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European Financial Stability and Integration Report 2011

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TABLE OF CONTENTS

EXECUTIVE SUMMARY **5**

CHAPTER 1: MARKET DEVELOPMENTS **8**

1.1 INTRODUCTION 8
1.2 EVOLUTION OF THE CRISIS (2007-2011) 8
1.2.1 From banking crisis to sovereign debt crisis *8*
1.2.2 Intra-EU contagion *11*
1.2.3 Feedback loop from sovereign debt crisis to banking sector *11*
1.2.4 State of play and policy implications *13*
1.3 SOVEREIGN DEBT MARKETS IN 2011 14
1.3.1 Sovereign stress spreading out *14*
1.3.2 Crisis triggering changes in investment patterns *15*
1.4 BANK SECTOR 17
1.4.1 Funding and inter-bank market developments *17*
1.4.2 Bank capitalisation and profitability *22*
1.4.3 Evolution and integration of bank financial intermediation *25*
1.5 CORPORATE BOND AND EQUITY MARKET 31
1.5.1 Equity markets *31*
1.5.2 Corporate bond markets *32*
1.6 INSURANCE SECTOR 34
1.6.1 Market development *34*
1.6.2 Market integration and the role of insurers as long-term investors *37*
1.6.3 Challenges ahead *39*
1.7 MARKET INFRASTRUCTURES 39
1.7.1 SEPA *39*
1.7.2 Trading infrastructures *40*
1.7.3 Post-trading infrastructures *42*
1.7.4 Derivatives *43*
1.8 OVERALL ASSESSMENT 44

CHAPTER 2: POLICY DEVELOPMENTS **47**

2.1 INTRODUCTION 47
2.2 FINANCIAL ASSISTANCE AND SUPPORT MEASURES 47
2.2.1 Permanent financial backstop mechanisms *47*
2.2.2 Financial assistance programmes *48*
2.2.3 Enhanced credit support by the ECB *48*
2.3 ENHANCED ECONOMIC GOVERNANCE 49
2.3.1 Fiscal surveillance *49*
2.3.2 Macroeconomic surveillance *50*
2.3.3 Additional proposals strengthening budgetary surveillance in the euro area *51*
2.3.4 European Semester and Euro Plus Pact *52*
2.3.5 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union *52*
2.4 REFORMS OF THE FINANCIAL SECTOR 53
2.4.1 New architecture for financial supervision *54*
2.4.2. Stability and governance of financial institutions *55*
2.4.3. Efficiency, integrity, liquidity and transparency of markets *56*
2.4.4. Protection and inclusion of consumers and investors *58*
2.4.5. Measures to stimulate investment in the real economy and assisting SMEs *59*
2.5 CONCLUDING REMARKS 59

CHAPTER 3: STRUCTURAL CHANGES IN THE EU BANKING SECTOR **61**

3.1 INTRODUCTION 61
3.2 SIZE AND STRUCTURE OF THE EU BANKING SECTOR 61
3.3 SCOPE FOR FURTHER CONSOLIDATION AND SECTOR RESTRUCTURING 65
3.4 EXAMPLES OF STRUCTURAL CHANGES IN DIFFERENT COUNTRIES 67

3.4.1 Denmark: Implementation of a bank resolution scheme ... *67*
3.4.2 Germany: Restructuring of Landesbanken and other banks ... *68*
3.4.3 Ireland: Major restructuring of banking sector ... *69*
3.4.4 Spain: Restructuring of the savings banks and other reforms ... *70*
3.4.5 UK: Proposals to ring-fencing retail banking ... *71*
3.5 IMPLICATIONS FOR CROSS-BORDER BUSINESS AND MARKET INTEGRATION ... 72

CHAPTER 4: CHANGES IN THE EU INSURANCE SECTOR ... 74

4.1 INTRODUCTION ... 74
4.2 ORGANISATION ... 76
4.2.1 What factors other than the current crisis and regulation have catalysed significant organisational change? ... *76*
4.2.2 How has the crisis affected the way insurers organise themselves? ... *77*
4.2.3 How has new regulation affected the way insurers are organised? ... *78*
4.2.4 Impact on pursuit of EU objectives ... *79*
4.3 UNDERWRITING AND INVESTMENT ... 79
4.3.1 How has the crisis affected insurers' underwriting and investment activities? ... *79*
4.3.2 How has new regulation affected insurers' underwriting and investment business? ... *84*
4.3.3 Impact on pursuit of EU objectives ... *88*
4.4 EXPERIENCE OF THE SINGLE MARKET ... 89
4.4.1 Objectives ... *89*
4.4.2 Size of national markets ... *89*
4.4.3 Level of integration in EU insurance markets ... *90*
4.4.4 Benefits ... *91*
4.4.5 The way respondents operate in the Single Market ... *92*
4.4.7 How has regulation affected insurers' EU operations? ... *94*
4.4.8 Impact on pursuit of EU objectives ... *95*
4.5 CONCLUSIONS ... 95
4.5.1 Organisation ... *95*
4.5.2 Underwriting and investments ... *95*
4.5.3 Single Market ... *97*

CHAPTER 5: EU HOUSEHOLDS AND THE FINANCIAL CRISIS ... 98

5.1 INTRODUCTION ... 98
5.2 HOUSEHOLDS' OVERALL FINANCIAL BALANCE SHEET ... 98
5.2.1 Volume ... *98*
5.2.2 Composition ... *99*
5.3 IMPACT OF THE CRISIS ON HOUSEHOLDS ... 100
5.3.1 Households as savers and investors ... *100*
5.3.2 Households as insurees ... *103*
5.3.3 Households as borrowers ... *104*
5.4 CONSUMER PERSPECTIVE ON THE FINANCIAL SECTOR ... 107
5.5 CONCLUSIONS ... 107

EXECUTIVE SUMMARY

In 2011, the financial and economic crisis entered into its fifth year, turned more complex and required more difficult policy solutions to safeguard financial stability. The sovereign bond markets have been at the centre of financial market tensions in 2011, with stresses in Greek sovereign debt spreading to other vulnerable Member States and also reaching some of the large economies, such as Italy and Spain. Given the significant sovereign debt exposures of EU banks, the sovereign debt troubles multiplied the concerns about banks' liquidity and solvency. Concerns about the financial position of banks, as well as a lack of market transparency on their actual position, made funding more expensive and harder to obtain in the second half of the year. The interbank market dried up even further. Increased risks in the banking sector reinforced the stress in the sovereign debt markets, creating a dangerous vicious circle. The complex intertwined relationship between financial and sovereign debt markets, as well as adverse feedback effects to the real economy, complicated the solution to the crisis and called for policy action on different fronts.

Against this backdrop, the Commission published on 12 October 2011 a roadmap for stability and growth, which advocated decisive action on five points which are mutually reinforcing: (i) comprehensive measures on Greece to ensure its economic sustainability and credible economic adjustment measures in other vulnerable Member States, (ii) the completion of an adequate firewall against contagion in euro-area sovereign debt markets, (iii) a fully coordinated approach to strengthen EU banks' capital base, (iv) the speeding up of stability and growth-enhancing policies, and (v) the reinforcement of the integrated economic governance framework (including integration of the European Stability Mechanism and the Stability and Growth Pact into the same fully integrated governance system to increase coherence and efficiency). This strategy has been endorsed by the euro area leaders, and significant progress has been made in the implementation of all five elements in the last months of 2011. In addition to the measures adopted by the EU or national governments, the European Central Bank (ECB) took exceptional measures at the end of the year to provide longer-term financing to banks and thereby support liquidity and bank lending to the real economy. The combination of policy decisions agreed at EU level during 2011 and the extraordinary measures by the ECB seemed to have succeeded in at least tentatively stabilising the financial situation at the turn of the year 2011/2012 and in giving policy makers some breathing space to further pursue and implement the required policy measures and to give an appropriate and lasting response to the challenges of the crisis.

The crisis has clearly demonstrated that in particular the euro area is one integrated monetary and financial system. The economies of the Member States are intrinsically linked through their financial sectors and through their participation in the euro system. The crisis demonstrated that concerns about debt sustainability in one Member State can have direct implications for the funding conditions of banks in other Member States. This necessitates a holistic approach to crisis resolution, including continued efforts to improve financial sector regulation and supervision as well as the governance of the euro area, building on the major achievements in these domains since 2009.

The crisis has significantly amplified market volatility, and indicators of financial integration reflect that volatility since 2007. The financial system and the banking sector in particular have started undergoing a process of restructuring in several countries. The outcome of this restructuring will be critical for the future of the Internal Market for financial services and the integration of capital markets in Europe. The possibility of national solutions implying a retrenchment of banks behind national borders cannot be excluded. This would however partly undo the significant benefits of European financial integration and endanger economic

integration at large. Much can be gained if the changes are properly coordinated and encompassed in the new supervisory and regulatory frameworks developed at EU level.

2011 has also illustrated the clear complementarity between financial stability and integration. Economic and financial integration is not an obstacle to stability, and integration can deliver strong benefits for the broader economies. However, economic governance has to evolve together with integration if the benefits from integration are to be sustainably secured and not to be at risk of getting squandered, as witnessed in the recent past. If the required steps are taken to provide the right supervisory and regulatory environment for financial activities and if macroeconomic stabilisation rules and mechanisms are in place, the economic potential of the EU's Internal Market can be maximised to deliver more sustained and higher growth and more employment.

The financial integration process in Europe has, as a result of the crisis, partly been halted or indeed reversed in some segments of the market. Cross-border capital flows have fallen sharply (partly reversing some of the excesses that have fuelled unsustainable private and public sector spending, leading to the boom-bust cycles experienced in some EU countries). There are also signs of EU banks retrenching behind national borders. However, even if cross-border business has declined in some segments of the market, it is encouraging that financial firms have largely preserved their cross-border presence in the EU and that the integration of market infrastructures has progressed further. With a new institutional framework in place at EU level, and if the adopted or proposed significant reforms are implemented, financial integration can progress at a more sustainable pace to deliver improved market outcomes for the users of financial services and economic growth.

Chapter 1 presents a comprehensive account of the main market trends and developments in 2011 that had a direct impact on financial stability and integration.

Chapter 2 sets out the major policy steps taken in 2011 to redress the situation and provide the foundations of more stable and sustained growth. The intensity, complexity and interconnectedness of the problems of sovereign debt, banks, the wider financial system and the real economy required the deployment of various and mutually reinforcing measures in order to strengthen the transparency and resilience of banks and other parts of the financial system, and to improve economic governance in Member States, the EU and euro area, thereby also reducing the probability of future sovereign debt crises. These elements, necessary for paving the way for recovery and long-term economic growth, have been at the core of the policy agreements reached at European level in 2011 and will guide policy efforts in 2012.

Chapter 3 provides an overview over broad trends of the evolution of EU bank sector structure. In the light of the stress in the banking sector that has been present since the start of the crisis and intensifying again during 2011, the restructuring of the sector has been relatively limited to date. However, this process can be expected to intensify over the years to come. This will not only shape the resilience of the banking sector but also determine the structure and degree of integration in the EU banking sector. The restructuring responses to date have often been national in nature. This presents potential risks to the EU integration process if the measures are uncoordinated and focused on the domestic market only. EU-wide measures and coordinated policy action are therefore of particular importance to prevent further disintegration and preserve the benefits of an integrated market.

Chapter 4 gives an assessment of the impact of the crisis and regulation on the insurance sector, based on findings from a questionnaire completed by a sample of leading EU insurance companies. It reports that insurers' responses to previous crises, their geographical diversification and their preparations for Solvency II have strengthened their capacity to withstand the current crisis. However, insurers continue to face major challenges, including

low interest rates, exposures to sovereign debt (including an increased home bias in sovereign debt holdings) as well as low economic growth which affects non-life business especially. Moreover, the need to ensure attractive returns on life products could lead some insurers to increase their holdings of high return/risk products. These challenges reinforce the importance of strong supervision and the timely introduction of the risk-based prudential regulation of Solvency II. While some insurers are restructuring their EU operations to facilitate major cost savings and reduce risk, certain unwarranted obstacles to the Single Market remain. While Solvency II will remove some of them, other unjustified obstacles must be removed, especially where their costs are significant.

Chapter 5 considers how household sector financial wealth and household borrowing evolved in the crisis. The aggregate data shows important compositional changes (e.g. a shift from equities to bank deposits) as well as the continued growth of assets and liabilities. However, this obscures certain significant national developments which in some cases (e.g. with respect to bank deposits and housing debt) imposed social costs and affected growth and financial stability. The crisis affected households in many ways, including by contributing to the price volatility of financial instruments and related non-financial assets including housing. This increased the challenge for some households of properly assessing and comparing different financial products and services. The crisis reinforced the need for effective policy action to help prevent the accumulation of excessive household debt in the future and to strengthen household understanding of, and trust in, the financial system. The latter is crucial if the financial system is to play its core role in intermediating efficiently between savers and borrowers, with households as net savers acting as large-scale providers of stable and long-term funding.

This report does not provide a comprehensive overview and analysis of all developments across all the different financial market segments. It focuses on the main market and policy developments that are relevant from both a financial stability and integration perspective. Some market segments, in particular 'shadow banking', are not covered in the report because of separate on-going work. The report generally reflects data and other information up to end-2011 and, in some sections, up to end February 2012.

CHAPTER 1: MARKET DEVELOPMENTS

1.1 INTRODUCTION

This chapter starts by setting out the evolution of the financial and economic crisis that explains the market conditions observed in 2011. Section 1.3 then describes the main developments in European sovereign debt markets. Section 1.4 focuses on the EU banking sector, in particular as regards the banks' funding conditions (liquidity) and their balance sheet repair (solvency). It also studies the functioning of the banking sector's financial intermediation role. Section 1.5 examines capital markets, in particular the role of corporate debt and equity markets in providing capital to the real economy. Section 1.6 presents the major developments in the EU insurance sector, including how the sector has been affected by the sovereign debt crisis. Section 1.7 focuses on developments in market infrastructures. The chapter concludes with an overall assessment of the challenges in the foreseeable future as regards both financial stability and integration (section 1.8).

1.2 EVOLUTION OF THE CRISIS (2007-2011)

The financial and economic crisis that started as a private (sub-prime) debt crisis spilling from the USA to Europe in 2007 reached new dimensions in 2011. In 2011, the crisis became more complex as concerns about the sustainability and potential restructuring of public finances created new tensions in financial markets. The problems that appeared already in Greece and Ireland in 2010 spilled over to other countries in 2011, putting a halt to and in some cases reversing capital flows and financial integration and threatening the foundations of European monetary integration. As the crisis evolved, it has become increasingly complex, and different feedback mechanisms created a vicious circle linking public sector finances with the banking sector and financial markets, with adverse consequences also spilling over to the real economy. The wider dimension of the problems demanded a stepping up the measures to solve the crisis.

This chapter starts with a recapitulation of the events that led to the state of affairs in 2011. It seeks to provide a clearer perspective of the new complexities that have appeared in the latest stages of the crisis and the interrelationships between the sovereign debt and the financial crisis, between financial integration and stability issues, and across different financial market segments.

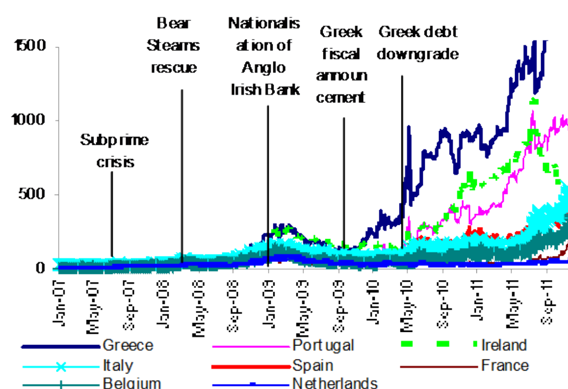
1.2.1 From banking crisis to sovereign debt crisis

From the introduction of the euro until July 2007, spreads on European government bonds moved in a narrow range with little differentiation between countries (see chart 1.2.1). Increasing financial integration led banks to diversify sovereign debt portfolios. Public debt from any euro area country was broadly considered as good as the best among them and could be used to get liquidity from the ECB or as collateral in wholesale markets. Unfortunately, risks were significantly underestimated. The US subprime crisis of 2007 served as the trigger to unwind the previously accumulated imbalances and miscalculations of risk. It marked the start of the global banking crisis, as the solvency of many banks in the EU and elsewhere was put into question.

Governments came to the rescue of their national banking systems and provided significant state aid to financial institutions in order to avert the consequences of possible failures.[1] Bank recapitalisation took place with direct (capital injections) or indirect (guarantees, asset relief) public aid. Moreover, countries were confronted with steep declines in tax revenues and increased expenditures. As the financing needs of the public sector grew bigger, the spreads of sovereign debt started revealing differences among Member States.

A sovereign's bond spread responded increasingly to the weaknesses of its own financial sector.[2] Financial and sovereign shocks became even more intertwined after the nationalisation of Anglo Irish Bank, when the ability of sovereigns to bail out the financial sector first came into doubt—not only did the weakness of the financial sector raise sovereign spreads, but shocks to a sovereign's fiscal strength reduced its ability to provide state support to banks.

Chart 1.2.1: **Sovereign bond spreads (basis points)**



Notes: Spreads of 10-year benchmark bonds compared to Germany. Vertical axis cut at 1,500 basis points.
Source: Bloomberg.

A number of country-specific factors added to the problems and set the conditions of a new phase in the crisis, characterised by highly interlinked sovereign and banking risks.

- Greece already had high levels of public debt (113% of GDP in 2008). Markets questioned the capacity of the authorities to maintain the sustainability of public finances.

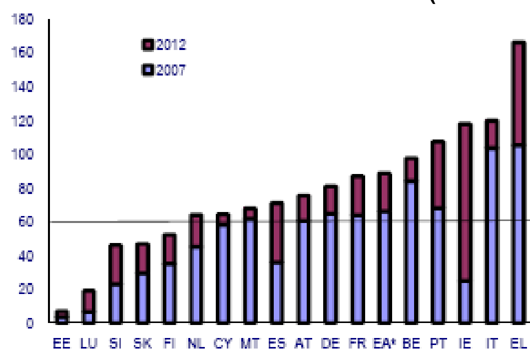
- In Ireland, the government's fiscal position was considered strong before the crisis but then deteriorated due to the cost of supporting banks. The cost of support cost was exacerbated by the size of the banking sector relative to the domestic economy and the exposure of banks to a boom-bust cycle in domestic real estate asset prices. The capacity to generate tax revenues was severely reduced as the end of the real estate boom lowered the growth prospects for the Irish economy.

- In Portugal, a prolonged period of falling competitiveness dented the country's potential to recover from the fiscal effort that the bail-out of banks required. Investors were concerned that Portugal's low growth rates could affect its capacity to maintain the viability of public finances. Competitiveness concerns also applied in other countries of the euro area periphery (see below).

More generally, high debt levels, serious and persistent budget deficits and low actual and expected economic growth (see charts 1.2.2 and 1.2.3) contributed to the sovereign debt crisis, in particular in the euro area periphery.

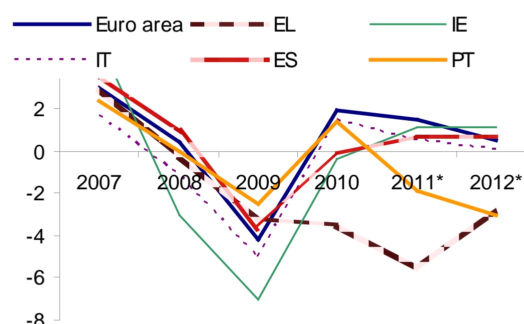
[1] See Box 3.1.1 in chapter 3.
[2] See IMF (2011), 'The Eurozone crisis: How banks and sovereigns came to be joined at the hip', November.

Chart 1.2.2: **Public sector debt in euro area (% of GDP)**



Source: Commission Services (2011), Quarterly Report on the Euro Area, Volume 10, No. 3

Chart 1.2.3: **GDP growth rate (annual change in %)**



Notes: * Forecast in autumn 2011.
Source: Commission Services (2011), 'European Economic Forecast', Autumn.

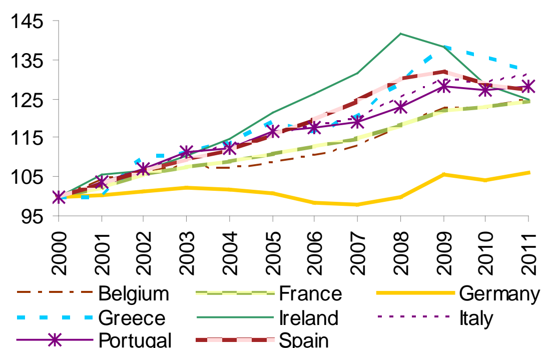
In addition to the structural weaknesses in the banking sector and the wider financial system, the financial crisis exposed a number of structural problems that had been building up for some time. Over time, the competitiveness of the vulnerable countries in the euro area eroded. Unit labour costs increased significantly in the periphery compared to the core (chart 1.2.4), and large current account imbalances built up within the euro area (chart 1.2.5).[3] Increased public and current account deficits were fuelled by freely flowing capital within the Single Market. The strong cross-border capital flows into the non-tradable sector (and into government debt and interbank markets) financed demand rather than supply and imports rather than exports, leading to imbalances that turned out to be unsustainable.

As current account deficits widened, countries became increasingly dependent on capital inflows, and a sudden stop of capital inflows could cause financial disruption and severely impact growth. Indeed, when the crisis hit, private capital flows to the euro vulnerable countries reversed and financing constraints became apparent. In some vulnerable countries, private capital flows were largely replaced with ECB and official financing.

Some of the CEE countries, in particular those that had pegged their currencies to the euro at an early stage (the Baltic States and Bulgaria) but also others (e.g. Hungary which had an adjustable pegged exchange rate regime until 2008 and then moved to a floating rate regime), experienced credit and domestic demand booms and very high current account deficits. When the financial crisis started and capital flows dried up, domestic demand and GDP fell sharply, leading to a steep rise in unemployment. The reversal of capital flows forced sharp adjustments in the current account deficits (see the Estonian example in chart 1.2.5).

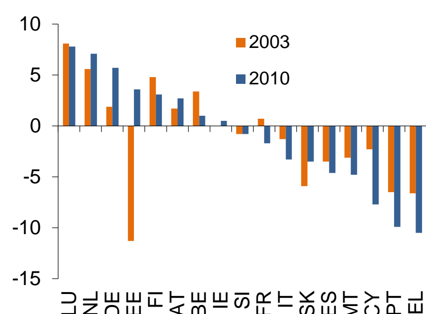
[3] For more detail, see European Commission (2010), 'The impact of the global crisis on competitiveness and current account divergences in the euro area', Quarterly Report on the Euro Area, Volume 9, No 1 and European Commission (2010), 'Surveillance of intra-euro area competitiveness and imbalances', *European Economy Series, 1/2010.*

Chart 1.2.4: **Unit labour costs (index, 2000=100)**



Source: Eurostat

Chart 1.2.5: **Current account imbalances (% of GDP)**

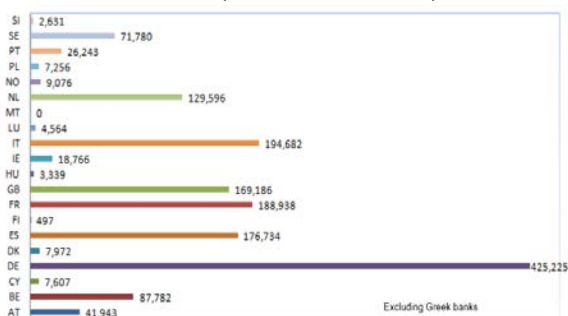


Source: IMF

1.2.2 Intra-EU contagion

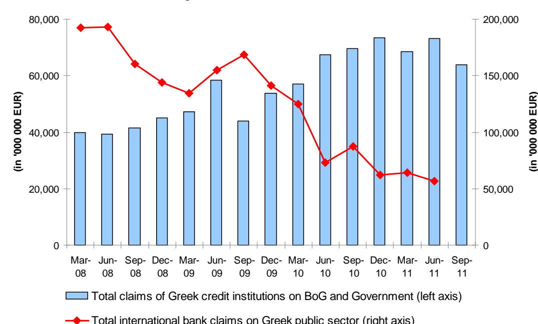
The high level of financial integration, in particular in the euro area, increased the risk of cross-country contagion. For example, many European banks held in their portfolios a significant amount of sovereign debt (and other financial assets) from other Member States, including the high-spread countries (chart 1.2.6). However, the Greek crisis did not spill over to other European economies until mid-2010. Delays in the resolution of Greece's sovereign debt problems raised concerns of a possible Greek default. It also triggered wider confidence losses of investors in other euro area countries. The developments in sovereign debt markets are set out in section 1.3.

Chart 1.2.6: **Net direct sovereign exposures to EEA countries (€million, 30/09/2011)**



Notes: Based on EBA EU 2011 Capital Exercise. The data is not for the entire EU banking sector, but for a sample of EU banks.
Source: EBA.

Chart 1.2.7: **Domestic and foreign bank holdings of Greek public debt**



Source: Commission departmental calculations based on Bank of Greece, BIS, ECB and AMECO

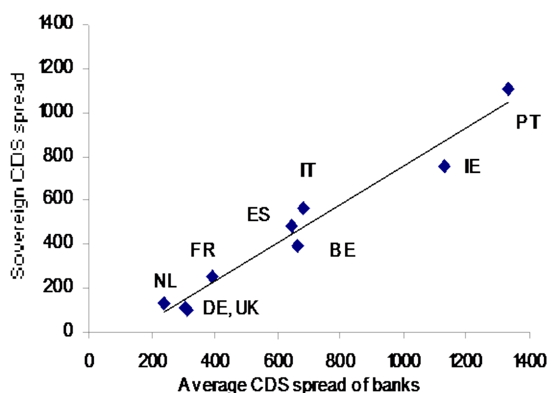
The aggravation of the situation in Greece, followed by Ireland and Portugal, led to important changes in the portfolio composition of banks' holdings of public debt. Banks from countries in difficulties started to increase their holdings of domestic public debt, while banks from other Member States cut down their exposures to debt in the high-spread countries. Chart 1.2.7 illustrates these changes for Greece, showing an increase in Greek banks' holdings of Greek public debt compared to a decline of international bank claims on such debt. The greater home bias in sovereign debt holdings increased the risk of adverse effects spilling over from sovereign debt to domestic banks and exacerbated the stability concerns in the euro area periphery.

1.2.3 Feedback loop from sovereign debt crisis to banking sector

The growing concerns about the sustainability of public finances, combined with weakened economic growth prospects, had implications for the stability of the banking sector. Both sides of banks' balance sheets were affected by increased sovereign risk (see Box 1.2.1 for

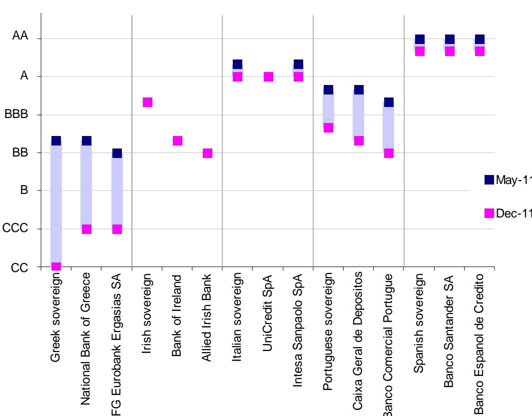
more detail). On the asset side, banks were exposed to losses on their sovereign portfolios. On the liability side, banks' funding costs showed close correlation with sovereign risk premiums. The interlinkages are evident from the correlation between CDS spreads of a country's government and those of its banking sector (chart 1.2.8), and the relationship between credit ratings (and rating downgrades) of banks and their home sovereign (chart 1.2.9).

Chart 1.2.8: **5-year CDS spreads for banks and sovereign debt (basis points)**



Notes: 5-year CDS spreads, showing the average for a small sample of banks per country and the sovereign, as of end November 2011. High CDS spreads for Greece are omitted.
Source: Bloomberg.

Chart 1.2.9: **Issuer ratings for sovereigns and banks**



Source: S&P long-term issuer ratings.

Box 1.2.1: **Feedback loops from sovereign risk to bank funding costs**

The feedback from sovereign risk to banks (and bank funding costs) works through different transmission channels: [4]

Direct exposures—Banks tend to have sizeable exposures to the home sovereign, with holdings of domestic government bonds being particularly large in countries with high public debt.[5] The 2011 EBA stress test results showed that, for a sample of EU banks the aggregate exposure-at-default (EAD) Greek sovereign debt outstanding was €98.2bn. 67% of this debt was in fact held by domestic banks. The aggregate EAD exposure was €52.7bn for Ireland (61% held domestically) and €43.2bn for Portugal (63% held domestically).

Credit ratings—Since the start of the crisis, about two-thirds of domestic banks in the EU have had their credit ratings lowered within six months following a sovereign downgrade,[6] and sovereign credit ratings often present a ceiling for the ratings of domestic banks (see chart 1.2.11 above).

Government guarantee—The worsening of fiscal positions of sovereigns can reduce the funding benefits that banks derive from implicit or explicit guarantees, if investors perceive sovereigns to no longer be capable of bailing out their domestic banks. There is evidence that, at least in euro area countries severely affected by sovereign risk concerns, implicit government support for large

[4] For a detailed discussion of these and other effects, see BIS (2011), 'The impact of sovereign credit risk on bank funding conditions', Committee on the Global Financial System, CGFS Papers No 43, July.
[5] In addition, banks also have direct, on balance sheet exposures to sovereigns through their market-making role in OTC derivatives markets.
[6] See BIS (2011), op.cit.

banks has declined since end-2009 (i.e. the credit rating agencies have lowered the systemic support uplift that applied to the banks' credit ratings).[7]

Collateral—The deterioration in a sovereign's creditworthiness reduces the value of the collateral that banks can use for wholesale funding and to obtain liquidity from the central bank. The cost of funding in the wholesale markets increases as the quality of the collateral deteriorates since the margins required grow.

Other—A number of other channels apply, such as the decrease in market confidence and investors' risk appetite due to weak public finances and the potential crowding-out of bank debt issuance by sovereign debt issues if supply of capital is limited.

1.2.4 State of play and policy implications

The link between sovereign debt and banking remains tight[8] and, over 2011, it has become increasingly complex to break the feedback loops and as far as possible avert any adverse repercussions for the real economy.

As discussed in more detail in the remainder of this chapter, in 2011 spreads continued to increase in more countries, both for banks and sovereigns. New tensions appeared, such as those in the interbank lending and money markets, which temporarily reached proportions similar to those observed at the time of the Lehman failure. The deteriorating economic growth prospects added to the pressures across the euro area and beyond. Fiscal consolidation to bring down public debt as well as bank deleveraging via credit supply restrictions may make any recession deeper. Also, the structural adjustments required to unwind the imbalances that had built up within the EU prior to the crisis suggest a protracted and painful recovery.

Policy action has been taken on different fronts to counter the adverse developments and break the vicious cycle between sovereign debt, banking and real economy. As set out in chapter 2, this includes measures to:

- strengthen the balance sheet positions of banks and enhance the stability of the wider financial system,
- reduce the probability of sovereign debt defaults, and
- correct the imbalances between countries and promote long-term economic growth.

A key policy focus is on restoring GDP growth. Economic growth will not only help adjusting imbalances, but it will also improve public finances and make it easier to reform and strengthen banks and other parts of the financial system.

Financial integration facilitated the free flow of capital prior to the crisis.[9] While large and excessive capital flows helped fuel the boom-and-bust cycle experienced in some countries, it does not follow that integrated financial markets are necessarily more prone to greater volatility, instability and boom-and-bust cycles. Financial integration delivers huge benefits and has been a key source of economic growth. The crisis, however, revealed that integration

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[7] Implicit guarantees are also weakening as a result of regulatory intervention and lower willingness of governments to stand behind banks.

[8] There are also concerns about additional spillovers from the sovereign debt crisis that may affect not just banks but the entire financial system. For example, there are spillovers to insurance companies and other financial institutions via their direct holdings of sovereign and bank debt; and there may be further spillovers via the derivatives markets.

[9] The role of financial integration and its benefits for the European economy are examined in several reports, for example, International Monetary Fund (2011), 'Europe- Strengthening the Recovery', Regional Economic Outlook, May.

was not matched by the appropriate regulatory and supervisory institutions and related governance structures, in particular in the banking sector, but also in other parts of the financial system. Integration was far from complete in many markets and, as discussed below, the crisis put a break and in some cases reversed the integration trend. Going forward, more and better financial integration in the EU is needed to achieve financial markets that are capable of supporting economic growth without jeopardising financial stability.

1.3 SOVEREIGN DEBT MARKETS IN 2011

1.3.1 Sovereign stress spreading out

In 2011, the sovereign debt crisis spiralled beyond Greece, Portugal and Ireland as investors feared the impact on other euro area Member States. Several policy actions were taken, both at Member State level (e.g. reinforced fiscal consolidation and structural reforms, etc.) and at EU/euro area level (private sector involvement for Greek debt, macro-economic adjustment programs for Portugal and Ireland, strengthening of EU economic and fiscal governance framework, etc.). While these measures succeeded to calm down bond markets, the relief proved only temporary. Soon after, bond spreads started to widen again with contagion spreading out further, on concerns that slowing economic growth would undermine public debt sustainability, that the benefits of the domestic budgetary consolidation efforts risked being wiped out by the further rising debt-servicing costs, and that some sovereigns (and banks) may struggle to refinance their maturing debt. It was only at the end of 2011 that market sentiment turned, supported by policy measures, successful sovereign bond auctions, and some improvement in the international macro-economic conditions.

After a temporary stabilisation of the sovereign bond markets in Greece, Ireland and Portugal, following the policy measures agreed by the European Council in December 2010,[10] tensions in these bond market segments intensified severely in the first half of the year. Over summer 2011, yields started to move higher in Spain and Italy as well, amid a perception in markets that euro-area policymakers had not done enough to manage the crisis (see chart 1.3.1).

On 21 July 2011, the euro area Heads of State or Government responded to the unfolding crisis including by an agreement on a second programme for Greece, the modalities for private sector involvement (PSI) in the voluntary exchange of Greek sovereign debt, measures to increase the effectiveness of the EFSF/ESM (e.g. permission of EFSF to grant loans to governments for recapitalization of domestic banks, lowering of interest rates and lengthening of maturities of EFSF loans for all borrowers), commitments to sustain budgetary consolidation and a proposal to enhance economic governance and crisis management in the euro area. Besides, to ensure depth and liquidity in distressed bond market segments, the ECB announced an extension of its Securities Markets Programme. The announcement of these various measures had a calming effect on sovereign debt markets, but again only temporarily.

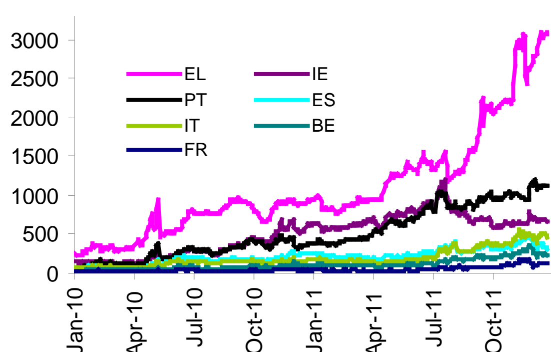
Since summer, even yields on some AAA-rated sovereign bonds, which so far had kept stable spreads with the German Bund, started to rise and decoupled from the Bund, as a result of concerns about the impact of slowing economic growth and contingent liabilities generated by the EFSF/ESM on domestic fiscal consolidation. The additional measures of the European Council on 23 October and the Euro Summit of 26/27 October were unable to counter this trend of widening sovereign bond spreads of a broadening group of Member

[10] The measures included, among others, the creation of the European Stability Mechanism (ESM) with own capital to replace the temporary European Financial Stability Facility (EFSF).

States. Moreover, as more and more euro area Member States were facing sovereign debt troubles, concerns were triggered over the spread of the EFSF bonds over the German Bund. However, towards the end of 2011 and turning into 2012, the sovereign-debt crisis abated gradually, supported by the very substantial progress with the set up and implementation of different policy measures at EU and Member State level (see Chapter 2) and by the ECB's 3-year long-term refinancing operations of December 2011 and February 2012, which considerably eased euro-area banks' funding conditions and risks. Also, the market's reaction to several rounds of sovereign credit-rating downgrades since December has remained muted.

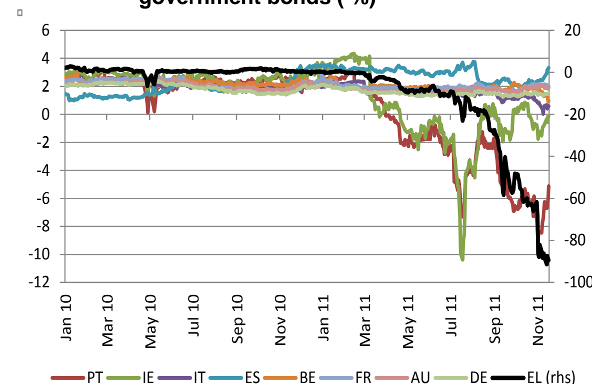
One of the stabilising elements in euro area sovereign bond markets over 2011 has been the narrowing of Irish spreads in the latter half of the year, driven by progress at the level of bank restructuring and deleveraging, the successful implementation of fiscal consolidation measures and the EU/IMF programme, further steps in structural reform of the economy, and economic growth remaining positive (albeit modestly) supported by a strong export performance. Further, despite the widening of spreads of some core Member States (such as France and Austria), real yields in these countries remain low by historical standards.

Chart 1.3.1: **Sovereign bond spreads to German Bunds (basis points)**



Source: Reuters Ecowin

Chart 1.3.2: **Spread between 10-year and 2-year government bonds (%)**



Source: Reuters Ecowin

1.3.2 Crisis triggering changes in investment patterns

The sovereign debt crisis may have been reinforced by banks, in the EU and abroad, unloading their sovereign bond portfolios in an effort to limit potential losses. Compared to the pre-crisis years when country risk was underestimated and sovereign bonds from any country in the euro area were considered as good as the best of them, the crisis led to significant changes in banks' (and other investors') investment patterns in sovereign debt. Since mid-2010 and during 2011, the mounting tensions in a growing group of sovereign bonds led banks and other investors to pull holdings out of these countries. Cross-border holdings by EU and global banks in sovereign bonds issued in the euro area periphery declined (see chart 1.3.3).

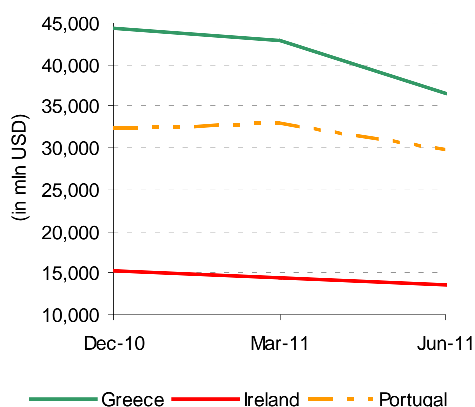
The capital was transferred to assets with the lowest credit and liquidity risk, in particular German Bunds, US Treasuries and UK Gilts, leading to a substantial drop in these benchmark yields (see chart 1.3.4). Over 2011, the US Treasury market remained in particular a favourite safe haven, despite meaningful concerns about the US federal debt level and the political disagreement on how to curtail its accretion.

At the same time, as other investors pulled out, banks in the euro area periphery tended to increase their holdings of domestic sovereign bonds (see chart 1.2.9 above for Greece), possibly helped by funding facilities offered to banks by the ECB. This increased the

exposure in these countries to domestic risks and tied the domestic banks even closer to the fate of the sovereign. Increased home bias in sovereign debt holdings is also observed for insurance companies (see chapter 4).

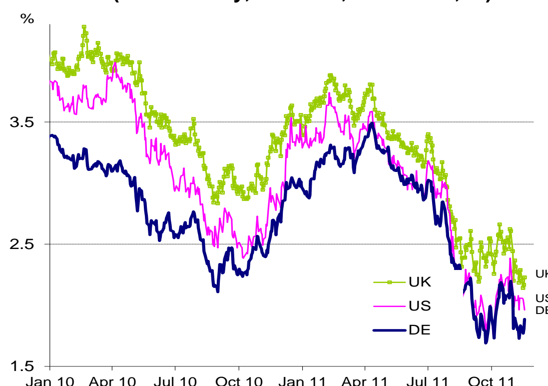
While the underestimation of country risks prior to the crisis led to patterns of unsustainable market integration, the reversal in risk perception –in the form of flight to quality and increased home bias in sovereign debt holdings– exacerbated problems in the high-spread countries and strengthened the negative feedback loops between sovereign and domestic banks in those countries.

Chart 1.3.3: **Cross-border sovereign debt holdings of European banks**



Source: BIS

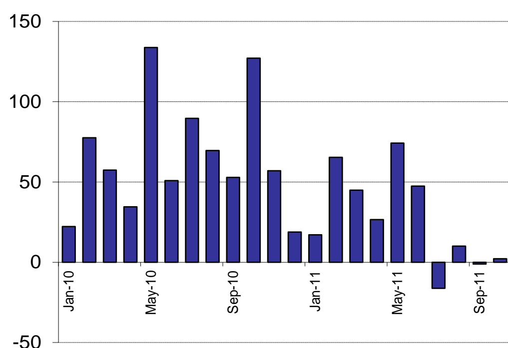
Chart 1.3.4: **10-Year benchmark sovereign bond yields (US Treasury, UK Gilts, DE Bunds, %)**



Source: Reuters Ecowin

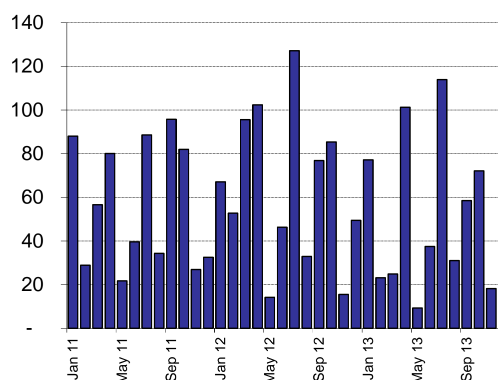
Apart from Greece and Portugal, both of which received external financing from the EU/IMF programme after their funding window shut down, sovereign bond issuance - within and outside the euro area - has been successfully met, although in several cases at much higher costs. Chart 1.3.5 shows the net issuance of euro-denominated sovereign bonds over 2010-2011 (i.e. 'par value of issued bonds' minus 'par value of maturing bonds'). The EU public sector's financing needs peaked in 2010, due to a combination of high deficits and maturing sovereign debt, but remained at elevated levels over 2011.

Chart 1.3.5: **Net issuance of sovereign bonds, (in €billion)**



Source: Bloomberg

Chart 1.3.6: **Redemptions of sovereign bonds, (in €billion)**

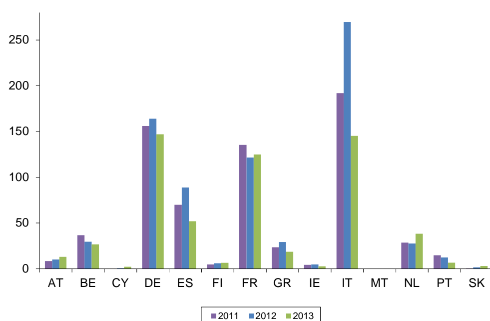


Source: Bloomberg

The increasing amount of maturing bonds and expected flow deficits (Charts 1.3.6 to 1.3.8), as well as the structural portfolio adjustments by institutional investors facing restrictions, either of regulatory nature or from internal codes of practice, has continued putting further pressure on the primary markets. Measures to reduce government deficits and debt levels are

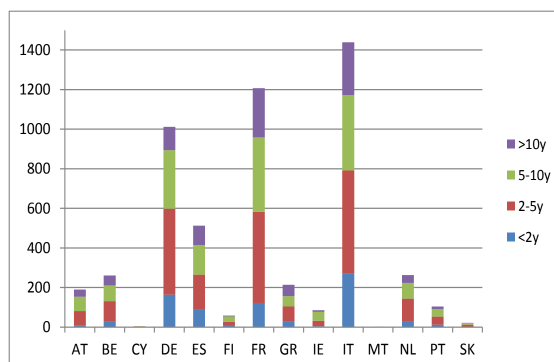
therefore critical to reduce the risk of a debt overhang problem that would make it increasingly costly for the countries to obtain the required funding in the market.

Chart 1.3.7: **Government's refinancing needs, selected countries (€ billion)**



Source: Bloomberg

Chart 1.3.8: **Maturity structure of sovereign bonds**



Source: Reuters Ecowin

In retrospect, it is clear that the failure of policy measures to calm down financial markets revealed a problem of credibility. While financial assistance programmes have gained time for the Member States concerned to initiate reforms, markets were over parts of the year unconvinced that the budgetary consolidation and reform strategies would eventually succeed in ensuring the sustainability of public finances. Developments of term spreads (i.e. differences between 10- and 2-year bond or CDS spreads) suggest that markets have increasingly focused on the short-term prospects up to 2014 rather than on long-term debt sustainability (see chart 1.3.2 above).

1.4 BANK SECTOR

This section describes the main developments in the EU banking sector. It focuses in particular on the increasing funding pressures during 2011, banks' capital position and profitability prospects and the implications for bank lending within and across EU borders. Bank sector restructuring is separately analysed in Chapter 3, which contains a special feature on the evolution of bank sector structure since the crisis as well as the outlook for further structural changes and the implications this may have for EU market integration.

1.4.1 Funding and inter-bank market developments

Markets for short- and long-term funding became increasingly impaired in 2011, with the range of available funding instruments falling and the cost of funding rising. The interbank market largely dried up. The ECB and other central banks took action to maintain bank liquidity and facilitate refinancing. The measures included the longer-term refinancing operations (LTROs) announced by the ECB at the end of 2011 as part of enhanced credit support measures to support bank lending and liquidity in the euro area money market.[11] The LTROs have alleviated funding pressures in the short term but cannot offer a long-term sustainable solution to structural weaknesses in the banking sector.

Compared to before the crisis when many banks were over-reliant on wholesale and short-term funding, banks had to shift their funding structures towards more stable funding sources, such as customer deposits and equity while reducing their exposures on wholesale and interbank funding. Equity funding is discussed separately in section 1.4.2. For the large and complex banking groups in the euro area, the average share of customer deposits in total

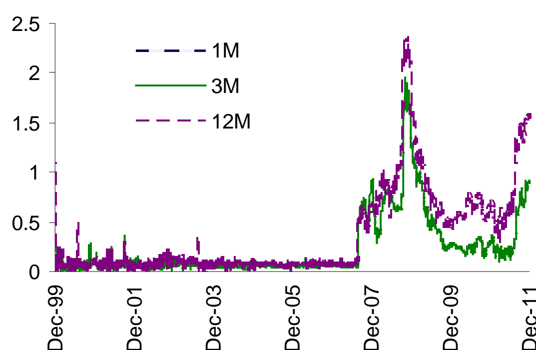
[11] http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html

liabilities increased from 29% in 2008 to 34% by summer 2011.[12] While the share of interbank funding generally decreased, many banks continue to rely to a significant degree on interbank and other wholesale funding markets. The increasing wholesale market tensions have made those banks particularly vulnerable, especially if from countries with high sovereign debt risk.

The increased problems in the interbank funding market are evident from the widening of the Euribor-OIS spread during 2011 (chart 1.4.1). The spread has come down at the end of 2011 and beginning of 2012, reflecting the improved funding conditions also as a result of the ECB LTROs.

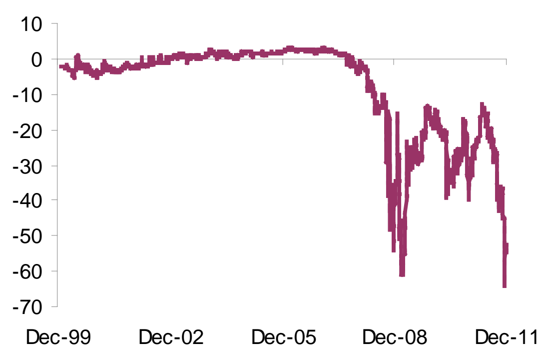
European banks' funding pressures were particularly acute in US dollars. During the second half of 2011, US money market funds (MMFs) have withdrawn significant funds from the EU banking system (see Box 1.4.1), reflecting concerns about the sovereign debt crisis and related banking risks. In addition, they have increased available liquidity to mitigate potential redemption risk and avoid excessive price volatility by reducing their average asset maturity. At the same time, the cross-currency swap spread between euro and US dollar sharply widened (chart 1.4.2). The conventional interpretation is that the more negative the spread, the greater the imbalance between the demand for US dollar liquidity relative to the funding currency (Euro).

Chart 1.4.1: **Euribor-OIS spreads (basis points)**



Source: Bloomberg

Chart 1.4.2: **Cross-currency swap, €bn/USD, 5 years (basis points)**



Source: Bloomberg

European MMFs did not fill the funding gap arising from the withdrawals of US MMFs and also reduced their exposures to the euro area. Although on aggregate as big as their US peers, European MMFs are more fragmented and lacked homogeneity, standardisation and common definition. The lack of integration within European MMFs is also related to their use of three different currencies (Euros, Pound Sterling and US dollar).[13]

Box 1.4.1: **US money market funds and EU bank funding**

The total size of US money market funds (MMFs) grew rapidly during the past decade, reaching about US dollar 3.9 trillion of assets under management at their peak in early-2009. However, MMFs experienced severe difficulties after the failure of Lehman Brothers in September 2008, when one of the largest funds in the US, the Reserve Primary Fund, 'broke the buck'—in other words, its net asset value (NAV) fell below one US dollar, thereby resulting in losses for its

[12] ECB (2011), *Financial Stability Review*, December.

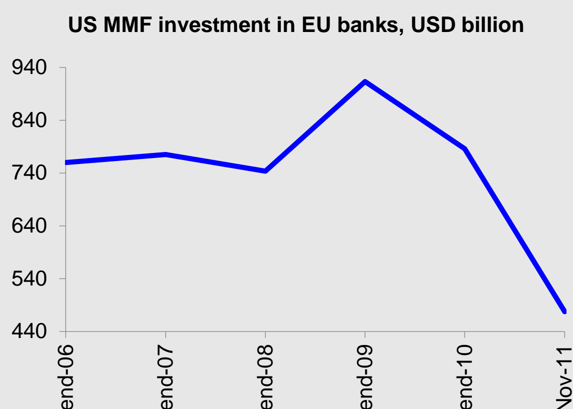
[13] The European Securities and Markets Authority (ESMA) is working to promote the common definition and classification of MMFs by providing clarity regarding the content and activity of these diverse vehicles within EU. This would foster integration of the market within Europe and also facilitate the monitoring of stability and other sector trends.

shareholders. This led to panic runs on other MMFs, as investors feared that they as well would not be able to maintain their NAV at committed levels. These withdrawals contributed to severe impairments in US money markets, which spilled over to various segments of the US non-bank financial system, for which MMFs are an important source of funding.

In response, the US Treasury announced a temporary insurance program, and the Fed established a lending facility and temporary liquidity swap arrangements with other central banks that helped to stabilize short-term credit markets. After these developments, there has been a gradual decrease of total assets under management of US MMFs. At the same time, the MMFs started to diversify their investment into short-term debt and certificates of deposit issued by European banks. This was a result of declining investment opportunities in the US, for example resulting from lower dependence on short-term wholesale funding and debt maturity extension by US banks

However, since mid-2010, in parallel with the escalating European sovereign debt crisis and its spillover to bank funding markets, the exposure of US MMFs to European banks in general and to vulnerable countries' banks in particular has decreased dramatically (see chart).

US MMF investment in EU banks, USD billion



Note: Based on a sample which accounts for about 70% of the total market.
Source: Fitch

The proportion of MMFs' exposure to European banks in the form of repos (i.e. secured lending) has increased. As of month-end November, repos represented 27% of total European exposure, up from 9% as of year-end 2009. This shift to secured lending might reflect further US MMF risk aversion. The change in the composition of US MMFs investments contributed to renewed strains in short-term interbank money markets in Q3 2011, posing additional funding pressures for European banks.

In January 2012, the European Systemic Risk Board (ESRB) issued a recommendation on US dollar-denominated funding of EU banks, addressed at national supervisory authorities, to take action such that a recurrence of the strains in US dollar-denominated funding is avoided (ESRB/2011/2).

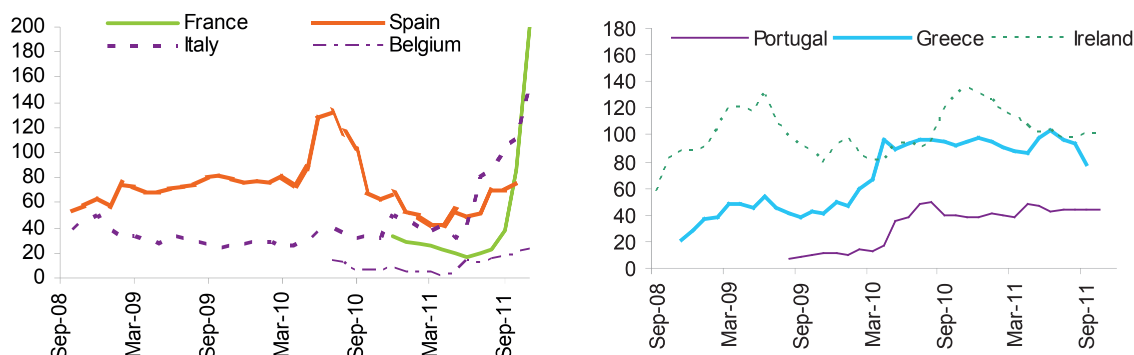
In response to the increased strains in money markets and in order to improve liquidity conditions and minimize the risk of contagion to US markets, on 29 June 2011, the Federal Reserve – in co-ordination with the ECB and other central banks – announced an extension of the existing temporary US dollar liquidity swap arrangements through to 1 August 2012.[14] US dollar liquidity started to be increasingly drawn from these facilities, with the ECB being a main user of the Federal Reserve US dollar swap lines during August until December 2011. Moreover, the number of euro area banks tapping the ECB's three-month dollar facility increased, following this coordinated move to cut dollar funding costs for banks. The ECB

[14] These swap arrangements were established in May 2010 during the first phase of the European sovereign debt crisis and authorized through to 1 August 2011.

also decided, in cooperation with other central banks, to establish a temporary network of reciprocal swap lines and make possible liquidity operations in other currencies.

In 2011, banks in several Member States made increasing recourse to the ECB lending facility. While the amounts borrowed have been flat for the euro area periphery in 2011, they have been sharply increasing for the banking systems that have been affected significantly by the US MMF funding withdrawals, such as France, Italy and Belgium (chart 1.4.3).

Chart 1.4.3: **Recourse of national banking systems to the ECB lending facility (€billion)**

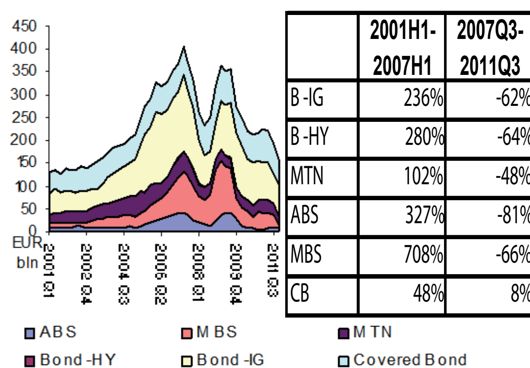


Source: National Central Banks (NCBs)

Source: NCBs

Conditions in the medium and longer-term funding markets also became increasingly fragile in 2011. Spreads on bonds issued by banks rose significantly in almost all market segments since summer 2011, as the sovereign debt crisis further spilled over into bank funding markets. This made new issuance almost impossible for a large part of the EU banking sector. The issuance of all senior unsecured debt (investment grade bonds and medium-term notes) fell and remained low from a historical perspective (chart 1.4.4). The issuance in the market for senior secured debt has also fallen.

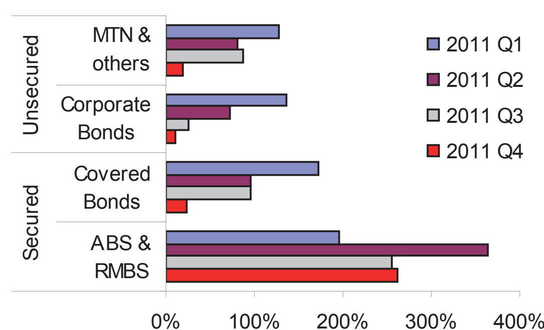
Chart 1.4.4: **Debt Issued by EU banks, by type of debt**



	2001H1-2007H1	2007Q3-2011Q3
B-IG	236%	-62%
B-HY	280%	-64%
MTN	102%	-48%
ABS	327%	-81%
MBS	708%	-66%
CB	48%	8%

Notes: Table shows % increase in issues of investment grade bonds (B-IG), high-yield bonds (B-HY), medium-term notes (MTN), asset and mortgage backed securities (ABS, MBS) and covered bonds (CB).
Source: Dealogic

Chart 1.4.5: **% of debt issued by banks over maturing debt, by type of debt, 2011**



Source: Dealogic

Banks did not refinance all maturing debt (see also chart 1.4.8 below), and the gap between issued and maturing debt amounted to about 5% up to December 2011. Debt issuance amounts exceeded maturing debt in 2011 only in the secured debt markets, in particular asset-backed securities (ABS) and mortgage-backed securities (MBS) (see chart 1.4.5). Covered bonds have also gained importance in banks' funding strategies, as the access to non-secured wholesale funding has become more difficult. The increase in the asset-backed market

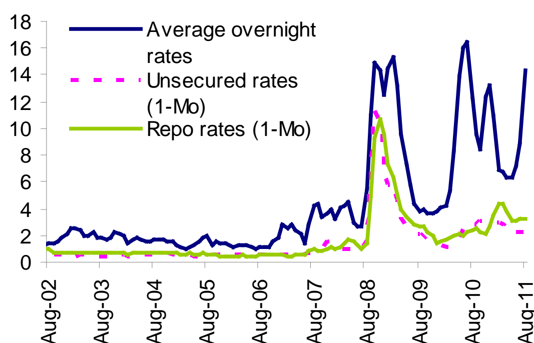
can be explained by the fact that ABS started to be used as a collateral asset type in Eurosystem credit operations (€100bn in 2006 compared to €700bn at mid-2011, accounting for 30% of total collateral). Many EU banks, especially medium-sized ones and/or banks in countries with financially stressed sovereigns, have focused on creating central bank-eligible collateral, via on-balance sheet asset securitization. They also originate non-central bank eligible ABS which they swap with central bank-eligible collateral from the insurance sector (the so-called 'OTC liquidity swaps') (see also section 1.4 on insurance).[15]

Geographic segmentation of both short- and long-term bank funding markets increased significantly in the crisis. In the interbank markets, this segmentation is visible from the increased dispersion in the average overnight lending rates between euro area countries (chart 1.4.6). This price indicator shows a level of disintegration equivalent to what was observed around the time of the Lehman demise and after the Greek rescue. The increase in the dispersion was less marked for longer maturities and in the secured market.

In the medium and long-term debt markets, country-dependent price differentiation affected the primary markets and also spilled over to the secondary markets. In addition to the price indicators, the changes in the level of cross-border investments and holdings of bank debt tend to confirm the increased disintegration of the funding markets. For example, euro area banks have significantly reduced their holdings of debt securities issued by banks in other parts of the euro area, compared to their holdings in similar securities issued by their domestic peers (chart 1.4.7).

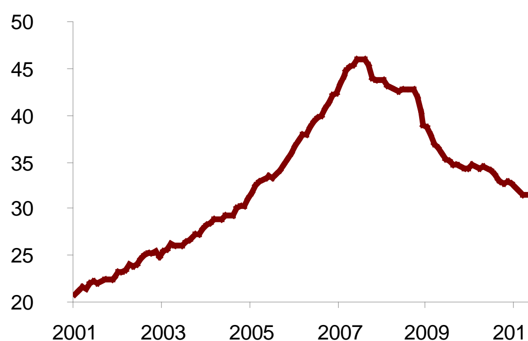
The geographic segmentation is also evident from the fact that banks in some countries have faced increasing difficulties in terms of both the availability and the cost of funds—i.e. country risk has become an important pricing factor, with banks' funding situation deteriorating broadly in line with the creditworthiness of the home sovereign. In the extreme, banks in Greece, Ireland and Portugal have found it difficult or in some cases impossible to access the funding markets and instead have become reliant on central bank liquidity. More generally, geographic segmentation reduces market depth and liquidity, with implications for efficiency and economic growth, and is a symptom of the impaired funding markets for European banks.

Chart 1.4.6. **Cross-country standard deviation of euro-area interbank rates (basis points)**



Source: ECB

Chart 1.4.7: **Cross-border holdings of euro area MFIs of debt securities issued by other MFIs (%)**



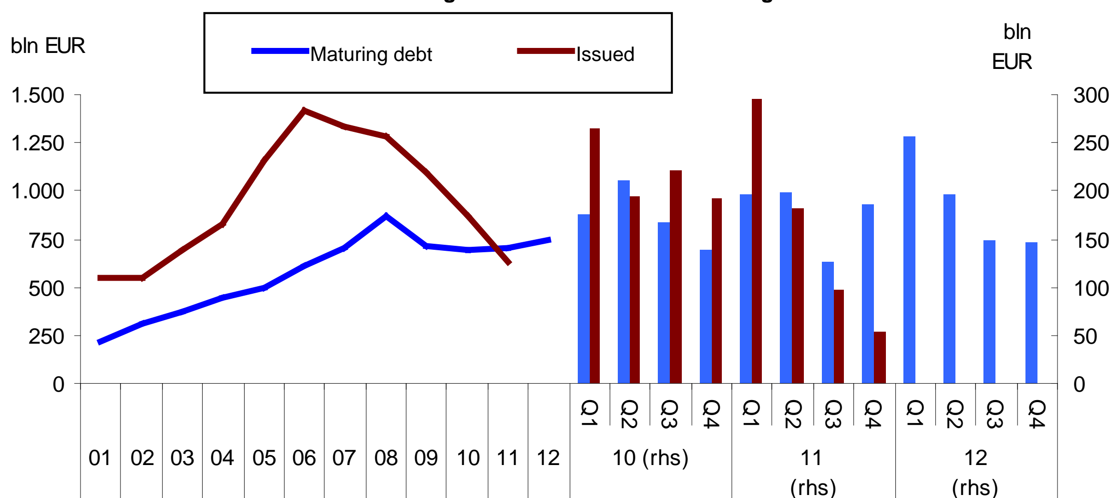
Notes: Refers to the cross-border holdings of euro-area MFIs of the debt securities issued by other MFIs (in percent of total domestic and cross-border holdings of debt securities issued by MFIs). Only

[15] The ECB Governing Council of December 2010 decided to introduce requirements to provide loan-level data of originators on the underlying assets to be eligible in the Eurosystem, in an effort to increase transparency and standardisation in banks' ABS markets. The ECB Governing Council of December 2011 decided to cut the minimum rating it accepts to repo a new structured finance transaction, but this only applies to securitisations of performing residential mortgages and loans to SMEs. The new rules present banks with an opportunity to raise extra funding and so make more efficient use of their asset base.

securities with over two years to maturity are considered.
Source: ECB

As bank sector restructuring has been limited to date and the size of bank balance sheets has on aggregate not declined in the EU banking sector (see chapter 3), the funding requirements of banks remain significant, also to refinance the maturing debt. As noted above, in 2011, banks did not refinance all maturing debt securities. Even if the funding gap was small and banks are increasing their funding through deposits, this presents a significant change in the market, since over the last decade the average percentage coverage of maturing debt securities was well above 100% (see chart 1.4.8). In 2012, the amount of debt maturing will reach almost €750bn, 6% higher than in 2011.

Chart 1.4.8: **Total EU banks' medium and long term debt issued and maturing**



Source: Dealogic DCM

As concerns about some banks' ability to refinance debt became significant at the end of 2011, the ECB allotted €489bn in the first of two long-term refinancing operations (LTROs) for banks to improve liquidity in the euro area money market. The second round of LTROs followed in February 2012, when the ECB lent a total of €529bn. The LTROs significantly eased the short-term pressures in funding markets and helps most banks to meet their wholesale debt funding requirements in 2012.

Bank funding conditions remain a risk, also given the persisting sovereign debt crisis and concerns about some banks' solvency position (see section 1.4.2). Persistent funding strains on banks could exacerbate concerns about financial stability and economic growth, in particular if banks respond to the pressures by lending less to the real economy. The impact of the crisis on bank lending is discussed further in section 1.4.3 below.

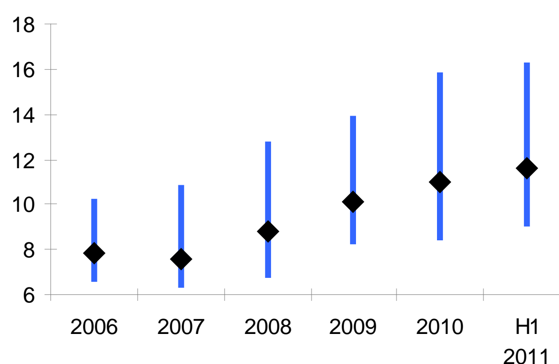
1.4.2 Bank capitalisation and profitability

As regards equity funding, banks' regulatory capital ratios improved significantly since 2009 (chart 1.4.9), as a result of capital-linked measures and some deleveraging efforts, driven by market pressures, new regulatory requirements or supervisory measures, and private restructuring operations, among others. By the end of 2010, public authorities had injected a total of €288bn of capital into the EU financial sector. While further state aid measures of this kind were approved by the Commission during 2011, actual capital injections by public authorities were more limited.

A number of banks raised common equity by tapping the capital markets, ahead of the EBA stress test of July 2011 and in preparation for the new stricter capital rules of Basel III and the EU's corresponding amendment of the Capital Requirements Directive (CRR/CRD IV).

Retained earnings have been a main source of capital generation, fuelled by recovering profitability in 2010. Moreover, many banks have tried to achieve higher capital targets by downsizing regulatory capital intensive activities and selling assets.

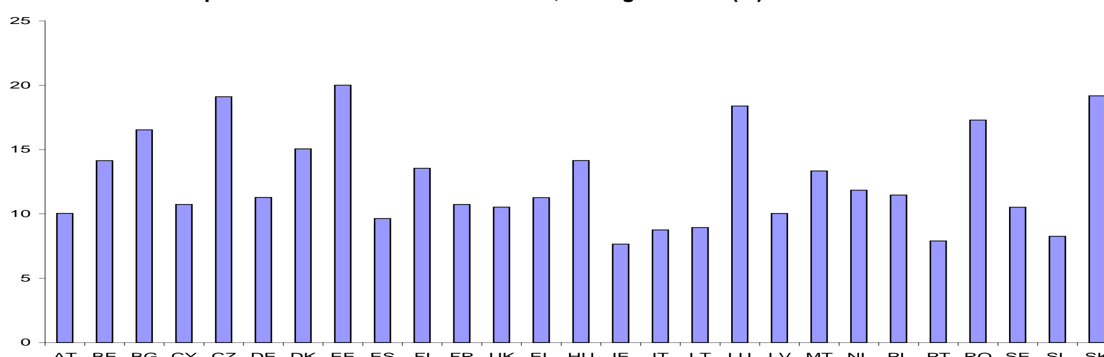
Chart 1.4.9: **Tier 1 capital ratio in euro area (%)**



Notes: Based on sample of 20 euro area banking groups. Shows minimum, maximum and median.
Source: ECB

The capital position of banks differs significantly between countries (chart 1.4.10) and between banks. Many European banks are already well positioned in terms of the new Basel III capital requirements, which are to be phased in the EU from 2013.

Chart 1.4.10: **Tier 1 capital ratio in different EU countries, average in 2010 (%)**



Source: ECB

This notwithstanding, the sovereign debt crisis had a negative effect on the market confidence in the EU banking sector. Following the measures agreed by the European Council on 26/27 October 2011, on 9 December 2011 the European Banking Authority (EBA) published a recommendation to National Supervisory Authorities (NSAs) regarding an EU-wide recapitalisation plan. To reassure markets about the banks' ability to withstand shocks and still maintain adequate capital, credit institutions were required to reach a 9% Core Tier 1 ratio by end June 2012, after accounting for a mark to market valuation of the sovereign debt in banks' books. The recapitalisation plan brings forward much of the capital burden associated with Basel III, creating a need for European banks to address the capital shortfall (Table 1.4.1).

Table 1.4.1: Recapitalisation needs for a sample of banks, September 2011

	€million		€million
AT	3,923	EL	30,000
BE	6,313	IT	15,366
CY	3,531	NL	159
DE	13,107	PT	6,950
ES	26,170	SI	320
FR	7,324	**Total**	114,685

Notes: Shows total capital shortfalls of a sample of banks per euro area country, based on the EBA 2011 recapitalisation exercise.
Source: EBA

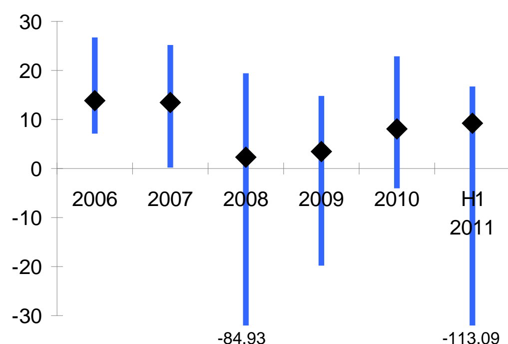
The total capital shortfall, based on September 2011 data and only covering a sample of banks in each country, was estimated by EBA to total €114bn, with €30bn for Greek banks alone. Other than Greece, the highest needs in absolute terms are concentrated in Spain, Italy and Germany. In relative terms, the banks from Cyprus, Belgium and Portugal are the ones with the highest needs of new capital (over 3% of risk-weighted assets).

In times of stress, banks may respond to the higher capital targets by reducing loans or engaging in other deleveraging that risks exacerbating a credit crunch. To counter this risk, under the EBA recommendation, national supervisors must ensure that banks' plans to strengthen capital lead to an appropriate increase of own funds rather than are being achieved through excessive deleveraging and lending disruptions to the real economy.

EBA's initial review of the capital plans submitted by the relevant banks in January 2012 suggests that, in aggregate, the proposed actions to cover the capital shortfalls will give a capital surplus of approximately 26%, creating some leeway in case some actions do not materialise. The actions predominantly focus on direct capital measures, including capital raising, retained earnings and conversion of hybrids to common equity. Measures impacting risk-weighted assets (RWAs) account for less than a quarter of the total amount of actions, but only in a small number of cases (3% of the total amount) are reductions in lending to the real economy included in the capital plans. EBA's in-depth analysis of the viability of the capital plans continued through February 2012.

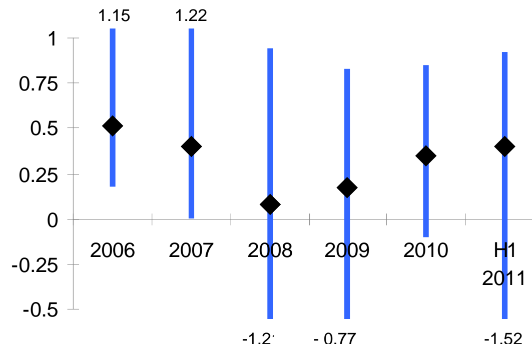
The weak position of some EU banks is also reflected in their profitability. Profitability recovered in 2010, with most of the large banking groups in the euro area returning to positive profitability. During the first half of 2011, profitability indicators remained on a level comparable to 2010 on average; however, the dispersion in profits increased and some banks experienced sharp declines in profitability (charts 1.4.11 and 1.4.12).

Chart 1.4.11: **Return on equity (%)**



Notes: Based on sample of 20 euro area banking groups. Shows minimum, maximum and median.
Source: ECB

Chart 1.4.12: **Return on assets (%)**



Notes: Based on sample of 20 euro area banking groups. Shows minimum, maximum and median.
Source: ECB

Although full-year results for 2011 were not yet available at the time of writing, the available data show that profitability deteriorated in light of the sovereign debt crisis, weaker than expected economic activity, large asset price declines and significant financial market volatility. The deterioration in performance was mainly due to higher loan loss provisions, including impairment charges on Greek sovereign debt and write-downs on toxic assets, and a deterioration in virtually all income sources. Net interest income suffered for some banks due to continued low short-term interest rates, higher funding costs and generally weak loan growth; net trading income was low given higher market volatility, declining asset prices and decreases in trading volumes; and fees and commissions have been affected given the lower levels of transactions, including M&A and equity issuance.

Concerns about performance are also evident in banks' share prices which have been falling in 2011, reflecting concerns about the impact of the sovereign credit crisis on banks' balance sheets and the large refinancing needs of European banks over the coming years.

The earnings outlook for European banks remains weak given the on-going sovereign debt concerns, weak economic growth and pressures arising from the more demanding regulatory initiatives on capital and liquidity. Asset quality is an issue for many European banks, especially in vulnerable countries at the centre of sovereign debt concerns. Non-performing loans also remained high in 2011, for example for banks with significant exposure to CEE countries, where asset concerns are often aggravated by the fact that many mortgages are denominated in Swiss Francs which significantly appreciated against many CEE currencies over the past year (see below). Although loan loss provisions fell since the peak of the crisis, they started to rise again in 2011.

The weaker economic outlook requires banks to increase their loan loss provisions so as to absorb possible losses stemming from lower credit quality. Any further losses and write-downs—be it for sovereign debt, bad loans, losses of market value of real estate and other assets or indeed losses related to the backlog of toxic assets dating back to the sub-prime crisis—would need to be absorbed by capital, putting further pressure on banks' capital position.

1.4.3 Evolution and integration of bank financial intermediation

While there is a structural need for bank deleveraging, the increased funding and capital strains on banks have renewed concerns about bank lending and the consequences that a potential credit crunch would have for the real economy. A reduced flow of credit to the economy is one of the main transmission channels of the financial crisis to the real economy. It affects in particular small and medium sized enterprises (SME), which make up the bulk of employment in the EU and which rely heavily on bank loans as a source of finance. As credit risks for banks increase with the slowdown in economic activity, there may be further pressure to restrict credit, with second-round effects on the economy.

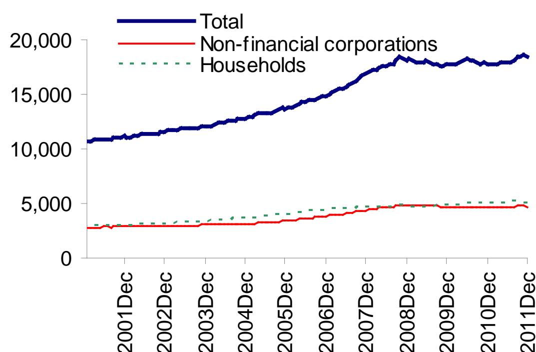
There have also been signs of increased retrenchment of banks behind national borders, with banks seeking to meet domestic lending targets and slowing down, or in some cases reversing, the credit flows to non-domestic markets across Europe.

General trend in bank financial intermediation

The total stock of loans granted by euro area MFIs has stagnated since the beginning of the crisis at a level of around €18 trillion (chart 1.4.13). The EU27 followed a similar trend at a level of €24 trillion. The stagnation also applied to loans to households and non-financial corporations in the euro area, which each amount to about €5 trillion on banks' balance sheets.

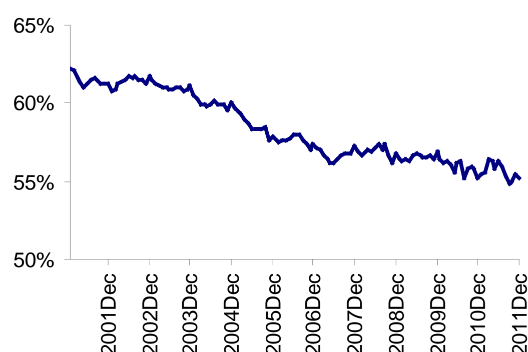
The share of loans in total assets decreased by three percentage points between 2007 and 2011, although a downward trend was observed even before the crisis (chart 1.4.14).

Chart 1.4.13: **MFI loans in the euro area (€bn)**



Source: ECB

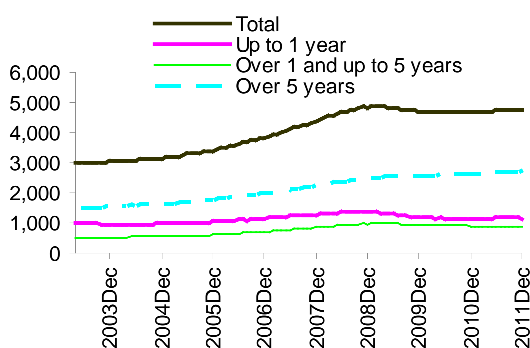
Chart 1.4.14: **MFI loans in the euro area (% of total assets)**



Source: ECB

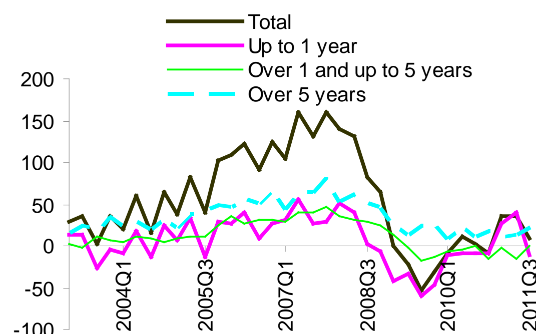
Loans to non-financial corporations were particularly affected since the start of the crisis, with banks' stock of loans with short maturities (up to 1 year) displaying a decline since 2009 to end 2011 (chart 1.4.15). The decline is more dramatic when measured in terms of the flow rather than the stock of loans (chart 1.4.16). Following a short period of improvement in the first half of 2011, the total value of new loans fell again considerably thereafter. The fall in these flows was particularly marked for loans of up to one year.

Chart 1.4.15: **MFI loans to NFCs in euro area (€billion)**



Source: ECB

Chart 1.4.16: **Quarterly flows of MFI loans to NFCs in euro area (€billion)**

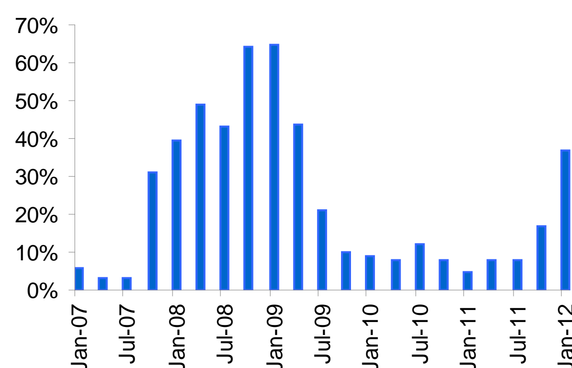


Source: ECB

These developments are the result of worsening conditions in relation to both the demand and supply of bank credit. On the demand side, the slowdown in economic activity lowered profitability expectations and the quality of loan applications deteriorated following the downturn in the economic conditions. Therefore, firms have reduced their demand for bank credit.

On the supply side, banks became less willing or able to give credit to the real economy. Recent releases of the ECB bank lending survey suggest that credit supply conditions have played a significant role in the stagnation of bank lending to non-financial corporations. Credit conditions tightened significantly in the second half of 2011, even if the tightening was not as widespread as at the peak of the 2008 crisis (chart 1.4.17). The lending surveys reveal that key factors behind the tightening were related to concerns about the banks' capital position, the deterioration in banks' liquidity position and their access to market funding, and the weakened general economic outlook.

Chart 1.4.17: **Credit standards in loans to corporates (% of banks tightening credit standards)**

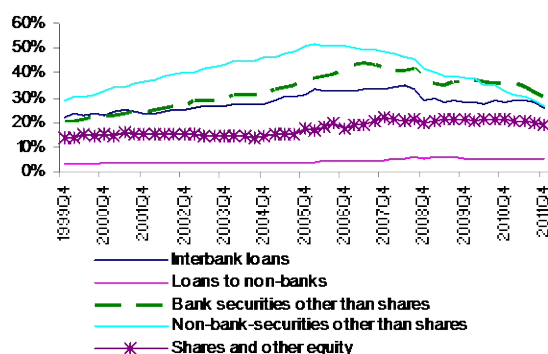


Notes: Shows percent of surveyed banks that tightened the credit standards on loans to corporates in the previous quarter.
Source: ECB bank lending survey

Cross-border bank financial intermediation

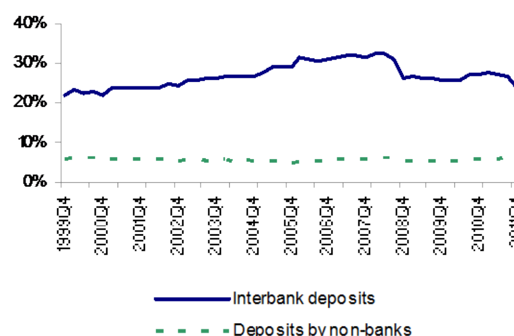
The crisis had a significant impact on the cross-border provision of banking services. This applies in particular to wholesale activities. Retail banking integration, which had always remained at lower levels, seems to have been less affected. The decline in cross-border provision is evident in the aggregate balance sheets of banks. On the assets side (see chart 1.4.18), the share of cross-border loans and securities investments by banks has fallen relative to domestic business. Banks have been relying more on domestic than on foreign counterparties in their transactions. These developments are also reflected in cross-border liabilities (see chart 1.4.19).

Chart 1.4.18: **Cross-border assets of euro area MFIs (% of domestic and cross-border total)**



Notes: Measures cross-border assets in percent of the domestic and cross-border total. Cross-border measures euro area only.
Source: ECB

Chart 1.4.19: **Cross-border deposits of euro area MFIs (% of domestic and cross-border total)**

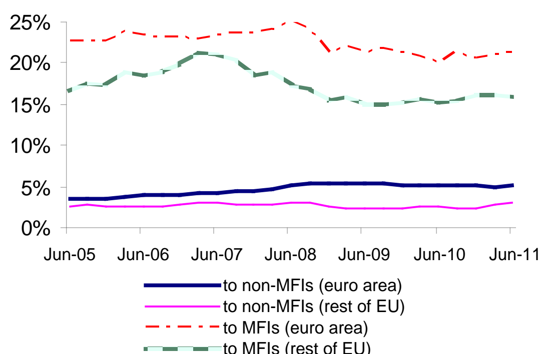


Notes: Measures deposits by residents in other euro area countries compared to the domestic and other euro area total.
Source: ECB

The cross-border loans of MFIs to their counterparts in the EU showed a particularly strong decline following the crisis, both in nominal terms as well as a percentage of total loans. A small decline is also observed for cross-border loans to non-MFIs in the EU, although their share of total loans was already relatively small (chart 1.4.20). Across the EU, national governments have asked banks to maintain or increase their lending to the (domestic) real economy, given concerns that the financial crisis could exacerbate real economy effects if banks cut back their lending.

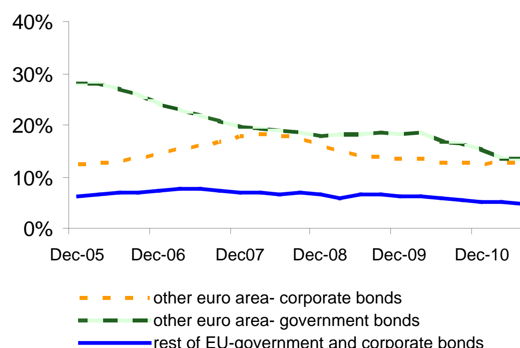
There has also been a decline in banks' holdings of debt securities issued in other EU Member States (chart 1.4.21). The share of cross-border holdings of government bonds issued in the euro area has fallen in particular, but there also has been a decline in cross-border holdings of corporate bonds.

Chart 1.4.20: **Euro area MFI cross-border loans (% of total loans)**



Source: ECB

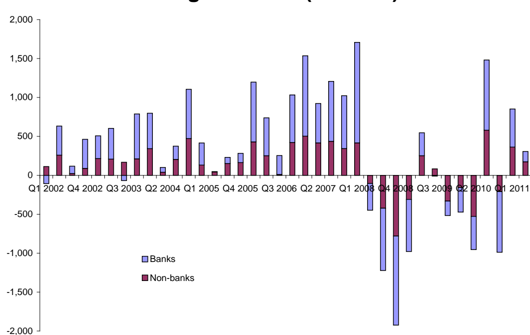
Chart 1.4.21: **Share of MFI cross-border holdings of debt securities issued by EU non-MFIs (% of total holdings)**



Source: ECB

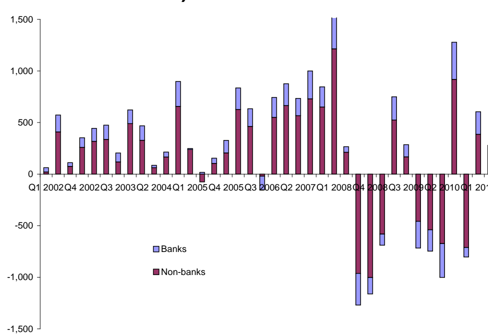
The decline in cross-border activity is also evident from the BIS locational banking statistics. For example, there has been a significant fall in the international assets of BIS reporting bank offices residing in the EU (chart 1.4.22); these claims include in particular loans to non-residents, deposits with other banks and holdings of international debt securities issued by non-residents as well as all foreign currency loans and securities holdings. The decline was been particularly noticeable regarding international claims to banks, but also concerns claims to non-banks. While there has been some recovery in the first half of 2011, international assets of banks in BIS-reporting Member States remain significantly below those observed before the crisis set in. A similar pattern is observed regarding the international assets of all BIS reporting banks with respect to their claims on banks and non-banks in the euro area (chart 1.4.23).

Chart 1.4.22: **Quarterly change in international assets (total claims) of BIS reporting banks residing in the EU ($ billion)**



Source: BIS locational banking statistics

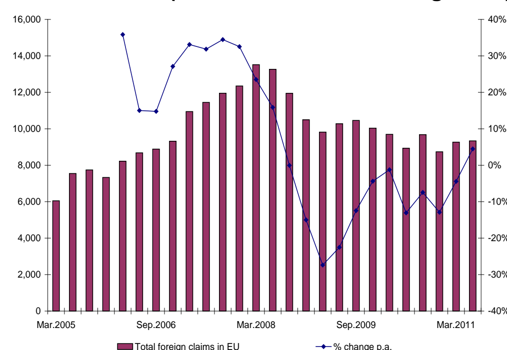
Chart 1.4.23: **Quarterly change in total claims of all BIS reporting banks on euro area countries ($ billion)**



Source: BIS locational banking statistics

Similarly, the BIS consolidated banking statistics, which report banks' financial claims on a consolidated basis (rather than on the basis of the location of the bank offices), show a decline in the total foreign exposures of European banks to other parts of the EU. Compared to the double-digit annual growth rates until mid-2008, foreign exposures fell sharply thereafter and only started to stabilise in 2011 at the lower levels last observed at the end of 2006 (chart 1.4.24).

Chart 1.4.24: **Total EU bank exposures to EU Member States ($ billion and annual change in %)**

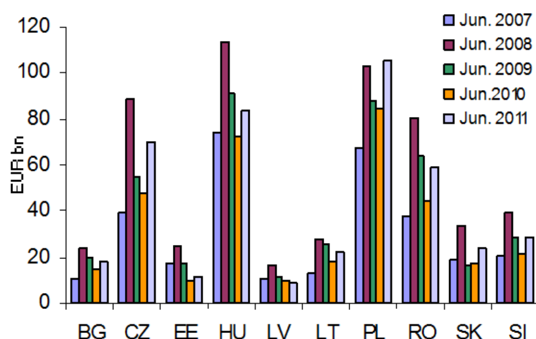


Source: BIS consolidated banking statistics

Cross-border credit flows have been of particular importance to the EU Member States in the CEE. Prior to the crisis, cross-border credit expansion occurred at a very rapid pace, both through cross-border claims and the significant role of local branches and subsidiaries of European banking groups (charts 1.4.25 and 1.4.26). Foreign ownership made up on average about 75% of total bank assets. Pre-crisis lending growth during 2005 and 2008 was in the high double-digit percentage range across the CEE, and these credit flows facilitated the financial integration and economic development across the region. However, at the same time, cheap credit (with loans often denominated in foreign currency—see Box 1.4.2) contributed to boom-bust cycles in a number of countries in the CEE region, including for example the Baltic countries and Hungary. While there were significant differences across the region, in general, the crisis triggered a sharp reduction or reversal of some of these credit flows, as EU banks reduced their foreign exposures. Cross-border outflows occurred throughout 2009 and the first half of 2010. As a result, the loan expansion slowed down significantly compared to the pre-crisis years. The situation reverted later in 2010 and early 2011.[16]

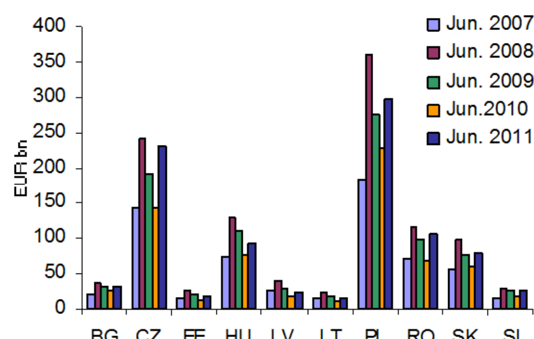
With banks' funding problems turning increasingly severe in 2011, new concerns emerged about credit outflows from the CEE and the consequences this would have for the real economy. In 2011, various EU banks announced a reduction in credit volumes and in some cases their complete withdrawal from the CEE region.

Chart 1.4.25: **Cross-border claims on CEEs (€billion)**



Source: ECB, BIS consolidated banking statistics and Commission departmental calculations

Chart 1.4.26: **Local claims of domestic affiliates of foreign banks in CEEs (€billion)**



Source: ECB, BIS consolidated banking statistics and Commission departmental calculations

[16] The European Bank Coordination Vienna Initiative, which was created in January 2009 and brought together private and public sector stakeholders of EU cross-border banks present in the region, also helped preventing a large-scale withdrawal of the banks from the region. The initiative entered a second phase (Vienna 2.0), with agreements reached on March 2012, given renewed risks to the region.

Box 1.4.2: **Cross-border lending and foreign exchange mortgages in Hungary**

The benefits of the Single Market have been very pronounced in CEE countries. Prior to EU accession, state-owned banks in the former centrally-planned economies of CEE were successfully privatized and became subsidiaries of banks in the old Member States. The economic performance of CEE was boosted by strong credit growth, supported by foreign subsidiaries and increasing financial services penetration.

Mortgage origination in non-domestic currency was widespread in some CEE countries (notably Hungary, Poland and the Baltic states) before the start of the global financial crisis. Mortgage loans in foreign currency (typically Swiss francs or euro) looked attractive to CEE borrowers as the mortgage rates were tied to the lower interest rates in the euro area and Switzerland. During this period, floating-rate CEE currencies were gradually appreciating against the euro and Swiss francs, thus making domestically denominated repayments less burdensome.

Among other problems affecting household mortgages (increasing unemployment, falling house prices, etc.), the global financial crisis changed the appeal of mortgages denominated in foreign currencies. Floating-rate CEE currencies depreciated against the euro and the Swiss franc, with negative consequences for retail borrowers who rarely hedge against foreign exchange risk. On 19 September 2011, the Hungarian Parliament passed a law allowing the early repayment of mortgage loans denominated in foreign currency at a fixed exchange rate. Exchange rates set by law were 180 HUF/CHF and 250 HUF/EUR, which was 22% and 12%, respectively, lower than the spot market rates at the announcement date of the measure. The law was a temporary measure to remain in effect from 29 September 2011 until the end of 2011. Other governments in CEE have not introduced such measures.

Foreign banks active in Hungary (the top banks by market share are subsidiaries of Austrian, Italian and Belgian banks reached an agreement with the Hungarian government on 15 December 2011, which mitigated to a certain extent the effects of the early repayment law. The government's contribution will be made through the bank levy, from which banks can write off the early repayment.

The benefits of the Single Market have been very pronounced in CEE countries. Prior to EU accession, state-owned banks in the former centrally-planned economies of CEE were successfully privatized and became subsidiaries of banks in the old Member States. The economic performance of CEE was boosted by strong credit growth, supported by foreign subsidiaries and increasing financial services penetration.

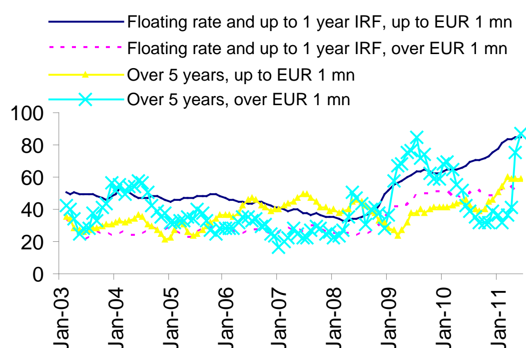
The crisis brought exchange rate risks to the forefront, and exposed financial system weaknesses regarding FX lending (see ESRB Recommendation, ESRB/2011/1). Also, the response of the Hungarian government contributed to the risk of direct loss spillovers to parent banks, particularly in Austria, where, according to the BIS, Hungary's share of total Austrian CEE claims reached 15% in the second quarter of 2011. Furthermore, a negative impact on Hungary, resulting from increased country risk, could also be expected. This would reinforce the reversal of cross-border credit flows to Hungary and the other CEE countries, which has intensified in 2011 as the sovereign debt crisis in the euro area progressed.

Cross-country dispersion in interest rates

The increased geographic banking market segmentation since the crisis is also evident when looking at the cross-country dispersion in retail interest rates in the euro area, even if a good part of this increased dispersion might merely reflect a reassessment of the respective counterparty risk in different countries. Since the crisis, the dispersion has increased, both for interest rates paid on loans by non-financial corporations (chart 1.4.27) and the rates on consumer credit and mortgages (chart 1.4.28). This applies across different types of bank lending and different maturities, but the increase in the dispersion appears to be particularly pronounced in the case of short-term lending and unsecured lending. While there have been

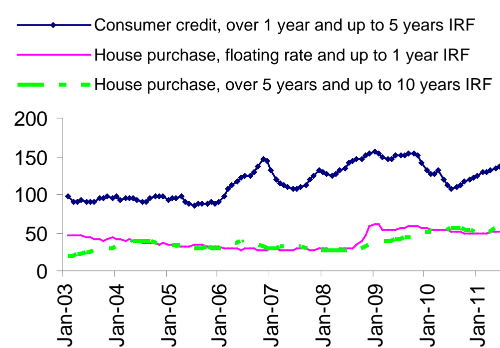
signs of re-integration for some instruments and maturities in 2010, this trend has not continued through 2011. Instead, interest rates have become more dispersed across countries. This increased dispersion largely reflects differences in bank financing conditions across the euro area as well as differences in credit risk and other conditions between domestic economies.

Chart 1.4.27: **Dispersion in interest rates on loans to non-financial corporations (basis points)**



Notes: Dispersion is measured by the standard deviation.
Source: ECB

Chart 1.4.28: **Dispersion in interest rates on lending to households (basis points)**



Notes: Dispersion is measured by the standard deviation.
Source: ECB

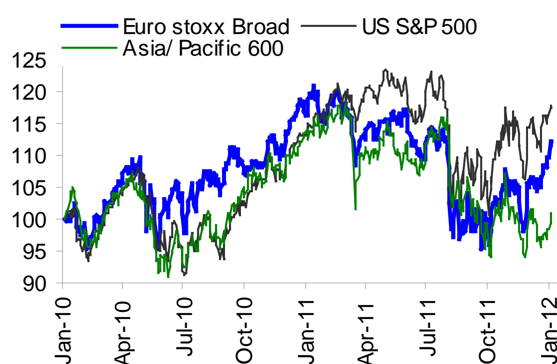
1.5 CORPORATE BOND AND EQUITY MARKET

The sovereign debt crisis and concerns about economic growth prospects negatively affected corporate debt and equity markets. High volatility in secondary markets spilled over to primary markets and, in particular since summer 2011, had an adverse impact on corporates' ability to raise capital, at a time when bank lending also became scarcer. This section provides a short overview of developments in corporate capital markets.

1.5.1 Equity markets

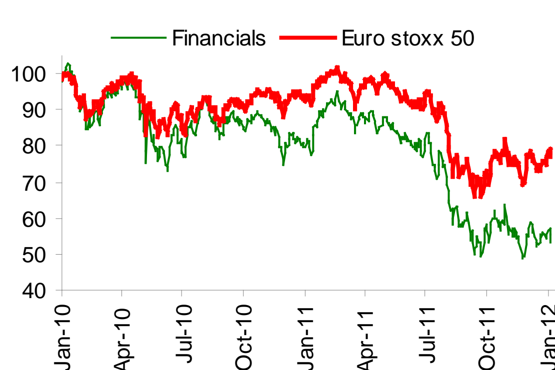
Equity markets, like other market segments, have faced severe headwinds over 2011 (chart 1.5.1). Entering the summer, markets started to get more seriously affected by the expanding sovereign debt crisis in the euro area, growing concerns about an economic growth slowdown and other factors. The biggest equity market correction took place in the EU, with the Dow Jones Euro Stoxx 50 index declining 35% between its February peak to its September low. While markets in the last few months of the year remained very volatile, stock indices recovered somewhat, also supported by public policy measures. The Dow Jones Euro Stoxx 50 index closed the year with a negative overall return of 18.4%, while the US Standard & Poor's 50 index closed positively at 2.9% and the Asia Pacific 600 index with a negative return of 12.2%.

Chart 1.5.1: **Global stock market performance (January 2010 = 100)**



Source: Reuters Ecowin

Chart 1.5.2: **EU stock market performance (January 2010 = 100)**



Source: Reuters Ecowin

Banking shares have been particularly badly affected in 2011, with the European banking index falling 48.6% from its February-high to its November-low and ending the year 34.3% below its starting value (see chart 1.5.2). Concerns about the exposure of already weak balance sheets to sovereign debt and to the global economic slowdown have led to this major underperformance. The underperformance of bank shares began already in 2010 and share prices for several major banks at the end of 2011 were close to their bottom level of spring 2009.

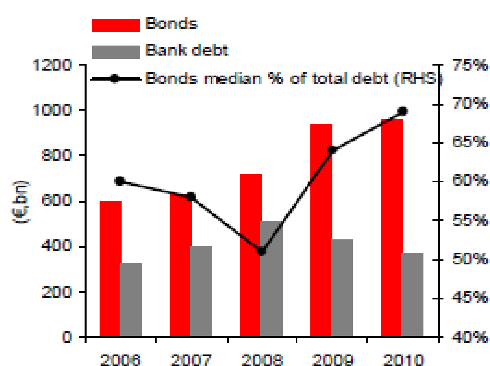
Depressed equity prices and high volatility in secondary markets also affected equity issuance of financial and non-financial corporations, in particular initial public offerings (IPOs), which declined since the start of the crisis. In 2011, a number of planned IPOs and secondary offerings were cancelled or postponed in light of adverse developments in the market. Although there has been an improvement since 2008 and 2009, the capacity of equity markets to provide funding to the real economy (and to financial institutions) remains subdued.

1.5.2 Corporate bond markets

European non-financial companies have relied more on bond markets since the onset of the crisis, also given that bank lending has been more difficult to obtain. Although the shift may only be temporary and reversed somewhat in the second half of 2011 given the deteriorating market conditions, this presents a move towards more US-style funding where debt capital markets are a more important source of corporate funding than traditional bank loans.

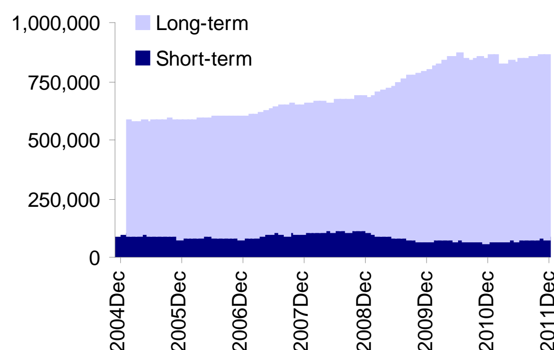
Based on the balance sheet information for 161 European firms, a report by Fitch shows how bank debt has decreased since 2008, whereas bonds have increased over recent years (chart 1.5.3). As one would expect, higher rated companies account for most of the outstanding volume of bonds, but even BBB and BB rated firms gained importance in this market. The increase in corporate bond funding is also evident from the development in the aggregate outstanding amounts of debt securities issued by non-financial corporations in the euro area. These totalled €777bn in October 2011 (90% long-term securities), having risen from about €652bn at the beginning of 2008 (chart 1.5.4). However, total amounts outstanding have been stagnating since 2010, with net debt issues of European corporates lower in 2011 than in the year before. This reflects deteriorating economic conditions in the second half of the year. Spreads on corporate bonds widened, in particular for high-yield bonds. Although bond issuance activity in 2011 fell somewhat compared to the previous year, it remained above the levels observed in the years 2006 to 2008.

Chart 1.5.3: **Outstanding balance of corporate debt (Fitch sample)**



Source: Fitch (2011), 'European Corporate Funding Disintermediation'.

Chart 1.5.4: **Outstanding amount of debt securities issued by euro area NFCs (€million)**



Source: ECB

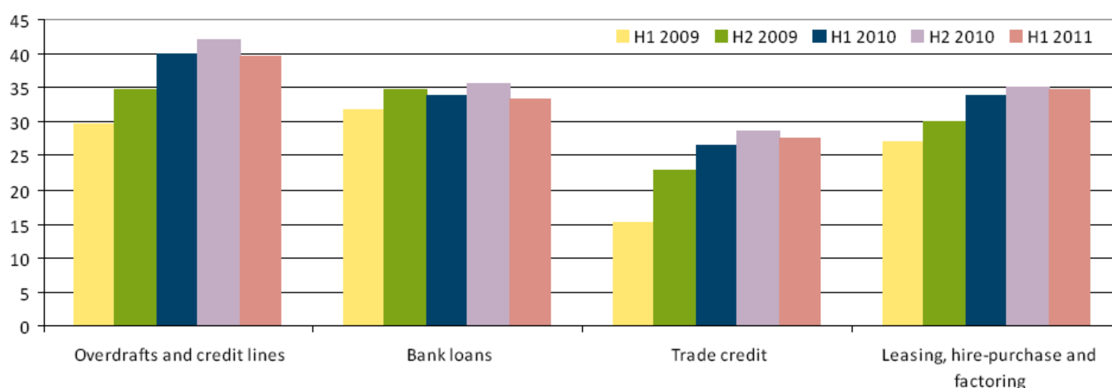
In the current market context, direct access to capital markets seems to offer European corporations some advantages for funding compared to bank debt. Longer maturities and lower interest rates are among the obvious advantages. But most importantly, having access to bond markets broadens the range of alternative sources of funding available to corporations in the real economy in times where bank lending is scarce. The more difficult banking environment, coupled with a growing investor appetite for bonds, may contribute to this trend to funding disintermediation continuing going forward. The trend is of course not without its own risks, for example, by exposing corporate issuers to the volatility of capital markets, as experienced in the crisis, and if it induces excessive leverage in particular in the high-yield end of the market

Thus, bond issuance seems to have become, at least temporarily, a viable alternative source of funding, at least for the bigger non-financial corporations in Europe that are better placed to tap into capital markets. This development does not improve the situation of those firms that face the more severe consequences of the credit crunch (in particular small-and-medium-sized enterprises (SMEs)), although new infrastructures are emerging that may provide direct access to capital markets for a broader spectrum of firms (see Box 1.5.1).

Box 1.5.1: **Access to finance of small and medium-sized enterprises**

SMEs in Europe are particularly reliant on banks as a source of funding. As confirmed in recent surveys by the ECB of SMEs' access to funding, bank finance (via overdrafts, credit lines and loans) is the main source of external finance of SMEs in the euro area.

Sources of external finance of SMEs (% of respondents using type of finance in previous 6 months)



Source: ECB SME access to finance survey.

Since the onset of the crisis, there has been a reduction in banks' lending capacity, and the reduced flow of credit has in particular affected SMEs. The funding difficulties continued (and in fact intensified) through to 2011. When asked in the ECB survey about their most pressing problem in the period from April to September 2011, for example, 16% of respondents replied “access to finance”, which ranked as the second most pressing problem after "finding customers". Access to finance appears to be a more severe concern for SMEs than for large firms (of which 11% considered “access to finance” to be their most pressing issue).

The latest EU 27 SME's Access to Finance Survey confirms the credit tightening trend. In particular, it reports that almost one third of the European SMEs who applied for a bank loan during the last six months didn't get the loan amount they had planned for. In general, the SME respondents in Europe consider that the conditions of bank financing worsened during the previous 6 months of 2011 in terms of the interest rate and other costs, collateral and required guarantees.

Unlike larger firms, SMEs are heavily reliant on bank funding and have more limited possibilities to diversify their funding sources and tap into capital markets. However, it is interesting to note the development of new infrastructures for issuing and trading corporate bonds, which may present alternative funding sources at least for the medium-sized companies in the market. For example, in Germany, a number of trading platforms have been opened by the German exchanges during 2010 and 2011 that target medium-sized companies, such as Deutsche Börse's 'Entry Standard Anleihen', Börse Düsseldorf's 'Mittelstandsmarkt' and Börse Stuttgart's 'Bondm'. The targeted companies are of medium size, and they are not required to have a listing of their stocks or comply with IFRS accounting rules. Issues range from €25-225 million and can be acquired by retail investors, although between 60-75% is held by institutional investors. The trend to increased capital markets access for medium-sized companies is likely to continue, since potential issuers have high financing needs, and they see lending conditions deteriorating further in the future. However, while the new infrastructures present an important development, the issuing and trading volumes have remained relatively small.

1.6 INSURANCE SECTOR

This section looks at market developments in the insurance sector and also considers the challenges that insurers will face in the near future. Chapter 4 contains a special feature devoted to a more detailed analysis of the insurance sector, based on a survey of nine European insurers (including one reinsurer and one third country insurer with EU operations), on the impact of the crisis, regulation and the experience of insurers with the Internal Market.

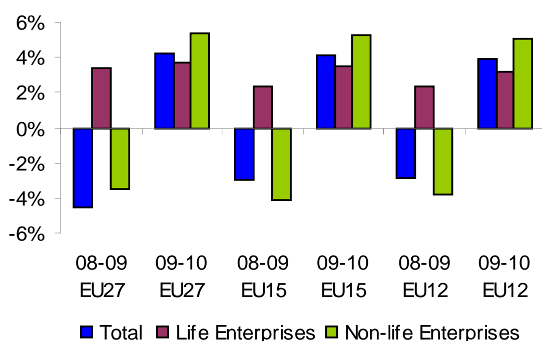
1.6.1 Market development

The European insurance sector showed a stable underwriting performance during 2010, despite the adverse economic climate and the ongoing turmoil in financial markets. Its total gross written premiums increased by 4.2% in 2010 for the EU27 on average (see chart 1.6.1), which is an improvement in both life and non-life business compared to the previous year. [17] However, there are considerable differences between Member States. In some countries, such as Spain and Greece, the deterioration in economic activity led to a decrease in total premiums. There also was a significant decrease in gross written premium in life business in

[17] Total gross written premiums in life and non-life business increased by 3.8% and 5.3% respectively compared to 2009. See EIOPA Financial Stability Report, December 2011. https://eiopa.europa.eu/publications/financial-stability/index.html

Belgium. In contrast, most of the Eastern European countries experienced an increase in both life and non-life business (see chart 1.6.2). Aggregate data for 2011 are not available yet.

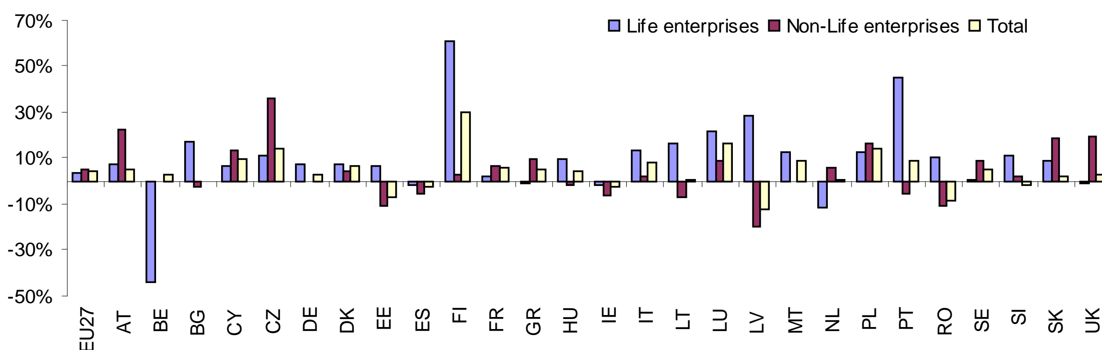
Chart 1.6.1 **Gross written premiums (annual growth rate in %)**



Source: EIOPA, December 2011

In addition to the financial crisis, large European primary insurance and reinsurance companies suffered from an unusual rise in natural catastrophes, which caused worldwide USD 218 bn of economic losses in 2010, three times higher than in 2009.[18] The costs of the global insurance industry were more than USD 43 bn, an increase of more than 60% over 2009. Especially the European reinsurance industry suffered above average loss claims. The Japanese earthquake and other natural catastrophes at the beginning of 2011 also caused some extraordinary losses for euro area insurers.

Chart 1.6.2: **Gross Written premiums growth, 2009-2010 (%)**



Source: EIOPA

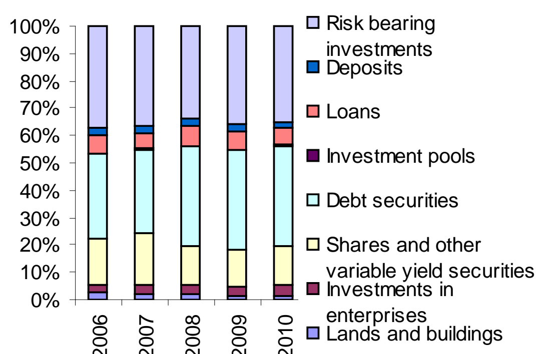
Nonetheless, the European insurance industry as a whole has so far demonstrated crisis resilience. Profitability, as measured by the average return on equity, rose to 7.4% in 2010 and the solvency ratio was on average 309%.[19] The latter was a slight improvement compared to the previous year. Note that the solvency ratio under current regulatory requirements is backward-looking and does not take market risk into account. The latter may also be the reason why in 2011, when the sovereign bond spreads widened considerably and market volatility increased, solvency ratios in life insurance remained at historically strong levels.[20] However, average figures for the EU do not represent the healthiness of each and every insurance undertaking in different countries. Weaker capitalized insurance companies and those undertakings with significant asset holdings that have been adversely affected during 2011 remained a concern.

As regards asset allocation, European insurers have clearly focused on fixed income products, reflecting the industry's relatively conservative approach to investing. For example,

[18] See Swiss Re (2011), Sigma 2/2011, World Insurance in 2010, May.
[19] The solvency ratio is defined as the available solvency margin divided by the required solvency margin. See EIOPA (2011), 'Financial Stability Report', December.
[20] Data from Bloomberg until 3Q 2011.

in the life insurance sector, investments in debt securities increased from 31% of total assets in 2006 to 37% in 2010 (chart 1.6.3). However, this includes both volume and price effects. The chart shows also that life insurers' holdings in shares and variable yield securities, as riskier asset classes, haven not changed much during the financial crisis. However, some big European insurance companies that were interviewed end-2011 stated that they have been de-risking since 2001 by adopting a more conservative approach to their investments (see chapter 4 for details). In terms of geographical differences, UK institutions retain a stronger focus on equity investment compared to insurers in other Member States which are more debt focused.[21] During 2011, EU insurers faced an impairment of the value of their Greek debts (especially in the second half of the year). They also wrote down impaired equity investments and marked Irish and southern European government bonds to market.

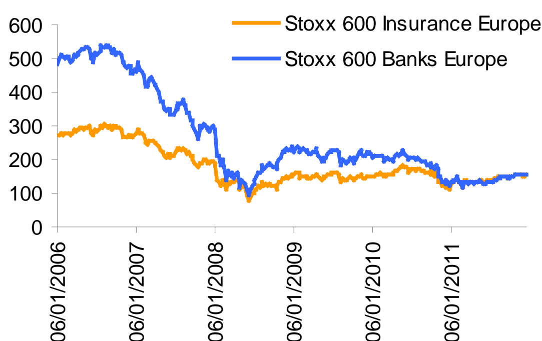
Chart 1.6.3: **EU 27 life insurers' asset allocation (% of total investment assets)**



Source: EIOPA, December 2011; risk bearing investments refer to investments for the benefit of life-insurance policyholders who bear the investment risk.

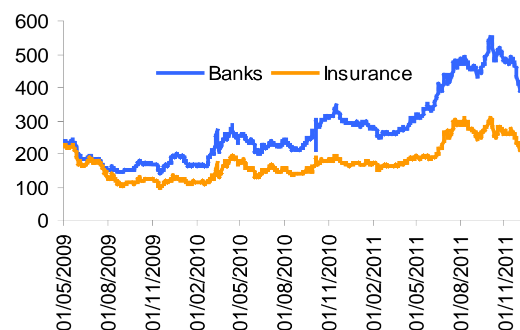
Long-term interest rates remained at historically low levels in 2010 and 2011. This has supported the accounting capital of insurers by increasing the value of insurers' available-for-sale fixed income investments. On the other side, the resulting low investment returns have hurt their profitability and increased the value of technical provisions for new contracts subject to the same terms on the liabilities side. Furthermore, the shares of insurance companies fell and their credit default swap spreads (CDS) have increased on fears of wider contagion in the second half of 2011 (see charts 1.6.4 and 1.6.5). The evolution of spreads shows that the financial markets perceive a high degree of interaction between banks and insurers. This is not surprising, as banks and other financial sector bonds account for the major part of fixed income assets held by insurers and reinsurers (in life insurance business: 61% of fixed income assets and 14% of the total investments at the end of 3Q 2011[22]). Therefore, the future of the insurance sector remains closely tied to that of the banking industry; a successful recapitalization of banks will therefore also ease the pressure on insurers. However, starting in 2010, the spreads between the banking and the insurance sector widened significantly due to the increased risks in the banking sector (see section 1.4 for developments in the banking sector).

Chart 1.6.4: **Stoxx indices for insurers and banks**



Source: Bloomberg

Chart 1.6.5: **Sector CDS spreads for banks and insurers**



Source: Bloomberg

[22] Source: Bloomberg.
[22] Source: Bloomberg.

The interconnectedness between the insurance and banking sectors is also reflected in new types of transactions between banks and insurers, such as liquidity swaps.[23] Given the problems with interbank lending, many banks relied on the ECB as the main provider of short-term funding. In order to get the right collateral for the central bank lending, banks can swap securities with institutional investors, such as insurers. Liquidity swap transactions are often complex; they are big in size (e.g. a substantial portion of an insurer's sovereign debt portfolio) and long in duration, and they involve the use of less liquid collateral (sometimes of poorer quality) and higher counterparty concentration (due to the size of the transactions).[24] Although the transaction volume has been relatively low in 2011, there is evidence of a significant increase in demand. The emergence of the liquidity swap market raises concern on growing interconnectedness between the insurance and banking sectors, and spreading of systemic risk across the financial system.

1.6.2 Market integration and the role of insurers as long-term investors

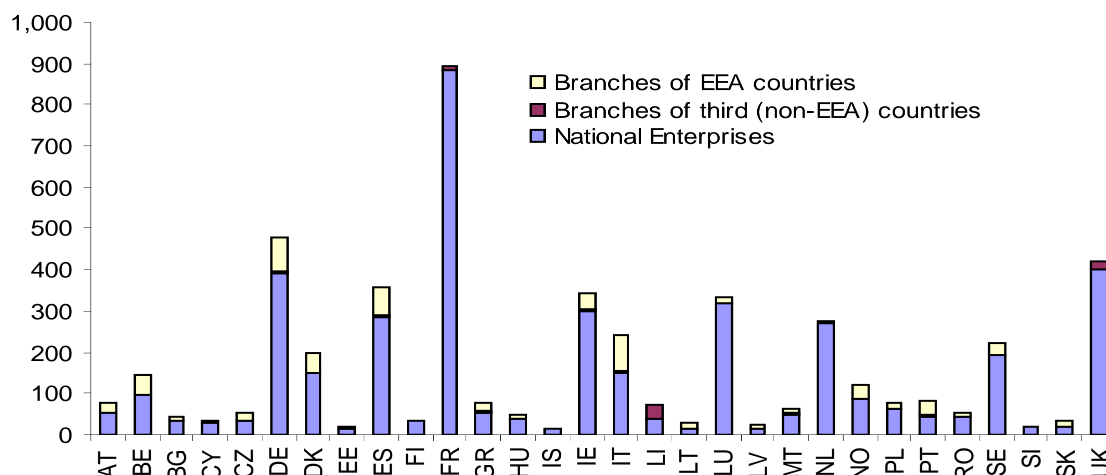
Market integration in the insurance sector is important from both the suppliers' perspective (e.g. risk diversification and economies of scale, larger investment possibilities) and the consumers' interests (e.g. greater competition and variety of products). The degree of integration differs in the primary insurance sector. In general, life insurance is considered to be more segmented than non-life insurance for different parts of the business chain, such as product development, distribution and operations. Also, for distribution in non-life business, integration is weak for retail insurance, but high for large business to business insurance. In contrast to primary insurance, reinsurance markets are well integrated, with the market being a global one.

An integrated market should enable an insurance company to easily enter other Member States and provide its services by choosing the legal structure that suits it best. In practice, most of insurers' business in other countries is carried out through subsidiaries. As regards foreign branches, data from EIOPA shows that their market share remains small in terms of both numbers of entities (see chart 1.6.6) and gross written premium (see chart 1.6.7). The average share of gross premiums written by foreign branches in the reporting Member States amounted to 2% in 2010.

[23] In a liquidity swap transaction, insurers lend sovereign debts, typically government bonds, to banks for a fee with banks giving structured credit assets, such as RMBS, (plus haircuts) as collateral. The bank uses then government bonds for repo transactions to meet their liquidity requirements, while the insurer benefit from the additional return (fee) for its assets.

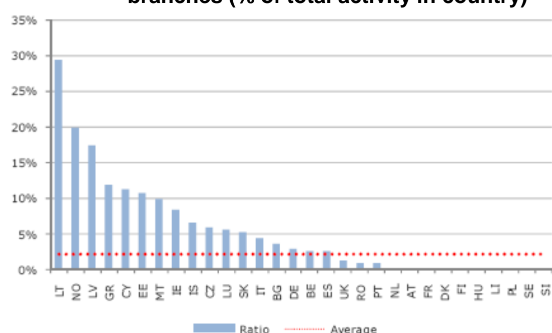
[24] See FSA (2011), 'Guidance consultation on liquidity swaps' Annex 2, July.

Chart 1.6.6: **Number of entities (2010)**



Source: EIOPA

Chart 1.6.7: **Gross premiums written by foreign branches (% of total activity in country)**



Source: EIOPA

The insurance sector plays an important role in financing the real economy, due to the long term character of insurers' investments and their dominant position in the European investment landscape, together with pension and mutual funds. For example, insurers manage 55% of the long-term assets[25] owned by private households in Germany. The insurers' share of corporate (loans) and real estate financing in Germany is 37%, while in France and the UK it is 34% and 32% respectively[26]. With the crisis, there has been a tendency of a flight to quality in insurers' investments. Since banks have been at the centre of the crisis and given the problems they continue to face, some of the large European insurers have cut their investments in (uncovered) bank bonds and have increased their holdings in covered bonds and German government bonds[27]. Some of them have also increased their fixed income investments in non-financial corporations, strengthening their role in financing the real economy.[28] However, since the non-financial corporate bond markets in Europe are not highly developed, fixed income investments in financial assets remains at a high level.

Solvency II, the new prudential regulation regime for EU insurers will, when implemented, further strengthen the Single Market and deepen integration by establishing consistent and harmonised standards across the EU (see chapter 2). Separately, in the pension market, the Commission is reviewing the revision of the Institutions for Occupational Retirement

[25] Long-term refers to fixed-income instruments with duration of over 5 years and equity held for more than 5 years.

[26] See: Solvency II and Basel III, The Reform of Europe's System of Insurance and Banking Regulation and its Effects upon Corporate Financing, Finanzplatz München Initiative, June 2011 and ECB data. For end 2010.

[27] See chapter 4 containing the special feature on insurance.

[28] See chapter 4.

Provision (IORP) Directive in order to promote an integrated market for occupational retirement provision across all EU Member States.

1.6.3 Challenges ahead

The insurance industry faces several challenges, some of which could materialize in the medium term, including the following. [29]

- Sovereign debt crisis—A continuing or deepening sovereign debt crisis would lead to further write-down of insurers' assets, as they hold considerable amount of sovereign debt. They are also indirectly affected through their holdings of corporate bonds issued by banks, which are also likely to suffer under an adverse sovereign debt scenario.
- Low economic growth—A more than expected deterioration of economic activity will impact new business sales, due to the resulting possible decline in demand for both life and non-life products.
- High market volatility—High interest rate volatility causes erratic movements of unrealized losses for those assets that are marked to market, which, in case of downturns, negatively impacts shareholders' equity.
- Low interest rate environment—A prolonged low interest rate environment will put pressure on insurers' investment returns and profitability in the medium term, particularly in relation to guarantee products in life insurance business. For example, for German life insurance companies, the average guarantee (2.25% at end 2011) on contracts is above the current running yields on ten-year German government bonds (1.9% at end 2011).[30] More generally, the stress test conducted by EIOPA, published in the Financial Stability Report in December 2011, suggests that 5% to 10% of the companies participating in the stress test would, in a low yield environment, face severe problems to cover their minimum capital requirements (MCR) in terms of Solvency II.[31] Moreover, an increased number of companies would become vulnerable to external shocks, since their capital position would deteriorate to slightly above the MCR.

1.7 MARKET INFRASTRUCTURES

The market infrastructures to provide payment, trading, clearing and settlement services have remained robust despite the stresses in the market during 2011, and advances have been made to achieve further integration.

1.7.1 SEPA

The Single Euro Payments Area (SEPA) initiative aims to achieve a fully integrated market for retail payment services in euro, with no distinction between cross-border and national payments. Moreover, SEPA seeks to contribute to the more general integration of retail banking markets as SEPA will allow individuals, corporations and public administrations to

[29] A supervisory survey on risk assessment of EIOPA Members in the second half of 2011 also shows that European insurance supervisors think the most eminent risks are related to the sovereign debt crisis, market volatility and equity market performance, a stronger than expected downturn in the economic cycle and regulatory and reporting changes. See EIOPA Financial Stability Report, December 2011, table 1 and 2.

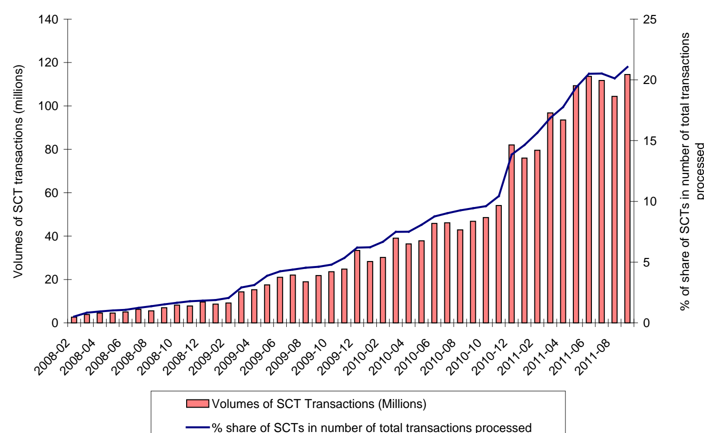
[30] The maximum guaranteed rate in Germany will be reduced from 2.25% to 1.75% on 1 January 2012, and all life insurance contracts sold before that date still benefit from the current guaranteed rate (see Fitch report on German life insurance outlook 2011).

[31] The setup of the low yield stress test is identical to the core test i.e. valuations are based on Solvency II/QIS5 Technical Specifications and the reference date is 31 December. The sample of undertakings was 82 in total.

make cashless payments denominated in euro throughout the euro area and the other SEPA countries from a single account anywhere in the SEPA, using a single set of payment instruments, as efficiently and safely as they can make them today at the national level.

While there is broad agreement on the significant benefits that SEPA can provide for all payment stakeholders, progress with SEPA showed a mixed picture. In particular, actual migration to the SEPA schemes had been low. More than three years after the launch of the SEPA credit transfer scheme in January 2008, 15.7% of all credit transfers processed in the euro area were SEPA credit transfers (see chart 1.7.1). Migration to the SEPA direct debit scheme, which was launched more recently in November 2009, was even lower at about 0.1% of total direct debit transactions in the euro area.

Chart 1.7.1: **SEPA credit transfer migration**



Source: ECB

Commission analysis suggests that without additional legislative intervention, SEPA migration would unlikely be completed in less than 15–20 years. This would greatly reduce the direct and indirect potential benefits of SEPA for the wider European economy. For this reason, the Commission published a proposal for a regulation (agreed in December 2011), which among other measures set 1 February 2014 as the definite migration deadline for credit transfers and (in respect of most requirements) for direct debits.

1.7.2 Trading infrastructures

The market structure in European securities trading has changed markedly over recent years. One clear driver was the Directive for Markets in Financial Instruments (MiFID) which came into force 2007. Amongst other things, this established the frameworks for a more competitive landscape by abolishing concentration rules and introducing a new category of trading venue - multilateral trading facilities (MTFs) - to compete with traditional securities exchanges, thereby offering market participants more choice and reducing costs through competition. Since then, new trading venues and products have come onto the scene and this has been accompanied by technological developments such as automated and high frequency trading. Together these regulatory, market and technological developments have altered the trading landscape.

Equities have been the asset class most impacted by the implementation of MiFID as the majority of equity trading takes place on exchanges as opposed to non-equity instruments such as bonds and derivatives which are generally traded OTC. In 2011, there were 231 trading systems (139 multilateral trading facilities (MTFs), 92 regulated markets). Out of these, 45 Regulated Markets and 50 MTFs were offering trading in cash equities.[32]

[32] Sourced from the Commission 2011 impact assessment of the revised MiFID proposals.

A MTF is, in broad terms, a system that brings together multiple parties which are interested in buying and selling financial instruments and enables them to do so. MTFs have tended to focus on particular market segments, especially shares, where liquidity is deepest. As per Thomson Reuters data (see Table 1.7.1), the largest MTFs (Chi-X, BATS Europe and Turquoise) now account for a sizeable share of equity turnover in the EU. The table also reports the share of Markit BOAT, which is a platform used by a number of investment firms to meet their OTC equity reporting obligations under MiFID and so represents an estimate of a portion of the trades taking place OTC.

Table 1.7.1: European equity trading platforms, turnover

	€billion	**%**
LSE	301	17
Euronext	238	13
Chi-X Europe	173	10
Deutsche Börse	150	8
MCEX	106	6
Six Swiss Exchange	72	4
Spanish Exchanges	58	3
Nasdaq OMX Nordic	56	3
Turquoise	53	3
BATS Europe	50	3
Other	135	8
Markit BOAT*	400	22
Total	**1,792**	**100**

Notes: * Markit BOAT is a reporting platform for OTC trades. Data up to September 2011.
Source: Thomson Reuters, The CityUK (2011), 'Equity Markets', Financial Markets Series, October.

A number of Regulated Markets have set up MTFs in order to diversify the model of service they provide. For example, Smartpool is run by NYSE Euronext, while in 2010 the London Stock Exchange (LSE) took a majority stake in Turquoise, which was set up in 2008 by a group of nine investment banks. More generally, competition in secondary market trading has intensified, and most exchanges have been building their technology offerings in order to compete more effectively with MTFs and expand their range of services on offer.

New trading structures have emerged or developed. For example, the development of broker crossing networks (automated systems that match client orders) and dark orders (an order for which there is not pre-trade transparency) has been facilitated by technological developments in electronic systems. Dark trading allows investors to trade large blocks of equities without showing their hand in the open market. This has typically been used by institutional investors who seek to limit the impact on prices from executing large orders. Large trades on regulated markets and MTFs may also be partially exempted from transparency requirements through waivers. On the other hand, excessive dark trading is detrimental to the price formation process on the "lit" markets (where there is pre-trade transparency). Dark trading has however grown quickly and may now account for 44% of EEA trading. Concerns have therefore been raised about their impact on price formation and whether too much of the market is now dark.

The trend to consolidation between exchanges has continued, being spurred by increased competition between trading venues and the need for significant investment required to meet a growing demand for faster and more sophisticated trading technology. There has been a spate of global merger and acquisition activities between stock exchanges in 2011, of which most attempted transactions were never completed mainly due to regulatory opposition and competition concerns. For example, the London Stock Exchange failed to take over Canada's

TMX Group; and the Nasdaq OMX and IntercontinentalExchange (ICE) takeover bid was repeatedly opposed on antitrust grounds. Deutsche Börse's planned merger with NYSE was cleared by the Committee of Foreign Investment (CFI) and the German financial supervisory authority (BaFin), but in February 2012 prohibited by the European Commission on the grounds that it would result in a quasi-monopoly in the area of European financial derivatives traded on exchanges.

The main stock exchanges provide a market for raising and trading equity capital in particular of the larger corporates. Nonetheless, there are exchanges for smaller companies, such as the London-based Alternative Investment Market (AIM) and the Plus-quoted market, Euronext Alternext, Star or AIM Italia, although other small-company exchanges have closed down their operations in recent years (e.g. Nasdaq Europe and the German Neuer Markt). OTC markets provide additional sources of equity capital for small companies. In addition, alternative platforms for trading equities of small companies such as MTFs are on the rise since the introduction of MiFID.

While MiFID created competition between trading venues and brought more choice and lower prices for investors, market, technological and regulatory developments have meant that MiFID needs to be updated to capture new trading systems and the risks posed by innovations such as high-frequency trading. Following an in-depth review, in October 2011, the Commission adopted proposals to revise MiFID so as to strengthen the protection of investors and make financial markets more efficient, resilient and transparent. The new framework will also increase the supervisory powers of regulators and provide clear operating rules for all trading activities.

1.7.3 Post-trading infrastructures

Although the European post-trading market infrastructure for securities transactions has been evolving, it is still fragmented and has not yet reached a level of efficiency and integration compatible with the requirements of the Single Market.

The 2011 Oxera report for the Commission confirmed that clearing and settlement markets are becoming more integrated and cross-border activity is increasing.[33] An increasing proportion of members on trading platforms, central counterparties (CCPs) and, to a lesser extent, central securities depositaries (CSDs) are domiciled in a country other than that of the infrastructures. For instance, between 2006 and 2009 the cross-border proportion of members has increased from 35% to 39% for trading platforms, from 30% to 37% for CCPs and from 2% to 3% for CSDs.

However, while clearing and settlement costs have come down overall, there remains a gap between the costs of domestic and cross-border transactions. For CSDs, the costs of cross-border transaction have declined compared to domestic costs—from 4.1 times higher costs on average in 2006 to 2.6 times higher costs in 2009. However, at other parts of the value chain the gap has widened; for instance, custodians' settlement fees charged to brokers were on average 4.2 times more expensive for cross-border than for domestic settlement in 2009 compared to 2.3 times in 2006. The persisting gap between cross-border and domestic costs can be attributed to a number of factors, including increased complexity of cross-border settlement as well as lower economies of scale (due to lower volumes) for cross-border transactions.

A number of private and public initiatives have been adopted over recent years with a view to increasing safety and/or efficiency in cross-border post-trade activities and achieve an

[33] Oxera (2011), 'Monitoring prices, costs and volumes of trading and post-trading services', a report prepared for the European Commission (DG Internal Market and Services), May.

integrated post-trade market in Europe.[34] The private initiatives include the Industry Code of Conduct on Clearing and Settlement, which is an industry-led initiative with the approval of the Commission and is essentially aimed at allowing users to choose their preferred service provider freely at each layer of the transaction chain. To this end, the Code provides for commitments by the signatories in three areas: price transparency, access and interoperability, and service unbundling and accounting separation.

As regards public initiatives, three existing legislative instruments already concern the post-trade environment: the Settlement Finality and Financial Collateral Directives and the Commission Withholding Tax Recommendation. The current pipe-line includes legislative measures such as the European Market Infrastructure Regulation ('EMIR'), which imposes rules to ensure greater levels of interoperability and introduces mandatory central clearing in the OTC market, as well as the Central Securities Depositories ("CSD") Regulation. The Commission also created an Expert Group on Market Infrastructures (EGMI), which issued its report in October 2011, advising the Commission on the various obstacles to a pan-European post-trade infrastructure. Another important driver of change is expected to come with the introduction of the European Central Bank's project TARGET2-Securities (T2S), which will create a single platform for securities settlement in Europe towards a borderless market for settlement services. Other policy measures, such as the Securities Law Legislation, are described in chapter 2.

1.7.4 Derivatives

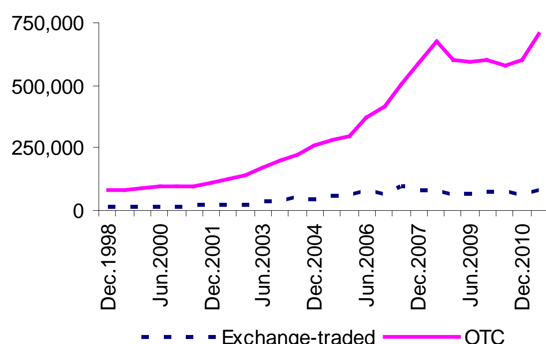
Derivatives play an important role in the economy, as they facilitate the trading and redistribution of risks. But they are also associated with certain risks. The near-collapse of Bear Sterns in March 2008, the default of Lehman Brothers on 15 September 2008 and the bail-out of AIG the following day started to highlight the shortcomings in the functioning of the global derivatives market, in particular in the over-the-counter (OTC) market where the majority of derivatives are traded.

The total amount of global derivatives outstanding in the OTC market, in terms of notional value, has broadly been stable in 2009 and 2010, following an 11% drop from the peak of $673 trillion in June 2008 (Chart 1.7.2). This relative stability in notional value since end-2008 contrasts with the sharp growth that had characterised the OTC derivatives market over the previous decade. This is linked with the moves to netting and central counterparty clearing of some contracts, particularly credit default swaps (CDS), which followed concerns over the systemic risks posed by OTC derivatives.

However, in the first half of 2011, OTC derivatives grew again sharply to reach $708 trillion by June 2011. One of the reasons for this increase in the volume of derivatives relates to banks efforts to get much needed liquidity.

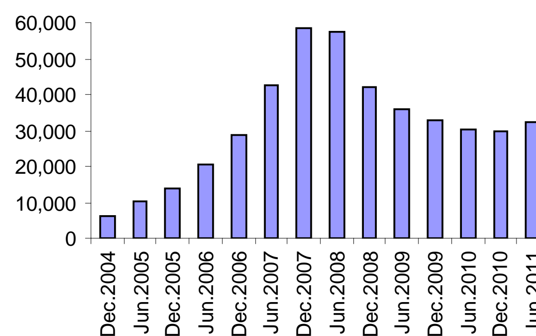
[34] An overview of developments is presented in the report by the Expert Group on Market Infrastructures (EGMI) of 10 October 2011. http://ec.europa.eu/internal_market/financial-markets/docs/clearing/egmi/101011_report_en.pdf

Chart 1.7.2: **International derivatives markets, notional value of amounts outstanding ($billion)**



Source: BIS

Chart 1.7.3: **OTC credit derivatives, notional value of amounts outstanding ($billion)**



Source: BIS

Interest rate instruments represent the majority of OTC derivatives, accounting for 78% of global notional value. Derivatives based on foreign exchange contracts make up a further 9% and credit default swaps (CDS) 5%. Particular attention has been paid to the role that CDS played during the crisis. According to BIS data, the notional amount of CDS worldwide fell by 48% from $58 trillion at end- 2007 to $30 trillion at end-2010, due to a combination of netting, centralised clearing and reduced spreads (chart 1.7.3). Again, the trend reversed in the first half of 2011 with the notional value of CDS growing by 8% over this period. In the EU, this recent growth applied in particular to sovereign CDS—the outstanding notional grew by 20% to reach €1 trillion, with sovereign CDS over some countries such as Germany and France growing twice as fast.

Exchange-traded derivatives make up only a small proportion of total derivatives. End-2010, the notional value of exchange-traded derivatives was $68 trillion and almost 9 times lower than the total OTC derivatives value of $600 trillion. Based on notional value of trading, the biggest exchange groups worldwide are CME Group, NYSE Liffe and Eurex.

1.8 OVERALL ASSESSMENT

Risks to financial stability increased significantly during 2011. The sovereign debt crisis in the euro area worsened and exacerbated problems for the EU banking sector, all amidst deteriorating prospects for economic growth. Sovereign debt problems spilled over from the euro vulnerable countries to the core and raised widespread concerns about the sustainability of public finances across the EU, including the ability of some sovereigns to refinance their debt.

Significant refinancing needs apply to EU banks, many of which continue to be highly exposed to euro area sovereign debt or are otherwise affected by the fate of the domestic sovereign. Bank equity market valuations have been low and highly volatile, which makes it more difficult for banks to raise any additional capital that they might need. As regards debt funding, in 2011, problems in the interbank lending and other wholesale funding markets reached proportions that were similar to those observed after the Lehman failure in 2008. With bank funding conditions tight, there is a risk of further tightening of bank credit to the real economy. Such a credit crunch would further weaken economic activity and adversely feed back to public finances. A recession could also expose bank credit risks, with higher credit losses exacerbating concerns about the profitability and capital position of banks.

Resolving the crisis and effectively reducing the adverse feedback loops between sovereign debt crisis, banking risks and the real economy requires action on different fronts—including fiscal consolidation, structural measures to enhance the competitiveness and growth

prospects of countries in the euro area periphery in particular, and strengthening the resilience of the banking sector and other parts of the financial system. Such measures are at the core of the policy agreements reached at EU level towards the end of 2011 (see chapter 2).

Nonetheless, significant risks continue into 2012. The crisis revealed substantial imbalances that had built up within the euro area and indeed globally, and their unwinding implies painful fiscal and structural reforms that will be difficult to implement politically. Also, continued stresses in bank funding markets may have a direct effect on credit supply to the real economy. Although measures have been taken to ease banks' funding position, such as the ECB LTROs provided at the end of 2011 (and in February 2012) as well as the EBA recapitalisation exercise and wider policy agreements reached at European level, bank lending has not yet picked up, also because uncertainty in the market continues to be high.

Moreover, there are vulnerabilities from spillovers to the wider financial system. For example, insurers have direct exposures through portfolio holdings in sovereign debt and bank capital, and they were affected by the low interest environment that is expected to continue in 2012. Although not considered in this report, other institutions relying on wholesale funding are also particularly vulnerable to stress in financial markets.

These risks to the financial system imply risks to the financial intermediation process, which in turn is critical for the real economy. Disruptions in the financial intermediation process reduce the ability of governments, non-financial corporations and households to raise capital, save, invest and manage risks.

The financial integration process in Europe has, as a result of the crisis, partly been halted or indeed reversed in some segments of the market. Although financial integration proceeded at a rapid pace prior to the crisis, the integration process remains incomplete and uneven. Debt markets had become most integrated (also reflecting pre-crisis excesses in credit growth), while cross-border flows in foreign direct investment[35] and equity portfolio investment remained more limited. Securitisation remains largely national, and the provision of cross-border retail financial services also is limited. With private capital flows in the boom years prior to the crisis largely taking the form of debt (e.g. bank credit), this exposed the countries in the euro area periphery countries to significant rollover risks; when the crisis hit, these capital flows stopped or reversed, resulting in significant economic and financial disruption, and required painful cuts in domestic spending.

The crisis revealed several shortcomings in the institutional framework to support the single financial market. For example, no effective tools were in place to monitor and resolve cross-border risks or to control the build-up of the imbalances that were fuelled by the freely flowing capital prior to the crisis. Therefore, when the crisis hit, the responses were largely national (e.g. state guarantees and resolution proposals) with little regard for the cross-border implications. Although intervention by the Commission limited the risk of distortions in state aid cases, the lack of other EU-wide policy tools impeded an effective response to the crisis from its onset. The resulting uncoordinated national measures risked distorting the effective functioning of the single financial market. At EU level, significant steps have been taken since to fill the institutional gap and to further harmonise regulations and supervisory practices (see chapter 2).

Subject to a better institutional framework to deal with financial sector problems, more rather than less financial integration is needed to overcome the current and future crises and to

[35] Foreign direct investment flows are examined, for example, in European Commission (2011), 'Capital movements and investment in the EU', Commission Services' Paper on Market Monitoring, February.

deliver sustainable growth. In comparison with what was observed in the current crisis, in a more integrated market, there would have been less negative feedback loops between sovereign debt problems and domestic banks in the euro area periphery. Bank exposures to sovereigns would have been more diversified, the market's perception of the risk of individual banks would depend less on the financial strength of the domestic sovereign, and an improved risk-sharing would have contained the funding cost increases observed for banks in the euro area periphery. An integrated market also gives more options for dealing with failures in the banking system. For example, foreign banks can more easily enter domestic markets and take over distressed banks, reducing the need for national state support and recapitalisations. This can further help breaking the feedback loop between banks and sovereign. With a pan-European supervisory regime in place, it should be easier to monitor the building up of excessive exposures in national banking systems and, when problems arise, to take coordinated action and share risks as appropriate.

Open markets facilitate the consolidation process in the financial sector, which normally occurs in the aftermath of a financial crisis but which has been slow in the current crisis, also due to the state support measures that were needed to prevent systemic banking crisis. The (limited) restructuring that has occurred to date has in some cases resulted in less integration, with banks retrenching behind national borders or policymakers tending to ring-fence national markets and preserve domestic activity (see chapter 3). However, it is encouraging to see that EU financial institutions have largely preserved their cross-border presence (including insurance companies, as discussed in the special feature in chapter 4) and that the integration of market infrastructures (e.g. with SEPA) has progressed further. New EU-wide institutions have been put in place, and better regulations have been implemented or are proposed. This should make it possible to achieve deeper (and better) market integration in order to help deliver improved market outcomes for the users of financial services (including consumers, as discussed in chapter 5) and long-term economic growth.

CHAPTER 2: POLICY DEVELOPMENTS

2.1 INTRODUCTION

The interplay between the persisting fragilities of the financial sector and the pressures on governments' public finances and sovereign debt markets became a mounting source of concern in 2011. In order to resolve the crisis effectively and to restore the EU economy to sustainable long term growth, the Union and Member States aimed for a coordinated approach to address both dimensions in parallel, i.e. the structural fragilities of the financial sector and the vulnerabilities of sovereign markets and related macroeconomic imbalances.

This chapter provides an overview of the main policy measures introduced or continued in 2011. It covers both the macro-financial policies, including financial assistance and other support measures (section 2.2) and economic governance reforms (section 2.3), and the ongoing reform programme to achieve a healthier financial sector (section 2.4).

2.2 FINANCIAL ASSISTANCE AND SUPPORT MEASURES

2.2.1 Permanent financial backstop mechanisms

In 2011, the European Union and its Member States further enhanced the crisis mechanisms available to Member States in need of financial assistance and established a permanent mechanism that will take over those responsibilities and act as the backstop in case of future crises.

The European Financial Stability Mechanism (EFSM) continues to perform its responsibilities in accordance with the operational structure decided by the Council in 2010. In July 2011, in light of sustained market turbulence, the Heads of State or Government of the euro area decided to make the intergovernmental European Financial Stability Fund (EFSF) lending capacity of €440bn fully effective to extend the mechanism's toolbox in order to make it more efficient (including the lowering of interest rates and lengthening of maturities of EFSF loans to Greece, Ireland and Portugal) The revised EFSF Framework Agreement went into effect in October 2011, upon ratification by all euro-area national Parliaments. After completion and endorsement of the relevant instrument guidelines, the EFSF can, in addition to loans, provide financial assistance in the form of precautionary credit lines, secondary or primary market interventions, and loans to Member States for the specific purpose of recapitalizing financial institutions (including to non-programme countries). In October, it was further decided to maximize the resources of the EFSF via two 'leveraging' options: the first will provide partial protection certificates alongside new issuances of euro-area government debt; the second will combine public and private funds in either one or multiple co-investment fund(s) that will then invest in the government debt of euro-area Member States with the objective of supporting market access and providing sovereign bond market liquidity. These enhanced options became operational in January 2012.

Significant progress was also made in ensuring that a more efficient permanent mechanism is established to assist as a backstop in the current crisis and provide stability support in case of future crises. The European Stability Mechanism (ESM) will be established via an intergovernmental Treaty and will be the largest international financial institution in the world, with a total authorized capital of €700bn, of which €80bn will be paid-in. The capital

structure will make the ESM, as compared to the EFSF, less vulnerable to the situations faced by participating Member States, and its streamlined governance structure will allow quicker decision-making and thus more efficient interventions in times of need. Although the ESM Treaty was signed on 11 July 2011, the July decisions of the Heads of State or Government to broaden the toolbox (it will benefit from the same tools as the EFSF) and enhance the mechanism's flexibility instigated an immediate revision. The revised ESM Treaty was signed in January 2012; the Treaty is in the process of ratification within national Parliaments. Work is being expedited to ensure that the ESM enters into force in July 2012 – in accordance with the agreement of the Heads of State or Government of December 2011.

2.2.2 Financial assistance programmes

In 2011, the financial assistance programmes have continued in Latvia and Romania (started in 2009) as well as Greece and Ireland (started in 2010). In April, Portugal requested international financial assistance from the EU, ECB and IMF following the rise of sovereign bond yields above sustainable levels (see chapter 1.3). In May, a two-year precautionary programme was set up for Romania, as the financial assistance programme came to an end. In November, a precautionary programme was also requested by Hungary, where the first aid programme that started in 2008 was ended in mid-2010.

The programmes differed with respect to the provided loan amounts, the source of funds, the institutional set up for monitoring and the specific national problems covered in the programme conditionality. In each country, the programme addresses particular financial sector problems, in addition to fiscal and structural issues.

2.2.3 Enhanced credit support by the ECB

Over 2011, the ECB has continued and extended its enhanced credit support measures. Besides liquidity management measures to accommodate banks' elevated liquidity demand (in the format of unlimited liquidity provision through fixed rate tenders with full allotment, the widening of the list of eligible assets for collateral, the lengthening of the maturities of its refinancing operations, and the provision of liquidity in foreign currencies, particularly in US dollars), the ECB expanded its Securities Markets Program (SMP) and launched a new Covered Bond Purchase Programme.

Securities Markets Program

The ECB Securities Market Programme (SMP) was activated in May 2010 on the three smaller countries in the euro area periphery (Greece, Ireland and Portugal) and then expanded in August 2011 to include Italian and Spanish sovereign bonds.

Under the SMP programme, the euro area national central banks and the ECB, in direct contact with counterparties, can conduct outright interventions in distressed euro area public and private secondary debt securities markets to ensure depth and liquidity in those market segments. The objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term. Between May 2010 and the end of December 2011, the ECB bought a total of €218 bn, although about €7bn of bonds/bills have matured since the start of the SMP (€5bn in Greece and €2bn in Portugal, based on the ECB weekly announcements), putting the end of 2011 total ECB holdings at about €211 bn.

The Eurosystem re-absorbed the liquidity provided through the SMP by means of weekly liquidity-absorbing operations.

Covered Bond Purchase Programme 2

In November 2011, the Eurosystem launched a second Covered Bond Purchase Programme (CBPP2), with a view to easing funding conditions for credit institutions and enterprises and encouraging credit institutions to maintain and expand lending to their clients. Under the CBPP2, eligible covered bonds for a total nominal amount of €40bn are to be purchased up until October 2012[36].

2.3 ENHANCED ECONOMIC GOVERNANCE

The crisis has revealed a number of weaknesses in the economic governance of the EU. The cornerstone of the EU response to these shortcomings has been a set of six legislative proposals put forward by the Commission in September 2010 (the so-called six-pack). This legislative package, which entered into force on 13 December 2011 after adoption by the European Parliament and the Council, has two main components: a strengthening of fiscal surveillance governed by the Stability and Growth Pact (Section 2.3.1) and the creation of a macroeconomic surveillance procedure (Section 2.3.2). For the euro area Member States, two supplementary Regulations, proposed by the Commission on 23 November 2011 and aimed at further strengthening the surveillance mechanisms in the euro-area, are on their way of being adopted (Section 2.3.3). The "European semester" is integrating all revised and new surveillance processes into a comprehensive economic policy framework (Section 2.3.4). Finally, on 2 March 2012, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) was signed, aiming at safeguarding the stability of the euro area and the EU as a whole by strengthening fiscal discipline and introducing stricter surveillance within the euro area, in particular by establishing a "balanced budget rule" (Section 2.3.5).

2.3.1 Fiscal surveillance

The so-called six-pack legislative package strengthens the preventive and corrective arms of the Stability and Growth Pact (SGP) and is supported by new enforcement mechanisms. The preventive arm of the SGP requires Member States to make significant progress towards medium-term budgetary objectives for their budgetary balances. To guide and assess their budgetary planning accordingly, an expenditure benchmark has been created. It makes sure that expenditure plans are adequately resourced by equivalent lasting increases in revenues. Moreover, stronger constraints should help Member States which are not yet at their medium-term objective to reach it. In order to enforce these rules, deviations have been quantified and, for euro area Member States, they can lead to the obligation to lodge an interest bearing deposit (of 0.2% of GDP as a rule) in case of continuous non-correction. Such sanction, like the other financial sanctions created by the six-pack, is adopted by the Council by reverse qualified majority voting.

On the corrective side of the Pact, the launch of an excessive deficit procedure (EDP) can now either result from Member States' debt developments or from their deficit. As it has been demonstrated that focusing on deficits was not sufficient to ensure debt sustainability, Member States with debt in excess of 60% of GDP will have to ensure its decline at a defined "satisfactory pace". The progress will be measured against a numerical benchmark, also taking into account the effects of the economic cycle and of any other relevant factor. A three year transition period will be granted for Member States currently in excessive deficit procedure to ensure sufficient progress towards compliance with this new debt benchmark. In

[36] The first Covered Bond Purchase Programme of the Eurosystem ended on 30 June 2010 when it reached a nominal amount of €60 billion

addition, progressive financial sanctions for euro area Member States will kick in at an earlier stage of the EDP: a non-interest-bearing deposit (0.2% of GDP as a rule) may be requested when a an EDP is opened, and failure to comply with recommendations for corrective action would result in a fine of the same amount. Enforcement is furthermore strengthened by the expanded use of reverse qualified majority voting.

Along with the reinforcement of the SGP, the reform of fiscal surveillance has reinforced the link between the European framework and the national fiscal frameworks – i.e. the elements that form the basis of national fiscal governance, such as the institutions shaping fiscal policy-making – so that they now abide by a set of minimum requirements defined in a Directive on national fiscal frameworks. If budgetary obligations of the SGP are set at the European level, budgetary planning and execution remain incumbent on national fiscal policy-makers: it seemed essential to address upstream possible national 'fiscal-structural' shortcomings in order to help Member States delivering on their fiscal commitments. If compliance with provisions of the Directive is required by end-2013 for all, euro area Member States made the political commitment to complete the transposition by end-2012. The implementation of the Directive should provide further opportunities for Member States to exchange information on best practices and constitute a possible springboard for further initiatives.

2.3.2 Macroeconomic surveillance

Over the past decade, Member States have made policy choices which have led to competitiveness divergences and macroeconomic imbalances within the EU. To identify and correct such divergences, a new surveillance mechanism called the Macroeconomic Imbalances Procedure (MIP) has been established. It consists of two regulations[37]: one on the prevention and correction of macroeconomic imbalances, the other on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

The MIP-surveillance under the preventive arm will follow the European semester timetable (see below). The starting point of the surveillance is an Alert Mechanism Report (AMR) which is a screening device where the Commission undertakes an 'economic reading' of early-warning indicators to identify the build-up of internal and external imbalances. Based on the 'economic reading', the Commission will identify the Member States it considers may be affected by, or may be at risk of being affected by, potentially damaging imbalances. The 'economic reading' will ensure that the Commission avoids automatic or mechanical interpretation of the values of scoreboard indicators[38] and considers all relevant economic and financial indicators with a view to get a more complete picture.

Taking due account of discussions in the Council and the Eurogroup on the AMR, the Commission will determine the Member States where it considers that further in-depth analysis is needed to determine whether harmful macroeconomic imbalances actually exist. The Commission can organise missions, with the ECB if appropriate, to conduct the in-depth reviews. It is these in-depth reviews, and not the AMR, which provide the basis for any recommendations to be addressed to the Member States under the preventive or corrective arm of the procedure.

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[37] Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances. Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November on enforcement measures to correct excessive macroeconomic imbalances in the euro area

[38] The Commission, after seeking the views of the European Parliament, Council and ESRB, presented the design of the initial scoreboard in the first AMR. However, the composition of the scoreboard indicators may evolve over time and there is agreement in principle to include a wider indicator of the financial/banking in the scoreboard in 2012.

If the in-depth reviews conclude that harmful imbalances exist but are still in the early stages, the new procedure allows the Commission to put forward preventive recommendations to the Council. In more serious cases, there is also a corrective arm where an excessive imbalance procedure can be opened for a Member State at any moment. In this case, the Member State concerned will be subject to a more binding and intrusive surveillance regime, and will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. Surveillance will be stepped up by the Commission on the basis of regular progress reports submitted by the Member States concerned.

The second imbalances regulation establishes a new enforcement regime for euro area countries. It consists of a two-step approach whereby an interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action. After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP). Sanctions can also be imposed for failing twice to submit a sufficient corrective action plan. The decision-making process in the new regulations is streamlined by prescribing the use of reverse qualified majority voting to take all the relevant decisions leading up to sanctions. This semi-automatic decision-making procedure makes it very difficult for Member States to form a blocking majority.

2.3.3 Additional proposals strengthening budgetary surveillance in the euro area

Given the significant potential spillovers between euro area Member States' economic and budgetary situations, there was a need to go beyond the six-pack legislative package, so as to strengthen the economic pillar of the Economic and Monetary Union. To this end, two other Regulations were proposed by the Commission on 23 November 2011, putting in place an enhanced monitoring procedure for the euro area Member States, which build on and complement the Stability and Growth Pact, thereby ensuring a seamless continuity of policy monitoring in all budgetary situations. The first Regulation will apply to all euro area Member States, with special more stringent provisions for those which are subject to an excessive deficit procedure (EDP). The second Regulation sets out explicit rules for enhanced surveillance for those euro area Member States facing severe difficulties with regard to their financial stability; those in receipt of financial assistance on either a precautionary basis or as part of a full-scale assistance programme; and those in the process of exiting such assistance.

The new monitoring requirements proposed by the Commission applying to all euro area Member States include the introduction of a common budgetary timeline and common budgetary rules, such as independent macroeconomic forecasts and independent fiscal institutions monitoring the implementation of national rules. Euro area Member States will be required to submit their draft budgetary plans for the following year to the Commission and the Council in the autumn. The Commission will examine them and will address an opinion to a Member State if deemed necessary. While this common exercise will enhance coordination and monitoring of budgetary policies across the euro area, the extent to which related opinions are taken into account by Member States concerned adds to the toolbox at the disposal of the Commission and of the Council when assessing whether an excessive deficit exists.

Besides, new monitoring requirements for Member States in EDP – based on an obligation to communicate information to the Commission on a regular basis – allow assessments to be made about the content and direction of fiscal policy at any point while a Member State is in an EDP. This creates the possibility to follow policy more closely and to ensure a timely and effective correction of the excessive deficit. Steps away from the correction of the excessive deficit may therefore be highlighted at any point by a recommendation from the

Commission. This would allow taking action well before the deadline for correcting an excessive deficit if the assessment concludes that it's the correction by the deadline is at risk.

2.3.4 European Semester and Euro Plus Pact

As a part of the EU economic governance reform, the EU launched a new framework for integrated economic policy surveillance, the "European semester", in early 2011. The new approach aims at integrated economic policy surveillance that takes into account spillovers across both policy areas and Member States. It allows giving ex-ante policy guidance to Member States for their preparation of national budgets and structural reforms.

The annual six-month cycle of the European semester starts with the publication of the Commission Annual Growth Survey, which suggests EU economic priorities for the next 12-18 months. In 2011, the priorities were macro-economic stability, creating more jobs and enhancing growth-enhancing structural reforms. In the European semester cycle, the priorities are discussed by several Council formations and the European Parliament ahead of the spring meeting of the European Council in March. On the basis of these discussions the March European Council provides Member States general guidance for their national fiscal and macro-structural policy plans (updates of Stability or Convergence Programmes and National Reform Programmes, respectively).

The Commission presents its assessment of the national policy programmes in respective Staff Working Documents and proposes country specific recommendations in the areas, where the national policy response is lacking or is insufficient. Following the discussions of the Commission proposals in several Council formations, the June European Council endorses country-specific policy guidance to each Member State (except for those under adjustment programmes for which the guidance comes from the financial assistance programme), as well as to the euro area as a whole. In the second half of the year, Member States are expected to take the recommendations into account when they finalise their draft budgets for the following year.

The European semester includes the assessment of policy commitments that Member States take in the context of the Euro Plus Pact. The Pact was agreed in March 2011 by the Heads of State or Government of the euro area and joined by Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. The purpose of the Pact is to strengthen economic policy coordination and improve competitiveness, which should lead to a higher degree of convergence. The four objectives of the Pact are: foster competitiveness, foster employment, contribute further to the sustainability of public finances, and reinforce financial stability. Each year, the participating Member States announce specific policy commitments in the agreed policy areas to be achieved within 12 months. The Commission assesses the commitments in its Staff Working Documents that accompany the Commission proposals for country-specific policy recommendations.

2.3.5 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

On 2 March 2012, the Heads of State or Government of all EU member states with the exception of the United Kingdom and the Czech Republic signed a Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union. The target date for entry into force is 1 January 2013.

One of the main elements of the Treaty is the so-called fiscal compact which proposes steps forward towards greater budgetary discipline and better coordinated fiscal policies in the EU. It includes a requirement for national budgets to be in balance or in surplus. The latter criterion will be met if the annual structural government deficit reaches the country-specific

medium-term objective, as defined in the SGP. Contracting Parties have also set a more stringent limit for their MTOs, which should not exceed 0.5% of GDP at market prices. In line with the preventive arm of the SGP, if significant deviations from this objective or the adjustment path towards it are observed, a correction mechanism will be triggered automatically. The mechanism includes an obligation to implement suitable measures to ensure the correction of the deviation over a defined period of time. Monitoring of compliance with the rule is to be exerted at the national level, by an independent institution. The EU Court of Justice will be able to verify national transposition of this balanced budget rule on request from one or several Member States. The latter's decision is binding, and can be followed up with a penalty of up to 0.1% of GDP.

At the European level, the TSCG also aims at ensuring a strict functioning of the excessive deficit procedure (EDP). First, a behavioural commitment was made by euro area Member States to support any proposal or recommendation by the Commission concerning an excessive deficit existing in another Member State of the euro area, except if a qualified majority of them is against (actually reproducing reverse qualified majority voting).In addition, Member States in EDP shall submit an economic partnership programme detailing the structural reforms needed to ensure that the correction of the excessive deficit is effective and durable.

The TSCG also provides for economic policy coordination and convergence amongst Member States. The Member States have to report on their public debt issuance plans and to make sure that major economic policy reforms are discussed beforehand and, where appropriate, coordinated among themselves. Euro Summits are institutionalised, to take place twice a year, and, according to the items for discussion, possibly inviting non-euro-area Member States to participate.

Further, as of 1 March 2013, any granting of financial assistance under the European Stability Mechanism will be conditional on ratification of the TSCG and transposition of the balanced budget rule into national legislation in due time. The provisions of the new Treaty are to be incorporated into the legal framework of the EU within five years after the Treaty's entry into force. To allow their rapid implementation, he Commission is fully committed to a swift anchoring of key elements of the TSCG into EU law, either in proposals currently being discussed (such as the draft Regulation on enhanced monitoring) or via new proposals.

2.4 Reforms of the financial sector

Following a wave of “emergency” measures in the crisis, the Commission launched a programme of reforms that target structural issues in the EU financial sector and the main sources of its vulnerability, as unveiled by the crisis and in line with the commitments taken by the G20:

- The low levels of high quality capital and insufficient liquidity in the banking sector, partly reflecting inadequate and pro-cyclical prudential requirements and failures in risk assessment and management;
- Supervisory shortcomings, particularly with regard to the supervision of individual institutions operating in a cross-border context and to the unregulated part of the financial sector;
- Corporate governance failures which contributed to excessive risk taking practices in financial institutions;

- Insufficient market transparency and inadequate disclosure of information to the authorities including supervisors, particularly with reference to complex structured financial products;
- Lack of adequate regulation and supervision of Credit Rating Agencies;
- Insufficient macro prudential surveillance of the financial sector as a whole to prevent macro-systemic risks of contagion;
- The absence of a harmonised framework to facilitate the orderly wind-down of banks and financial institutions which has contributed to put pressure on Member States to inject public money into banks to prevent a general collapse

The building blocks of this programme were illustrated in the Communication of 4 March 2009, Driving European Recovery, and the Communication of 2 June 2010 'Regulating financial services for sustainable growth" which set out the details of the financial reform package. The first elements were put in place in the period 2009-2010.[39]

2.4.1 New architecture for financial supervision

The key element of the reform package is represented by the new architecture for financial supervision which involved the establishment of the three new European Supervisory Authorities (ESAs) responsible for banking (European Banking Authority or EBA)[40], insurance (European Insurance and Occupational Pensions Authority or EIOPA)[41] and securities markets (European Securities Markets Authority ESMA)[42]. 2011 was the first year of operation of these new bodies. The ESAs are the first EU agencies to have the power, in precise circumstance, to make legally binding decisions vis-à-vis public authorities in Member States. The first year of the ESAs has been an eventful year, with market turbulence and the Greek crisis. These events have complicated the first year but also emphasized the need for the ESAs and given them an opportunity to demonstrate their added value. New activities were started, as the work on investor protection, control of credit rating agencies, and the drafting of technical standards. In addition, a mechanism for cooperation and information exchange with the European Systemic Risk Board has been developed[43]. The 2011 EU-wide stress test of banks by EBA achieved significant improvements over that conducted in 2010. The important responsibility of EBA to coordinate the ongoing bank

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[39] These were discussed in last year's 'European Financial Stability and Integration Report', published in May 2011.

[40] See 'Regulation (EU) No 1093/2010 of the European Parliament and of the Council, establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission decision 2009/78/EC', Official Journal of the European Union, December, 2010.

[41] See 'Regulation (EU) No 1094/2010 of the European Parliament and of the Council, establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission decision 2009/78/EC', Official Journal of the European Union, December, 2010

[42] See 'Regulation (EU) No 1095/2010 of the European Parliament and of the Council, establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission decision 2009/77/EC', Official Journal of the European Union, December, 2010

[43] Article 36 of the ESA Regulations and article 15 of the ESRB Regulation lay down the modalities of cooperation between the ESAs and the ESRB: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2010:331:SOM:EN:HTML

In addition, there is an ESA-ESRB agreement of 25/11/2011 on confidentiality procedures for exchange of information (link below).

http://eba.europa.eu/cebs/media/aboutus/Legal%20Texts/Agreement-ESAs-ESRB-on-confidentiality-procedures2.pdf

The ESRB is a member of the Board of Supervisors of each ESA and of the ESA Joint Committee (ESA Regulations article 40 and 55). Each Chair of an ESA is a member of the ESRB General board and of the ESRB Steering Committee and of the ESRB Advisory Technical Committee (ESRB Regulation, articles 6, 11 and 13).

recapitalization exercise has given it a high profile in Europe and emphasised its importance. During the market turmoil of August, ESMA played a role as a coordinator of national supervisors, and national bans on short selling were coordinated between a number of Member States. ESMA has also taken the responsibility for the control of credit rating agencies in mid-2011, and now is the sole supervisor of rating agencies in the EU. EIOPA has advised on the important reform of occupational pensions and helped to develop the strategy for the implementation of Solvency II. EIOPA has also conducted its own stress tests for the insurance industry.

The other key institution that became fully operational in January 2011 is the European Systemic Risk Board (ESRB).[44] Its mission is to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system. Specifically, the ESRB is responsible for collecting and analysing relevant information for the macro-prudential supervision, thereby monitoring interconnections between Member States and financial institutions, contagion channels, common behaviour and common exposures to risks, in an attempt to identify and prioritize systemic risks. No other EU institution had fulfilled this EU-wide role before, which was considered as an important shortcoming in financial supervision. The ESRB is mandated to issue warnings or make recommendations for remedial action to the risks identified. For example, in October, it published a set of recommendations on lending in foreign currencies, addressed to the Member States of the EU, their national supervisory authorities and the EBA.

2.4.2. Stability and governance of financial institutions

The overall purpose of Basel III is to have a more resilient, better capitalised, banking system capable of absorbing economic shocks, as opposed to multiplying economic shocks. The G20 leaders welcomed Basel III as an appropriate response to the recent banking crisis. Indeed, Basel III is based on the political will to increase the resilience of the banking sector by raising the quality and quantity of capital and introducing other new measures.

Improved stability of financial institutions will be achieved through the new ESAs which will coordinate the work of national supervisors, ensuring coherent supervisory practices and contributing to the establishment of a common rulebook for financial institutions. In July 2011, the **Capital Requirements Directive** (CRD) was revised in order to implement the Basel III agreement, which significantly increases the levels of capital which banks and investment firms must hold to cover their risks. The proposal includes provisions to improve risk control and oversight as well as to enhance supervisory review of risk governance in financial institutions. The CRD IV proposal follows the Basel Accord very closely and is accompanied by a thorough impact assessment, in line with Commission practice.

Although the crisis did not stem initially from the insurance sector, some insurance companies were directly involved and many suffered from the consequences. The work on **Solvency II**, which started long before the crisis, therefore continued, with entry into force expected on 1 January 2013. Solvency II will introduce economic risk-based solvency requirements in insurance firms across all EU Member States for the first time. The requirements will be more risk-sensitive and sophisticated than in the past, thus enabling better coverage of the real risks run by any particular insurer.

In November 2011, a new legislative proposal on **Credit Rating Agencies** ('CRA III') tackled further risks related to the functioning of the rating business, such as the "issuer-

[44] See 'Regulation (EU) No 1092/2010 of the European Parliament and of the Council, on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board', Official Journal of the European Union, December, 2010

pays" model, the overreliance on ratings, the lack of competition in the sector, and the specificities of sovereign debt. The initiative contributed to reducing the pressure on sovereign markets by introducing stricter rules in the domain of sovereign ratings: more frequent ratings (every 6 instead of 12 months), required publication before the opening of the markets, and more transparency through publication of complete reports. This could help investors to make their own assessment. There is also the obligation to inform the government concerned a working day before the publication of a sovereign rating. This will allow for correction of potential mistakes. The proposal also improves the diversity and independence of CRAs and puts in place measures to mitigate conflicts of interest by e.g. regulating the agencies' capital structure/cross-shareholders.

A proposal for a **review of the Directive of financial conglomerates** has been adopted to simplify and clarify the Directive with respect to a number of current problems (inadequacy of thresholds, complexity of supervisory tools etc.), and harmonize its application.

The publication of the results of the 2011 **EU-wide stress tests** for banks, based on stricter requirements, better coordination and peer review and a significantly higher degree of transparency, provided incentives for banks to restructure their operations, strengthen their capital base, and regain viability. Coordinated back-stop measures, with market-based recapitalisation in the first place, were set-up to take remedial action for banks failing the stress test. In the last resort case of public interventions, the EU State aid rules provide the appropriate framework to ensure financial stability and a level playing field.

A legislative proposal for a new **EU bank resolution regime** will follow in 2012 and will establish a series of legal arrangements that allow the relevant authorities to more easily restructure or resolve a distressed credit institution without recourse to public financial support.

Statutory Audit is an important contributor to financial stability as it provides assurance on the veracity of the financial statements of companies, including systemic financial institutions. The 2008 financial crisis highlighted considerable shortcomings in the European audit system. Audits of some large financial institutions resulted in 'clean' audit reports despite the serious intrinsic weaknesses in the financial health of the institutions concerned.

To tackle these issues the Commission adopted in November 2011 a comprehensive legislative proposal, including a proposal for a review of the Statutory Audit Directive as well as a proposal for a new regulation for public interest entities which include financial institutions. These proposals result from an extensive consultation process (e.g. the Green Paper on Audit Policy) and aim to improve audit quality by clarifying the role of the auditors, strengthening their independence as well as ensuring greater diversity into the current highly-concentrated audit market.

Furthermore, the Commission is also proposing to upgrade the Single Market for statutory audit services by allowing auditors to exercise their profession freely and easily across Europe, once licensed in one Member State. There are also proposals for a strengthened and more coordinated approach to the supervision of auditors in the EU. Taken together, all the measures should enhance the quality of statutory audits in the EU and restore confidence in audited financial statements, in particular those of banks, insurers and large listed companies.

2.4.3. Efficiency, integrity, liquidity and transparency of markets

A number of ongoing legislative proposals will contribute to the improved functioning of financial markets.

The Commission adopted in October 2011 a proposal for a **Regulation on Market Abuse**[45] and a proposal for a Directive on Criminal Sanctions for Market Abuse[46] as part of a package with the review of the **Markets in Financial Instruments Directive** (MiFID)[47].

The review of the MiFID seeks to improve transparency, efficiency and integrity of securities markets in several ways. For example, the scope of MiFID will be extended to new types of trading platform and financial instruments, thus removing some opaque areas of securities markets. Some derogations will also be removed, and transparency requirements will be extended to all kinds of securities, not just shares.

The legislation on market abuse was also revised to provide for a more effective prevention, detection and sanctioning of market abuses. The Directive aims to increase investor confidence and market integrity by prohibiting those who possess inside information from trading in related financial instruments, and by prohibiting the manipulation of markets through practices such as spreading false information or rumours and conducting trades which secure prices at abnormal levels.

The European Markets Infrastructure Regulation on **Over-The-Counter (OTC) derivatives markets (EMIR)** was proposed in autumn 2010, implementing the G20 commitment that standardised OTC derivative transactions be cleared via central counterparties (CCPs). The proposal's objectives are to increase transparency in the OTC derivatives market and to make it safer by reducing counterparty credit risk and operational risk. If a party to a transaction fails in mid-transaction, the existence of a CCP would mitigate the risk and uncertainty as to whether the transaction will be completed. A further obligation for OTC derivatives to be registered in trade repositories, with access for supervisors in the EU, will provide a better overview of exposures and will help detecting any potential problems, such as accumulation of risk, early on. Political agreement on the proposals between the Council and Parliament was reached in trilogue on 9 February 2012. EMIR is expected to enter into force at the end of 2012.

The European Commission adopted a proposal aimed at bringing more safety and efficiency to securities settlement in the EU in March 2012. The **Central Securities Depositories (CSD) Regulation**[48] proposes that the time of securities settlement should be shortened and that market participants should comply with strict measures in order to minimise settlement fails. It also proposes that CSDs should comply with a set of rules, in line with international standards, to ensure their safety and soundness, and that a true internal market for the services provided by national CSDs should be introduced.

A Regulation regarding **Short Selling and Credit Default Swaps** (CDSs), adopted in 2011[49], will increase transparency via a requirement for notification or disclosure of significant short positions relating to shares and sovereign debt, impose restrictions on short sales through a locate requirement, prohibit naked CDSs on EU sovereign debt instruments and enhance competent authorities and ESMA's intervention powers. This will enable supervisors to reduce the risks from short selling and CDSs and ensure a common regulatory approach across the EU.

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[45] See European Commission (2011), 'Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)', October 2011.

[46] See European Commission (2011), 'Proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation', October 2011.

[47] Directive 2004/39/EC.

[48] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0073:EN:PDF

[49] http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf
http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/713

The Commission Services are currently preparing a proposal to provide a clear answer to the central question of "who owns what" in terms of financial instruments in the EU's markets. The planned **Securities Law Legislation,** scheduled for the end of 2012, will address systemic safety and the role of collateral, protection for market participants when they buy, lend, or sell securities, and will ensure that investors can control their assets and exercise their rights regardless of their location in the Internal Market.

The Commission endorsed in November 2011 an **IFRS** amendment (related to IFRS 7) to improve the disclosures requirements relating to the transfer of financial assets. The Commission is also analysing the new standards on consolidation (IFRS 10, 11 and 12). The objective of these standards is to improve the consolidation of securitization vehicles and the disclosure requirements relating to unconsolidated participations in "structured entities" like securitisation vehicles or asset-backed financing. Other IFRS or amendments should be proposed by the IASB to the Commission in the forthcoming months, in particular regarding financial instruments accountancy.

2.4.4. Protection and inclusion of consumers and investors

Reforms must also improve citizens' and consumers' rights and protection in the financial services field. For this reason, the Commission has proposed a number of consumer-oriented reforms, and plans others.

First, the Commission has brought forward proposals to reform **Deposit Guarantee Schemes** (DGS)[50] and **Investor Compensation Schemes** (ICS)[51], on top of a recently-agreed increase of the guaranteed amount (to €100,000 under DGS, €50,000 under ICS). The proposed revised Directives include improved payout times, better funding of schemes, and a proposal for interlinkages and a mutual support mechanism between schemes (both deposit guarantee and investor compensation), to ensure that schemes in difficulties do not fail, to the detriment of consumers.

A proposal for a **Directive on credit agreements relating to residential property** was presented by the Commission in March 2011. It aims at creating a single market for mortgage credit with a high level of consumer protection while at the same time promoting financial stability by ensuring responsible lending to consumers. The proposal sets out: (1) conduct of business rules for the provision of mortgage credit; (2) a legal framework to ensure that all actors involved in the origination and distribution of mortgage credit are appropriately regulated (e.g. credit intermediaries, non-banks) and introduces a passport for credit intermediaries.

Agreement was reached late in 2011 on a Regulation setting an end-date for the completion of the **Single European Payments Area** (SEPA) for direct debits and credit transfers to speed up the process that will make payments all over the euro area as easy and quick as domestic payments. The migration deadline has been set at 1 February 2014 for credit transfers and (in respect of most requirements) for direct debits

For packaged retail investment products (**PRIPs**), a proposal is planned for spring 2012 to make sure that all consumers in Europe will in the future be able to get short, focused, and plainly-worded information about investments in a common format, with risks and costs made much clearer and easier to understand, aiding comparisons. In addition, EU rules

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[50] See European Commission (2010), 'Proposal for a Directive of the European Parliament and the Council on Deposit Guarantee Schemes (recast)', July 2010.

[51] See European Commission (2010), 'Proposal for a Directive of the European Parliament and the Council amending Directive 97/9/EC of the European Parliament and of the Council on investor-compensation schemes', July 2010.

governing those selling the products will be made more consistent and standardised where necessary. Such rules will be introduced for insurance PRIPS in a revision of the Directive on Insurance Mediation, to be presented at the same time.

The Commission aims at having a robust framework and convergent standards to ensure effective access to basic payment services throughout the Union. To enhance financial inclusion, the Commission tabled in July a Recommendation to ensure that EU citizens have **access to a basic bank account** with electronic payment instruments. This Recommendation stated the general principles that Member States are expected to follow when taking actions to remedy the current market deficiency regarding the right for access to a basic bank account.

2.4.5. Measures to stimulate investment in the real economy and assisting SMEs

A key focus is on balancing the need for strengthened financial regulation with stimulation of the real economy. It is not enough for the financial proposals to avoid a negative effect on lending and investment, they must as far as possible stimulate these. Proposed legislation in 2011 on **venture capital**[52] **and socially responsible investment funds**[53] are one example of this. The MiFID proposal referred to above introduces a new SME growth market which will provide greater visibility to SME-oriented capital markets by providing an SME label for such markets, while information and listing requirements for SMEs have been eased in proposals for revising the Transparency and Prospectus Directives.[54]

In addition, the Commission has proposed a budget of €1.4 billion for the financial instruments under the Programme for the Competitiveness of Enterprises and SMEs (COSME) for the 2014-2020 period. These instruments, working in conjunction with those included in Horizon 2020, will aim at reinforcing the access to loan guarantee and venture capital markets for European SMEs.

Moreover, the Commission adopted in December 2011 an Action Plan which contains various initiatives and funding measures to enable a better flow of credit and equity to European SMEs.[55]

Further reforms beneficial to the real economy are planned in 2012, including measures to improve portability of occupational pensions, promoting labour mobility.

2.5 CONCLUDING REMARKS

The financial reform agenda as a whole is not in tension with the growth objective, but is complementary to it. Improved financial regulation is part of the exit strategy from the financial and economic crisis – part of the solution, not part of the problem. At the same time, vigilance is required so as to avoid producing unintended consequences for the economy. Reform is vital to entrench stability in the financial sector and stability is itself a vital precondition of sustainable growth. Financial crises have a huge impact on growth. One

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[52] See European Commission (2011), 'Proposal for a Regulation of the European Parliament and the Council on European Venture Capital Funds', 2011.

[53] See European Commission (2011), 'Proposal for a Regulation of the European Parliament and the Council on European Social Entrepreneurship Funds', 2011.

[54] European Commission (2011), 'Directive of the European Parliament and the Council amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC', October 2011.

[55] Communication "An Action Plan to Improve Access to Finance for SMEs", COM(2011) 870 final, adopted on 07.12.2011

of the key goals of financial regulation is to prevent or mitigate future crises by making financial institutions and markets more stable and transparent. Regulation can help increase and smoothen economic growth over the cycle. Reform of financial services is also key to restoring confidence, without which the financial service sector cannot properly fulfil its function of allocating capital, nor attract foreign investment into the EU.

CHAPTER 3: STRUCTURAL CHANGES IN THE EU BANKING SECTOR

3.1 INTRODUCTION

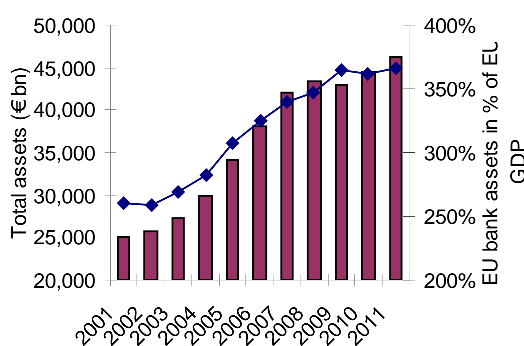
This chapter examines developments in EU bank sector structure and consolidation.[56] Compared to the stresses in the banking sector that have been present since the start of the crisis and intensified again during 2011, the restructuring of the sector has been relatively limited to date. However, bank sector restructuring can be expected to continue and intensify over the years to come. This will not only shape the resilience of the banking sector going forward, but also determine the structure and degree of integration in the EU banking sector. The crisis (and the largely national policy responses to it) has put a halt on the financial integration process, and there is a risk that without coordinated policy action at EU level the market will disintegrate further.

3.2 SIZE AND STRUCTURE OF THE EU BANKING SECTOR

There has not yet been a marked decrease in the size of the banking sector in Europe, as measured by total assets of EU banks, but a halt in growth compared to the pre-crisis years is nonetheless apparent (Chart 3.2.1).

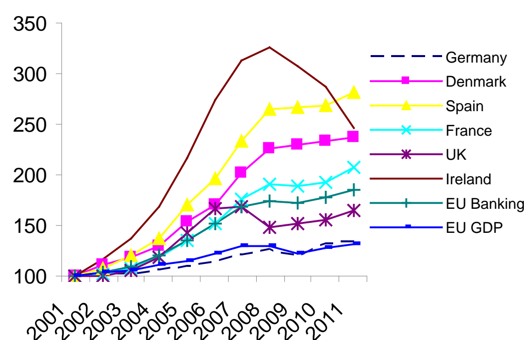
Total assets increased on average by more than 6% per year since 2001, which is more than EU GDP growth, to reach €43 trillion by 2008. In 2009, total assets of the EU banking sector shrank by approximately €460bn, indicating a reverse development due to the financial and economic crisis. Since 2009, the size of EU balance sheets have however expanded again, although total assets have been more stable in relation to EU GDP, as evidenced by the development in the ratio of assets to EU GDP. Since 2009, this marks a slowdown in the relative growth of the banking sector to the EU economy.

Chart 3.2.1 **Total assets in the EU banking sector**



Source: ECB.

Chart 3.2.2:**Total bank sector assets (index, 2001 = 100)**



Source: ECB.

The EU aggregates mask the significant differences in sector size and growth rates between countries (Chart 3.2.2). For example, in the euro area, Ireland and Spain experienced the highest growth in bank assets, with double-digit annual growth during 2001 and 2008. High growth rates were also observed in the new Member States (not shown in the chart), given the more limited bank sector development and resulting catch-up growth. The German bank sector by comparison grew significantly less in the years preceding the crisis.

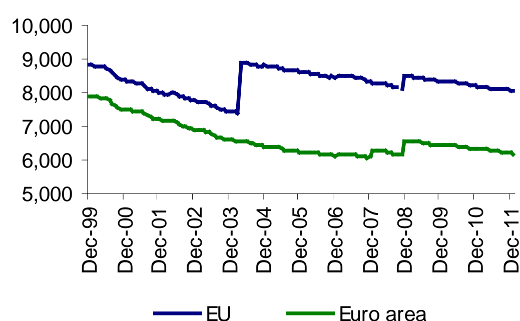
[56] The chapter examines the banking sector at aggregate level and does not provide detailed analysis in the different banking markets or of different bank business models.

The impact of the crisis on the size of the banking sector also varied significantly by Member States. While the banking sector of several countries continued to grow since 2009 (UK, France, Germany etc.), others experienced marked contractions in bank sector assets, such as Ireland where assets declined by more than 20% between end-2008 and end-2011.

Consolidation of the EU banking sector and a decline in the total number of banks started long before the crisis (Chart 3.2.3), and there is no evidence of the crisis accelerating this trend to any significant degree.[57] The limited impact of the crisis on sector structure is also evident when examining the number of exits and entries into EU banking markets; the inflows and in particular outflows of banks from the sector did not significantly change since the crisis started.

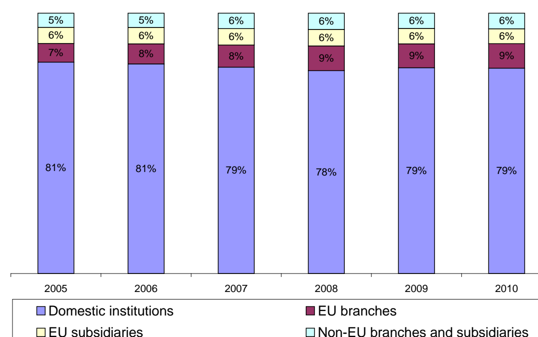
EU and non-EU branches and subsidiaries maintained their share in national banking markets compared to domestic institutions (chart 3.2.4). Thus, the cross-border presence of banks remained largely resilient to the effects of the crisis, even if the trend to further integration appears to have been halted.[58]

Chart 3.2.3: **Number of monetary financial institutions**



Notes: The breaks are due to EU accession and more countries adopting the Euro.
Source: ECB

Chart 3.2.4: **Domestic and foreign banks—Number in % of total**



Source: ECB structural indicators.

Given the severity of the crisis, one may have expected a much more rapid restructuring of the banking sector, including a reduction in capacity and the exit from the market of the weakest firms both within and across borders. The limited impact of the crisis can be partly attributed to the significant liquidity support provided by central banks and the state aid granted to banks by national governments in order to stabilise the banking sector and wider financial markets (see Box 3.1). Most Member States did not have an adequate crisis management mechanism for the resolution of banks and, even where such arrangements were in place, they were not consistently implemented. Most banks were therefore deemed as too systemic to fail, even relatively small banks. As a consequence, the EU only dealt with a few liquidations of small banks, unlike the US banking sector which witnessed hundreds of small- and medium-sized orderly bank failures (Washington Mutual being one of the biggest). Thus, the significant amounts of state support to banks have stabilised the banking market structure in the EU and prevented (or at least delayed) the reorganisation to avoid financial instability and adverse negative consequences on the economy.

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[57] Analysis by the Commission Services suggests that, so far, there has also not been a clear impact on concentration within the EU banking sector. A majority of Member States did not experience significant changes in concentration between 2007 and 2009, and while concentration increased in some Member States (Ireland in particular), others experienced a de-concentration phase during the crisis (e.g. France, Belgium and Poland). See Commission Services (2011), 'The effects of temporary state aid rules adopted in the context of the financial and economic crisis', Commission Staff Working Paper, SEC(2011) 1126 final, October.

[58] The relative stability in the share of cross-border banks also holds when measured in terms of total assets.

Box 3.1.1: **State aid measures in the context of the financial and economic crisis**

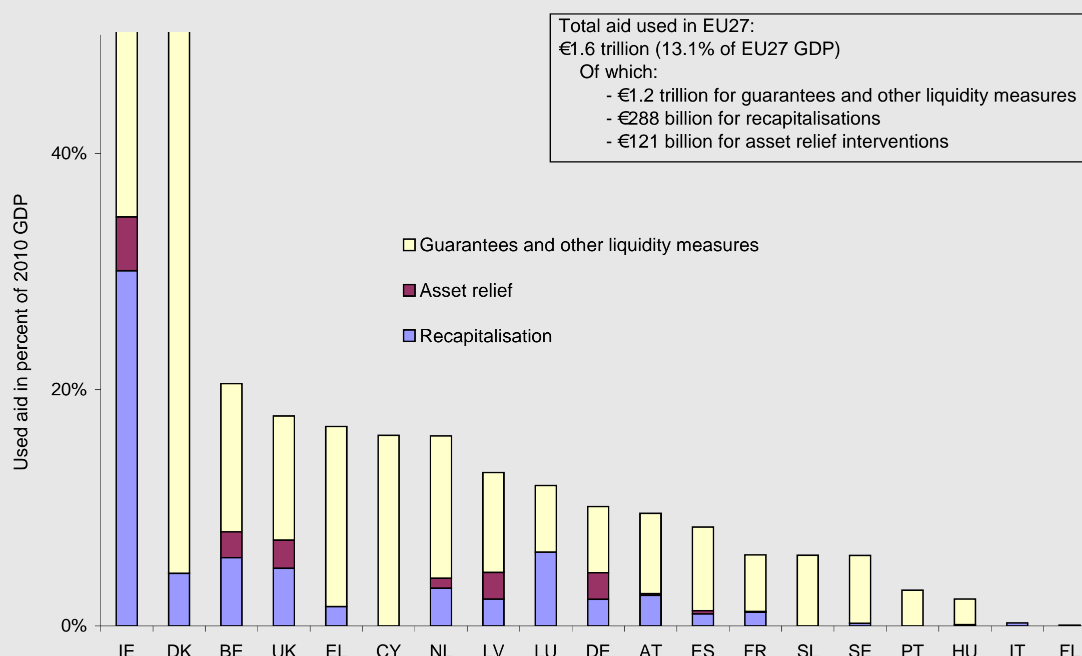
The scale of the financial and economic crisis that broke out in the autumn of 2008, and the systemic risks associated with it, was such that Member States granted unprecedented amounts of state aid to the financial sector in order to restore financial stability and a normal functioning of financial markets. During 2008 and October 2011, the Commission approved total state aid measures of €4.5trillion (36.7% of EU GDP), the majority of which in the form of guarantees on bank liabilities.

Approved amounts of state aid in the period 10/2008-10/2011 in the EU:

	Guarantees	Liquidity measures	Recapitalisation	Impaired assets	Total	
Years	€billion	€billion	€billion	€billion	€billion	% of GDP
2008	3097	85	270	5	3457	27.7
2009	88	5	110	339	542	4.6
2010	55	67	184	78	384	3.1
2011	49	40	34	0	123	1
2008-2010	**3290**	**198**	**598**	**421**	**4506**	**36.7**

In terms of the state aid actually used (as opposed to approved), the overall amount of aid used during October 2008 and 2010 includes €409bn for recapitalisations and asset relief measures, plus guarantees and other liquidity measures. The amounts of state aid granted during the crisis have been concentrated in a few Member States and a limited number of institutions.

Amounts of state aid actually used by the financial sector



Notes: Shows total amounts of used aid during October 2008 and December 2010, in percent of 2010 GDP. Vertical axis cut at 50%, such that high values for Ireland (269%) and Denmark (67%) are not shown. Eight Member States with zero amounts of used aid are omitted.

Source: Commission Services (2011), 'Facts and figures on state aid in the EU Member States', Commission Staff Working Document, SEC(2011)1487, December.

The analysis conducted by the Commission Services to date shows that the state aid granted since 2008 has been effective in reducing financial instability and cushioning adverse effects of the crisis on the real economy. Although it is too early to draw definite conclusions in this regard,

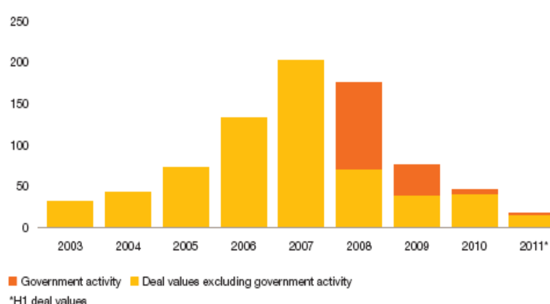
given the on-going restructuring of the aided banks, the analysis conducted to date suggests that state aid control by the Commission seems to have been effective in limiting the distortions of competition within the internal market and contributed to pushing EU banks on a path of long-term viability.[59] However, the state bail-outs of financial institutions have raised serious concerns about moral hazard, and there continues to be considerable uncertainty on financial markets, amplified by the sovereign debt crisis

Given the increased tensions in the sovereign debt markets since summer 2011 and the renewed pressure this has placed on the EU banking sector, in December 2011, the Commission updated and prolonged the special state aid rules dealing with banks in the crisis. The required recapitalisations of many banks imply that future aid is likely to increasingly involve State capital injections in the form of shares bearing variable remuneration. The new provisions explain how to ensure that the State is adequately remunerated if banks are recapitalised in this manner. A revised methodology was also agreed concerning the remuneration of guarantees for banks' funding needs – the bulk of the support to date. Banks continue to be required to submit restructuring plans to the Commission if they benefit from recapitalisation and impaired asset relief measures; heavy users of state guarantees on their liabilities are also required to submit a restructuring plan.

A weak economic and financial environment, some challenges in receiving market funding and the pressure to deleverage had also an important impact on M&A. The number of M&As in the EU financial services industry dropped markedly since the peak in 2007 (chart 3.2.5). With government activity lower in 2010, private M&A activity somewhat picked up in 2010, but remained well below the levels observed prior to the crisis. Following a small recovery of deal activity in summer 2010, financial services M&A in Europe have become increasingly subdued since, at the time of rising concerns about European sovereign debt markets and their impact on the financial sector and the wider economy.

During the crisis, international M&A somewhat slowed down, although not much behind domestic transactions, at least if measured by value (chart 3.2.6). However, given the exceptionally low volume and value of transactions, it is problematic to draw inferences on trends in the relative significance of international M&A deals. Nonetheless, it is of note that the largest international transactions mainly involved bidders from outside the EU and were not EU cross-border transactions.

Chart 3.2.5: **Financial services M&A in Europe value (€billion)**



Source: PWC (2011), 'Sharing deal insight', December.

Chart 3.2.6: **Domestic vs international M&A in European financial services value (€billion)**

Source: PWC (2011), Sharing deal insight', August.

The participation of governments and resulting shift in the ownership structure of the relevant banks was one of the factors that contributed to the decline in private M&A activity in 2009. The low volumes of M&A deals in 2010 and 2011 can to a large extent be attributed

[59] See Commission Services (2011), 'The effects of temporary state aid rules adopted in the context of the financial and economic crisis', Commission Staff Working Paper, SEC(2011) 1126 final, October.

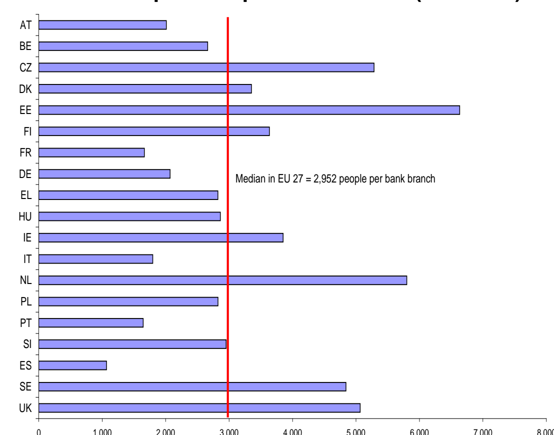
to the sovereign debt crisis and the exceptional levels of volatility observed in European financial markets. Banks focused on repairing their balance sheets and solving short-term problems (e.g. funding) rather than expanding their businesses through M&A. Uncertainties related to the economic environment and forthcoming policy changes, as well as banks' reassessments of risks and the low (and volatile) market valuations, also acted to deter M&A activity.

3.3 SCOPE FOR FURTHER CONSOLIDATION AND SECTOR RESTRUCTURING

Despite the on-going uncertainty and fragile economic environment, more M&A activity and wider sector restructuring can be expected in 2012 and beyond, for a number of different reasons. From a market structure perspective, many European banking sectors remain relatively fragmented, with a large number of small players that may search for synergy savings and economies of scale. Although the number of banks has fallen over time, there is scope for further consolidation in a number of EU banking markets.

Chart 3.3.1 presents just one indicator of bank sector capacity and efficiency (population per bank branch). The indicator varies across the EU, also due to different business strategies followed by banks and factors like population density. Nonetheless, the large number of local bank branches in countries like Germany, France, Italy and Spain indicates a potential for further consolidation and restructuring (see section 3.4 for examples of national restructuring efforts).

Chart 3.3.1: **Population per bank branch (local unit)**



Notes: Shows population per branch (local unit) of credit institutions. 2010 data. Not all Member States reported.
Source: ECB

In response to continued financial pressures and profitability levels that are still significantly lower than before the crisis, there has been a trend towards banks exiting non-strategic markets and putting up for sale their capital-dilutive businesses that fail to meet return on equity targets. Such non-core divestments can be expected to increase, coupled with acquisitions to strengthen banks' core businesses, in particular given many banks' need to increase their capital ratios (see chapter 1). A number of European banks have announced plans during 2011 to sell assets in order to boost their capital positions. On the other hand, banks with surplus capital may be keen to develop new growth avenues and, through acquisitions, access new customers and enter new products and faster-growing markets, in particular given the low interest environment and low returns on invested capital elsewhere.

As part of the increased divestment of non-core assets, some European banks have started to retreat from the geographic expansion of the previous decade by reversing prior acquisitions and withdrawing from cross-border investments. This includes in particular banks' smaller foreign operations as well as operations in Central and South Eastern Europe. Specific examples of withdrawal from foreign markets are plentiful: for example, the French banks BNP Paribas and Sociéte General in 2011 announced plans to offload significant assets abroad, with the latter planning cuts to its networks in Romania, Czech Republic and outside the EU; Italy's Banco Popolare put its Hungarian operations up for sale in the same year; British bank Lloyds is withdrawing from Ireland; and Commerzbank, Germany's second largest bank, announced a temporary freeze on new loans outside Germany and Poland, withdrawing from other countries in Eastern Europe where the bank was a major lender. At

the same time, however, other banks are emerging as new acquirers in CEE markets, such that the overall impact on cross-border business is less clear.

A related reason for increased bank restructuring going forward stems from the government intervention and state aid measures adopted during the financial crisis. The government recapitalisation measures are of limited duration, which may offer private M&A opportunities in the future. Although new state aided recapitalisations were required and governments increased their stakes in some financial institutions in 2010 and 2011, exit from recapitalisation measures has begun for some others. For example, in the Netherlands, Aegon (an insurer) made its final repayment of state capital in June 2011, and ING stated that it would repay the Dutch state in 2012 although in November 2011 announced that there may be delays due to higher capital requirements; and in the UK, the government agreed in November 2011 to sell all of the share capital in the (fully state-owned) Northern Rock to Virgin Money Holdings.

As part of its state aid control, the Commission imposed strict conditions on aided banks, including divestment of businesses and activities. This includes, for example, ING, which is divesting its insurance operations, KBC, which will run down its non-core activities in particular in the CEE and RBS, which is required to carve-out and sell parts of its UK SME and mid-corporate banking business and engage in further domestic and international divestment.

However, these state aid restructuring obligations have not been the dominant cause of divestment within the EU to date. Many of the EU top sellers since 2008 were banks free of state aid obligations, and many of the top acquirers were either banks which did not receive state support or were considered sound by the Commission. Thus, much of the restructuring to date was instead driven by banks' restructuring on their own initiative, which was also a means to avoid government support. State aid requirements are also unlikely to be the dominant cause for restructuring going forward. State aid has been concentrated in a comparatively small number of banks (see Box 3.1). Moreover, divestments in the context of restructuring requirements amount to a small percentage of total bank sector assets and are spread over a relatively long 5-year time horizon—for a number of state aid recipients, the deadlines are still two or three years away, but some banks will become forced sellers during 2012.

Regulatory reforms are likely to spur restructuring of the sector. The new capital and liquidity requirements that come into force with CRD IV will increase financial pressures and make it more difficult for banks to sustain return on equity targets. This may further encourage banks to concentrate resources on best-performing areas and divest businesses which are sub-scale and non-core.

Effective arrangements for bank resolution can also be expected to spur further restructuring, allowing the orderly winding-up and market exit of the weaker banks in the market. Bank resolution schemes have been implemented at national level (see sections 3.4.1 and 3.4.2 on Denmark and Germany). However, the proposals for an EU-wide crisis management and resolution framework are needed to avoid uncoordinated measures that are focused on the domestic market only and present potential risks to the level-playing field and EU integration process.

In the US, the Dodd-Frank Act has limited the activities that regulated deposit-taking banks can pursue (known as the 'Volcker Rule'). This may also spur some European banking groups to divest certain aspects of their proprietary trading operations, although there is likely to be a significant transitional period and the full ramifications of the new legislation are still unclear. In the UK, the Independent Commission on Banking (ICB) in September 2011 recommended the structural separation of retail banking and investment/wholesale banking

activities (see section 3.4.5). If the ICB recommendations are implemented, this would trigger significant reorganisation of the major UK banking groups.

The need for structural intervention is also being reviewed at EU level. At EU level, European Central Bank council member Erkki Liikanen is leading a group of experts examining whether structural reforms of banks bolster financial stability and improve efficiency and consumer protection. This group is expected, in the course of 2012, to make all the recommendations as regards the structure of EU banks it deems necessary to strengthen financial stability.

3.4 Examples of structural changes in different countries

There are significant differences in bank sector structure developments in different EU Member States. The nature and extent of sector restructuring depends on a number of factors, including the initial structure and performance (level of fragmentation, capacity utilisation and efficiency, capitalisation, etc.), the severity of impact of the crisis on the sector and the public policy response.

The following does not intend to give a full overview, but provides examples and highlights some of the specific features that characterise the evolution of bank sector structure in different countries, focusing in particular on the national public policy efforts in this regard. The restructuring responses have been national in nature, which presents potential risks to the level-playing field and EU integration process if the measures are uncoordinated and focused on the domestic market only. EU-wide policy measures are of particular importance in this context (see chapter 2).

3.4.1 Denmark: Implementation of a bank resolution scheme

In the autumn of 2008, the Danish Parliament passed legislation which included a general two-year government guarantee for payment of all unsecured, senior liabilities issued by Danish banks. The total guaranteed commitments amounted to approximately double Danish GDP. When this general guarantee expired, a new set of rules for winding up distressed banks came into force on 1 October 2010 (the so-called Bank Package III), with a view to ensuring that failing Danish banks would no longer receive state financial aid. Under this new winding-up scheme, unsecured creditors are no longer guaranteed full coverage of their claims.

The Financial Stability Company (FSC) is the public body in charge of the new winding-up scheme. Upon failure of a bank, the FSC will establish a subsidiary bank (New Bank) which takes over the assets of the failed bank (Old Bank). As payment for the assets, a proportional share of the unsubordinated liabilities (deposits, other unsecured unsubordinated debt, etc.) is transferred to New Bank. The remaining unsubordinated liabilities in Old Bank will be assured an earn-out, should the following winding-up lead to a surplus; they also maintain legal status as subordinated liabilities against the Old Bank, subject to normal insolvency rules.

At the point of transfer, the guarantee on deposits will be effective—i.e. 'The Depositor and Investor Guarantee Fund' (DGS) will cover deposits above the proportional share and up to €100k (i.e. the Fund covers the shortfall). The Fund then enters as creditor with unsubordinated liabilities against Old Bank.

The FSC injects required capital (and liquidity) into New Bank in accordance with the capital adequacy requirements. The capital earns a market return, and the risk is borne by the new

winding-up section established in the Danish DGS. The winding-up section is largely funded by industry in form of drawing rights on the participating banks.

Two failures of (smaller) Danish banks have been handled under the new regime in 2011, each leading to significant haircuts on senior creditors: Amagerbanken (the initial haircut for subordinated creditors whose claims were not covered by the DGS was set at 41%, but after a subsequent assessment the final payout was increased from 59% to 84.4%) and Fjordbank Mors (holders of senior unsecured claims reportedly faced a 26% loss).

The introduction of the winding-up scheme affected Danish bank credit ratings. In particular, the 'systemic uplift' to their stand-alone ratings, arising from the expectation of state support in a crisis, was reduced. Some Danish banks lost such support altogether, while it was reduced to one notch for the largest of them.

Partly in response to funding problems the winding-up scheme created for Danish banks, on 25 August 2011, Denmark introduced the 'Consolidation Package'. Among other measures, the package aims to incentivise healthy institutions to take over distressed financial institutions, thereby avoiding that a winding-up with potential debt-write down for senior creditors takes effect. The new regime was first tested in October 2011 in the case of a small Danish bank (Max Bank). Further failures of Danish banks were expected in the market, and they may either be dealt with under the winding-up scheme or the Consolidation Package.[60] The new tool can only be applied if the compensation from the FSC does not exceed the loss to the FSC were it to apply the winding-up scheme instead. The winding-up scheme remains in operation, thus providing a 'last resort' option.

3.4.2 Germany: Restructuring of Landesbanken and other banks

The crisis also revealed serious vulnerabilities in the German banking sector. Heavy losses and write-downs from international investments in subprime loans and structured assets weakened the capital base of some banks and led to the need for substantial state interventions.

The crisis exposed in particular the weaknesses of some *Landesbanken*, which had already been suffering from a lack of effective risk management structures and the absence of a viable business model before the crisis. In fact, some of the Landesbanken had to be rescued by the German government even before Lehman collapsed and the crisis unfolded (e.g. WestLB and SachsenLB), whereas others followed suit.

Landesbanken (of which there were eight at end-2011) are public banks that are controlled by the respective state governments and partly by the underlying savings banks. Their main objective is to engage in wholesale banking to support the local economy, including provision of finance to SMEs and other companies. They also operate as central administration for the savings banks (Sparkassen). As was revealed during the crisis, many Landesbanken had in fact moved beyond their core business purpose into international capital markets business, investing heavily in foreign commercial property, sub-prime debt and other structured securities, with severe consequences.

The Landesbanken sector had, for years, been less profitable than other banks, and its financial problems intensified well before the crisis when, upon European Commission intervention, the previously existing state guarantees to Landesbanken phased out (in July 2005). While the need for a restructuring of the sector and return to long-term viable business models has long been apparent, the sector restructuring only started, driven also by EU state aid control requirements. The restructuring measures require Landesbanken to refocus on

[60] Standard & Poor's (2011), 'Further bank failures likely in Denmark', July 28.

their core business and substantially downsize their activities.[61] Total assets are to be reduced overall, risk-weighted assets are to be scaled back, and certain participating interests as well as non-core activities are to be sold. For example, in July, WestLB, once Germany's most internationally ambitious state-owned bank, submitted a restructuring plan to the Commission in mid-2011, under which the bank would be split into a credit institution (to be owned by the savings banks and focused on providing services for these banks) and a 'service and portfolio management bank' (to be owned by the state of Nord-Rhine Westphalia); the rest of the business (including corporate business and project finance) will be sold. In December 2011, the Commission approved the WestLB split-up, which will lead to the sale and eventual winding-down of its banking activities.

In November 2011, Moody's downgraded the ratings of most Landesbanken (and various other public banks) to reflect the lower likelihood that these banks would receive external support. The reduced support assumptions were explained by the fact that future government support has become less certain (partly owing to the new bank resolution regime in Germany that enables the government to impose losses on creditors outside of liquidation) and because of the restrictions on the provision of state support due to the strict conditions set by the European Commission.

Besides the restructuring of the Landesbanken, Germany started a wider reform of its banking sector. In particular, on 1 January 2011 the German Restructuring Act ('Restrukturierungsgesetz') came into force.[62] The new law provides special rules to save ailing credit institutions and introduces a special two-tier pre-insolvency restructuring and reorganisation regime for credit institutions. It also provides supervisory powers to transfer assets and liabilities held by a system-relevant credit institution to another bank (including special 'bridge banks') in order to restructure the business of such bank and prevent insolvency. The Restructuring Act also sets up a new restructuring fund ('Restrukturierungsfonds') to finance the measures under the Restructuring Act. The new restructuring fund has a target size of €70bn and is financed by a bank levy, which was payable for the first time on 30 September 2011.

3.4.3 Ireland: Major restructuring of banking sector

The Irish banking sector was among the worst hit by the crisis, and the total state aid required to bail out Irish banks was among the highest in the EU relative to the size of the country and its financial sector (see Box 3.1.1 above).

In March 2011, the Irish government announced its proposals for a major restructuring of the Irish banking sector. The plan is to form two domestic universal full-service banks as the core pillars to the Irish banking system. The first pillar is presented by the Bank of Ireland, and the merger of Allied Irish Bank and the building society EBS (which took place in July 2011) creates the second pillar. Two other domestic banks are merged and wound down, and a third is restructured. The foreign banks in the market are to form another (albeit smaller) pillar of the banking system.

The restructuring proposals also involve further bank recapitalisation (€24bn) as well as a structured programme of bank deleveraging and re-focusing of operations on core activities. The core businesses are to be focused on serving the needs of retail, commercial and

[61] For some Landesbanken, the restructuring has involved a horizontal merger—for example, Landesbank Rheinland-Pfalz and SachsenLB into the Landesbank Baden-Württemberg (LBBW) in 2008. For others, such a merger was not seen a solution, also given the heterogeneity between the banks.

[62] Under the old rules, German banks were subject to ordinary insolvency laws. These rules remain in place and may remain relevant especially for smaller banks with a large retail customer basis.

corporate customers residing in Ireland or, in the case of overseas entities, who have significant trade or investment links with Ireland.

Plans have been agreed with all the banks providing for the deleveraging - through amortization and sale - of approximately €70bn of assets. Almost 80 per cent of the assets to be sold are located outside of Ireland. Each of the pillar banks has moved to establish core and non-core divisions and management teams for each business. Deleveraging committees with involvement of staff from the Department of Finance banking division have since been set up in each of the banks to ensure delivery of the targets. In 2011, both Bank of Ireland and AIB started to sell (and announced further sales) their loan portfolios, as part of efforts to reduce and clean up their balance sheets and non-core loans.

3.4.4 Spain: Restructuring of the savings banks and other reforms

Spain has taken important steps to strengthen its banking system by providing public support and taking measures to restructure savings banks, reinforce banks' solvency, clean up their balance sheets and improve transparency of their problematic assets. The sector has undergone a noticeable consolidation as a result, especially among the mutual savings banks ('cajas') which were hardest hit in the financial crisis. The consolidation and restructuring over the last two years has reduced the number of institutions from 45 to 15.

The Spanish banking sector has traditionally been fragmented, with excess capacity in the system. As of end-2009, there was almost 1 branch for every 1,000 inhabitants in Spain, which is almost twice as much as the euro-average. The Spanish savings bank sector in particular showed some low levels of efficiency, with a large number of small branches and high staffing levels in international comparison. With the financial crisis, the business models of Spanish banks came under pressure, in particular in the case of savings banks. On the asset side, banks were hit by the collapsing real estate sector. On the liability side, wholesale markets, which had become a primary source of funding, dried up. The prospect of more demanding capital requirements put additional pressure especially on the savings bank sector. In addition, the weak operating environment and the increase in non-performing assets were expected to significantly reduce the internal capital generation capacity of many savings banks. At the same time, savings banks' particular ownership structure, as per their statute, limited their capacity to tap financial markets to bolster capital levels.

The first phase of the restructuring started with the creation of the Fund for Orderly Bank Restructuring ('Fondo de Restructuración Ordenada Bancaria', FROB) in June 2009. The main purpose of this fund is to assist and foster the reorganization of the Spanish banking industry as well as to provide resolution for ailing institutions. In 2010 and 2011, a number of mergers or acquisitions as well as creations of Institutional Protection Schemes (so-called SIPs) were recognised by the Bank of Spain (BdE) as groups for regulatory purposes, some of which requiring financial support from the FROB. A SIP, also called "cold-merger," presents a sort of joint-venture in which participating savings banks pool resources (e.g. capital, liquidity, risk management) with a central entity while maintaining some practical and legal independence.

Subsequently, the legal and regulatory framework of savings banks was fundamentally reformed in summer 2010. The new regulation amendments give savings banks a menu of options to facilitate their access to capital markets and wholesale funding: to issue equity-like instruments in the existing structure; to operate through a bank; to become part of a SIP; or to change the bank's legal nature and become a foundation and a (potentially minority) shareholder of the bank to which it transfers its business. Additional changes were made to enhance the governance structures of the banks. In order to further strengthen market confidence, in 2011, the Spanish government adopted a series of measures including

strengthening the level and quality of minimum capital requirements. As a result, the SIPs as well as some savings banks decided to spin-off their banking business to newly created commercial banks and started the process of listing these new entities on the stock exchange. Some medium-sized cajas were also reported to be looking for investment in equity from private equity and private investors, in some cases in conjunction with funding from the FROB.

Given on-going concerns about banks' balance sheets and access to wholesale funding markets, further reforms were introduced in early 2012. They include requirements for Spanish banks to increase provisions and capital to deal with the most troubled (mainly real estate) assets and to clean up their balance sheets. These are one-off measures designed to dispel uncertainties arising from Spanish banks' exposures to this sector. €175bn (more than half of the total) of real estate assets are considered to be troubled, based on end-June 2011 data, with under a third of the exposures covered by current provisions. Under the new requirements, banks must set aside extraordinary specific provisions (approximately €25bn) and need to make a general provision for non-troubled assets (approximately €10bn). Banks are required also to create a capital buffer (approximately €15bn) to deal with the most troubled assets. The clean-up of balance sheets, which must be achieved by end 2012, will increase covered exposures considerably.

The financial system reform also intends to promote further mergers and consolidations. Banks that merge will be allowed an additional year for the clean-up of their balance sheets. Mergers can be facilitated by the FROB acquiring contingent capital bonds in the merger. This further consolidation aims to guarantee the survival of only the viable institutions, increase efficiency and remove excess capacity.

3.4.5 UK: Proposals to ring-fencing retail banking

In response to the financial crisis, the UK Government set up an Independent Commission on Banking (ICB) to review the need for structural and non-structural reforms to create a more stable and competitive UK banking sector. The final recommendations of the ICB, published in September 2011 and likely to be implemented over the coming years, envisage separation of retail and investment banking activities. While not requiring full structural separation, the plan is to ring-fence the retail banking activities of universal banks in a separate subsidiary.

The *mandated activities* to be conducted only by ring-fenced banks include taking deposits from, and providing overdrafts to, individuals and SMEs. *Prohibited activities* within the ring-fenced bank include any services outside the EEA; any services to other financial institutions (other than deposit-taking and payment services); trading or markets business; derivatives transactions (other than hedging retail risks); etc. *Permitted activities* within the ring-fenced bank include taking deposits, providing payment services, secured and unsecured lending, trade finance, project finance, etc. to any type of customer as long as the customers are within the EEA. Strict provisions should apply to limit the legal, operational and economic links between the ring-fence and other parts of the banking group (e.g. own capital, limits to intra-group dealings, separate governance arrangements).

The ring-fencing provisions apply to UK banks and banking groups—i.e. EU banks operating in the UK via branches (but not subsidiaries) would not be subject to the ring-fencing restrictions. The proposals are expected to require major organisational changes in the large UK universal banks, with costs highest for those that currently have the most significant investment banking operations.

The UK government welcomed the proposals (which also include specific measures to increase the loss absorption capacity of banks and promote competition between them) and

announced that it would implement the ICB's advice in stages, with the full package of reforms completed by 2019.

3.5 Implications for cross-border business and market integration

Since the start of the crisis, integration in the European banking market has lost some momentum and, although banks have largely maintained their cross-border presence, there are signs of declining cross-border activities and banks retrenching more behind national borders (see also chapter 1). With wider sector restructuring expected to take place going forward, there is a question about what the impact will be on EU cross-border banking business and the Single Market.

Since the crisis, banks have started to increasingly divest non-core assets, which often includes foreign assets, be it because foreign markets are considered more peripheral and risky, because there is some home bias owing to greater familiarity and expertise in home markets, or because banks need to meet domestic lending targets and are too capital constrained to also maintain their foreign operations.

However, the pattern of banks' divestments to date has not been so clear-cut. For example, the majority of divestments of the largest sellers in Europe since 2009 were domestic. There also appear to be differences between sellers and acquirers, as most of the largest players' acquisitions were international whereas divestments tended to be domestic. This is contrary to the hypothesis that, across the board, banks have refocused on their domestic market and divested non-domestic activities.

Also, while there is a risk of increased retrenchment behind national borders going forward, the sale of foreign operations by some banks (potentially forced sales and at low valuations) is likely to present opportunities for market entry or expansion for other, potentially less capital-constrained foreign banks.[63]

A lot will depend on the design of public policies and in particular the degree of coordination at European level. One lesson that can be learned from the crisis is that nationally based and uncoordinated actions of governments can have (unintended) adverse consequences on the banking market integration process. In particular, the state aid interventions by national governments in 2008 and 2009 were aimed at rescuing domestic banks and preventing collapse in the home markets. These measures differed in magnitude and design and consequently had the scope to distort the level playing field between domestic and cross-border banks.[64]

A related impediment to market integration that became apparent during the crisis was the lack of adequate resolution arrangements when it comes to the failure of cross-border banks. The failures of banks like Dexia and Fortis resulted in very uneven resolution, and so did those of the Icelandic banks. The national resolution frameworks that have been in place, or established since the crisis, in different countries can also raise concerns from a market integration perspective. For example, unilateral implementation of a resolution scheme could lead to significant differences in funding costs between domestic banks and other EU banks

[63] An example is Spanish banking group Santander, which in March 2011 completed its acquisition of one of Poland's largest banks (Bank Zachodni WBK) from the Irish bank AIB. Other banks are also emerging as new potential cross-border acquirers.

[64] Some measures imposed directly discriminated against foreign players in the market, such as the initial bank guarantee scheme set up in Ireland in autumn 2008 which guaranteed all deposits but only at six domestic Irish banks—the guarantee was subsequently extended to other banks' subsidiaries in Ireland, 'with a significant and broad based footprint in the domestic economy', as well as to foreign branches of 'a systemic significance'. Commission Decision NN 48/2008.

and may disadvantage the former to a degree that risks distorting the level-playing field and damaging the Single Market. This makes the case for the simultaneous introduction of a harmonised debt write down tool for resolution authorities across the EU and ideally more widely. In line with these considerations, the EU crisis management and bank resolution proposals will seek to introduce a common EU framework for crisis management in the banking sector (see chapter 2).

Overall, the crisis has presented significant challenges for the EU bank sector integration process. Although banks have largely maintained their cross-border presence and continue their cross-border activities, the integration process has been temporarily put on hold. There are signs of reduced cross-border banking provision and a refocusing on domestic markets, which may have partly been driven by public policy intervention. Going forward, from an integration perspective, it will be important to adopt policy measures at EU and national level that address financial stability concerns without resulting in further fragmentation of the internal market for banking services. EU measures are already introduced or in train to deliver this objective, including the overhaul of the EU supervisory architecture or the advancing of the integration of market infrastructures and application of SEPA, to name just two examples discussed in chapters 1 and 2.

CHAPTER 4: CHANGES IN THE EU INSURANCE SECTOR

4.1 INTRODUCTION

Insurance[65] companies play a vital role in the European economy, notably by providing protection to policy holders against future negative events, as providers of savings products and, as major institutional investors, by helping to finance the real economy and the financial industry.

By contrast to banks, their core activities in the years preceding the financial crisis did not directly contribute to it in a material way. Moreover, insurers' recourse to financial support from the public authorities in order to withstand it was much less than that of banks. It is difficult to assess the overall impact of the crisis on insurers given the length of time required for losses in insurance portfolios to materialise, especially in relation to their life and pension business.

However, the crisis has affected the way insurance companies organise themselves and the business they do. At the same time, EU insurers have been subject to a number of national and EU regulatory initiatives (some of which remain in train and most of which were not inspired by crisis considerations) which have also had an impact on their organisation and business.

This chapter is based on responses to a Commission questionnaire completed in late 2011 by nine insurers (including one reinsurer and one third country insurer with EU operations). It is thus based on the behaviour of individual firms, rather that of the overall sector[66].

The questionnaire essentially asks:

- *What has been the impact of the crisis and EU regulatory reform on respondents' internal organisation and core underwriting/investment business?*
- *What is their experience of the Single Market in insurance, including their strategies, as well as the benefits and challenges arising from it?*

This chapter considers the issues that emerge from respondents' answers, where these are relevant to the pursuit of the following EU policy objectives:

- **Consumer protection**, in terms of ensuring that a policy holder can be confident that the insurer will meet its claims and that the policy holder understands the specific features of individual products. This objective has implications for inter alia insurers' financial robustness, internal organisation (including governance) and the transparency of its products, disclosures etc.
- **Competition and innovation**, in the sense of insurers – and providers of similar products to insurers - competing on a broadly level playing field to provide products which meet consumers' evolving needs. Consistent with this objective, regulation should not distort competition in favour of or against part of the sector, or other sectors where it is competing with them, unless the scale of the resulting benefits and lack of alternative ways of securing them, so dictate.

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[65] The term insurance is taken to subsume reinsurance throughout the chapter.

[66] References to insurers below are to the sample, or part of it where its 'behaviour' is adjudged typical of the sample as a whole; except where it clearly refers to a larger group e.g. all EU insurers.

- **A Single Market** in insurance, defined here as a market in which insurers, regulated and supervised in a harmonised manner, are free to provide services across the EU without EU and/or national regulation per se pushing them to adopt one legal form rather than another (e.g. branches and subsidiaries) or obliging them to be located in the consumer's Member State.

- **Financial stability**, in the sense of the sector contributing to the goal of sustainable, non-inflationary growth of output and employment in the economy as a whole, rather than it being a source of vulnerability and thereby facilitating future 'shocks' which jeopardise this objective. It is therefore important e.g. that the sector continues to buy and hold long term financial assets which meet its long term liabilities and deliver an attractive return. By doing so, it provides long term finance to non-financial corporates and financial institutions (especially banks) and thus facilitates economic growth. Moreover, organisational and business changes which lead insurers to focus increasingly on pure insurance activities, rather than other financial business for which they compete with non-insurers, can enable insurers to play a stabilising, counter-cyclical role. By contrast, changes which increase their similarity with other financial institutions, thus reducing diversity in the financial sector, may do the opposite.

In addition, the insurance sector has an important role to play in helping meet other EU objectives, including in respect of pensions and climate change (e.g. flood insurance[67]) etc.

The chapter is structured as follows. First, changes in the way that respondents are organised, notably those arising from the crisis and regulation are discussed in section 4.2. Section 4.3 analyses changes in their underwriting business and how they invest to match their related liabilities, focussing on the extent to which they reflect crisis and regulatory factors. Section 4.4 considers respondents' views on the Single Market in insurance and their own strategy and experience in it. The emphasis given to this section reflects the Commission's brief to maintain and deepen the Single Market. Finally, the main conclusions are outlined in section 4.5.

Box 4.1.1: **Main features of sample insurers**

The sample consists of nine companies, headquartered in seven Member States and one third country. It includes one mutual and one reinsurer. They collectively employ a workforce of approximately 300,000 employees and serve about 250 million customers across the EU.

They account for some 28% of the EU insurance market (in terms of their EU gross premiums), while their total assets comprise 38% of total assets of all insurance companies in the EU. The bulk (over 50%) of their[68] business in terms of gross written premiums is intra-EU, with between 18% and 50% in their home markets.

A common feature of the majority of respondents is that they have a significant share of the market in more than three other Member States. Some of them have a large global presence, especially in emerging markets. For five participants, gross written premiums outside the EU were over 50% of their total premiums.

Insurers in the sample operate mainly through subsidiaries for life business. In the non-life sector they operate through both subsidiaries and branches.

Note that the sample is not homogeneous, in the sense that the composition of its members' business varies significantly, as does their relative dependence on particular EU markets (e.g.

[67] By incentivising those at risk to take steps to reduce the risk of flooding, as well as by providing cover against potential damage.
[68] Excluding that of the third country respondent.

CEE 'growth' markets as opposed to Western European 'mature' markets) and their reliance on the household, SME and corporate sectors.

4.2 ORGANISATION

The internal organisation of insurers refers here inter alia to the allocation of responsibility for core functions (e.g. risk management and asset-liability management[69] – ALM) across the firm, including at group, regional and country management level; and initiatives to simplify their arrangements (e.g. legal structure). The drivers behind the more important organisational changes undertaken in recent years are considered in this section.

4.2.1 What factors other than the current crisis and regulation have catalysed significant organisational change?

'Dot com crash'

All respondents have undergone significant organisational change in recent years. For the majority of them, the main catalyst was the dot com crash in 2000-2 (subsuming 9/11) rather than the 2007 crisis. Insurers responded by revising their business strategy (e.g. by selling non-core businesses to focus increasingly on 'insurance' per se and by reducing their equity investments); and overhauling key functions notably risk management and ALM.

In particular, most of them established the role of Chief Risk Officer (CRO) after the dot com crash and a 'three lines of defence' approach to risk management, under which responsibility for specific aspects was assigned to: the local business (especially for life and health given the high degree of local customisation); an independent risk management function; and internal audit (also independent). Dual reporting lines were introduced for country risk managers and the roles of risk management and ALM were formalised and clearly separated through the organisation.

Reduced complexity

The drive to make insurers less complex organisations arose in part from the crisis. But it also reflected senior management's desire to restore its control after takeovers and, especially, to reap substantial cost savings e.g. from optimising the use of capital within a group and reducing the amount of time allotted to board meetings. Such cost savings facilitate lower prices for customers and higher profits. However, the weight attached to such simplification has increased during the current crisis, since it enhances management's ability to respond quickly and effectively as the crisis evolves, including to any adverse crisis impacts on insurer' business.

Recent, including ongoing simplification initiatives by respondents include:

- A pruning of the number of legal entities, with one insurance group reducing the number of its companies from around 1,000 in 2000, to approximately 600 in 2011. In the case of subsidiaries, this reduced the number of boards and the cost of running them.
- The sale of non-insurance affiliates e.g. banks.
- A narrowing of product ranges, in part to simplify business organisation and thus enhance group oversight and control.
- A shortening of the time to launch new products in the market.

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[69] Taken here to refer to the process by which an insurance company manages its balance sheet – i.e. the management of interest rate, currency and credit risk arising from a mismatch between assets and liabilities.

- The introduction of standardised IT services across the group, so as to capture economies of scale and ensure state of the art technology.
- A shift from a geographical to a channels framework to deal with sales and claims in one insurer, linked to the growing role of internet and phone based distribution – 99% of its customers are now in touch with it by phone or on line.

4.2.2 How has the crisis affected the way insurers organise themselves?

The crisis has also affected the way insurers organise themselves.

Group role

The crisis, and related pressure from national supervisors, has caused respondents to more clearly delineate the relative role of group versus subordinate entities and to expand group's role, e.g. in:

- Providing strategic direction to subordinate entities.
- Overseeing/monitoring local entities' business decisions.
- Improving the exchange of standards and best practice across the group. In order to ensure that key group standards and best practices are applied across the group, there has been a trend towards group disseminating them via professional 'families' – i.e. clusters of specialists from across the business.
- Leading a more integrated approach to activities where there are potential synergies, such as asset management, HR, procurement and the legal department.

Most business lines continue to be managed locally, but certain lines are global - e.g. health insurance for expatriates and variable annuity business – with production and operations largely undertaken in one centre, but distribution normally local.

Risk management

While the crisis did not cause respondents to overhaul their risk management frameworks, it did lead to risk management becoming more centralised in most of them. In several cases, the parent is now responsible for risk management for the group, and setting group risk standards, while the identification, assessment and control of local risks are decentralised.

The crisis has encouraged the closer monitoring of asset valuations, speedier reporting and a heightened frequency and automaticity in respect of margin calls on derivatives business. Reflecting this, some insurers have embarked on significant IT projects during the crisis, with a view to delivering and thence sharing, more timely management information.

Third, the crisis has led respondents to place more emphasis on specific risks and mechanisms to mitigate them, including:

- On the underwriting side, the risk that policy holder behaviour might change due to the crisis, e.g. lapse ratios increase.
- Counterparty and market risks, which have increased in the crisis. Respondents have tended to address these risks via existing risk control mechanisms, including by reducing limits; earlier use of triggers; in extremis, bans on certain investments; and extending the range of assets/counterparties to which such constraints applied. In this way, insurers were better able to adapt to crisis 'news', e.g. the realisation that certain fixed income investments, notably sovereign and bank exposures were either not free of default risk, or more susceptible to it than previously assumed. Moreover, market risk is increasingly managed on a global basis. In practice, this may mean group

ensuring that positions taken in particular entities are offset by hedges taken on by other entities, so as to minimise group risk, irrespective of the type of market risk - e.g. sovereign default, equity and low interest rate risk – concerned.

- Macroeconomic and political risks, e.g. relating to the future of EMU and its ramifications for policy holder behaviour, investments etc. Internal stress scenarios and crisis planning have become increasingly important risk management tools. Scenarios undertaken early in the crisis to identify possible 'extreme' risks, helped prompt timely management decisions, e.g. to reduce counterparty ceilings in some cases.
- Franchise risk, which has become increasingly important including at group level, partly as a result of a general erosion of public trust in the financial sector. However, there is evidence that insurance is ranked higher than certain other parts of the sector.[70] Moreover, the maintenance and strengthening of the group brand is perceived to offer significant potential competitive advantage.

ALM

Respondents observed that the way that the ALM function is undertaken has not changed significantly because of the crisis. However, the crisis has contributed to a renewed awareness of the need for the strict independence of risk management and investment.

As the crisis has increasingly affected sovereigns, group ALM has in some cases taken action to ensure that a greater proportion of matching is undertaken in domestic fixed income assets. This partly reflects its appraisal of the risk from specific stress scenarios, including withdrawal from EMU, where a policy of matching liabilities with assets issued in the same country and thence currency is perceived by respondents to increase their ability to meet their commitments to policy holders. However, it is recognised that such an approach may increase losses in certain scenarios – e.g. where the fair value of available for sale domestic sovereign bonds falls sharply due to default risk, but the liabilities they match remain as they were - compared with more diversified strategies.

4.2.3 How has new regulation affected the way insurers are organised?

Solvency II

Solvency II is not yet in force, but is already affecting the way insurers organise themselves, in at least one insurer to a much greater extent than the crisis is. For example, risk management, ALM and governance arrangements play a much greater role in the Solvency II framework than in Solvency I. Reflecting this, respondents are amending their organisational structures to ensure that they are fully compliant with it. Some have also strengthened their compliance teams in different ways, including in one case by creating a Chief Compliance Officer role. Moreover, the expected increase in demand for expertise on risk management is leading some firms to recruit this scarce resource now and thus gear up early for the Directive.

National authorities have also helped speed up adaptation to the measure. Thus, the Swedish FSA introduced a new 'traffic light system', in the spirit of Solvency II, in 2006. Using stress scenarios, insurers' exposure to various financial and insurance risks are measured on both the asset and liability side. These include risk on the assets side, which was not reflected in the size of their capital requirements under existing prudential rules. This proved a valuable management tool as the crisis evolved. Other Member States which have moved in a similar

[70] European Commission (2011), 'Consumers Market Scoreboard - Making Markets Work for Consumers', European Commission, October

direction include the UK, via the Individual Capital Adequacy Standards (ICAS)[71] regime that was introduced for general insurance companies in 2005 and in many ways anticipates how Solvency II is expected to develop. In addition, the Swiss Solvency Test (SST) provides a third country example of a risk-based capital regime in operation.

4.2.4 Impact on pursuit of EU objectives

Respondents have undergone a number of important organisational changes over the last decade, which were driven more by the dot com crash and the continued search for efficiency savings, than by the crisis and regulatory reform though both played a role too. These changes have better enabled insurers to respond to the extreme challenges posed by the crisis thus far. They have thus contributed substantively to policy holder protection and, indirectly, to financial stability. They have also contributed to more competitive insurance markets.

4.3 UNDERWRITING AND INVESTMENT

4.3.1 How has the crisis affected insurers' underwriting and investment activities?

The financial crisis has changed the external environment in which insurers operate. Certain features of this new environment have raised challenges for them, including low interest rates, heightened credit concerns especially in respect of some sovereign issuers and banks, financial market volatility, as well as lower than previously expected economic growth (see Chapter 1, section 1.6 for the impact of market developments on insurers). They have affected insurers' ability to meet their existing underwriting commitments and the pricing of new life[72] insurance business. Therefore, the impact of each of them on insurers' overall business is considered below, rather than on their underwriting and investments taken separately This is followed by an examination of their aggregate impact, as reflected in their combined balance sheet.

Low interest rates

(i) Existing life business

The crisis led to low interest rates as governments, subject to major fiscal constraints, relied on central banks to pursue expansive monetary policy to sustain aggregate demand in their economies. Market prices now reflect an expectation of continued low short-term interest rates for a considerable period, including negative real rates. Lower interest rates result in capital gains on fixed income assets (mostly bonds) held, which are normally outweighed by the increase in the discounted value of liabilities – typically much larger for life insurers than the gain on fixed income assets – through a lower discount rate and a short duration mismatch[73] In addition to these immediate 'stock' effects, lower interest rates have an ongoing impact on the income ('flow') that insurers receive on their fixed income assets, by cutting the yield obtained on new fixed income assets.

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[71] See Financial Services Authority (2005), 'Modernisation of the regulatory regime in general insurance: How far can we come? An FSA perspective', Speech by Dr. Thomas F. Huertas, Director, Wholesale Firms Division, at the FSA Insurance Conference.

[72] Non-life (e.g. P&C) and health premiums, which are typically re-priced annually, are based mainly on claims brought by insurees, rather than on investment returns – by contrast to life premiums. Non-life and health claims, and consequently premiums, are typically influenced less by financial market conditions, such as market interest rates, economic situation and growth prospects, than life business is.

[73] Such that the duration on the asset side is less than that on the liability side.

Life insurers typically guarantee a significant part of their business in certain countries, e.g. Germany, for lengthy periods. Therefore they cannot adjust their premiums to interest rate changes as they can with non-life products. In addition, they typically do not fully hedge the interest rate risk on their life business via the assets they hold against it, given their need to provide attractive bonuses on their 'with profit' policies and the difficulty of finding effective hedging instruments (e.g. suitable bonds and derivatives). In such cases, they are vulnerable to the risk that reinvestment rates prove insufficient to meet the guaranteed minimum returns that they have committed to and thus a stream of future losses.

The problems for insurers from low interest rates are most acute where:

- They have written substantial business in markets with a high guarantee ratio (e.g. the bulk of German life policies are guaranteed, with the average guarantee reportedly over 3%).
- They cannot adjust guarantees on existing business.
- They are slow in adjusting new premiums.
- Interest rates have fallen below the average guaranteed rate on the existing life book. For example, in Sweden, guaranteed rates are reported to be typically in the 3%-4% range, whereas the yield on 10 year government bonds has been around 2% since mid-2011. Given insurers' bias towards domestic rather than foreign government bonds, this risk is greatest for Member States which have seen a marked strengthening of their credit-standing, rather than the converse.
- There is a significant duration gap[74]. This is especially challenging for some currencies, where the long term bond and derivatives markets necessary to facilitate duration matching are insufficiently liquid or do not exist.

(ii) New life business

Most respondents have adjusted to low interest rates by providing lower guarantees[75] on certain new life products, thereby reducing the appetite of savers for them, rather than by no longer selling guaranteed products. Attempts to substitute guaranteed with other savings products e.g. unit-linked life policies, on which the policy holder bears the investment risk, have proved challenging due to consumers' increased risk aversion in the face of the financial crisis and weak equity markets. Moreover, insurers have encountered fierce competition for savings from other financial institutions, especially banks, which have raised returns on their own savings products in response to tighter wholesale market funding conditions. Banks' increased focus on the retail savings market has at times conflicted with their role in distributing insurers' products. Therefore the volume of some insurers' products (e.g. unit-linked policies) distributed by banks has decreased.

It was observed that reinsurers are less affected by low interest rates than primary life insurers for they typically take on insurance risk, rather than investment risk, and do not offer products with guaranteed investment returns.

[74] Duration measures a bond's sensitivity to interest rate changes. Duration matching is used to ensure that a portfolio's overall rate of return is constant when interest rates change. It does not fully remove interest rate risk when the relationship between a bond's price and yield changes is non-linear. In this case, the firm faces 'convexity risk'.

[75] For evidence on insurers' success over 2005-2009 in bringing down guaranteed rates, in all but three Member States, see EIOPA (2011), 'Financial Stability Report 2011, First half-year report', June.

Sovereign credit risk and the 'home bias'

Sharp divergence in yields on bonds issued by different governments in the crisis has forced a re-evaluation of sovereign credit risk by investors, including insurers. There have been sales by insurers of some sovereigns on the grounds that the yields on their debt do not offset this risk and of a 'flight to quality'. But adjustment has come largely from the disposition of new investment funds, rather than via sales of existing sovereign holdings.

Respondents reported that their marginal appetite for sovereign debt is far below what it would be if they could, as before the crisis, assume it to be risk-free. Several stated that the composition of their and/or the sector's sovereign bond holdings had altered during the crisis. Since mid-2009, they have displayed increased 'home bias'[76], which has helped to ease funding pressures for some governments.

Various justifications were offered to explain insurers' increased home bias.

- First, insurers that operate solely in one Member State tend to hold its sovereign debt only. Where the yields on it are high, pan European insurers which also restrict themselves to such debt rather than diversifying into other lower yielding sovereign debt can reap the same high yields and thus remain competitive with them.
- Second, matching with domestic assets mitigates currency risk, which arises from currency mismatches including potential mismatches arising from the possible dislocation of the euro.
- Third, in certain countries, national accounting rules would appear to reduce the cost of holding domestic sovereign debt. E.g. the Italian anti-crisis law allows Italian insurers to exclude certain unrealised losses on their current assets, including Italian sovereign bond holdings, from their eligible capital calculation for solvency purposes, on a temporary basis[77]. However, the apparent benefit to them was considered to be largely offset by the requirement that they post equity reserves (for the same amount) to meet such losses[78]. Moreover, the Italian approach, and similar approaches adopted in other Member States, do not permit them to ignore such losses in disclosures by listed insurers.

However, an increased home bias is also seen as potentially problematic.

- First, it reduces the extent to which insurers are able to diversify their credit risk across different sovereign issuers, exposing them to the risk that the value of domestic sovereign debt falls sharply, where the resulting losses cannot be passed onto policy holders. If this risk materialised the insurer would suffer immediate accounting losses if such debt was marked to market, which would feed through to its prudential capital. In practice, this risk is most acute for insurers headquartered in and/or most active in vulnerable euro area Member States, whose sovereign debt is under most pressure.
- In particular, a de facto home country rule removes the theoretical option of investing in non-domestic sovereign debt to capture the higher yields it may carry. In practice,

[76] With respect to euro area insurance companies and pension funds, this finding is consistent with the ECB (2011), 'Financial Integration in Europe' report, May.

[77] They have the option to not account at solo level for their unrealized losses provided that: (i) the valuation is coherent with the future cash outflow of the insurance undertaking; (ii) the difference between the most recent book value and the market value at year end is classed as a non-distributable – to shareholders - reserve.

[78] In 2012 under a new national law, the option to not account for unrealized losses shall be limited to EU government bonds, but there will be no predefined limits to the eligibility of the equity reserve for solvency purposes, provided that any supervisory measures can be taken by despite such eligibility, when the insurer's solvency is hampered. ISVAP is expected to issue a detailed regulation to implement this.

this is not material given insurers' unwillingness to take on the credit risk associated with higher yields.

- Furthermore, a policy of holding only domestic debt may increase group interest rate risk; as compared with an alternative policy of mixing high and low yielding euro area sovereign debt, on the grounds that the latter e.g. German bonds tend to rise in value, when high yield debt falls and vice versa.

Increased volatility

Certain respondents reported that the growth of variable annuities business has been boosted by the low and volatile interest rates experienced during the crisis. However, significant losses had been registered on older products. These stemmed mostly from the nature of the embedded options they contained, which made hedging them more difficult, though in most cases their business was relatively small.

Faced with increased asset price volatility, insurers have also sought to de-risk their investment books. Some[79] have done so by increasing their holdings of better quality bonds, including secured corporate bonds and bunds. They also stepped up their hedging of interest rate and equity risk via derivatives. However, insurers' ability to pursue such strategies is limited in practice by liquidity constraints in some markets, and their long standing 'buy and hold' culture. In consequence, portfolio adjustment has mainly been undertaken by the allocation of newly available investment funds, rather than by diversifying existing assets.

Liquidity risk

The importance of ensuring ready access to funds (to minimise 'liquidity risk'), especially for banks, has been demonstrated during the crisis. This risk is less acute for insurers than banks due inter alia to the nature of policy holders' claims on insurers which cannot be easily liquefied on demand at short notice. Instead their claims can normally only be lodged following an insured event, the probability of which is generally uncorrelated with the economic or financial market cycle; or by cancelling the policy, usually only at the cost of a substantial fee. Insurers are nonetheless at risk if e.g. they are forced to make major unexpected payouts due e.g. to natural disasters or increased surrender rates. Even in these cases, the lags involved are normally such that investments can be sold opportunely, rather than on a forced sale basis.

However, there remains a risk that insurers are unable to raise the funds they need, if their assets are illiquid and they are required to make larger than expected cash outflows to meet margin calls on collateralised business, claims and early surrenders. Reflecting this, the crisis incentivised insurers to manage their liquidity risk more effectively. Some respondents have chosen to centralise external funding activities across their groups and hold a central pool of liquidity, the use of which is steered at group level.

Reduced economic growth

In principle, a significant economic slowdown could reduce demand for insurance. It could also increase credit risk on insurers' investments, e.g. corporate debt, and thus reduce profits assuming that the insurer rather than its policy holders bear most of such losses.

In practice, respondents did not experience a notable rise in claims due to the crisis and the related economic deterioration in some Member States. However, one reported a slight rise in life claims, perhaps due to increased surrenders by customers with new, short-term liquidity

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[79] However, it should be noted that the split between secured and unsecured corporate bonds was provided by only four firms. Interestingly, the proportion of secured corporate bonds ranged widely, e.g. between 21% and 70% at end-2010.

needs. Another observed a rise in fraudulent claims on some non-life lines e.g. fire and motor, though overall this was not large enough to register at group level. Indeed the impact of the crisis was dwarfed for some firms by other unrelated factors including catastrophe risk e.g. from adverse weather, Fukushima etc., especially in 2011. Moreover, lower than forecast inflation due to reduced economic growth, helps to reduce claims from those projected on the basis of previous inflation forecasts. Nonetheless, insurers remain watchful in case damaging trends emerge in policy holder behaviour, e.g. lapse ratios rise in high spread countries.

Aggregate impact on composition of insurers' business

The aggregate impact of the crisis and other factors is reflected in the size and composition of respondents' combined balance sheet in 2010 compared with 2006 before the crisis.

Their overall EU life business increased significantly, reflecting in part lower yields which increased the value of their existing liabilities, as well as the enhanced appeal of new life contracts relative to certain other savings products in the crisis. However, their EU non-life business was broadly flat. Non-life business is more closely correlated with income growth, which fell below its pre-crisis trend in the EU. By contrast their global non-life business grew by 11% (as compared with 4% for their global life business), due to buoyant developing country business.

Chart 4.3.1 below shows the composition of respondents' combined assets in both years, using their data. Changes in the value of particular assets reflect both changes in market prices for them and volume changes (purchases or sales). The key points are as follows:

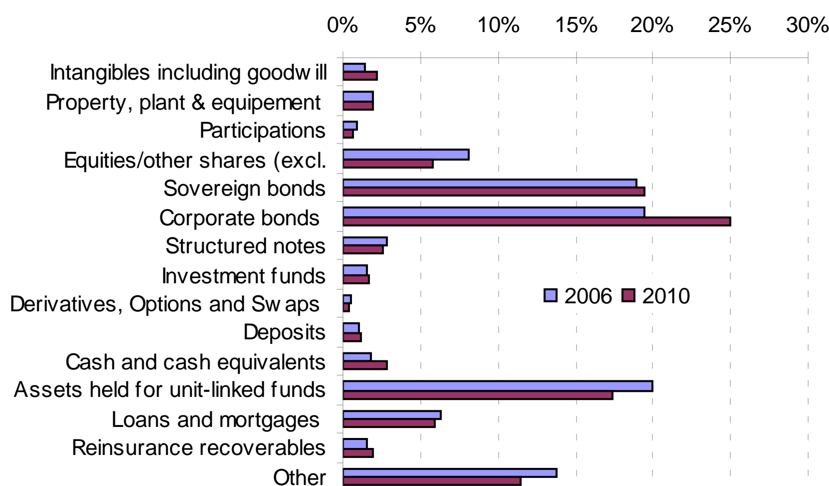
- Corporate bonds increased from 19% to 25% of their total assets over 2006-10. This reflected not only price movements, but also new investments in non-financial corporate bonds. Some respondents reported a switch to highly rated and covered bank bonds. Original maturities were typically in the three to five year range. Many respondents stated that they sought to increase investments in corporate bonds, even if the latter did not have a senior rating. However, the potential for new investments in non-financial corporates is limited, since corporate bond markets in Europe are less developed than in the US.
- The percentage of sovereign bonds to total assets was broadly flat. Most respondents reported an increase in their 'domestic'[80] holdings.
- Equities'[81] share in respondents' assets dropped slightly in 2006-10 (from 7% to 5%). The decrease in equities in the crisis appears to have been mainly driven by falling equity markets. The reduction was much smaller than that after the dot-com crisis, when respondents reduced their equity holdings, from around 20% to around 7% of total assets by 2006. The 2007 crisis highlighted the risk associated with the equity stakes of insurers in banks, and thus the need for them to be managed separately and intensively.
- The share of direct loans to corporates, and mortgages in total assets remained almost flat over 2006-10 at about 6%. Insurers, which hold mortgages against their long-term life liabilities, cited the extremely low default rate to date.
- Property, plant and equipment fell only slightly. Looking ahead, some participants plan to increase and diversify their property holdings, in part to fill the gap left by reduced bank funding to this sector since the crisis. But others envisage reducing them in reflection of their reduced risk appetite.

[80] Meaning holdings of home Member State sovereign bonds.
[81] Excluding equities held for unit-linked funds.

The data does not show securitisations. One insurer noted the specific lessons learned from the crisis in relation to the risk on structured credit, including the need for increased capital and new pricing models.

The figures do not indicate a major switch into investments in assets with high expected returns, such as equities, lending, mortgages and property[82]. It should, however, be emphasised that the relative weight in total assets of certain asset classes varied considerably between insurers. For example, the range for sovereign bonds was 6% to 25% of total assets, with vulnerable country issuers having the highest percentage. By contrast, the weight of corporate bonds and equities in total assets was broadly similar in nearly all participants.

Chart 4.3.1. **Asset composition of eight respondents in 2006 and 2010** (assets as % of total assets on average)



Source: Respondents' data

4.3.2 How has new regulation affected insurers' underwriting and investment business?

General issues

A large number of regulatory and supervisory initiatives are expected to affect insurers' business and have already done so in some cases. The extent to which insurers will implement them in advance depends in part on how certain it is that proposed reforms will be adopted, how confident they can be about the detail, likely transition periods and market pressure to implement them early.

In order for new regulation to achieve its goals, the interactions between different reforms should be considered especially where their effects conflict with, rather than reinforce each other. For example, an increased supply of long term bank debt may result from proposed liquidity and crisis management requirements for banks. However, some respondents considered that Solvency II[83] discouraged them from holding 'long term assets' in general, including long-term bank debt. The Commission's view is that Solvency II incentivises insurers to reduce their credit risk and to hold long term bonds to match long term liabilities, while also disincentivising the holding of bonds which carry a high credit risk, including from banks.

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[82] Separate figures for certain asset categories, such as private equity, commodities and infrastructure, which would facilitate a more detailed analysis, were not available.

[83] It was recognised in the interviews that not all of the detail had been finalised.

While it remains hard for insurers to rank the importance of new regulations since most has not yet been finalised, respondents all saw Solvency II as by far the most important. Other key initiatives included PRIPs, insurance mediation, IORP (institutions for occupational retirement provision) and that on gender policy. These and other measures are discussed below.

Solvency II

(i) Capital

Partly motivated by the launch of the Solvency II project in 2000, large insurers started constructing and in some cases applying internal capital models before the 2007 crisis, which have helped them through the crisis. However, only a small number of Member States allow their use for prudential purposes (in addition to Solvency I). Nearly all respondents plan to use full or partial internal models to calculate their EU wide capital requirements under Solvency II including those who do not use them at all now.

Insurers will be much more risk sensitive under Solvency II in respect of their capital allocation. This applies especially to those insurers which do not currently[84] apply a risk based approach[85]. Nearly all respondents by contrast already apply a risk-based approach for internal risk management purposes and the allocation of economic capital. Insurers will also increasingly assess the overall impact on their capital requirement after diversification. Some respondents have already examined the capital required against assets under Solvency II and adjusted their asset allocation accordingly, including by e.g. holding more covered bonds. The scale of the diversification 'dividend' from Solvency II capital requirements will be substantial for well diversified insurers' (30%-40% reductions[86] from current requirements were cited by some respondents. The recognition of diversification in prudential requirements could advantage large and well diversified insurers more than those that offer only one type of business (e.g. only life), typically monoliners[87]. It was considered that, at the margin, this could contribute to industry consolidation, reinforcing the importance of activist competition policy. In practice, however, it may be outweighed for some firms by the impact on them of Solvency II's other requirements e.g. in terms of organisation/corporate governance and compliance.

Insurers are seeking to de-risk themselves because of their experience in the crisis of e.g. the risks associated with guarantees and, in the view of certain respondents, due to the lack of appropriate countercyclical measures in Solvency II. They have a number of options in this regard, some of which they are actively considering if not yet adopting, including by:

- Reducing guarantees on new life products, and in extremis by no longer providing them. However, this makes it harder for insurers to help efforts to meet the EU's demographic challenge.
- Replacing guaranteed with alternative, less capital intensive, fee-based products without guarantees such as certain unit-linked products. However, such products are highly sensitive to market conditions and thus may not appeal to policy holders.

[84] Under Solvency I, capital requirement reflect technical reserves (for life business) and premiums and reserves (for non-life).
[85] Other drivers include pressure from investors and rating agencies.
[86] EIOPA reports a 35% figure for participants in QIS5 –See EIOPA (2011), 'EIOPA Report on the fifth Quantitative Impact Study (QIS5) for Solvency II', graph 10, p.31, March.
[87] However, this ignores the point that the recognition of reinsurance in Solvency II, but not Solvency I, is likely to benefit small insurers more than large insurers.

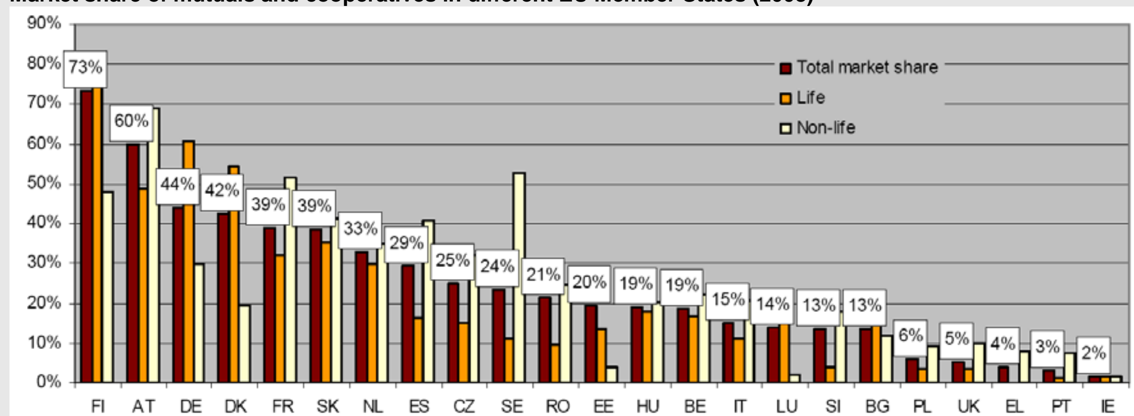
- Retreating from activities heavily exposed to market conditions such as savings and asset management; and focussing more on pure insurance products, e.g. property and casualty, as well as death and disability protection.

The precise form that Solvency II (including Level II implementation measures) will take is not yet finalised and work is under way to address some of the above issues, e.g. by adjusting the requirements against guaranteed products. It could nonetheless have a business impact on particular types of insurance companies (see Box 4.3.1 for a discussion of the possible impact on mutuals).

Box 4.3.1: **Mutual insurance companies**

Mutual insurance companies have no shareholders, but are owned instead entirely by their policy holders. Their market share by premiums in Europe amounted to close to 25% in 2008[88]. The share of mutuals and cooperatives varies considerably across Member States (see chart below).

Market share of mutuals and cooperatives in different EU Member States (2008)



Note: ICMIF Annual Mutual Share & Global 500 for 2007-2008, 2010. Calculated by the authors. The values represent the total market share.

Source: European Parliament (2011), 'The role of mutual societies in the 21st century', Directorate-General for Internal Policies, Employment and Social Affairs, IP/A/EMPL/ST/2010-004.

Mutuals add to the diversity of the insurance industry and enhance competition. It has been argued that they fared better than joint stock insurers in the crisis, reflecting inter alia their stronger capital and longer term perspective, but persuasive empirical evidence is lacking[89]

Since mutuals cannot raise share capital, and the alternative option of making calls on their members is cumbersome and therefore extremely rarely applied, their capital largely comes from accumulated earnings. This could in principle make it challenging for them to raise high quality capital (Tier 1 own funds under Solvency II) in a sufficiently timely fashion as compared to joint stock insurers that are able to issue share capital as well as increase their capital through earnings. However, Solvency II allows a significant proportion of capital requirements to be met with Tier 2 and Tier 3 own funds in the form of ancillary own funds[90], such as calls mutual insurers can make on their members. In addition, the option of issuing share capital can often be prohibitively expensive in difficult markets. Moreover, the Solvency Capital Requirement (SCR) is not a floor, which means that any insurers, including mutuals, which breach it, are not required to take immediate steps to make up the shortfall. This reduces the burden of complying with Solvency II's capital requirements.

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[88] Based on gross premiums and including EU, Norway and Switzerland; source AMICE.

[89] See European Parliament (2011), 'The role of mutual societies in the 21st century', European Parliament, Directorate General for Internal Policies, p.63-64, July 2011.

[90] Off balance sheet items which will increase the excess of assets over liabilities that an undertaking has once an item is called upon and paid in.

The minimum requirements to be a mutual are broadly similar in Solvency II to those in Solvency I. In particular, special provision is made for national rules to continue to apply to undertakings including mutuals below a certain size, operating in only one country. Thus such small mutual start-ups are not disadvantaged relative to their position pre-Solvency II.

(ii) Reporting

The harmonisation of reporting requirements in Solvency II, including standard reporting templates, was seen to facilitate material ongoing IT savings, once an insurer has made the necessary one-off investment to upgrade its IT system. E.g. it enables insurers to revamp their internal reporting systems to provide not only the requisite information under Solvency II, but also the information required for internal 'front end' purposes. It was observed that in the same way, the introduction of IFRS in 2004 had been a catalyst for some insurers to pool different information streams including for accounting and control purposes, via new IT systems. However, some respondents consider that greater clarity on what is required by Solvency II Directive is necessary for firms to finalise such planning.

Insurance accounting

Some respondents consider that the diversity of national GAAPs could provide an incentive to adopt one corporate structure rather than another. E.g. if the application of restrictive national GAAP rules – e.g. with regard to equalisation reserves in some countries – to foreign branches led to higher capital requirements for foreign business, this could push them to opt for subsidiary status instead. One considered that if surplus capital held in foreign subsidiaries was not recognised as capital available for the group as a whole, insurers might respond by pushing debt down to their overcapitalised subsidiaries, as a means of transferring capital to the parent.

The scope of national quarterly disclosures varies widely. There was a case for 'light' not 'heavy' disclosures, given insurers' dependence on the estimation of liabilities as well as the short-term pressures they imposed on management. But one respondent observed that it could be very difficult for an individual Member State to make such a switch during the crisis, given the likely market reaction.

Pensions

IORP, which covers certain occupational pension providers, is under review and an EU proposal to revise it is scheduled by end-2012. Insurance companies are important providers of pensions as well as service providers to, and operators and managers of IORP. Several respondents consider that uncertainty about the prudential requirements in IORP, including how they relate to the requirements on insurers' pensions business under Solvency II, as well as when IORP will be agreed and come into force, create uncertainty for insurers and other pension providers as they plan ahead. They believe that given the importance of pensions, it is important to remove such uncertainty as soon as is practically possible; and if feasible, to ensure a level playing field in the requirements for pension providers, including in respect of consumer protection.

The insurance intermediation review, PRIPS and MiFID

It was observed that the raft of consumer protection focussed regulation that has been proposed or is envisaged, could have a bigger direct impact on the policy holder than all other regulatory measures. In particular, simple, well calibrated disclosure requirements, which allow consumers to compare the prices of economically similar products; together with harmonised rules on financial advice (covering suitability, fees, conflicts of interest etc.) could increase consumer trust in the financial - including insurance - sector. They could thus lead to increased demand for insurance services. However, several respondents note the risk

that, if not well calibrated, new regulatory as well as tax requirements (on e.g. surrender penalties) could have a significant negative impact. In addition, some consider that certainty about new EU and indeed national rules is crucial for insurers, as they plan what products to supply in future.

Gender

Following the Test-Achats ruling of the Court of Justice,[91] new insurance contracts concluded as of 21 December 2012 may not differentiate between male and female customers. The obligation not to differentiate concerns both insurance premiums and benefits. As a result, insurers need to make significant systems changes (predominantly for life assurance, but also motor insurance), and other adjustments to their business, in certain Member States. Moreover, it is likely to affect premiums (or benefits) on certain products, e.g. raising the cost of annuities for men, and perhaps overall demand for insurance products. One respondent stressed the need for more clarity to be provided concerning EU and national rules since this was crucial when planning what products to supply in future.[92]

Credit rating agencies

Respondents state that EU regulation concerning rating agencies has not in itself caused them to change the way in which they use external ratings. However the crisis has meant that ratings are seen as less informative than before. This has led some of them to strengthen their complementary in-house credit monitoring so as to produce internal ratings. Such internal ratings are used to inform investment decisions, for risk management and to better align internal capital with the risks associated with their asset portfolios. One respondent observed a shift away from external ratings to market implied information including CDS spreads. Separately, the main fixed income benchmark indices used by insurers tend to rely on external ratings, even though yields on similarly rated issuers can vary widely. It was suggested that indices which automatically remove issuers exhibiting abnormal returns would be more useful to insurers. However, official pressure might be necessary to persuade banks constructing such indices to modify them in this way.

4.3.3 Impact on pursuit of EU objectives

The crisis and regulation have had a major impact on respondents' business. The crisis has given rise to, or made more acute a number of challenges, including those relating to low interest rates, sovereign indebtedness and reduced growth, which continue. Regulatory initiatives have helped firms respond to them. But their full implementation, especially the speedy entry into force of Solvency II, stands to materially strengthen policy holder protection. Per se, the de-risking undertaken by many respondents in the crisis, including the shift to insurance as opposed to market risk, is conducive to financial stability. Careful calibration of proposed Solvency II implementing rules and new accounting regulations is vital to ensure that new regulation does not inadvertently adversely affect the long term financing of corporates. The crisis, especially the low interest rates set in response to it, has made it more difficult to ensure that long-term savings are sufficient to meet the growing EU pensions gap. The crisis and new regulation have not had a major impact yet on competition. It will be important to make sure that the final form of Solvency II proportionately caters for the full range of players in the sector, thus supporting diversity in the sector which is conducive to financial stability.

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[91] Judgment of 1 March 2011 in Case C-236/09, OJ C 130 of 30.4.2011, p. 4

[92] See Guidelines on the application of Council Directive 2004/113/EC to insurance, in the light of the judgement of the ECJ in Case C-236/09 (Test-Achats) http://ec.europa.eu/justice/gender-equality/files/com_2011_9497_en.pdf

4.4 EXPERIENCE OF THE SINGLE MARKET

This section considers respondents' experience of the Single Market. First, it examines their views on what the objectives of a Single Market and integration in the insurance market, mean in practice, what determines the size of the market and its level of integration. It then examines the benefits they have reaped from it, factors determining how they entered different national markets, how they have operated cross-border (including the relative advantages/disadvantages of branching and subsidiarising for pan-European insurers) as well as the impact of the crisis and regulation on their EU business.

4.4.1 Objectives

Several insurers consider that the Single Market should ensure that:

- An insurer that is based in one Member State can choose the legal structure it wishes, to provide services to an insuree in another Member State.
- EU and/or national laws should not incentivise it to opt for one legal or operational structure rather than another.
- Unless it is impossible to achieve the policy objective underlying such laws without this effect.

The main means of providing such services are via:

- The provision of insurance services by an insurer in one Member State to insurees in another.
- Their provision by branches located within a host market.
- Their provision by a subsidiary located therein.
- An insurer in one Member State forming strategic alliances with market incumbents in another, for them to sell its products in the latter's markets.

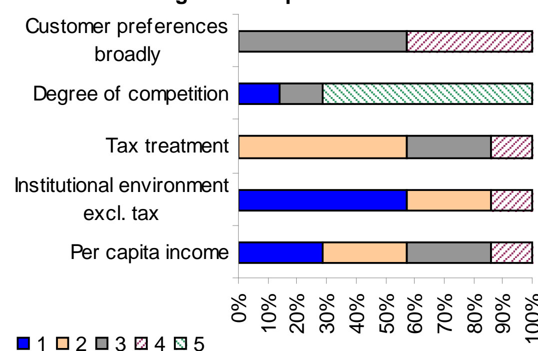
The extent to which the EU insurance market is 'integrated' should be considered by reference to the type ('line') of insurance concerned (e.g. primary life and non-life, reinsurance) and by function – product development, distribution and operations. An integrated line or function is considered to be one for which most components of the value chain can be shared across different countries in the EU; conversely, a segmented one means that they are conducted within one country due to e.g. the differences between national regulation, supervision, taxation and customs.

4.4.2 Size of national markets

The relative depth of a national insurance market can be measured by the ratio of gross premiums to GDP (its 'penetration ratio'). Six respondents consider that the institutional environment – excluding tax, but including the social security system, and for example the extent to which specific types of insurance such as health or car insurance are compulsory or not – is the main factor determining penetration ratios (see chart 4.4.1). Life insurance provision e.g. is generally much greater in countries where there is a low level of public provision of pensions. Similarly, the obligatory nature of certain types of cover in some countries (e.g. for physicians, as well as general health insurance in the Netherlands) has spawned large markets.

The second most important factor is perceived to be per capita income. Data presented for a number of countries including outside the EU, suggests that the relationship is stronger for non-life than for life insurance, implying that a prolonged period of below trend growth would especially impact non-life insurance. The correlation is most pronounced in emerging rather than mature markets. The desire of some insurers to expand in the CEEs reflects this long term relationship. Life insurance is considered more closely linked to personal disposable income, i.e. post tax, debt servicing etc., than non-life.

1 **Factors influencing different penetration ratios**



Source: Respondents' data. 1 stands for the most important factor and 5 for the least important one.

Tax (which affects the appeal of certain insurance products, relative to other investment products) and customer preferences/'culture' broadly are considered the third and fourth most important variables explaining divergent penetration ratios.

4.4.3 Level of integration in EU insurance markets

Overall

Respondents consider that the reinsurance sector is significantly more integrated than primary insurance markets, since the reinsurance business is a global one. In contrast, primary markets are much more segmented, reflecting both national public policies (spanning e.g. law, tax and social security) and natural 'barriers' (e.g. language, culture, product preferences and local distribution preferences). Within them, life insurance is perceived to be more nationally segmented than non-life/health. Within functions, primary insurance distribution is less integrated and thus more 'localised' than product development and operations. However, the situation is not static and integration is increasing in a number of areas (see below). Nonetheless, respondents suggested a number of initiatives (stated below) which could deepen integration and competition, to the benefit of policy holders.

Product development

The lack of integration of product development for life reflects differences in national social security systems and consumer preferences; as well as the local 'rules' concerning such products and related tax incentives for different financial products. Transferring innovative products from one country to another requires often complex local adaptation. Progress was nonetheless reported on variable annuities, and in respect of the distribution of certain UK products to other countries. Should governments reduce their pension provisions, in reflection of current fiscal pressures, the demand for certain life products is likely to increase across many EU countries simultaneously. If the level and form of support they provide through the tax system increases too, demand for and development of similar life products could increase.

Non-life and health are also partly nationally segmented, notably for individuals. This reflects differences in legal frameworks (including what type and level of insurance is compulsory), institutional arrangements (e.g. the scope of public health cover) and other factors (e.g. taxation rules, renewal date procedures, different national histories regarding product preferences etc.). However, pockets including general insurance cover for large corporates, marine cover and health insurance for expatriates, are much more integrated.

Moreover, there are signs of EU products gradually emerging in other areas, e.g. motor insurance, notwithstanding differences in e.g. crash rates.

Distribution

Distribution arrangements are more country, than business line specific, by contrast to product development and operations. They differ significantly across the EU. Bancassurance - defined here as a partnership between a bank and an insurance company, which enables the insurer to use the bank as a sales channel – is especially important for life products in France, Italy, Spain and Austria. It provides an effective means of providing services into an entirely new market quickly. By contrast, agents play a major role in Germany and brokers in the UK. Non-life distribution is more uniform, with agents and brokers providing the most important channels, due to the need for a reliable after sales service. Brokers dominate in commercial and industrial lines of business. Direct insurance including over the internet and by phone has increased sharply, but remains national rather than pan-European given differences in national laws (including the jurisdiction of the court that deals with contractual disputes), redress mechanisms, cultures etc. It is used more for non-life than life. There is growing interest in the potential benefits of new technologies, e.g. the potential of social network platforms for distribution and market research purposes. Ireland and Luxembourg are the main centres for the remote (i.e. freedom of services) distribution of life products.

Operations

A large part of operations, e.g. claims management, remains local. However, where a group approach is efficient, as for certain aspects of IT, respondents seek to integrate associated standards, processes etc., leaving local systems to address local issues such as those related to contracts. Such integration may occur across particular countries as well as at higher levels within the group.

Proposals to deepen integration

Individual respondents suggest a number of ways to further integration to the ultimate benefit of the policy holder. These include by:

- Streamlining policy wording requirements so that one standard form can be applied to all Member States.
- Harmonising insurance guarantee schemes (IGS) to ensure that consumers enjoy the same level of protection across the EU, irrespective of whether they purchase their insurance from a domestic insurer or not.
- Harmonising the general good requirements that govern local conduct of business.
- Minimising or making more transparent the variations in local mandatory requirements (e.g. compulsory cover conditions, social and labour costs, mandatory pooling arrangements and other general good/conduct of business requirements).
- Eliminating differences in accounting rules.
- Harmonising 'squeeze out' rules regarding minority shareholders at EU level. Different national laws here may make it difficult for a majority shareholder to implement its pan-European strategy in terms of e.g. mergers and setting up new branches.

4.4.4 Benefits

Respondents receive significant benefits from diversifying their underwriting and investment business geographically, including from supplying services to fast growing markets including in the EU. These benefits are reflected in less volatile P&L due to enhanced access

to capital markets, as well as product and geographical diversification in the EU; and will result in reduced capital requirements under Solvency II.

Expansion also allows for significant economies of scale, e.g. from best practice and know-how sharing in respect of underwriting, bancassurance, distribution (including sales force management), claims handling, risk management and IT (e.g. consolidation of European data centres) especially where the same language is used and/or similar business models/portfolios, procurement and branding. In addition HR benefits accrue from establishing a distinct culture across the firm and from being able to offer international careers to potential recruits and existing staff.

However, the scope for economies of scale varies considerably between different areas. E.g. IT systems can be used with some adjustments across the EU, but pricing and administration must generally be done locally, reflecting language and other barriers. Second, they are limited compared to other industries due to differences in product specifications and distribution networks across the EU. Third, different national tax treatment may impede some forms of cross-border business.

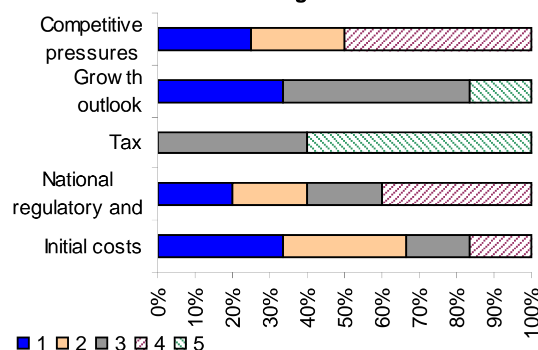
4.4.5 The way respondents operate in the Single Market

Entering new markets

The potential for market growth was the single most important driver of expansion into new markets, followed by the degree of competition and reflecting this, perceived profit margins (see chart 4.4.2 below).

In most cases respondents entered new markets by acquiring an incumbent firm. This allowed them to exploit local knowledge and economies of scale immediately. Where acquisitions were not possible, opportunities for joint ventures, e.g. minority stakes that may be subsequently increased were considered. Green-field sites tended to be chosen in markets with the most growth potential, in which the insurer's existing capability could be leveraged. Green-field sites and joint ventures were more common in new Member States.

Chart 4.4.2 **Factors influencing the form of market entry**



Source: Respondents' data, 1 stands for the most important factor and 5 for the least important one.

Acquisitions and green field start-ups alike tend to be subsidiaries, especially on the life side. A strong business case is generally required before such decisions can be reversed, given the cost and time (often several years) required for doing so. Reflecting this, subsidiaries dominate the current stock of respondents' EU life affiliates. The majority of respondents undertake their non-life business too via subsidiaries, rather than through branches.

Competitive pressures have nonetheless led some firms to consider the way they operate cross-border, including the case for remote provision of services and where as in most cases services are provided locally instead, whether to do so from branches or subsidiaries. The introduction of the European Statute has provided a further option for pan-EU insurers.

Remote provision

Provision of services from an entity in one Member State to a consumer in another, remains very small-scale, due in part to differences in national laws and conduct of business

requirements. These relate inter alia to claims handling procedures, compensation fund requirements, and participation in mandatory pools such as terrorism cover for large risks. Thus primary insurers are only able to make a business case for such provision in the case of specialised consumer groups, e.g. multinational corporates, for which compliance with regulatory (including conduct of business) and tax requirements can be dealt with centrally. Such a case rests on the benefits of a central platform, common staffing and infrastructure. Even then, arrangements must be made to meet local general good requirements. Moreover, such 'international business' may not be covered by the local policy holder protection scheme should there be one. As a second best, insurers have sought to centralise certain back office functions to benefit from shared know-how, low/negligible marginal costs etc. These include product manufacturing where expertise in one country can be leveraged to produce similarly products for another and IT, where this is not prevented by outsourcing restrictions.

Branches and subsidiaries

Primary insurance services are mainly provided by branches and subsidiaries in the same Member State as the policy holder. The market share of foreign controlled undertakings and branches/agencies of such undertakings in overall EU primary insurance reportedly stood at 37% in 2009, almost double its level in 2000 (19%). This indicates the large increase in the provision of services by non-domestic insurers.

The savings from a branch structure are deemed to accrue from the more efficient use of capital, a reduction in corporate governance costs (e.g. less board meetings), and lower compliance costs (as they are subject to the regulation and supervision of the home Member State) including under Solvency II and greater management control.

However, respondents pointed to a number of possible incentives to subsidiaries including:

- National accounting rules where these applied to branches (see above).
- The greater transparency of profits/losses and taxation for a subsidiary, compared to a branch.
- National authorities' concerns about foreign branches given the different national prudential requirements under Solvency I and the diversity of national GAAPs, combined with the mismatch between the ability of domestic authorities to supervise foreign branches and their perceived responsibility for doing so. These concerns, which are stronger for life than non-life providers, have in practice deterred most but not all large insurers from adopting a branch structure in the EU.
- Customer uncertainty about the robustness of their potential claims against a foreign branch, as opposed to a locally incorporated subsidiary of the same firm – especially in the absence of a harmonised EU insurance guarantee framework.
- The ability at least in principle, for a parent to allow a subsidiary to fail, without fatally damaging the parent; which is significantly harder to do with a branch.

In practice, branches tend to be used for global lines, where the services provided e.g. health insurance for expatriates are relatively homogeneous across countries. They are also used for some functions within the group, such as back office. Branches are expected to multiply if product manufacturing, distribution and operations continue to become more homogeneous.

European Company (SE) status

The adoption of the Regulation on the European Company Statute in 2001 enabled insurers to choose to take this legal form (*Societas Europaea*). In principle this allows the firm to transfer its registered office within the EU without dissolving the company in one Member State in order to form a new one in another Member State. This freedom, which could have

beneficial tax implications, is subject to a number of conditions. Respondents considered that SE companies had gained minimal practical advantages to date.

Opportunities

Respondents stressed the need for innovation in insurance given the insurance challenges presented in EU markets. These included:

- The pension crisis[93] and demographic challenges.
- Health insurance as public health services are cut back.
- Mitigating, managing and financing large-scale natural disasters e.g. flooding.
- Supply chain risk, which the crisis revealed to be a major economic risk (e.g. in the automobile sector).

More broadly, European insurers maintain a large share of the global insurance market. Their global competitive position will be strengthened by measures which make the Single Market in insurance more competitive and thus innovative.

4.4.6 How has the crisis affected insurers' EU operations?

The economic and political ramifications of the financial and sovereign debt crisis have underlined the importance of a well-functioning financial system, including the insurance sector. Reflecting this and most insurers' relatively safe passage through the crisis to date, some national authorities have reportedly been reluctant to allow foreign headquartered insurers to restructure themselves in such a way as to substantially reduce domestic supervisors' locus over them, in particular via setting up branches. In the face of such perceived concerns and the length of the legal process required to mount a challenge, insurers have largely desisted from pursuing such restructuring, thereby forgoing the associated efficiency savings. This could mean that the potential benefits to consumers and insurers alike from a deeper Single Market in insurance are not fully realised.

In addition, respondents expressed concerns that certain national authorities, partly in response to severe fiscal problems, have made proposals, which de facto discriminate against foreign financial institutions including insurers. One respondent referred e.g. to recent proposals in Hungary regarding private pension contributions and also employee benefits.

The need to perform in difficult market conditions, has reinforced the trend for large insurers to focus on taking leading positions in markets where they see the opportunity to register significant, risk adjusted profits in the long term, and to withdraw elsewhere, thus reducing the number of markets in which they are active.

4.4.7 How has regulation affected insurers' EU operations?

The differences in national regulation, and the interpretation of EU regulation which, together with other factors including the institutional environment, contributed to the adoption of a subsidiary rather than a branching structure in the EU by large insurers, have not diminished in the crisis. While Solvency II and to a lesser extent future EU accounting regulation[94] will remove some of them in future, most respondents are not yet sufficiently

[93] One insurer has estimated that Europe's annual pensions gap is EUR 1.9 trillion. This is the gap between what citizens need to save for retirement and what they actually put aside across the 27 EU Member States. The calculations assume that, on average, people need 70% of their pre-retirement income to provide an adequate standard of living in retirement and a 5% p.a. return on investment in pension funds.

[94] The consequence of different accounting rules now is that several sets of accounts have to be prepared to meet the different requirements, which adds to the cost of operating in more than one Member State.

certain about the final outcome, to restructure before they are agreed. However, a minority have made progress in this direction, basing their strategy in part on their assumption that EU regulation and supervision will become significantly more harmonised post-Solvency II. Some respondents stress the need to ensure more clarity as to the remit of different regulatory and supervisory authorities so as to reduce uncertainty and potential conflict as to the boundaries between them.

Some respondents considered that host authorities would continue to invoke 'general good' provisions after Solvency II, which given their heterogeneity and in some cases, complexity, would act as a barrier to the integration of retail products e.g. health and life products.

4.4.8 Impact on pursuit of EU objectives

The crisis has increased the search for costs savings via the integration of insurers' cross-border business in the Single Market, but also made it more difficult in some cases for insurers to effect the necessary structural changes (e.g. cross-border branching).

The completion of specific EU regulatory initiatives, notably in respect of Solvency II and accounting, but also a number of targeted new initiatives, offer the prospect of a deeper Single Market, which brings material benefits to policy holders.

4.5 CONCLUSIONS

4.5.1 Organisation

The 2000-02 'dot com crash' led insurers to focus increasingly on ALM and a more risk-based approach to their investments. In doing so, it had a greater impact on insurers' internal organisation than the current crisis. Moreover, senior management, incentivised in part by market pressure on them to 'perform', has been a further force for change in some insurers.

While the crisis has not affected functions such as risk management and ALM appreciably, the group's (HQ) locus within them has expanded significantly so as to cope with the increased market and other risks from the crisis. However, the length of time over which insurers' losses materialise, especially on life business, make it difficult to draw firm conclusions at this stage regarding the overall impact of the crisis on insurers.

Recent 'simplification' initiatives have been pursued to reap cost savings, as well as to enhance management's ability to respond effectively to the unfolding crisis. Examples include a reduction in the number of legal entities (e.g. from around a thousand companies to approximately 600 over 2000-2011 for one insurance group), new standardised group-wide IT services, the sale of non-insurance affiliates and the withdrawal of some non-insurance lines.

4.5.2 Underwriting and investments

Low interest rates

The crisis has resulted in low interest rates which the market expects to be maintained over a prolonged period. They typically have a negative effect on insurers since the capital gain on their fixed income assets is normally outweighed by the increase in the discounted value of their liabilities from applying a lower discount rate and a short duration mismatch. In particular, they create problems for primary insurers which have written large amounts of guaranteed life business in countries with abnormally low sovereign yields and thin, long-term bond markets which make matching such business challenging. Low interest rates and the de-risking of insurers' books (partly to smooth earnings) will reduce the level of

guarantees offered on new life products and thus the demand for them. By doing so, it makes it harder for insurers to help efforts to increase long term savings - the EU's annual 'pensions gap' is estimated by one firm to be nearly EUR 2 trillion a year. An alternative would be for them to provide higher returns by holding riskier, and thus higher yielding assets. While there are few signs of that as yet, continued supervisory vigilance is called for.

Some insurers would like to increase sales of life products, for which the policy holder bears the risk e.g. unit-linked policies. But these are unlikely to take up the slack, given fierce competition from banks (reflecting their wholesale funding problems) and other savings products including UCITS. Therefore, some insurers wish to focus on insurance per se (i.e. P&C, life protection and health products, protecting against mortality, morbidity risks etc.), as opposed to savings, unit-linked and asset management business which bear mainly market and credit risk. Other things being equal, a shift away from savings-type insurance products would further reduce the link between the financial crisis and the stability of the sector, given the limited correlation between the economic/financial market cycles and the underwriting cycle for such risks.

Home bias in insurers' sovereign debt holdings

Insurers reported that EU insurers increased the proportion of domestic sovereign debt in their overall sovereign debt holdings (this includes their foreign subsidiaries' holdings of host country sovereign debt) during the crisis, and there is some, albeit incomplete evidence to support this. Given that the perceived default risk on high yield, euro area sovereign debt has increased during the crisis, this finding is surprising at first glance.

Other risks

Insurers' large exposures to banks, especially but not only on the fixed income side, mean that they remain vulnerable to a further deterioration in the banking sector. A continued sluggish EU economic recovery will restrict the growth of general insurance, which may enhance competition and bear down on premiums in this already tight market. Insurers appeared less concerned about lapse ratios rising if growth weakened. While they remained vigilant, other risks e.g. from natural catastrophes had proven much greater in recent times.

Opportunities

The fiscal impact of the crisis is expected to accentuate a trend reduction in the width of governments' social welfare net (including health and pensions services). This should provide major opportunities for the sector. The level and slope of the yield curve, as well as insurers' ability to match their assets and maximise their returns will help determine how attractive insurers' offerings are in this growing market. The increasing costs of natural disasters, and the needs of the world's growing population, will also increase demand for insurance.

Solvency II

Solvency II is already having a significant impact. It has induced firms and their authorities to embrace some of its provisions early. These include introducing stress scenarios (including their impact on policy holder behaviour) and internal models (thus risk-weighted capital allocation), as well as ramping up the profile of risk management. Some concern was expressed that the diversification benefits and compliance costs of Solvency II may advantage large pan-EU insurers given the broad composition of their business and their capacity to bear the increased compliance 'overhead', relative to monolines/ small insurers including mutuals[95]. If so, the diversity of the sector, and thus the resilience of the financial system could be reduced.

Disclosure

The scope of national quarterly disclosures varies widely. There was a case for 'light' not 'heavy' disclosures, given issuers' dependence on the estimation of liabilities as well as the short-termist pressures they imposed on management. But it could be very difficult for an individual Member State to make such a switch during the crisis given the likely market reaction.

4.5.3 Single Market

Some interviewees expressed a wish for a Single Market in which an insurer could choose the legal structure it adopts to provide services to an insuree in another Member State without EU and/or national law incentivising it to opt for one structure rather than another, unless there was an unassailable reason for this. But this did not apply in practice; e.g. the diversity of national GAAPs. One respondent suggested that a new study be undertaken to identify precisely, any material, unjustified obstacles to the Single Market in insurance that remain in place and ways of removing them.

Branches were seen by some as cost efficient; and two companies had sought to switch some of their operations from subsidiaries to branches for this reason. However, the greater transparency of a subsidiary's performance and taxation provided a counter argument; as did the possibility for a parent to 'ring fence' risks across the group by using separate subsidiaries, something which did not apply in the case of a branch.

In reality, certain interlocutors considered that some domestic authorities were against allowing foreign branches. Indeed their opposition had increased in the crisis, in the light of the domestic perception that they were responsible for policy holders, irrespective of whether an entity was a branch or a subsidiary. But insurers, in their drive to reduce costs, are likely to press increasingly for unjustified national obstacles to such rationalisation to be removed.

The greater harmonisation of prudential and accounting requirements that is proposed, accompanied by a growth of trust between national supervisors, should ease some inhibitions about the loss of control that this entails. But prospects for significant progress in this direction will be slow so long as the financial system including financial markets remains fragile, increasing the perceived risk of financial institutions failing, especially when insurance guarantee schemes do not exist in every Member State, and it is not proposed harmonise them at EU level. Moreover, differences in national social security systems, tax and consumer preferences will continue to make it highly unattractive to provide life as opposed to non-life services from a foreign branch.

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[95] They accounted for around a quarter of gross premiums for the EU insurance sector in 2008.

CHAPTER 5: EU HOUSEHOLDS AND THE FINANCIAL CRISIS

5.1 INTRODUCTION

The financial crisis has had important implications[96] for EU households, including via its impact on growth, employment, earnings, disposable income, public finances, the provision of public services, savings ratios[97] and wealth including financial as well as non-financial (e.g. housing) wealth. Drawing on some aggregate EU as well as national data in respect of their financial balance sheet, this chapter considers how household financial wealth evolved during the crisis and why. Rather than providing an exhaustive account, it seeks to highlight how households have been significantly affected by the crisis, thereby raising some new challenges for EU policy makers.

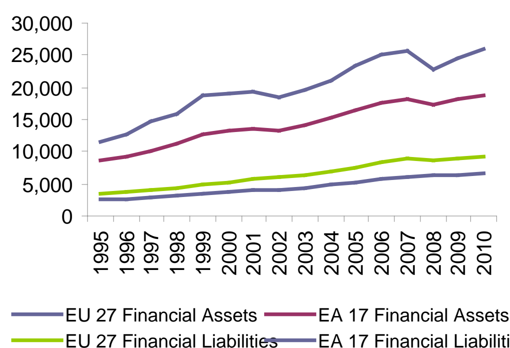
Section 5.2 examines aggregate household balance sheet data, followed by section 5.3 on the impact of households as users of the financial system[98], in particular as savers and investors, insurees and borrowers (particularly as mortgagors). Section 5.4 briefly considers the finding of the Commission's latest 'Consumer Markets Scoreboard' survey, with the main conclusions in section 5.5.

5.2 HOUSEHOLDS' OVERALL FINANCIAL BALANCE SHEET

5.2.1 Volume

EU and euro area households' financial assets, which comprise nearly three times their equivalent liabilities grew by 3% and 7%, respectively, over 2006-2010, despite a fall in late 2008 and early 2009 when equity holdings and insurance companies' technical reserves fell sharply (see chart 5.2.1).

Chart 5.2.1: **Household financial assets and liabilities (EUR billion)**



Source: Eurostat

Households' financial assets increased over 2006-2010 in most Member States, but fell in several euro area countries including in Greece (11%), Spain (4%) and Italy (4%), as well as in the UK (13%) and Latvia (5%). Sharp falls in equity holdings, especially in 2008 when equity markets slumped, were important notably in Greece.

The ratio of financial assets to GDP varies considerably between individual Member States. E.g. the ratio stood at just over 60% in Latvia and Slovakia and at nearly 300% in the Netherlands and the UK in 2010. Such divergences were driven inter alia by variations in

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[96] Other factors than the crisis also affected households - including their financial behaviour - during the crisis, e.g. technological developments, increased longevity etc.

[97] The EU savings rate rose sharply in 2009, falling back thereafter to just above its pre-crisis level.

[98] See p. 10 of Special Eurobarometer 373 report on retail financial services (requested by European Commission Directorate-General Internal Market and Services and co-ordinated by Directorate-General for Communication) which indicates that 84% of EU citizens surveyed had a current bank account, 51% non-life insurance products (e.g. motor or home cover), 40% a credit card, 31% life insurance, 19% a mortgage, 13% a personal loan, 11% shares or bonds and 7% investment fund(s). The figures vary widely between Member States.

per-capita GDP, the role of the state and financial market development. Other things being equal, crisis-related shocks to wealth were greater for Member States whose asset to GDP ratios were high.

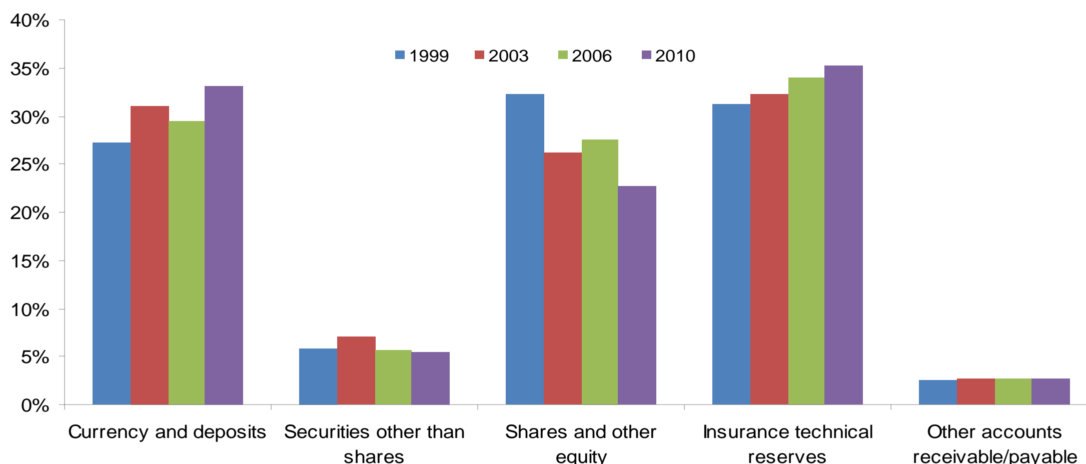
Household sector financial liabilities comprise loans (over 90% of the total, the bulk of which are for house purchase), trade credit (which is important in some Member States) and other items. They increased in nominal terms over the crisis and relative to GDP in all Member States except Germany. In terms of GDP, they were highest in 2010 in Cyprus, Denmark, Ireland, Portugal and the UK. The picture for the EU as a whole, of a dip in mortgage lending in 2008 and then a continued increase lifting the 2010 level above its pre-crisis level, is similar to that for the euro area, except that total EU mortgage lending fell more sharply in 2008.

5.2.2 Composition

The composition of household sector assets[99] changed significantly over the crisis (see chart 5.2.2). In particular:

- Currency[100] and deposits increased as a proportion of total financial assets to around a third of total assets.
- Insurance technical reserves[101], overwhelmingly for life rather than non-life insurance products, rose over the crisis as a whole to 35% in 2010, despite a marked fall in 2008.
- Offsetting these increases, equities' share of total assets declined from 27% to 22% (reflecting in part a sharp fall in share prices in 2008-9) while that of shares other than equity (including bonds) remained at just over 5%.

Chart 5.2.2: **EU27 Households' financial assets by instrument (% of total financial assets)**



Source: Eurostat

[99] Holdings of investment products other than insurance products, such as UCITS are not separately identified here.

[100] Notes and coin in circulation that are commonly used to make payments. It accounts for just under 9% of euro area households' currency and deposits.

[101] Essentially the reserves that insurers must create to meet future claims on policies they have written. Figures include pension fund as well as insurers' technical reserves, most being insurers'. See http://forum.europa.eu.int/irc/dsis/nfaccount/info/data/esa95/en/een00253.htm for statistical definition.

5.3 IMPACT OF THE CRISIS ON HOUSEHOLDS

The aggregated, balance sheet-focussed picture in section 5.2 obscures much of the interesting and relevant information available, especially at Member State level. This section examines the impact of the crisis on households' dependence on the financial sector, as savers/investors, insurees and borrowers. It also provides detailed national narratives (see Boxes) to exemplify some of the more significant effects of the crisis.

5.3.1 Households as savers and investors

Household currency and deposits grew strongly for the EU as whole and the euro area (16%, 20%, respectively, over 2006-2010) and the growth rate for deposits (around 4% per annum for the euro area) was more stable than that of non-financial corporates' deposits. Deposits in the CEE, which already constituted a large share of total financial assets (reflecting underdeveloped insurance sectors and the absence of a shareholder culture in some countries), increased by much more than the EU average. The appeal of deposits reflected a number of factors.

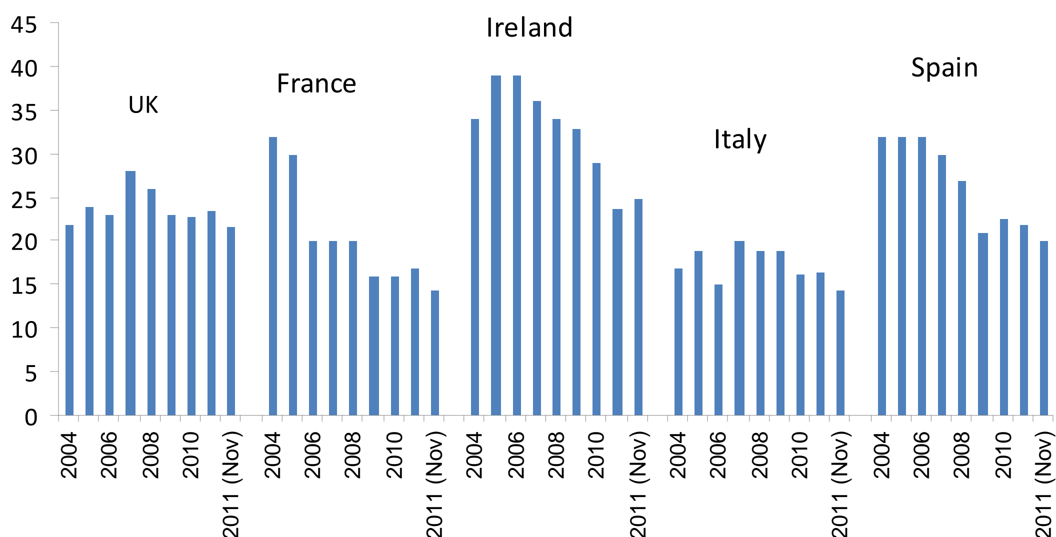
First, it was driven in part by households' desire to safeguard their principal at a time when alternative assets, e.g. equities were highly volatile; and, given uncertainty about their personal disposable income, via an asset which could be liquefied as required without significant penalties to finance consumption. In particular, the appeal of deposits relative to alternative assets, the market value of which depended on financial market developments, increased at a time of greater market volatility and depressed equity markets. Equity markets fell sharply from 2007 and despite periodic upturns since then, remain well below pre-crisis levels. E.g. the Dow Jones Stoxx 50 index[102] in 2011 was nearly 40% below its level in June 2007. Unsurprisingly, the stock of equities and its share of households' financial assets dropped in most Member States. The largest reductions were in Greece (76%) and Spain (37%), where the economy and thus households were especially badly hit by the crisis. Reflecting this, it is likely that these falls reflected sales of equity holdings, as well as lower share prices. The increases seen in several CEEs through the crisis, were mostly from very low initial levels and therefore insufficient to outweigh the reduction in equities elsewhere.

The shift towards less risky financial assets is consistent with surveys that indicate greater risk aversion on the part of households. A survey in five countries (see chart 5.3.1) showed that over the crisis, the proportion of consumers prepared to accept a higher level of risk for some of their savings/investments, in return for a higher possible return, fell significantly in each of them. A lack of relevant information (to e.g. allow consumers to compare prices, charges and risks on different products easily) and a low level of financial education may have contributed to this shift, for some households, during a period of volatile markets and increasingly complex and innovative markets. However, the results of a study on behavioural economics, focused on investment services[103] demonstrate that consumers' choices are often based on irrational decisions irrespective of the information available to consumers and their level of financial education. In consequence, policy intervention to protect consumer interests effectively may be necessary.

[102] Historical close, period average for euro area (changing composition), Euro, Dow Jones Euro Stoxx 50 Price Index.

[103] Consumer Decision-Making in Retail Investment Services: a Behavioral Economics Perspective - November 2010 http://ec.europa.eu/consumers/strategy/docs/final_report_en.pdf

Chart 5.3.1: **Consumer attitudes to savings: % of respondents agreeing "I am prepared to accept a high level of risk for some of my savings/investments in return for a higher possible return"**



Source: Aviva consumer attitudes to saving surveys

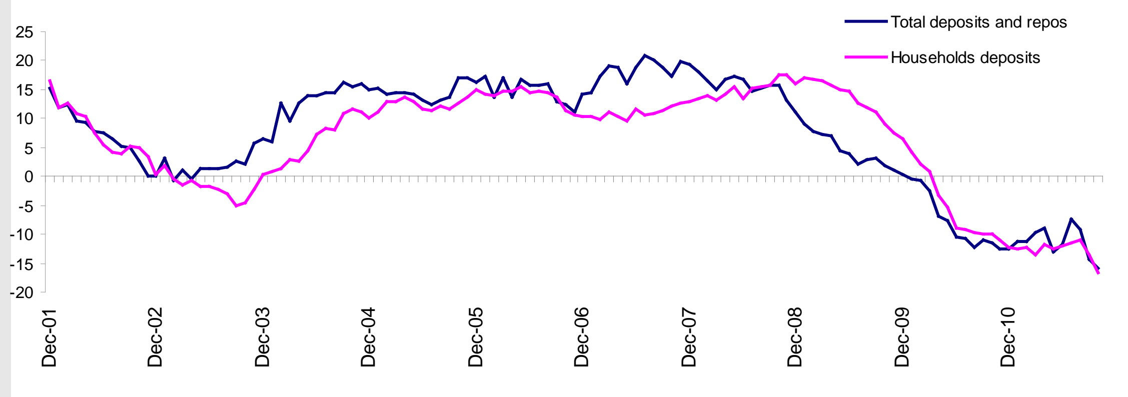
Second, in the face of their wholesale funding pressures, banks themselves sought to reduce liquidity risk by increasing the proportion of retail (including household) deposits in their overall funding. To this end, they raised interest rates on long-term savings deposits. For example, the differential between the rate on new deposits held with euro area MFIs with an agreed maturity of up to one year and that on new deposits redeemable at up to three months' notice, rose from mid-2009 when the rates were much the same, to over 1% by end 2011.

Third, changes to the EU deposit guarantee framework during the crisis, driven in large part by financial stability considerations, as well as government support to some banks, reinforced household demand for bank deposits (a 'safe haven'). Urgent measures were introduced in October 2008 to revise the existing EU framework for deposit guarantee schemes, based on Directive 94/19/EC, including an increase in the guarantee level from a minimum of €20,000 to at least €50,000 in June 2010, and thence a uniform level of €100,000 from 2010, together with speedier reimbursement.

Box 5.3.1: **Greek bank deposits**

National household sectors e.g. in Greece did not all respond to the crisis in the same way. Having grown strongly as in most other countries until 2009, Greek household bank deposits fell sharply from the end of 2009. The Greek household sector reduced its deposits with the Greek banking system by 26% between December 2009 and December 2011 to €145.4bn (see chart below). However, as there was an increase in certain other deposits including those held by other financial institutions and insurance companies, overall bank deposits fell by 16%. The decline reflected: the downturn in the Greek economy; concern regarding default risk on Greek sovereign debt (given the implications of this for Greek banks holding it); and uncertainty regarding the future of Greece in EMU (and thus the risk of euro bank deposits being redenominated).

Total and domestic household deposits in Greece (year on year % change)

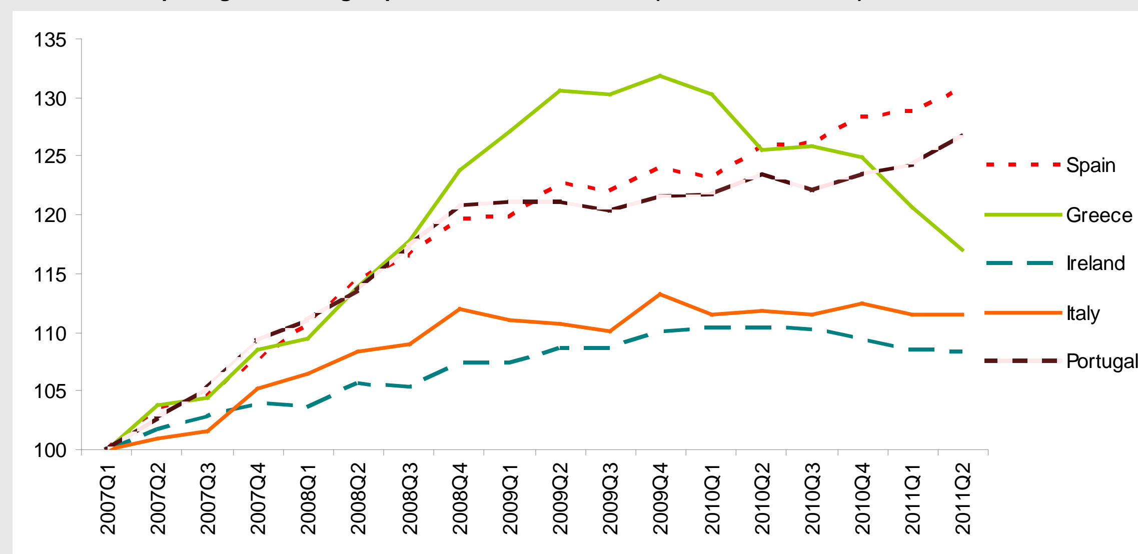


Source: ECB

The decline occurred despite rising interest rates, with e.g. the rate on household deposits of maturities up to 1 year rising from 2.10% to 4.88% between December 2009 and December 2011, against an equivalent increase for euro-area banks from 1.67% to 2.78%. Given the erosion of their deposits, banks were forced to sharply increase their use of ECB repos over this period. They thus became and remain increasingly dependent on the ECB.

While there have been significant falls in overall deposits in other countries encountering sovereign debt problems, only two (Ireland and Italy) experienced a significant decline in household deposits over this period (see chart below), which in both cases was much less pronounced than in Greece.

Households' deposit growth in high-spread euro area countries (base: 2007Q1 = 100)



Source: ECB

In the Greek case, the erosion of confidence in local banks induced households to move their money into other assets (including deposits with other banking systems), in order to preserve their wealth during the crisis[104]. To the extent that low income households were less well equipped than high income households to effect such transfers, they may have either incurred more costs in doing so, or been deterred from making such a switch. Household concerns about the credit-standing of Greek banks and the Greek government meant that the existence of a

[104] However, hard evidence detailing the extent to which household deposits were run down in order to finance consumption in the wake of the economic slowdown, or transferred in a 'flight to quality' to foreign banks ,or funnelled into other assets including gold, is unavailable.

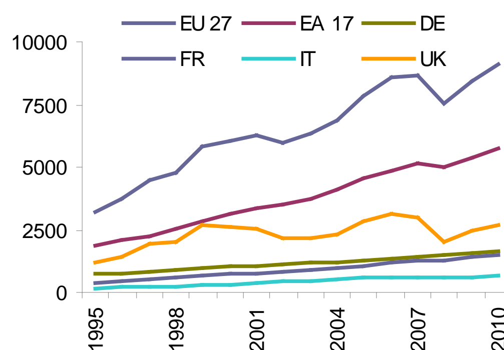
deposit guarantee scheme (DGS) with a high minimum guarantee proved insufficient to staunch such withdrawals.

5.3.2 Households as insurees

Households purchase insurance policies as protection against future negative events. The technical reserves that insurers create to meet the costs of such contingent claims comprise a financial asset from the standpoint of households and other policy holders. The vast bulk of such reserves are held against life policies, which incorporate a large saving, as well as an insurance element.

Their evolution over the period 1995-2010 is presented in chart 5.3.2. It shows growth of 7% and 17%, respectively, over 2006-2010 for EU and euro area aggregates, despite a dip in 2008.

Chart 5.3.2: **Households' insurance technical reserves (EUR billion)**



Source: Eurostat

Technical reserves increased in all but two countries. However, the depth of the insurance sector varies enormously between Member States. It is typically small in the CEEs and consistent with this, even after rapid growth during the crisis, they accounted for only a small proportion of EU households' technical reserves. Conversely, in countries such as France, Germany, Italy and the UK, where the insurance sector is much more mature, the share of assets was much higher. Changes in reserves in such countries, which collectively account for just less than three quarters of EU technical reserves, largely determined the evolution of the EU and euro aggregates. Thus the downturn in EU technical reserves in 2008 was driven in part by a sharp fall in the UK, given that UK households account for some 30% of total EU households' technical reserves[105]. This fall in UK life business reflected in large part the impact of falling stock markets on the value of policies with an equity component (e.g. with-profits, unit-linked, and pension policies). However, changes in the tax and regulatory environment – which affected the appeal of particular insurance lines against each other, as well as competing non-insurance products – also played a role.

Nearly three quarter of individual contracts (accounting for nearly 70% of all life contracts) offered guarantees regarding their capital or return in 2009. Discussions with a sample of large insurers (see Chapter 4) indicates that the appeal of such guaranteed products, as opposed to life products for which the policy holder not the insurer bear the risk, rose in the crisis. This was due in part to the response of risk-averse households to volatile markets in alternative assets e.g. equities. The crisis may also have accentuated the trend towards reduced state provision for e.g. old age, with more responsibility being placed on the individual her/himself instead. Although some insurers sought to increase sales of non-guaranteed products, guaranteed products continued to dominate in markets where they were already popular.

[105] Source: Eurostat, net equity of households in life insurance reserves and in pension fund reserves (AF61).

5.3.3 Households as borrowers

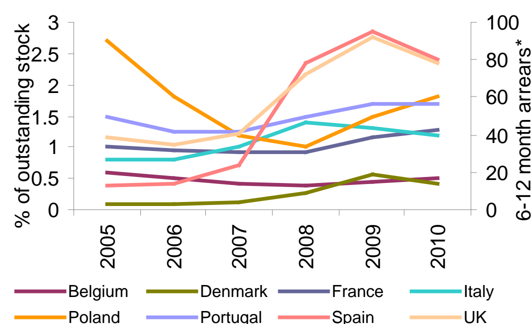
For many households[106], loans for house purchase ('mortgage' loans here) are by far their largest financial liability. The crisis affected households' capacity to service existing loans for house purchase; and their ability to increase such borrowing. Its impact varied widely between Member States reflecting in part the proportion of households with mortgages. For example, a recent survey[107] reported that the highest proportions were in the Netherlands (53%), Denmark (48%) and Sweden (45%), whereas less than 10% had one in eight countries, with the lowest shares in Lithuania (1%), Bulgaria (2%) and Romania (3%).

Households' debt servicing capacity reflected inter alia increased unemployment in many Member States in the crisis, reduced earnings and personal disposable income growth, the stock of existing debt (which was excessive in certain countries which had previously experienced a housing boom) and the interest rate paid on such loans (which reflected both the easing of monetary policy in response to the crisis and increased margins for some lenders).

In a number of countries, the outcome was that the debt servicing burden grew appreciably. The extent of this increase is mirrored in data for borrowers' arrears, repossessions and doubtful loans. The evidence points to a sharp rise in arrears in some countries (see chart 5.3.3), notably Spain and the UK, as well as in repossessions in several EU markets in the years from 2008 Q3.[108] This was followed by an amelioration of the situation in several thereafter, with arrears and repossessions stabilising in 2010 in most markets. (While in certain countries, e.g. Ireland, non-performing loans increased in 2010, this was from a low base.) This improvement reflected in part a low interest rate environment which, together with forbearance programmes agreed by governments and banks, offset the effect of increased unemployment in some countries. Such forbearance programmes reflect the high cost for borrowers and lenders alike from foreclosure, which is perceived as the last resort for the lender, in the absence of alternative options. The increase in arrears from pre-crisis levels during the crisis resulted in levels which were below those experienced in previous housing recessions (e.g. those in Denmark, Spain and the UK in the early 1990s).

The crisis has also affected the supply of and demand for new loans for house purchase[109]. The euro area bank lending survey indicates that banks tightened their standards on loans for house purchase (and consumer credit) from late October 2007 to early January 2009, loosened them somewhat until October 2010 and then tightened them again. The tightening of standards in 2011 (see chart 5.3.4) reflected the poor economic outlook and sovereign debt concerns, which increased pressures on banks to deleverage. Demand for housing loans and consumer credit followed a similar profile as consumer confidence weakened and in the former case, housing

Chart 5.3.3: **Evolution of arrears in eight EU Member States**

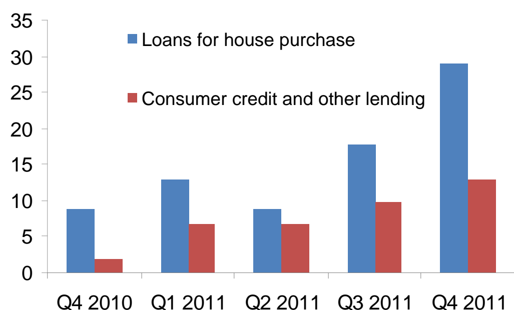


Notes: * Number of mortgages in arrears – UK. The chart is based on different definitions of arrears and should therefore be used to indicate trends, not for quantitative cross-country comparisons.
Source: European Mortgage Federation

[106] And for the sector as a whole – e.g. the stock of euro area households' mortgage borrowing is more than five times as large as the consumer credit extended them.
[107] Special Eurobarometer 373, see previous footnote on this.
[108] See European Mortgage Federation, especially 'Study on non-performing loans in the EU' 2011.
[109] See also the section 1.4.3 on bank lending in Chapter 1.

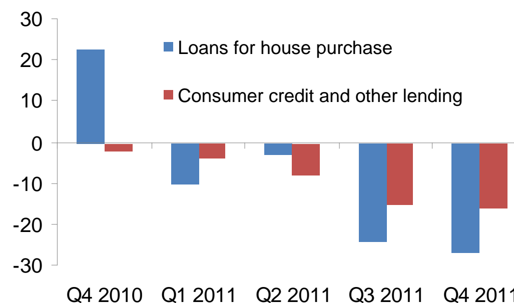
market prospects deteriorated (see chart 5.3.5). Moreover, surveyed banks expect a sizeable drop in the net demand for housing loans and consumer credit in 2012 Q1.

Chart 5.3.4: **Credit standards applied to the approval of loans to households (% of banks reporting tightening of credit standards**



Source: ECB

Chart 5.3.5: **Demand for loans to households (% of banks reporting positive loan demand)**



Source: ECB

However, the detriment to households was greater in some countries than in the EU as a whole, especially those where there was a sharp decline in house prices and thus households' non-financial wealth.

Box 5.3.2: **Mortgage market in Ireland and Spain**

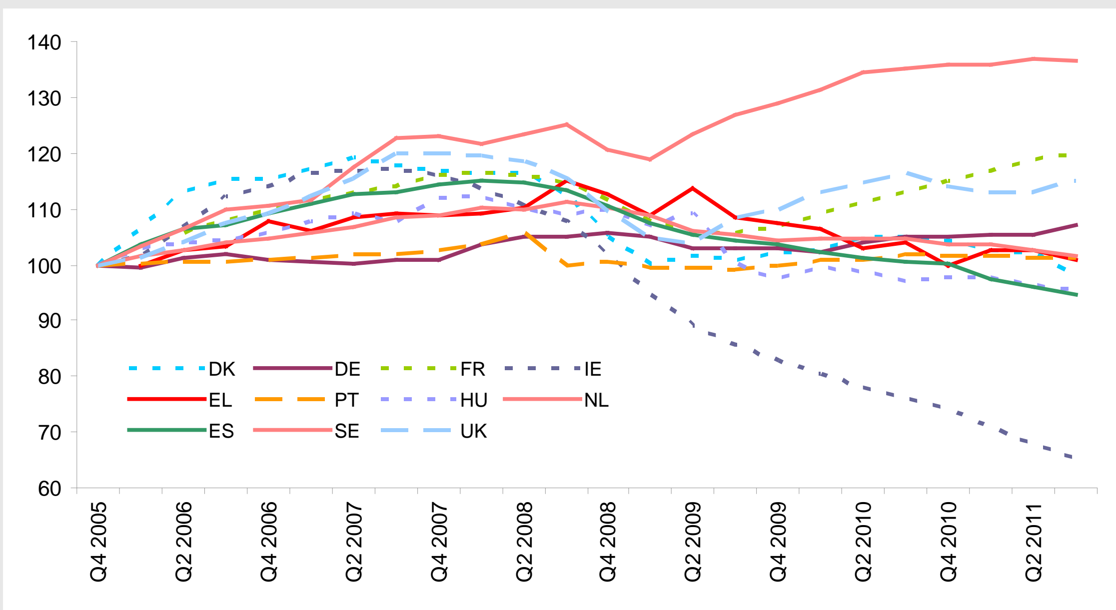
The problems experienced by households were most acute in countries like Ireland and Spain which had experienced large housing booms and rapid growth in mortgage lending, only to face an increased servicing burden in the crisis and minimal if any growth in overall lending for house purchase.

Both countries experienced a major construction boom in the years leading up to the crisis, [110] which led to an over-supply of housing. The crisis precipitated reductions in GDP and disposable income, increased unemployment and a tightening of credit standards. These developments made it harder for mortgagees to service their debt and reduced household demand for new mortgages.

With the market weighed down by the supply overhang from the construction boom, house prices started to fall in both countries especially in Ireland. The chart below records the large fall in Irish house prices which by 2011 Q3, had fallen 44% from their level four years earlier. This reduced households' overall net wealth which had already been eroded by weak stock markets. Spanish house prices fell by 16% over the same period.

[110] See Figure 2 in CEPS Special Report on 'A new mortgage credit regime for Europe', by Dubel and Rothemund, regarding construction and housing overbuilding 2001-2009 as a percentage of the long term (1970-2000) average.

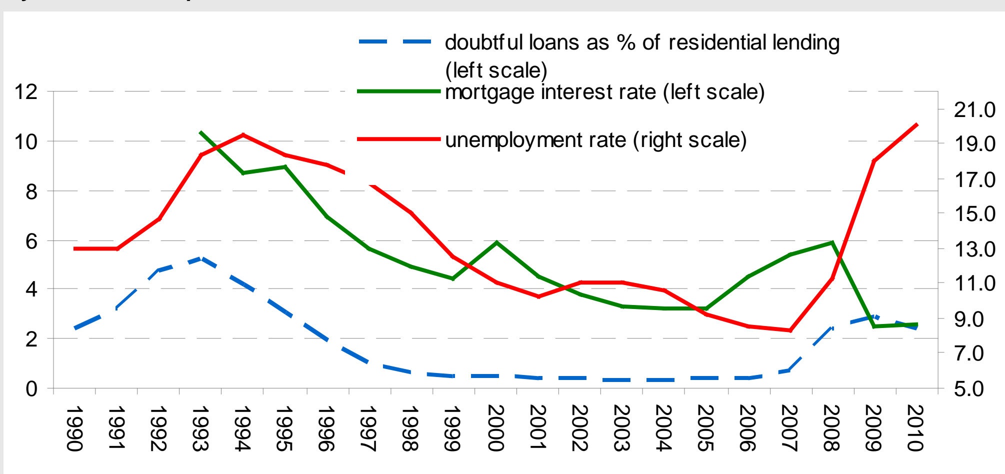
Nominal house price indices in selected countries (base: 2005 Q4 = 100)



Source: European Mortgage Federation

Lower house prices contributed to putting many borrowers into negative equity, reducing their ability to refinance their loans. Despite a fall in mortgage rates in 2009-2010 from 2008 levels, arrears rose in both countries. Thus in Spain, the ratio of doubtful mortgage loans to total mortgage loans outstanding rose from 0.43% in 2006 to 2.44% in 2010 (see chart below) but remained well below the levels seen in the early 1990s; while in Ireland, arrears[111] doubled over the period 2009 Q3 to 2010 Q4 alone.

Key indicators in Spain



Source: European Mortgage Federation

At the same time the supply of lending decreased as banks, concerned about borrowers' future debt servicing capability, and wishing to strengthen their balance sheets via deleveraging, moved towards more responsible lending practices including lower loan to value ratios for new mortgages than prior to the crisis. This further weakened house prices, increasing negative equity[112] so that existing mortgagees found it harder to extract equity, pushing up arrears.

The crisis thus affected the flow of new lending and thence the outstanding stock. For example, there was a sharp reduction in new lending in Ireland, with e.g. new mortgages issued in 2010

[111] Ratio of existing arrears to total outstanding residential loans.

[112] Negative equity occurs where the value of a house falls below the outstanding loan.

only one sixth of those in 2007. In addition, the stock of euro area MFIs' lending for house purchase fell by 37% over the period from early 2008 to December 2011. In Spain, the stock of lending for house purchase nearly tripled from early 2003 to end-2008, to plateau over the following three years, with a slight fall in 2011. At the same time, the value of household sector wealth, dominated by housing assets, fell even more sharply. This further dampened consumer confidence and economic growth.

Thus Irish and Spanish households found it more onerous to service their existing debt, and more challenging to increase or take out new debt than pre-crisis. The economic and social consequences were and continue to be severe.

5.4 Consumer perspective on the financial sector

Survey evidence could in principle indicate whether the crisis has led to the erosion of consumer confidence in the financial sector. In practice, however, the main survey undertaken at EU and Member State level – the Consumer Markets Scoreboard – is not available on a consistent basis throughout the crisis. However, the latest survey[113] (October 2011), a large part of which is comparable with the same survey a year earlier, carries some lessons. In particular, the EU 27 Market Performance Indicator shows two segments of the financial sector – mortgages and investments, pensions, securities – close to the bottom of the services list. This largely reflected relatively low ratings for trust (linked to the complexity of these markets and/or the difficulty of assessing quality at the time of purchase) and comparability (of services within these categories). Such perceived relative deficiencies are especially important at a time when governments and some financial institutions are seeking to transfer more financial risk to households (given fiscal constraints etc.), and when financial markets are becoming increasingly complex and at times volatile.

It can also be damaging if households respond by reducing their interactions with the financial system across the board, since this reduces the system's ability to play its core role of intermediating saving and investment across the economy; as well as restricting its capacity to provide households with the products they require to smooth their life time consumption.

5.5 Conclusions

Individual EU households have had very different experiences in the financial crisis, depending on among other things their specific situation (age, income, employment status, level of debt etc.), the structure and performance of their national economies (including the financial sector and housing market), as well as the way that national, as well as EU authorities have acted in the crisis. Despite their diverse experiences, a number of conclusions can be drawn from EU aggregate and national data.

The financial crisis has had a significant impact on the financial position[114] of the EU household sector. In particular there has been a shift in the composition of its financial assets towards safe as opposed to high risk assets, reflected in a greater proportion for bank deposits and a reduced share for equities. Household liabilities, dominated by loans for house purchase have continued to rise. The burden of servicing them has increased in certain

[113] From October 2011 Consumer Markets Scoreboard, European Commission Directorate-General for Health and Consumers.

[114] Defined narrowly in terms of their financial balance sheet excluding other items such as the burden placed on them as taxpayers due to government support to banks in the crisis. This could be considered an additional crisis impact, to those set out here.

Member States, with households suffering significant detriment, e.g. negative equity and repossessions.[115]

Moreover, survey evidence indicates that a majority of people in the EU continue to declare that their household situation has deteriorated in the last year, reflecting a combination of higher inflation, rises in indirect taxes, low or stagnant wage growth and other austerity measures restricting governments' room for manoeuvre.[116] The share of households experiencing financial difficulties across the EU has been steadily increasing since the beginning of 2011, particularly among lower quartile income groups. The number of people running into debt problems is back up to levels last observed in late 2008. Moreover, there are signs of rising poverty in many Member States, including in certain population subgroups (in particular those with already weaker links to the labour market) in Member States less affected overall by the crisis.

Households' difficulties in interacting with the financial system, e.g. in terms of their capacity to compare different products and to effectively assess their risk profiles (including their sensitivities to changes in interest rates[117]), have made it difficult for them to adjust in the crisis to volatile market and economic conditions. They have also contributed to financial instability. It is vital that they are addressed by measures which enable them to 'make informed decisions in a marketplace free of deception and abuse'[118].

The need for such measures is reinforced by a number of structural changes, which are likely to increase households' exposure to financial risk. These include:

- A continuing reduction in state social welfare provision including pensions.
- An increase in the complexity and number of financial products available to households.
- Further technological innovation (e.g. more use of the internet, smart phones etc. for financial dealings) which brings with it increased security (including fraud) risk, uncertainty as to the presiding jurisdiction when seeking recourse etc.
- The entry of new providers of financial services e.g. in the payments area, together with greater cross-border provision of financial services, including from previously unfamiliar financial institutions.

Provided that timely, effective action is taken, household trust in the financial system should be strengthened, thus enhancing the household sector's role in providing the long term and stable funds, which the financial system intermediates to the benefit of the wider economy.

A number of significant policy initiatives have been, or are scheduled to be, launched at national and EU level to ensure an appropriate level of consumer protection. These include initiatives on deposit guarantee schemes, PRIPs, MiFID, insurance mediation, and credit agreements relating to residential property. Recent progress on some of these initiatives is described in Chapter 2. In addition, given both the social problems arising from household over-indebtedness in some countries, as well as its impact on the supply of new credit to

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[115] See European Commission (2011), Quarterly Report on the euro area Volume 10 No 4 regarding the impact of the crisis on household savings in the euro area. It suggests that the wealth effect on consumption from changes in asset values may be offset by the mortgage 'down payment' channel, i.e. when house prices are high, credit constrained first time buyers need to set aside more money to cover the part of the overall price that is not covered by the bank

[116] See European Commission (2011), EU Employment and Social Situation Quarterly Review, December.

[117] Borrowers including mortgagors will face a significant rise in debt servicing costs when the current sustained period of abnormally low interest rates eventually ends.

[118] See Financial Stability Board (2011), 'Consumer finance protection with particular focus on credit', October.

households, the Commission will carry out an extensive study[119] on households' over-indebtedness. It will analyse the different drivers, and assess the impact of household over-indebtedness, and list initiatives aimed at alleviating the situation.

[119] Preliminary results are expected by end 2012.

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