promote market discipline.

To set the right incentives for a common deposit insurance, the calibration of premiums could be better linked to the supervisory assessment on an institution's risk profile, including the bank's risk appetite and the individual risk reduction objectives. The tool should be flexible enough to capture new emerging risks in a dynamic way, embedding a forward-looking and qualitative component.

What role does the ESM already play and what will be its role in the future with the new mandate?

The ESM plays a key part within the euro area architecture in enabling risk-sharing during crisis times. And although prevention is always better than cure, it is fair to say that we have a good mechanism in place to manage a crisis.

ESM's financial assistance programmes are designed to alleviate the impact of a crisis and ensure a certain degree of shock smoothing in more vulnerable euro area countries.

With the new mandates, the ESM will contribute more to risk sharing.

- We will provide the backstop to the Single Resolution Fund (SRF), making the crisis management of large banks more robust.
- On financial assistance, together with Commission we will design and monitor future country programmes, including the design of policy conditionality.
- Outside programmes, we will play an enhanced role, following macro-economic and financial developments in all euro area member states to ensure crisis preparedness.
- For the precautionary credit lines, the eligibility process will be made more transparent and predictable.

All in all, the ESM will play a bigger role in ensuring financial stability.

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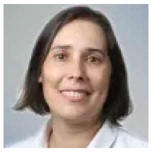

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