IEO
Independent Evaluation Office
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BACKGROUND PAPER

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IMF Financial Surveillance in Action: Country Case Studies from Europe and Sub-Saharan Africa

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Country Case Studies from Europe and Sub-Saharan Africa

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ABBREVIATIONS

ACE	allowance for corporate equity
AMC	asset management company
AML-CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BdI	Banca d'Italia
BRRD	Bank Recovery and Resolution Directive
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
CCP	central counter pa
CDS	credit default swap
CET	common external tariff
CMA	Capital Market Authority
CMU	Capital Markets Union
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGS	deposit guarantee
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSSA	Financial Sector Stability Assessment
GDP	gross domestic product
GFSR	*Global Financial Stability Report*
G-SIBs	global systemically important banks
GSE	Ghana Stock Exchange
HRE	Hypo Real Estate
IKB	Deutsche Industriebank
IRB	Institutional Review Board
ISD	Integrated Surveillance Decision
ISP	Intesa Sanpaolo
LGDs	losses given default
MCM	Monetary and Capital Markets Department (IMF)
MPS	Monte Paschi di Siena
MREL	minimum requirement for own funds and eligible liabilities
NPL	non-performing loans

NPRA	National Pension Regulatory Authority
OMT	Outright Monetary Transactions
PRA	Agency Review Panel
ROSC	Reports on the Observance of Standards and Codes
RWA	risk-weighted asset
SDN	Staff Discussion Note
SEC	Securities and Exchange Commission
SIP	Selected Issues Paper
SME	small and medium-sized enterprises
SRB	Systemic Risk Board
SRM	single resolution mechanism
SSM	Single Supervisory Mechanism
STS	simple, transparent, and standardized
TA	technical assistance
TNs	Technical Notes
WEO	*World Economic Outlook*

CHAPTER 1—IMF FINANCIAL SURVEILLANCE OF THE EURO AREA

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EXECUTIVE SUMMARY

During the period under review, financial surveillance of the Euro Area was generally of high quality and influential. Relationships with authorities at the European level were well established and based on mutual respect and trust. This was also true in regard to national authorities, even if in a few cases there were disagreements on IMF messages, particularly those conveyed in multilateral surveillance. The IMF contributed to moving along the banking union agenda, urged measures to strengthen banks' capital and called to speed up the resolution of non-performing loans. The IMF's global perspective is seen by officials to bring significant value.

The IMF faced idiosyncratic challenges when implementing surveillance of the Euro Area. First, the Euro Area is not a member of the IMF. Second, the EU has its own, well-developed, internal surveillance processes. Third, during the period under review the Euro Area had a major, almost existential crisis. And, fourth, the Fund had to continually adjust to a changing EU architecture on financial stability, especially the creation of the banking union.

Overall, IMF bilateral financial surveillance of the Euro Area during this period was effective, with recommendations grounded in a well-articulated macrofinancial vision of the Euro Area. The IMF got it right on most points, especially when alerting on banking risks. But Article IV surveillance focused largely on banking, with gaps in other areas, e.g., insurance and capital markets. In part, this was because of a tendency to focus on issues where the Fund has expertise and to re-examine priorities only very gradually. The most recent FSSA for the Euro Area, published in July 2018, partially redresses this imbalance.

Chapter 1 of successive *GFSRs* helped shape the Fund's message on financial stability in the Eurozone during the crisis; and it had a critical role in pointing to the need for bank recapitalization. On the other hand, authorities were often critical of the *GFSR* analysis and treatment of data. While IMF staff used public data in its analysis, it relied on in-house methods for processing and interpreting data, with assumptions that sometimes (perhaps legitimately) differed from the authorities' methods. This may have weakened the Fund's message and its impact. Full transparency on the methodology for Chapter 1 of the *GFSR* would go a long way towards alleviating these concerns.

Three challenges. First, in order to better identify the priorities for financial surveillance in the Euro Area there needs to be better coordination across the IMF. Second, the Fund staff's skills mix needs to be tilted towards more economists with a finance background. Finally, to enhance its credibility and influence the Fund needs to develop a comprehensive analytical framework for examining financial stability.

I. INTRODUCTION AND CONTEXT

1. This report evaluates the IMF's financial surveillance of the Euro Area for the period since 2012, following the Executive Board approval of the Integrated Surveillance Decision (ISD) (IMF, 2012a) and the launch of the Financial Surveillance Strategy (IMF, 2012c).[1] The report assesses the relevance, technical quality and influence of the Fund's analysis and advice in the context of Article IV consultations, the Financial Sector Assessment Program (FSAP), and multilateral surveillance. It discusses these activities against the backdrop of policy debates within the Euro Area and its member countries on creation of the Banking Union and significant reforms in other segments of the financial sector.

2. The report is based on a review of IMF documents as well as documents from the European Central Bank (ECB), the European Bank Authority (EBA), and national central banks.[2] It reflects interviews with officials at the ECB, the EBA, the European Commission (EC), as well as authorities and officials in members of the Euro Area. It also benefitted from interviews with many IMF staff, including members of Article IV and FSAP missions to the European Union (EU) and Euro Area countries. In addition, the paper draws extensively on country case studies on IMF financial surveillance in Germany and Italy prepared by Jeffrey Anderson (Anderson, 2018a; 2018b), and a background paper by Nicolas Véron on IMF financial sector work in the Euro Area (Véron, 2016) prepared for the 2016 IEO evaluation on the IMF and the Crises in Greece, Ireland and Portugal (IEO, 2016).

3. During the evaluation period, the IMF faced four specific challenges when implementing surveillance of the Euro Area, some permanent and some more circumstantial.

(i) The Euro Area is not a member of the IMF; only individual states are members. Therefore, while specific formal arrangements have been made to organize Euro Area surveillance, it still requires a lot of diplomacy. Individual states naturally insist on their prerogatives, while EU institutions consider that, functionally, they are the responsible authority in many of the relevant domains. Sequencing of the Article IV consultation with members on Euro Area policies and for member states has become an issue. The European institutions consider it appropriate for the Euro Area Article IV consultation to be undertaken first, with national level Article IV consultations proceeding later, and that

[1] Events prior to that date are mentioned and described when necessary for the analysis.

[2] This report examined the Euro Area FSAP completed in July 2018, in addition to the earlier European Union FSAP and FSAPs for Euro Area countries, but due to its timing there were no discussions with relevant IMF staff after its completion.

developing issues be identified at the Euro Area level.[3] This suggestion was resisted by member states.

(ii) The EU has its own well-developed, internal surveillance processes. For member states, the multiplicity of surveillance exercises within Europe, not always well-coordinated, may complicate actions and compliance. There is sometimes greater divergence among EU institutions than between the EC and the IMF. Indeed, this evaluation did not identify any major disagreement between the IMF and the EC on financial sector issues or macrofinancial policies.[4] However, intra-Euro Area disagreements complicate surveillance as differences among countries makes it difficult for the IMF to break through and be heard.

(iii) During the period under review, the Euro Area had a major, almost existential economic and financial crisis. There were several Fund-supported programs in Euro Area countries that were negotiated in cooperation with the ECB and the EC—the Troika. The interaction between surveillance and program activities is not studied in this report, as some IMF-supported Euro Area programs have already been evaluated by the IEO (see IEO, 2016 and Véron, 2016). Experience derived from those programs may have influenced or shaped the Fund's institutional view on some financial issues.

(iv) Finally, the Fund has had to continually adjust to a changing environment. Euro Area and EU architecture on financial stability has been constantly and significantly evolving during this period, with changes affecting institutions, the rules of governance, and policies. One central question examined in this report is the extent to which IMF surveillance influenced this evolution.

4. The remainder of the report is organized as follows. Sections II and III examine the IMF's Article IV consultations and FSAP exercises, respectively. Section IV discusses aspects of multilateral financial surveillance, in particular the *Global Financial Stability Report* (*GFSR)*, that have played a significant role in Euro Area policy debates. Finally, Section V concludes with some observations and recommendations.

[3] The members of the Euro Area are members of the IMF, but the Area itself is not. Therefore, formally the Fund does not hold Article IV consultations with the Euro Area itself. Instead, it holds Article IV consultation discussions with the union-level entities and these discussions form an integral part of the Article IV consultations with the member countries. Formally, these discussions are referred to as "Article IV consultation with members on Euro Area policies." However, for simplicity, this report refers to them as the Euro Area Article IV.

[4] Major disagreements did take place on other topics, such as on the implementation of the Stability and Growth Pact.

II. BILATERAL SURVEILLANCE: ARTICLE IV

5. This assessment concludes that overall IMF bilateral financial surveillance of the Euro Area since 2012 has been effective. The underlying analysis was sound and key policy recommendations were grounded in a well-articulated vision of the Euro Area. As a result, the Fund was able to play a significant role in the run-up to the Banking Union and advise on its implementation.

6. However, when it comes to "core" financial stability issues, the record is more nuanced. The IMF got it right on most points. However, an almost exclusive focus on banking over the period prevented the Fund from speaking strongly and influentially on questions of major importance for the future, particularly regarding insurance and capital markets. Also, in recent years, IMF analysis and policy recommendations regarding the banking sector were too focused on non-performing loans (NPLs). In sum, IMF financial surveillance has been most effective when closely matched with its core macroeconomic competencies. It seemingly has been more hesitant and less robust, although still relevant, on other financial issues.

A consistent and well-articulated macrofinancial vision

7. Over the last decade, the Fund has held a very firm, consistent, and analytically rooted view of the requirements that a successful European monetary union should meet. Remarkably, that vision has constantly underpinned and inspired all the surveillance exercises, irrespective of the prevailing political constraints and climate in the Euro Area. In the tradition of fiscal federalism, the Fund's pronouncements and recommendations have underlined the incompleteness of the European Monetary Union and the necessary creation of fiscal capacity—together with more risk sharing—at the European level.

8. The IMF approach to financial stability in the Euro Area derives directly from that vision. It argues for a centralized financial stability architecture for the EU (e.g., see 2012 Selected Issues Paper on the Banking Union; Tressel, 2012). Its rationale and details were, for the most part, fully articulated as early as 2011, in an Article IV background paper on "Lessons from the European Financial Stability Framework Exercise" (IMF, 2011b).

9. The approach rests on three pillars: (i) a common resolution mechanism and authority with a common backstop; (ii) a common deposit guarantee scheme; and (iii) a common supervisory authority, to "align incentives with the common good rather than with the objectives of 'national champions' … [and] help solve these coordination problems within the monetary union and the broader EU" (Tressel, 2012). This was expected to foster financial stability and help forestall further financial fragmentation. The common supervisory authority was seen as a complement to the other two in that "[a] supra-national supervisory regime for large banks should support the establishment of common backstops" (Tressel, 2012).

10. In reality, due to political disagreements amongst Euro Area countries, only the common supervisory regime pillar has been fully implemented, with the creation of the Single Supervisory Mechanism (SSM). The resolution mechanism remains partially funded and there is no common deposit insurance scheme. This report finds, however, that the Fund has not been inhibited by political pushback from Euro Area authorities with regards to the need to further develop these outstanding elements of the financial stability architecture. From 2013 onwards, the Fund has continued to argue in favor of its proposals, even as prospects of their adoption have faded.

- The 2014 Article IV staff report warned that in the final agreement "the [Single Resolution Mechanism] decision-making procedure remains cumbersome, the [Single Resolution Fund] transition period too long (8 years), and its financial capacity limited given the concentration and size of large financial institutions" (IMF, 2014a).

- The 2015 Article IV staff report noted that "[f]urther steps to establish a common backstop would help sever the bank-sovereign link" (IMF, 2015b).

- The 2016 Article IV staff report stated that "[g]reater risk sharing should proceed hand in hand with measures to reduce banking sector risks. Risk sharing, without risk reduction, may lead to moral hazard and unintended transfers, while risk reduction alone fails to address the need for a common backstop in a systemic crisis" (IMF, 2016c).

- The 2017 Article IV staff report mentioned that "[c]ompleting the banking union, by establishing a common deposit insurance scheme with a common fiscal backstop, would foster the free flow of liquidity and provide reassurance to supervisors that the bank-sovereign link is severed" (IMF, 2017b).

- The 2018 Article IV staff report commented that "[a]longside needed steps to reduce legal fragmentation, a truly borderless single banking market will require a shared financial safety net. Specifically, this means a common backstop to bank resolution and a common deposit insurance scheme" (IMF, 2018a).

A significant and proactive role in the Banking Union's creation

11. The IMF played a significant and proactive role in the establishment of the banking union. The banking union was agreed in principle by Euro Area leaders at a European Summit on June 29, 2012. The Fund was well prepared, as attested by the Selected Issues Paper (SIP) produced immediately afterwards (Tressel, 2012), which reflected the analysis that had been developed in IMF (2011b) and since. The Fund had a proactive role in the process, holding seminars with European officials in May and June 2012. Staff members were also in close contact on the issue with top ECB officials in the months prior.

12. The decision in principle was only the beginning of a difficult negotiation process between members of the Euro Area. Armed with previous analysis and a robust and consistent doctrine, the Fund was able to deploy its influence and offer recommendations that could have

maximum impact. This is certainly a good example of surveillance playing a catalytic and facilitating role in a major policy issue.

13. In this case, IMF advice was grounded on highly developed analytics. In February 2013, the Fund published a Staff Discussion Note (SDN) on "A Banking Union for the Euro Area" (Goyal and others, 2013).[5] According to staff interviewees, the Banking Union SDN had been ready for some time. It developed further, in a systematic way, the Fund's previous analysis and contained recommendations on common deposit insurance, common resolution backstop, and the possibility for the ESM to directly recapitalize banks. The last recommendation was ultimately adopted by Euro Area leaders. The SDN, together with SIPs and working papers that dealt with the same theme, formed the basis for a continuous and intense dialogue with European authorities. They offer a great example of cross-fertilization between policy research and surveillance.

Other financial topics received less attention

14. The heavy emphasis on the banking sector in financial surveillance crowded out other important topics for surveillance. Banking issues have been given a prominent, almost exclusive, place in the IMF's financial surveillance of the Euro Area (e.g., since 2012, banking has occupied between 90 percent and 100 percent of the space devoted to financial surveillance in Article IV staff reports—admittedly a simplistic statistic). Obviously, the banking dimension of the Euro crisis was extremely important and special attention to the banking sector was justified. However, as illustrated below, important developments took place outside banking where greater IMF attention would have been helpful.

- The Solvency II Directive on insurance was adopted in November 2009, then amended in April 2014, with delegated regulations adopted by the Commission in October 2014 and September 2015. During that period, important debates took place within Europe on the consequences of the Directive for capital allocation in the EU as well as its impact on the behavior (procyclicality) of the European financial system. There were also important financial stability concerns linked to the impact of low interest rates on the insurance industry. In a 2017 SIP, IMF staff assessed financial stability risks stemming from the Euro Area insurance sector (Mitra, 2017). The findings, namely that systemic risks are low, were included in a paragraph in the corresponding 2017 Article IV staff report (IMF, 2017b).

- As a follow-up to the Banking Union, in February and September 2015 the EC launched the Capital Markets Union (CMU) project. Only one paragraph, with very general wording

[5] SDNs are used as vehicles to formulate and disseminate Fund staff's opinion and recommendations, without committing the institution to a formal view.

on recommendations, was devoted to this initiative in the 2016 Article IV staff report (IMF, 2016c).[6]

- The EU has engaged in an intense debate on the role and place of securitization in its financial architecture. A discussion paper on the issue was published by the Bank of England and the ECB in May 2014 (BOE and ECB, 2014). Fund staff devoted a SIP on securitization in the 2014 Article IV to capital market development and SME financing (Al-Eyd and others, 2014). This was followed, in May 2015, with an SDN on "Revitalizing Securitization for Small and Medium-Sized Enterprises in Europe" (Aiyar and others, 2015a) that advocated measures for high quality securitization.[7] Summaries of these works were included in the 2014 and 2015 Article IV staff reports (IMF, 2014a; 2015b), respectively, but there was limited follow up in subsequent Article IV staff reports.

15. Article IV staff reports and FSAPs for individual Euro Area member countries, as well as the EU FSAP of 2013 and the Euro Area FSAP of 2018 show a greater diversity of topics. For example, the 2016 Article IV staff report and 2017 FSAP for Luxembourg (IMF, 2016b; 2017a) devoted significant attention to the asset management industry and shadow banking. Most important, the 2018 Euro Area FSAP (discussed below) covers a full range of financial stability issues outside the banking sector, helping to provide more balance to the Fund's coverage.

Reasons for the focus on banking in Article IV surveillance

16. The situation of the Euro Area banking sector fully warranted the attention it received during the evaluation period, but other factors also played a role in limiting coverage of other sectors:

- During interviews, staff noted that there is an unavoidable tendency to focus on topics where the IMF has expertise. Fund experience on financial sector crises was historically mainly related to banking, e.g., the 1997–98 East Asian crisis. Thus, the Fund had greater familiarity with the analytics and policy of banking crises and restructuring. Many recommendations formulated for the Euro Area drew (sometimes explicitly) on that experience. However, financial stability problems may, in the future, be outside the banking sector as financial intermediation migrates towards non-banks.

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[6] The paragraph reads as follows: "Faster progress on the capital markets union would also spur greater private risk sharing and non-bank financing alternatives. Some headway has been made with the changes to insurers' capital changes for infrastructure investment under Solvency II and the proposal for simple, transparent, and standardized (STS) securitization, which should be swiftly adopted. Beyond these measures, a more ambitious and clearer timeline for deeper institutional changes, such as the harmonization of insolvency regimes, would be beneficial" (IMF, 2016c). Similar remarks are made in Anderson (2018a; 2018b).

[7] This SDN formed the basis for a joint conference (with EIB) on the subject, which brought together a range of public and private sector participants and created a consensus on moving forward.

- The IMF's internal review process seems not to have created sufficient incentives to focus on non-banking sector issues in financial surveillance. It is striking that topics covered in the analytical chapters of the *GFSR,* such as asset management, insurance, and shadow banking, have not filtered down more into Euro Area surveillance.[8]

- Finally, IMF guidance to staff on Article IV consultations prescribes that surveillance should be focused, thus encouraging selectivity in coverage.

The message on bank profitability and non-performing loans (NPLs)

17. A consequence of the IMF focus on banking has been a tendency for surveillance to go "deep" rather than going "broad." In the process, the NPL problem became very prominent.[9] NPLs are a serious problem in parts of the Euro Area and a very valid topic for surveillance. NPLs are also part of broader problems: the weak profitability of Euro Area banks, their persistent low valuation (relative to book value), the uncertainty of their business model, and the slowness in cleaning their balance sheets (relative to the U.S.).

18. The Fund identified NPLs as a major weakness in various bilateral surveillance reports. A 2013 SIP (Al-Eyd and Berkman, 2013) identified the causes of financial fragmentation of the Euro Area: cross-border banking flows had declined; term funding costs had increased; bank assets had become increasingly encumbered; pressures on bank balance sheets, including on profitability, had increased; weak growth and high levels of private balance sheet debt in the periphery were weighing on the health of bank balance sheets; and asset quality was declining (e.g., with NPLs in 2013 rising in Spain to 10.4 percent and those in Italy hitting 13.4 percent).

19. NPLs were rightly considered as part of a broader diagnosis. The 2014 Article IV staff report (IMF, 2014a) highlighted the need to mend balance sheets and complete the banking union as key policy issues. In so doing, it noted that "successfully executing the ongoing asset quality review and stress tests should spur balance sheet repair and help reverse fragmentation" and that "impaired balance sheets continue to inhibit monetary transmission and the flow of credit, particularly to SMEs" (IMF, 2014a).

20. NPLs were highlighted as a major issue in 2015 with a dedicated box in the Article IV staff report (IMF, 2015b), drawing on a SIP on "Policy Options for Tackling NPLs in the Euro Area" (Aiyar and others, 2015b) and a SDN published in September 2015 (Aiyar and others, 2015c). A whole section in *GFSR* Chapter 1 (IMF, 2015c) is also devoted to NPLs. In addition, the whole financial section of the 2016 Article IV staff report (IMF, 2016c) is exclusively devoted to NPLs. No

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[8] The Asset Management Industry and Financial Stability in *GFSR*, April 2015 (IMF, 2015a), The Insurance Sector—Trends and Systemic Risk Implications in *GFSR*, April 2016 (IMF, 2016a) and Shadow Banking around the Globe: How Large, and How Risky? in *GFSR*, October 2014 (IMF, 2014b).

[9] In a speech at Jackson Hole in 2011, the Managing Director pointed to the urgent need for bank recapitalization in light of issues with NPLs (Lagarde, 2011).

other single banking issue has received comparable coverage in the Fund's publications over the period.

21. According to IMF staff, the focus on NPLs came about partially because there was a feeling that the Fund could add value by being specific and concrete about what needed to be done. They also reportedly saw a link between a clean-up of NPLs and restarting the flow of credit. NPLs were also a key concern of some Euro Area authorities who appreciated the IMF contribution to their efforts to push for speedy resolution of bank weaknesses. These issues had also been echoed in the *GFSR* and by market participants. The question is not, therefore, whether there was a problem that deserved to be emphasized. Rather, whether the issue of NPLs should have been allowed to shape the message of Fund financial surveillance for so long.

22. A few considerations on the treatment of NPLs. First, NPLs are very much concentrated in a few countries, with half of them in Italy (others include Cyprus and Greece). So NPLs are systemic for the Euro Area only because Italy is systemic for the Euro Area—that articulation does not appear in Article IV or *GFSR* reports.

23. A second consideration relates to the analytical robustness of the Fund's recommendations. NPLs can be a problem for banks because they create uncertainty with regards to the quality and valuation of assets which makes bank funding more expensive. For the broad economy, bad loans can perpetuate "zombie" firms, thereby impeding efficient capital allocation and, ultimately, growth. This is basically the argument implicit in the 2013 and 2014 Article IV staff reports (IMF, 2013b; 2014a). However, in its 2015 and 2016 Article IVs (IMF, 2015b; 2016c), the Fund adopted a different line: quick elimination of NPLs would "free" capital and allow a prompt resumption of credit growth as well as better transmission of monetary policy. The underlying analysis in support of this conclusion was based partially on a statistically observed negative correlation between the level of NPLs and credit growth. This correlation and its analytical anchoring have been challenged by authorities and other researchers (see Anderson, 2018a; 2018b). In fact, for NPL resolution to "free" capital, the loans would have to be sold at their book value (net of provisions). However, given the apparent gap between book and market values, such a resolution would require some form of budgetary support, which would run afoul of EU competition policy and state aid rules. This problem is clearly identified in Article IV staff reports but no explanation is given about how to solve the impasse. The fragility of the whole line of argument was perceived and pointed out during the internal review process but the doubts that were raised did not percolate into the final reports.[10]

24. Finally, there seems to be a contradiction between the stated objective of quickly restarting credit flows and the parallel concern expressed about the corporate debt overhang. It is not clear how that contradiction may be resolved in the short term. As noted in Article IV staff

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[10] In interdepartmental comments on the 2016 policy note, MCM and RES noted that the fiscal cost of the proposed resolution scheme could be high and create problems with EU state aid rules, and that aggressive time-bound targets for NPL disposal could put downward pressure on loan prices and exacerbate the problem.

reports, it would necessitate, inter alia, a reform of bankruptcy regimes (presumably to allow for corporate debt restructuring) that would likely take place on a very different time frame.

25. Ultimately, as the Japan and Nordic experiences had shown, a successful and quick resolution of NPLs and banks' balance sheet repair has to be accompanied by public support, either as recapitalization or through public purchase of bad loans. Strongly arguing in that direction would have challenged EU competition rules, which the IMF appeared reluctant to do.

The message on bank resolution

26. With regards to the resolution of banks, the Euro Area (and the broader EU) are in a unique situation. Because the EU is an ensemble of nations with different budgets and legal systems, a strong competition policy (with strict regulation of state aid) is necessary to ensure the integrity and effective functioning of the single market. The EC is solely responsible for implementing this policy. On the other hand, the resolution of banks implies, in most cases, some form of public support if negative consequences are to be avoided for overall financial stability. There is, therefore, an acute tension (if not an incompatibility) between two important EU policy objectives, namely competition and financial stability.

27. This tension was described by the Fund as early as 2011 in the Euro Area Article IV staff report (IMF, 2011a). IMF (2011b) explained in very balanced language that "the state aid regime for the banking system needs to take account of the development of resolution frameworks together with systemic and stability considerations that are special to the financial sector" and it stated that "[t]he new bank resolution regime, by facilitating earlier and more market-based restructuring of problem banks, should reduce but not eliminate the need for a regime for state aid to the financial sector. The two regimes should be consistent with each other[.]" This message was echoed in the 2013 FSAP report which appropriately noted that competition and state aid policy had served as the de facto coordinating mechanism in bank restructuring during the crisis, as it was the only binding EU framework available for this purpose (IMF, 2013a).

28. The EU Bank Resolution and Recovery Directive (BRRD) was published on May 15, 2014. That Directive fundamentally transformed the policy landscape and gave high priority to competition over financial stability objectives by subjecting state aid to banks to extremely stringent conditions. The BRRD introduced a compulsory process to "bail in" a weak bank's creditors as a prerequisite to any public recapitalization (with some limited exceptions). The BRRD approach is different from the approach that had been advocated by the IMF for a Common Resolution Fund publicly funded at the Euro Area level. It was also different from the standard approach to resolving banks, where fast and public recapitalization is used to avoid contagion and loss of confidence in the banking sector.

29. IMF staff was aware of the potential difficulties that the BRRD policy could generate, which became apparent in the case of Italian banks.[11] However, except for a set of very general statements in a box in the 2013 EU FSAP, the Fund did little to express an opinion or seek to provide input into the process leading up to the BRRD. Perhaps, the IMF decided that challenging the EU institutions on one of their core (competition) policies would not be appropriate. The Fund may also have acted out of conviction that the primacy of competition policy embodied in the Directive was fundamentally justified.[12] These are valid and strategic decisions on how to shape the message of surveillance. However, the Fund could still have offered an analysis of the trade-offs involved in a very complex and central issue for the financial stability of the Euro Area. The IMF is well placed and equipped for such an analysis. Indeed, a SDN entitled "Trade-offs in Bank Resolution" was published in February 2018 (Dell'Ariccia and others, 2018).

III. FSAPs

30. The FSAP was established in 1999 as a voluntary, comprehensive and in-depth assessment of a country's financial sector based on a pre-determined format (IMF, 1999). In September 2010, the Fund made a financial stability assessment under the FSAP mandatory every five years for jurisdictions with systemically important financial sectors (including eight of the Euro Area countries) (IMF, 2010).[13]

31. The FSAP has three components: (i) identification of the source, probability, and potential impact of the main risks to macrofinancial stability and analysis of resilience to these risks; (ii) analysis of the country's regulatory and supervisory framework; and (iii) analysis of the authorities' capacity to manage and resolve a financial crisis should the risks materialize. Each country is made to go through a standardized set of tests. The first pillar most often involves stress testing part or all of the financial sector against a diversity of shocks. The second pillar necessitates a point-by-point review of existing institutional arrangements, benchmarked against international best standards. FSAPs are both a "health check" and a risk identification exercise.

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[11] See Anderson (2018b) for a full description and analysis of the discussions between the EC and IMF staff on the tension between EU competition policies and financial stability concerns. Separately, identifying some of the loopholes in the system that gave rise to the Italian experience was difficult ex ante without detailed knowledge of the Italian legal system and insolvency framework. The time and knowledge necessary to conduct this analysis goes way beyond what can be expected form an Article IV consultation.

[12] In interviews, a senior staff involved in Euro Area surveillance emphasized that the IMF was supportive of limits on state aid since it is an integral part of the single market. "Therefore, we don't question competition rules and state aid. We support the underlying principle of the BRRD to make banks safer and limit recourse to public taxpayers." IMF staff also indicated that in fact "it took the IMF a long time to understand that banks could be a subject for competition policy and state aid under the rules of the single market."

[13] As mentioned above, the Euro Area is not a member of the IMF—only its member countries are. Consequently, from a legal perspective, the regional FSAPs for Europe or the Euro Area are not mandatory surveillance (under the 2010 framework) but rather a form of technical assistance on behalf of member countries (similar to FSAPs for countries with non-systemic financial sectors). Nevertheless, current practice appears to treat regional FSAPs for Europe/Euro Area as if it was mandatory every five years.

Most data are collected by the authorities and access to detailed bank-specific data (such as available to supervisors) has to be arranged on a case-by-case basis—which is not always forthcoming.

32. There have been two regional FSAPs for Europe, the first one covering the EU as a whole published in March 2013 and the second one covering the Euro Area in July 2018. This section is mainly based on the 2013 FSAP for the EU and relevant issues from respective FSAP exercises for the three largest countries in the Euro Area: Germany, France, and Italy. The analysis also reflects a review of the 2018 Euro Area FSAP and its technical notes as well as conversations with staff involved in preparing the FSAP (but due to the timing, there were no discussions after the FSAP was completed).

33. European authorities and IMF staff pointed at the following institutional features of FSAPs:

- FSAPs are subject to the principle of equal treatment between countries, which is interpreted as requiring the implementation of the same tests and verifications for all countries, even when already performed by local supervisors, according to a standardized methodology.

- FSAPs are very resource intensive for both the IMF and authorities. In particular, scarce IMF finance specialists devote a great deal of time to duplicating risk assessments that have already been carried out by authorities. The usefulness of these independent stress tests is debated by country authorities and market participants. In interviews for this report, many country officials observed that while initially the FSAP stress tests were useful as regulators were learning about new approaches, recently there has been an increasing sense of duplication of what is already being done by officials.[14]

- The comprehensiveness of the FSAP's assessment of institutional arrangements may weaken the credibility of the exercise, as it is sometimes perceived by authorities as following a "box ticking" approach, with no appreciation of the current relevance of different issues.

- Procedural and resource constraints may prevent IMF staff from identifying and spending time on issues of special relevance and FSAPs may become disconnected form the timetable and content of the Article IV surveillance;

[14] Current and former senior IMF staff are divided on this issue. In interviews, some indicated that the IMF needs to conduct its own independent assessments as a key element of surveillance. Others indicated that stress testing often consists of double-checking authorities' similar exercises. They suggested that these efforts are harder to justify as authorities in more countries are familiar with the techniques, and that it would be more sensible to evolve towards the IMF reviewing the authorities' stress testing models and assumptions. Different views are also present among authorities. For example, Anderson (2018a) cites various German officials on both sides of this argument regarding the 2016 FSAP.

- Advanced consultation with authorities on topics and priorities ahead of FSAPs is less developed than for Article IV missions.

34. There are potential difficulties that arise as a result of the FSAP format; this was very apparent in the EU 2013 FSAP. Both the timing and the constrained framework prevented the FSAP from having a significant impact on the policy debate. The FSAP was published three months after the agreement on December 12, 2012 to establish the SSM. Given the intensity of the discussions that took place between countries to reach that agreement, there was little scope for the FSAP to add value in terms of policy prescriptions. Accordingly, a part of the report consisted of a description of financial segmentation risks facing the Euro Area which were presumably already well known (IMF, 2013a). Another part was comprised of standard statements on and prescriptions for the implementation of the SSM decision.

35. However, the EU FSAP could have made a significant impact on two issues, had they been developed and followed up in subsequent surveillance exercises. The first issue was the problem of bank resolution in the EU for which, as mentioned above, the FSAP initiated an analysis but it was neither further developed nor elaborated. The second such issue related to the arrangements for macro prudential policies and the role of the European Systemic Risk Board (ESRB).

36. In the banking union, micro prudential supervision of the largest banks is done at the Euro Area level (by the ECB) but macroprudential supervision mostly remains a national competence. The EU FSAP accurately described the peculiar governance arrangements that result from this specific distribution of powers:

- National authorities in the EU predominantly are responsible for macroprudential oversight, although adequate frameworks are still lacking in some countries.

- Coordination and internalization of cross-border spillovers is achieved at the EU level by the ESRB through a (non-binding) "act or explain" mechanism for member countries in response to warnings and recommendations.

- Coordination of national macroprudential policies is especially important in the EU, given its highly integrated markets, as well as constraints on the use of monetary policy.

- The ESRB lacks binding legal authority; it relies on "soft" power and is also handicapped by its very limited resources and burdensome governance.

- While the ECB only has authority over banks, the ESRB covers the entire financial system, including insurance and occupational pensions, as well as market infrastructure, financial markets and products. The report noted therefore that the ESRB would be well suited for effective identification, analysis and monitoring of EU-wide systemic risks (IMF, 2013a).

37. The wording hinted at a possible discussion on the appropriateness of retaining essential macroprudential powers and tools at the national level. Analytically and from a policy

perspective, this is an important topic in a single financial market and monetary union. The FSAP analysis has been repeated and summarized in subsequent Article IV staff reports, but with no further elaboration. While the IMF has been very insistent on the need for fiscal capacity at the Euro Area level, the Fund has never discussed the pros and cons of having a Euro Area or EU macroprudential policy in an integrated financial and monetary union.

38. The Euro Area FSSA published in July 2018 (IMF, 2018b) partially redresses the imbalance between banking and other financial stability topics.

- Significant consideration is given to important questions related to market infrastructures (CCPs) and systemic liquidity with two Technical Notes (TNs) devoted to those issues (IMF, 2018c; 2018d).

- The report and associated TN formulate detailed recommendations on the regulation and supervision of investment firms (e.g., the most systemic should be supervised by the SSM) (IMF, 2018b; 2018e).

- The report (with a section in a TN) also discusses at length the macroprudential framework in the Euro Area (IMF, 2018b; 2018e).

- Coverage of developments related to the CMU was limited, with only three paragraphs in the main report (IMF, 2018b) and minor technical recommendations.[15]

- Capital market issues are examined in some detail in a TN (IMF, 2018c), however, with an exclusive focus on the supervisory framework and the treatment of third countries relative to Brexit. No attempt is made to assess the impact of MIFID II, the implementation of which coincided with the FSAP and raised many problems, perhaps because IMF staff considered that this would be more appropriate for individual country FSAPs, given that securities regulation remains a national responsibility.

- Finally, part of a TN is devoted to a detailed discussion of the insurance sector and its supervision (IMF, 2018e). This very informative document broadly reflects the analysis and opinions of the supervision entity (European Insurance and Occupational Pension Authority) and recommends an increase in its coordination powers. The TN also formulates technical recommendations on Solvency II. However, these are not reflected in the main report, which has only two very general paragraphs devoted to insurance (IMF, 2018b).[16] The very optimistic assessment of the sector's resilience and ability to

[15] IMF staff noted that a background note on the CMU was prepared, but not published.

[16] IMF staff stated that the insurance sector is very diverse across Euro Area countries and insurance is a national supervisory responsibility covered by the EU rather than Euro Area directives, hence national FSAPs are better suited for coverage of such issues.

sustain an increase in interest rates is not backed by quantitative analysis. Overall, the Fund's financial surveillance coverage of the insurance sector remains underweighted.

39. The Euro Area 2018 FSSA (IMF, 2018b) also brought a welcome, if partial and debatable, clarification on the Fund's position on bank resolution issues.[17] The staff recommends that all state aid regimes be aligned on the BRRD, therefore imposing a uniform 8 percent bail-in requirement on all banks and dispensing the current, more flexible, rules governing national liquidations. The clear and explicit objective is to eliminate all existing incentives to circumvent the EU resolution regime through national liquidations. The motivation is also to strengthen the Systemic Risk Board (SRB). The proposal would entail a further loss of flexibility that, according to IMF staff, could be compensated by the creation of a systemic exemption. These recommendations are broadly consistent with the analysis of the 2018 SDN (Dell'Ariccia and others, 2018).

40. If implemented, the 2018 FSSA recommendations would also bring strict limits to any flexibility in the application of a bail-in (IMF, 2018b). Alternative possibilities are not discussed in the report, such as limiting the BRRD application to the most important and systemic banks, thus exonerating smaller (local) institutions of the obligation to issue debt that could be bailed-in (a requirement that may prove difficult to satisfy). The future of precautionary recapitalization, recently used by a member state as an alternative to resolution, is also not discussed.

IV. MULTILATERAL SURVEILLANCE: THE *GFSR*

41. The *Global Financial Stability Report (GFSR)* is an IMF flagship report published twice a year, in April and October during the Spring and Annual meetings. It is widely disseminated, advertised and read and is the main element of multilateral financial surveillance.[18] Country officials in Europe and elsewhere are generally appreciative of the analysis and recommendations presented in the *GFSR*. The *GFSR* usually has two or three chapters.

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[17] In addition, the FSSA and the associated Technical Note (IMF, 2018b; 2018g) formulate many useful and operational recommendations, e.g., quick build-up of capital (MREL), reinforcing the SRB's independence, and to better coordinate planning and preparation for resolutions.

[18] Other elements of IMF multilateral financial surveillance include the *World Economic Outlook (WEO)*, the *Fiscal Monitor*, the Early Warning Exercise and IMF collaboration with other international organizations, the latter two of which are discussed in Zettelmeyer (2018). In addition, Article IV consultation staff reports can be a form of multilateral surveillance to the extent they cover significant outward spillovers from members' policies. Separately, IMF management public communication can be an influential communication tool, though not per se a form of multilateral surveillance. This is illustrated by the example of the speech given by the Managing Director at the Jackson Hole Symposium in August 2011 (Lagarde, 2011). In the speech, the Managing Director explained that banks needed urgent recapitalization, and warned that if this was not done the crisis could spread to core countries, or even trigger a liquidity crisis. The speech was backed by estimates of bank losses and resilience and how this could affect their ability to lend. The speech had a significant impact on the policy debate about the prudential treatment of Euro Area banks. It is still seen by European authorities as decisive in pushing for the "capital exercise" decided one month later as an essential part of the overall package of reforms of the Eurozone.

42. This assessment focuses on Chapter 1 of the *GFSR*, which identifies major risks and formulates policy recommendations related to the contemporaneous situation of the financial sector and markets. During the period under review, Chapter 1 often covered issues directly or indirectly related to financial stability in Europe, with special emphasis on the banking sector, and it played an important role in shaping the Fund's message on financial stability in the Eurozone during the crisis.

43. The *GFSR* also comprises one or two more analytical chapters that examine in depth analytical issues relevant for global financial stability. These analytical chapters drew praise from interviewees, especially in the public sector. Central bankers judged the analytical chapters to be of better quality than similar papers produced by the Bank for International Settlements (BIS). According to a senior ECB official the analytical chapters are "very effective in driving attention on policy matters and weak spots."

44. Officials generally praised Chapter 1 for its content, its contribution to identifying risks, and, particularly for the Euro Area, its balance between highlighting country circumstances and bringing a multilateral perspective. Officials at Euro Area-wide institutions appreciated the focus on weaknesses in the banking sector in Europe and, more recently, the attention to European banks' low profitability. That said, some European officials, particularly at the national level, felt that the analysis was sometimes unnecessarily alarming, mainly due to a lack of understanding of European institutions and frameworks. Two examples of these concerns were disagreements with the IMF estimates of the capital needs of European banks and on the impact of NPLs. Officials argued that the data used by the IMF was different from theirs and that it was not possible to replicate the analysis.

45. European officials indicated that the *GFSR* could be more effective by being more explicit on the assumptions, data and methods that underpin its analysis. They explained that the problems with data, analysis and presentation have sometimes obscured the Fund's message and weakened its impact. Two lines of improvements could be pursued. First, readers of the *GFSR* should be made aware in the text of the main methodological choices that have been made (even if only in a footnote at the beginning). Very few readers are currently aware, for example, that the IMF (with good justification) has a different approach to banks' capital adequacy than supervisors. Second, just as with rigorous scientific experiments, graphs and tables in Chapter 1 should be replicable by any competent observer. A methodological annex should be made available online at the time of publication, sufficiently detailed in terms of data and methodology to enable independent analysts to replicate the tables and graphs contained in the main text.

46. Officials would have liked a more systematic interaction on how themes are selected and whether they merit priority. They indicated that they are consulted late in the process and only to correct factual errors. They also frequently pointed out how this approach was in contrast with the back and forth exchanges with IMF staff in the context of Article IV consultations.

47. IMF staff explained that the *GFSR* is based on publicly available data, but admitted that the analysis is sometimes difficult to follow. They are careful not to publish analyses that could heighten market tensions. But they see as a strength of the *GFSR* that it has the freedom to identify and analyse critical risks, without having to manage an ongoing relationship with country authorities. This allows the *GFSR* to raise issues of global relevance, or that affect more than one country. Staff indicated that often the *GFSR* raises issues that are then followed up with authorities by the corresponding Article IV consultations. This was the case on banking issues in the Euro Area and, more specifically, on NPLs.

48. According to interviews conducted for this paper, the analysis of European financial issues in the *GFSR* does not seem to be widely read by investors and it has little traction in the markets. It is perceived as too long, too dense, and too carefully nuanced to be of much interest to people engaged into day-to-day market activities. This should not be a source of concern as it is not the purpose of surveillance, nor should it be, to move markets or influence market perceptions.

V. CONCLUSION

49. During the period under review, financial surveillance of the Euro Area was generally of high quality. Relationships with authorities at the European level were well established and based on mutual respect and trust. This was also true in regard to national authorities, even if in a few cases there were disagreements on IMF messages, particularly those conveyed in multilateral surveillance. The IMF had significant influence on country authorities' and Euro Area officials' thinking on major financial sector issues. It contributed to moving along the Euro Area reform agenda, particularly on measures to strengthen banks and in regard to the banking union agenda. The IMF's global perspective is seen by officials to bring significant value. However, the strength of surveillance depends on the topics. The closer the Fund is to its core competencies, the more comfortable it has been in challenging authorities, thereby enhancing the independence of its surveillance.

50. Looking into the future, this review raises three interrelated issues:

(i) First, there were gaps in the coverage of financial surveillance in the Euro Area. For example, securitization, insurance, asset management and shadow banking did not receive sufficient attention in Article IV consultations. FSAP coverage was broader, which was valuable on some important topics but some other areas received excessive attention in what seemed like "ticking the boxes" that duplicated work and added little value. There was too much inertia in the selection of topics, perhaps because different parts of the Fund were not fully brought together to define the priorities. There may be a need for more coordination between MCM and country desks. It is puzzling to see how little of the *GFSR* analytical chapters inspire and determine bilateral surveillance – another reason to strengthen coordination.

(ii) Second, some authorities indicated that there was significant variability in the financial and macrofinancial skills in Article IV teams. It seems that staff's mix of skills needs to be tilted towards more economists with a finance background, particularly financial economists and financial specialists on capital markets, insurance and accounting. In addition to recruitment and in-house training, the Fund would also benefit from more secondment of officials with economic background and experience in financial stability issues. It could also benefit from IMF economists being seconded to the ECB, EBA, and other relevant European institutions.

(iii) Finally, the Fund needs to develop an analytical framework of reference for examining financial stability. A senior European official remarked that "reading through five years of FSAPs, there does not seem to be a general model of how a financial sector should work." True, this is a gap in the profession and not only in the IMF. But not many other institutions have the IMF's analytical capability and resources. The Fund is constantly developing and updating its (institutional) vision on how the macro economy should work. It should aim at doing the same on issues related to financial stability. Building its own doctrine on financial stability would enhance the role the Fund plays in multilateral forums and organizations. This may be necessary in the current period, where difficulties lie less in implementing past reforms than correctly detecting future risks and challenges in a constantly changing technological and economic environment.

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CHAPTER 2—IMF FINANCIAL SURVEILLANCE OF GERMANY

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EXECUTIVE SUMMARY

This case study finds that the objectives of the 2012 financial surveillance strategy have largely been achieved in Germany. Risk identification has been strengthened, reflected in an integrated view developed across IMF surveillance products and mainstreamed in annual Article IV reports. Fund analysis and advice were valued by officials, who hold in high regard the rigor, technical expertise and understanding of country circumstances. Fund financial surveillance was seen by German officials as having been particularly helpful in identifying gaps and weaknesses in supervision, safety nets and resolution mechanisms under the evolving European architecture, on macroprudential issues, especially on the need for effective tools and better data to monitor financial stability and spillover risks that might arise in real estate financing.

Most officials appreciated the 2016 FSAP, although it had been less impactful than the 2011 FSAP that had shaped Fund financial surveillance of Germany until recently. Officials, particularly at the Bundesbank, saw value to the informal exchanges and the stress tests. Other officials were less clear on the value added by the 2016 FSAP, given the cost both to the Fund and to the German authorities. In any case, German officials indicated that the coverage of Germany is warranted to legitimize acceptance of IMF scrutiny in other countries.

Article IV surveillance over Germany has generally been consistent with FSAP messages. Officials also pointed to Euro Area Article IV reports as valuable since they covered relevant cross-country issues. By comparison, the *GFSR* seems to have had less traction, partly because it often focuses on low probability risks and because it offers less detailed advice on how to address issues it identifies, although the overall quality of its analysis was appreciated. German officials were united in expressing concern about comments about individual institutions, particularly in the *GFSR* but also in public communications and the FSAP.

Looking forward, the study identified two central financial issues where the Fund has yet to make a strong contribution: how best to remedy the low profitability of banks and insurance companies, given the persistence of the low interest environment and the three-pillar banking system that have come under significant pressure from narrowed lending spreads and advances in financial technology; and the causes and financial sector impact of Germany's sustained large current account surplus. A related question is how to advance capital markets issuance by German firms, which would lessen dependence on banks and help to advance Capital Markets Union. Particular focus is warranted on large banks and insurance companies with significant spillover potential, as well as weaker Landesbanks and Sparkassen.

I. INTRODUCTION

1. This country case study evaluates the relevance, quality and impact of IMF financial surveillance over Germany for the period since the 2011 Financial Sector Assessment Program (FSAP) report.[1] Section II provides a brief overview of the main challenges, debates and constraints relating to financial stability and financial policymaking since 2011. Section III lays out the coverage of macrofinancial issues in the 2011 and 2016 FSAP reports, *Global Financial Stability Reports (GFSRs)* and Article IV reports. Section IV evaluates how well the IMF did in identifying key risks, providing useful analysis, integrated messages and sound advice and the influence on official thinking and policy action.

II. CONTEXT

2. Prudent macroeconomic policies and earlier structural reforms have contributed to impressive German economic performance in recent years, with unemployment decreasing to a record low as output strengthened. Macroeconomic performance has been good despite what some view as a problematic financial structure that required sizable state support during the global financial crisis and has more recently been characterized by low profitability and inefficient business models.

3. Against this background, major changes in financial regulation and supervision at the global, European and national levels have been accompanied by steady progress towards strengthening capital and liquidity buffers for banks and insurance companies, leaving the German financial system robust to a broad range of shocks. Architectural challenges have included implementation and coordination across different regulatory frameworks for larger and smaller financial institutions and the need for clarity on crisis management and deposit insurance backstops. Low interest rates have added to profitability pressures for banks and insurance firms while increasing risks connected with real estate lending. Macroprudential tools have been developed to help contain risks, and stronger supervisory action has been undertaken to steer insurance companies away from risky yield-seeking investments.

4. IMF financial surveillance at the time of the 2011 FSAP was influenced importantly by the still recent legacy of the global financial crisis. Along with idiosyncratic weaknesses in individual banks, the crisis was the proximate trigger for €144 billion of state aid to financial institutions in the form of direct recapitalizations and impaired asset relief during 2008–12, equal to 5.2 percent of GDP.[2] Including funding for assets taken over by "bad bank" windup institutions, general government debt was boosted by 11.9 percent of GDP by the end of 2010, a figure that was

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[1] This report is based on interviews, publications and materials available before December 31, 2017.

[2] European Commission (2017). Alongside these asset measures, liability support via borrowing guarantees and asset swaps amounted to €140 billion. Approved state aid during 2008–12 amounted to €197 billion of assets and €457 billion of liability support, equal to €655 billion, or 23.7 percent of GDP. Direct fiscal impact was limited during 2008–12, with outlays net of receipts adding an average of 0.3 percent of GDP a year to the general government deficit.

reduced to 7.2 percent of GDP by the end of 2016 by asset recoveries and disposals and by GDP growth. Banks assisted or intervened during this period included five publicly-owned Landesbanks and the second largest private commercial bank. Two sizable private banks specializing in real estate, IKB and Hypo Real Estate (HRE), were downsized and sold, one Landesbank, West LB, liquidated, and others merged with or acquired by other Landesbanks.

5. The main challenges to financial stability in Germany have remained centered on the need to assure adequate capital and liquidity, viable business models and strong governance. Equally important, given the heavy losses of the 2008–12 period, has been ensuring sufficiently rigorous supervision, initially of banks and later including insurance companies, asset managers and central counterparties. Ensuring the legal authority and the data needed for effective macroprudential oversight grew in importance as the European Central Bank (ECB) gradually reduced interest rates from late 2011 to zero or less by early 2014, giving rise to the need for a broader policy toolkit to contain systemic risks, especially those might otherwise emerge in real estate lending. Crisis management and bank resolution remained central issues throughout the period. These efforts shifted from ensuring adequate resources for the national bank restructuring fund established in 2008 and clarifying interactions with different deposit insurance schemes to the current focus on achieving effective coordination among the various German and EU authorities under the evolving European architecture, especially the Single Supervisory Mechanism (SSM), which began functioning in late 2014. Attention has also been focused on resolving remaining deposit insurance gaps and uncertainties.

III. Overview of Recent IMF Financial Surveillance

6. For much of the period under review, Fund financial surveillance of Germany was shaped by the 2011 FSAP, an exercise with heavy attention to Reports on the Observance of Standards and Codes (ROSCs) conducted before the IMF adopted its current financial surveillance strategy in September 2012.

7. The main findings of the 2011 FSAP included concern that low profitability would hamper the ability of financial institutions to build stronger buffers against shocks. The report also called for "overdue" structural reforms to be advanced, with Landesbanks singled out as requiring thorough restructuring and probable downsizing amidst a more general imperative for stronger commercial orientation and greater competition across the regional boundaries within which Landesbanks traditionally operated. Reforms prompted by the large banking sector losses of 2008–12 were judged to have left financial sector regulation and supervision at a high standard. Even so, more timely and extensive information collection was recommended to support rigorous on-site supervision, forward-looking supervisory action and the rationalization and clarification of deposit insurance schemes to enhance crisis management. The FSAP also advised that Germany should participate actively in developing mechanisms to deal with cross-border European crises.

8. The 2016 FSAP built on these themes, relying in part on stress tests of the banking and insurance sectors with multiple adverse scenarios, assessing that financial system resiliency was robust to a broad range of shocks in the wake of a further round of major financial sector reforms over the preceding five years. Attention was given to the activities of the large, systemically-important commercial banks and insurance companies and associated spillover risks, including those that might be spread via the global interlinkages of Frankfurt's central clearing counterparty.

9. The 2016 FSAP paid particular attention to issues at some very large financial institutions, mentioning specific financial institutions by name, as did Fund officials in response to questions at an October 2016 GSFR report press conference. The 2016 FSAP noted in a section on systemic risk and spillovers that equity returns suggested a high degree of interconnectedness between the two largest commercial banks, a medium-sized specialist property lender and three of the four largest insurance companies. Network analysis was used to assess that Deustche Bank appeared to be "the most important net contributor to system risks" among all G-SIBs,[3] with the banking sector as a whole having among the highest degrees of potential for outward spillovers, along with banks in France, the U.K. and U.S.[4] Both Deutsche Bank and Commerzbank were assessed as significant sources of outward spillovers to other German banks and insurers, with Allianz, however, characterized as "the largest contributor to systemic risks among the publicly-traded German financials."[5] Further references included the statement that "(t)he relative importance of Deutsche Bank underscores the importance of risk management, intense supervision of G-SIBs and the close monitoring of their cross-border exposures, as well as rapidly completing capacity to implement the new resolution regime".[6]

10. Another key focus of the 2016 FSAP was on identifying and addressing gaps remaining from post-crisis reforms of regulation and supervision carried out at the global, European and national levels. These included the full implementation of Basel III/CRR/CRD IV[7] and Solvency II as well as moves to implement Banking Union with the establishment of the SSM and the single resolution mechanism (SRM). Another area of attention was the low profitability of banks and insurance companies given the persistence of the low interest environment and a three-pillar

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[3] Global systemically important banks.

[4] Measured as average percentage loss of bank capital elsewhere due to source country banking shocks.

[5] IMF (2016a).

[6] An earlier reference to Deutsche Bank, also relegated to a footnote, noted the effect on earnings of repeated fines, observing that they "may be indicative of corporate governance issues". The October 2016 *GFSR* did not name specific institutions when reporting on the need for large banks to transition away from "dated business models" requiring large balance sheets. In response to press questions, however, Fund officials affirmed that Deutsche Bank was among the group of banks needing to adjust to convince investors that their business models were viable.

[7] CRR refers to the EU's Capital Requirements Regulation and CRD IV to its latest Capital Requirements Directive.

banking system characterized by large shares of publicly-owned and cooperative banks and business models based on maturity transformation and guaranteed savings products that was under increased pressure from narrowed lending spreads and advances in financial technology. Recommendations in the 2016 FSAP centered on finalizing the reform agenda and putting in place associated architecture, prioritizing resolution processes that safeguard taxpayers and securing the information needed to better monitor financial stability risks and spillovers, especially those connected with real estate and housing finance.

11. Article IV messages were consistent with those in the 2011 and 2016 FSAPs. Early on, structural issues and soundness considerations prompted calls to scale back public capital support extended after 2008, reduce the balance sheets of the windup institutions established for HRE and West LB, two large banks intervened in 2008 and 2009, and press ahead with the restructuring of the Landesbanks and their business models. More generally, supervisors were advised to continue pushing banks to augment capital buffers, adjust business models and focus on improving efficiency and profitability. This emphasis was extended in 2014 to medium-sized life insurance companies, the capital buffers of which came under increased pressure as lower interest rates made it more difficult to find high enough yielding investments to meet minimum return guarantees on investment products sold to savers. For banks, concerns that lower interest rates could encourage excessive risk taking reinforced a shift towards a stronger macroprudential framework, with an expanded toolkit of regulations such as loan-to-value limits and data to better assess risks, including on individual loans, loan concentrations, borrower finances and real estate prices. Calls were repeated to strengthen the European crisis management framework, including by developing a coherent harmonized roadmap towards reversing banking system fragmentation across Europe as part of a fully integrated Banking Union. In the 2017 report, these recommendations were reinforced with advice to formalize a coordination mechanism for systemic crises, underpinned by contingency planning.

12. Coverage of Germany in *GFSRs* has usually been subsumed in discussions about the challenges facing European banks more generally. Early on, focus was directed toward the dangers of adverse sovereign-bank feedback loops in other Euro Area countries[8] and the economic and financial risks posed by deleveraging and credit contraction as banks strove to adjust to tightened capital and liquidity requirements amid weakened borrowing demand.

13. Messages relevant to Germany in *GFSRs* included underscoring that much work remained to be done to repair the credit transmission mechanism, even though most non-performing

[8] Germany was more the beneficiary of worries about sovereign-bank linkages in other Euro Area markets than victim of concerns about its own banking sector stresses. This is ironic, perhaps, given the size of the public debt taken on in Germany to recapitalize banks and facilitate transfers of impaired assets, which at 11.9 percent of GDP was larger as a share of GDP through 2010 than any other EU member state except Ireland, and accounted fully for two-thirds of the increase in general government debt during 2007–10 and one-seventh of outstanding government debt at the end of that period.

loans (NPLs) had been removed from German bank balance sheets with the transfer of toxic assets connected with the U.S. mortgage market (and some Euro Area periphery debt) to the "bad bank" windup institutions. Home-grown NPLs were much smaller.[9] Later *GFSR* assessments called for sharpened asset quality reviews for Euro Area banks more generally, including smaller ones. Reinforced cost reduction was advised as well, along with toughened supervisory approaches, along the lines of those applied to HRE and West LB, to resolve unviable institutions, accelerate consolidation and reduce overbanking.

14. Specific mention was made in the October 2016 *GFSR* of developments among German savings banks, the Sparkassen, and their counterpart institutions in Spain and Italy. "As outlined in the 2016 Germany FSAP, the German savings bank sector has deleveraged as banks refocused on core businesses, reduced noncore assets and participations, closed foreign offices, and sold a number of subsidiaries, although more restructuring and downsizing is needed. Foreign currency activities and refinancing risks were cut back, while dependence on wholesale market financing declined" (see IMF, 2016c). Also referencing the 2016 FSAP, a separate section in Chapter 1 of the October 2016 *GFSR* on challenges for life insurance companies and pension funds due to low interest rates noted the difficulties facing German life insurers due to the longer and higher return guarantees they have typically offered and the spillover risks posed by insurance firms' interconnections with banks and asset managers.

IV. EVALUATING IMF FINANCIAL SURVEILLANCE SINCE 2011

15. Interviews with German officials and private sector analysts conveyed a broad consensus that IMF financial surveillance has generally done well in identifying key problems and risks in Germany in recent years, providing useful analysis and advice. Policy messages appear to have been effectively integrated across both the bilateral and multilateral surveillance reports, although the latter have been much more focused on Euro Area issues and architecture. Officials see the IMF as having considerable influence on official thinking on financial issues.[10] They agreed with others in citing IMF advice on strengthening macroprudential oversight and its stance against state aid for politically connected banks as having been important in Germany when this was an issue. IMF recommendations on Banking Union and its related architecture were thought to be having the same kind of positive influence in Europe, along with its advice to strengthen efforts to address NPLs.

16. The IMF's global perspective is seen by officials as to bring in significant value for financial surveillance of Germany, especially via the macrofinancial expertise developed as its

[9] NPLs held by banks declined to roughly 2 percent of total exposures by early 2017, half the EU average (European Banking Authority, 2017). A significant portion of German NPLs represented shipping loans made by commercial banks and Landesbanks.

[10] Bundestag insistence that the Fund participate in the Greek program was offered as evidence of the great weight IMF advice carries in Germany, with interviewees referencing its independence and expertise.

financial surveillance efforts have grown. Some in the private sector demurred, saying that they did not learn much from the IMF's work in this area and suggesting that Germany's relative lack of financial sector difficulties did not justify the intensified focus involved in the 2016 FSAP. German officials agreed with European counterparts, however, that the focus on Germany is needed to legitimize acceptance of IMF scrutiny in more problematic countries.

17. On whether Fund advice should be public or private, German officials were united in expressing concern about comments about individual institutions. It was a mistake for the IMF to name specific firms, they argued, given the danger that the market could read more than intended into any such references and create unnecessary and unhelpful volatility. One official reflected that statements about Deutsche Bank being a global risk, needing a new business model with a much smaller balance sheet, had made a challenging situation worse. Even so, there was agreement that press reports about the mention by the IMF of Deutsche Bank in the 2016 press briefing misconstrued what was actually said by staff and that text references at the time in the FSAP and *GFSR* were "not so bad." As regards the FSAP text, staff observed that references were based on publicly available information and had been reviewed and accepted by the authorities before publication.

18. More generally, one official observed that there were very few instances where the IMF has said things not already being said in the markets. Market sensitive information, moreover, has never been leaked. IMF impartiality is trusted, so that when it does go public with advice that does move markets, as was the case with the Managing Director's 2011 Jackson Hole speech, its willingness to speak out is seen to be an important reason to listen.

19. Others were less reverential about IMF advice, public or private. One official commented that more detailed proposals and greater expertise were needed for Fund advice to make more of a difference, especially on key issues such as how to change business models, strengthen financial institutions' profitability and encourage greater reliance on capital markets. IMF recommendations must be listened to, but not necessarily followed. The IMF's good standing, as a result, translates to little real impact in the end.

FSAPs (2011 and 2016)

20. The 2011 FSAP was viewed by officials as particularly impactful on the need to develop a macroprudential framework, which was useful in passing needed legislation to implement the Financial Stability Council. Also helpful were calls for macroprudential tools like the loan-to-value regulations, which were eventually enacted in 2016. Messages in the FSAP and Article IV that the instruments were needed helped to develop the political momentum required to pass enabling legislation. Scope was limited politically, however, to implement the detailed real estate reporting

the IMF also recommended.[11] Focus on risks in the insurance sector was also seen to be important, but some of those interviewed joined officials in Brussels (and staff) in expressing disappointment that the IMF was not able to offer more specific advice on measures to remedy weak profitability in the insurance sector.

21. There were varying views of the value of the 2016 FSAP. Government officials and their counterparts at the Bundesbank thought it quite useful, including its continued value in focus on spillovers, despite its considerable cost in resources and time during a period when financial difficulties were not pressing. Most thought it provided good value by covering the relevant topics, identifying the right vulnerabilities and contributing helpfully to improving coordination among a multitude of regulatory agencies. The staff was seen as very competent, with good engagement and a generally good understanding of the local environment. Officials saw particularly good value from informal exchanges on these issues at the staff level.

22. Stress tests conducted as part of the 2016 FSAP were highly regarded by the Bundesbank, whose officials thought they provided useful complementary value to the other exercises being done in Germany and at the European level. IMF experts were seen as bringing added value, including via methodological discussions, contagion measurements and how not to overlook issues. Several shared the view that the IMF's stress test work had helped to make the German models better. There were some issues on understanding hard-to-interpret data to which the Fund was given "less than perfect" access, but IMF staff were seen as highly competent and well-versed in the "state of the art."

23. Other officials were less clear on the value added by the 2016 FSAP, given the cost both to the Fund and to the German authorities, arguing that the problems were well known: low profitability due to overbanking and Sparkassen that need to be closed. Stress tests were seen as less helpful, in this view, with the ECB addressing the significant institutions (SIs) and the rest, the less significant institutions (LSIs), not posing systemic risks.

24. One point of contention was a divergence of views on two-tiered supervisory boards. While noting Germany's well-developed corporate governance requirements, the FSAP report viewed the oversight role played by supervisory boards as too passive, resulting in limited operational oversight thanks partly to streamlined processes for fit-and-proper and technical knowledge requirements. Noting the difference of views with the staff, one official expressed appreciation for a "healthy debate" about whether the German practice was "compliant" and "materially compliant" with the Basel Core Principles.

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[11] One official thought the recommended real estate reporting would have been deeply unpopular. The same view was given about the additional macroprudential tools that were not legislated, i.e., setting borrowing limits pegged to income. Some voters would have seen these, the official suggested, as blocking them from buying houses as an alternative to investing in bank deposits and bonds, positive returns on which the ECB was seen as having largely eliminated.

GFSRs

25. Views on the *GFSR* were varied. Commenting generally, one official thought it provided a very good summary of the current state of international financial developments, setting the agenda for policymakers even if it didn't reshape thinking. Another considered the analytical work in the *GFSR* to be good but wondered how useful it was for guiding policy. On European issues where German influence weighs heavily, another official viewed the Euro Area Article IV reports as the appropriate vehicle for policy advice to member states. These were taken more seriously than the *GFSR*, despite its high quality and often more systemic perspective, particularly as the Euro Area reports covered cross-country issues like low interest rates, financial institutions' low profitability, poor business models and excess capacity. The *GFSR*, by comparison, has little traction, this official thought, partly because it often focuses on low probability risks.

26. On bank consolidation and profitability, the *GFSR* had the same message for four years on the need for business model change. More helpful would be to spell out how to get there. Should there be more loan generation? More fee generation? More direction is needed on how to facilitate this. Staff shared this sentiment with several noting the need to develop more expertise. Officials thought there was too much discussion about consolidation without details in the *GFSR*, much of which seems to flow from the difficulties experienced trying to encourage more mergers among German and Italian banks. Progress on mergers in both countries and across more borders should remain a key objective where more detailed Fund advice could be valuable.

Article IV reports

27. A key issue for bilateral Article IV surveillance has been Germany's sustained large current account surplus, which some on the staff, in the private sector and in Brussels see as having an important financial sector dimension.[12] Several interviewees, including staff, commented on the need for more analysis of what is driving high private saving and low private investment and what role, if any, might be played by the financial system, its incentives and structure. Given doubts among many in both official and private circles that demographics or the fiscal stance can explain the size of the surplus, a view the IMF's external balance assessment reporting shares, analysis to help form views among policymakers and their political masters about other causes would be helpful, several officials suggested, especially if these related to the financial system.

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[12] Estimated at 8.4 percent of GDP during 2017 in the 2017 Article IV report, the current account surplus was 3-6 percent of GDP wider than the norm estimated under the IMF's External Balance Assessment procedure, which adjusts for demographic effects and optimal policy settings. Key conclusions from the Board discussion of the IMF's 2017 External Sector Report relevant to Germany included the call in the directors' discussion "for more research on the drivers of corporate and household savings...," looking more carefully into "the large difference in gross corporate saving behavior across advanced economies and the role it plays in driving imbalances."

28. Noting that macrofinancial analysis was a weak point of surveillance, not just for the IMF, a Brussels-based official thought that regular Article IV reports should examine whether taxation and the structure of banking and insurance account in part for Germany's "excessive" saving rate. Another European official thought that the Fund should try to understand whether more innovation in financial instruments available to savers and institutional investors might impact saving and if a wider range of alternatives to banks might affect investment decisions by companies and households[13] An academic thought it important to examine the distortive effects of the disproportionate share of banking sector profits earned by small savings banks, the Sparkassen, many of which are under local control and closely linked to local politics. This was important, the interviewee argues, since Sparkassen account for a large share of (essentially free) savings deposits that they are able to invest in low-risk securities with few losses and only modest capital requirements.

29. Others thought Fund analysis might look into why household saving had not declined with lower deposit interest rates and bond yields, focusing as well on whether income substitution effects had led households to try to compensate for lower returns by saving more, and thereby adding to the current account surplus. Staff concede that more work could usefully be done on whether barriers to other forms of saving have contributed to households' strong preference for bank deposits and fixed income investments, including the guaranteed variety offered by insurance companies.

30. There were different views on what role the Fund should play as regards digitization and Fintech. Some officials thought that the Fund could advise on risks, while others thought the IMF should help to elaborate and advance regulatory and supervisory approaches that support innovation while keeping an eye on the risks.

[13] This official noted that this would require the IMF to develop a view about what the financial sector should look like and how to get there. The same official also observed that a lack of the needed macrofinancial expertise led staffs of macroeconomists at the IMF and the European Commission alike to often join others in falling back on the mantra that the excessive external imbalances such as Germany's must be "mostly fiscal."

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CHAPTER 3—IMF FINANCIAL SURVEILLANCE OF ITALY

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EXECUTIVE SUMMARY

This study finds that Fund financial surveillance of Italy has broadly succeeded in fulfilling the objectives of the IMF's financial surveillance strategy as it was revised in 2012. Identification of risks and vulnerabilities was strengthened, a mostly integrated view developed across Fund surveillance products, and financial sector analysis and advice mainstreamed into annual Article IV reports. That said, interviews revealed a range of different views about the quality of the IMF's analysis and its traction with policymakers.

IMF financial sector surveillance during this period was conducted against the backdrop of a double-dip recession that left real GDP lower in 2017 than before the global financial crisis struck in 2008. Most interviewees agreed that the resulting increase in non-performing loans (NPLs) was due more to weak economic activity and the deficient insolvency framework than shortcomings in bank supervision. Stress tests done as part of the 2013 FSAP did not underestimate the pressure on capital adequacy, measuring outcomes against forecasts. IMF reporting focused appropriately on strengthening bank capital and liquidity buffers, identifying balance sheet repair as key to renewing economic expansion and reducing vulnerabilities. IMF messaging did quite well in delicate circumstances, providing a reasonably balanced warning of financial sector risks and vulnerabilities, not being too strident in public, but sharper in private. Policy messages have been mostly consistent across different IMF reports, including the *GFSR*, where occasionally sharper statements helped to highlight Italy's potential for regional and global spillovers. Fund reporting also played a useful role at the European level, bringing attention to issues on how the European framework affected the resolution of Italian banking problems.

The area where the IMF could have been more effective was to have more convincing analysis of why slow NPL resolution was a problem for the economy and how NPL disposal could be accelerated. In both these areas, officials were unconvinced that the Fund understood well enough the specific Italian environment. Differences of view about NPLs, their effects, and how best to resolve them have been a source of clear tension between the IMF and country officials. IMF advice might have had more traction had it focused on how its advice on state-backed asset management companies could work within EU state aid and competition rules.

I. Introduction

1. This country case study for Italy provides background for an evaluation of the relevance, quality and impact of IMF financial surveillance by the Independent Evaluation Office for the period since the adoption of the current IMF financial surveillance strategy in 2012.[1] Section II provides an overview of the main challenges, debates and constraints relating to financial stability and financial policymaking in Italy. Section III outlines the coverage of macrofinancial issues in the 2013 FSAP report, Article IV consultations, *Global Financial Stability Reports (GFSRs)* and other multilateral surveillance reports. Section IV evaluates how well these reports did in identifying key risks, providing useful analysis, integrated messages and sound advice and in influencing official thinking and policy action. Section V concludes, offering recommendations about future IMF financial surveillance of Italy and more generally.

II. Context

2. Declining competitiveness and ongoing structural weaknesses have contributed to a disappointing economic performance in Italy despite efforts in recent years to advance needed reforms. A double-dip recession left output in 2017 weaker than its pre-crisis level in 2007 despite three successive years of renewed but moderate expansion. A high level of debt, meanwhile, has left public finances vulnerable to the eventual normalization of Euro Area monetary policy despite successful efforts to bring the fiscal deficit to within the 3 percent of GDP Maastricht limit. Sizable bank holdings of domestic government debt leave open at least a remnant of potentially damaging sovereign-bank feedback linkages. These have been mitigated, however, by the bank recapitalization loan facility of the European Stability Mechanism (ESM) and bail-in requirements for shareholders and junior bondholders under the EU's 2013 Banking Communication, although in Italy's case these requirements have proven difficult to apply in practice.[2]

3. Bank financial performance has improved as the economy has recovered but remains under strain with profitability depressed by high costs, unprofitable business models, a compressed yield curve and high levels of nonperforming loans (NPLs), which peaked in 2015 at €360 billion before provisions, equal to 17.5 percent of gross loans and 22 percent of GDP.[3] New

[1] This report is based on interviews, publications and materials available before December 31, 2017.

[2] For reasons discussed below, provisions of the Bank Recovery and Resolution Directive (BRRD) have not yet been applied in Italy despite having come into effect at the start of 2016. These require the bail-in of shareholders and senior as well as junior bondholders up to a minimum of 8 percent of an intervened bank's total liabilities.

[3] IMF (2016b).

NPLs have begun to slow, however, as provisions have continued to increase, lowering the aggregate, net of provisions to €173 billion, or 10.3 percent of GDP at the end of 2016.[4]

4. Financial sector vulnerabilities came into sharp focus in Italy during the year or so preceding the IMF's adoption of a new financial surveillance strategy in September 2012. In the context of the Euro Area crisis, Italy was seen as a significant source of risk given its years of mediocre economic performance and the high level of NPLs in the banking system. The European Central Bank (ECB) had only just finalized the preparation of the Outright Monetary Transactions (OMT) program announced in July 2012, under which it would make direct secondary market purchases of Euro Area sovereign debt[5] to alleviate pressures caused by worries about currency redenomination tail risks. Broader financial concerns remained salient, even so.

5. Efforts to address financial sector vulnerabilities in Italy have taken place against a background of major changes in financial regulation and supervision at the global, European and national levels in response to the global financial crisis. As elsewhere, these have centered on ensuring stronger capital and liquidity buffers for banks and insurance companies to improve resilience. In Italy (and the rest of the Euro Area), architectural challenges have included implementation and coordination across different regulatory frameworks for larger and smaller financial institutions and the need for clarity on crisis management and backstops, especially the common funds for bank resolution and deposit insurance, promised under full Banking Union and required to address what remains of the sovereign-bank feedback loop. Euro-area wide backstops, however, will not be supported politically in key European partners until legacy banking cleanup costs are seen to have been cleared, in Italy and other countries as well. The road toward Capital Markets Union figures to be longer still, given the larger share of bank-dependent small and medium enterprises (SMEs) in value added and employment in Italy than in most other EU member states.[6]

6. So far, Italy's efforts at bank recapitalization and resolution have involved relatively small government outlays. Cumulative fiscal support for bank capital injections during the period before bail-in requirements came into effect at the start of 2016 amounted to €11.8 billion in Italy, or 0.7 percent of GDP.[7] Another €16 billion was authorized in December 2016 for recapitalizations,[8] of which €10.6 billion was tapped in June 2017. These funds were used partly for the precautionary recapitalization of Monte Paschi di Siena (MPS), the fourth largest bank by assets, to meet a projected shortfall under the adverse scenario of the 2016 stress test conducted by the ECB's

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[4] IMF (2017b).

[5] If needed, with appropriate conditions.

[6] European Commission (2017a).

[7] European Commission (2017b).

[8] Another €4 billion was authorized then for government guarantees of new issues of bank bonds.

Single Supervisory Mechanism (SSM). The rest compensated Intesa Sanpaolo (ISP), the second largest bank, for taking over the viable parts of two Venetian banks deemed large enough in their region for their liquidation (and the bail-in of subordinated debt under EU rules) to be contrary to the public interest.[9] Part of MPS' shortfall was met by bailing in junior bondholders, but with provisions to compensate retail holders able to prove that their bonds had been "missold."

7. In the EU as a whole, by contrast, €821 billion of state aid was approved for bank recapitalization during 2008–15. Of this, €466 billion was used, equivalent to 3.2 percent of EU GDP. Recapitalization and impaired asset measures in other Euro Area member states during 2008–15 ranged from 3-4 percent of GDP in Austria and the Netherlands and near 5 percent in Germany and Luxembourg to 5 percent in Spain and almost 11 percent in Belgium.

III. Recent IMF Financial Surveillance

8. IMF bilateral surveillance of financial sector issues in Italy was shaped by the 2013 FSAP report and by concurrent and subsequent annual Article IV reports. Messages in the 2013 FSAP and Article IV reports were closely aligned, with the latter framing the need for action on financial sector issues within the former's assessment that while Italy's financial system had emerged resilient from the global financial crisis, the resulting economic downturn had left the system with reduced buffers against future risks and vulnerabilities. The most pressing vulnerabilities were identified as weak profitability, deteriorated loan quality and reduced coverage of NPLs by provisions and collateral. Both the FSAP and the Article IV reports stressed the need for targeted financial sector action and continued ECB liquidity provision to preserve financial stability and support the real economy. More broadly, Article IV reports also emphasized the need to push ahead with a broad range of long-lagging structural reforms to strengthen competitiveness and remedy the disappointing performance of growth and employment while recognizing the progress made in advancing overdue fiscal adjustment.

9. Specific recommendations in the 2013 FSAP included measures aimed at increasing loan loss provisions, improving bank efficiency, developing an NPL market and requiring banks to strengthen capital and funding plans. Improved governance was called for as well, especially among foundation-owned institutions and cooperatives, the larger of which the IMF argued should be converted into joint stock companies. MPS was identified by name in the FSAP report as systemic, with its rehabilitation a key priority as a result of problems stemming from "an accumulation of management and governance failures."[10] Bank supervision was characterized as

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[9] In addition, ISP was also given up to €12 billion of guarantees against potential losses on the two banks' performing loans.

[10] Internally, staff communicated to management that MPS asset quality and capital were low, with its largest shareholder—a municipal foundation—both politically-dominated and essentially bankrupt, and viability dependent on an optimistic restructuring plan. Noting potential systemic implications were depositor confidence shaken, staff recommended close monitoring and contingency arrangements to take early control of the bank, if needed. Staff also noted that political sensitivities led them to refrain from any public statements on MPS at the time of the FSAP mission.

strong but with gaps to be addressed, including related-party transaction regulations, "fit and proper" rules, and legal authority for the central bank to take corrective action when needed. The FSAP also called for stronger securities market supervision, including more onsite inspections, and improved insurance supervision under a recently enacted reorganization.

10. A key FSAP finding was that the banking system would be able to withstand both a weak macroeconomic outlook and the phase-in of tougher Basle III requirements, but with depleted capital buffers under two adverse stress test scenarios. System-wide capital ratios were projected to decline based on a sample of 32 banks and banking groups[11] but remain well above regulatory minima in a baseline scenario that assumed renewed real GDP growth averaging 0.6 percent a year during 2013–17. Larger capital ratio declines were projected under a no growth variant and a crisis scenario with output more than 4 percent lower than in the baseline scenario. In the event, the aggregate bank capital ratio increased instead of declining, exceeding the aggregate projected in the baseline scenario by more 3 percentage points even though real GDP growth fell short of the baseline assumption by an average of 0.3 percentage points a year (Table 3.1). Capital raising and further reductions in risk-weighted assets contributed to higher ratios, but smaller credit losses than projected in the FSAP also appear to have been a factor.[12]

Table 3.1. 2013 FSAP Bank Stress Test Assumptions and Results

	Real GDP in 2017 (2012=100)	Growth, 2012-2017 (In percent, average)	CE Tier One Capital (as percent RWA)	Tier One Capital (as percent RWA)
Baseline	102.8	0.6	9.2	9.2
Slow	100.1	0.0	8.4	8.5
Adverse	98.5	-0.3-	6.0[1]	6.0[1]
Latest	101.5[2]	0.3[2]	12.5[3]	12.8[3]

Sources: IMF (2013c, d), (2017e); and Banca d'Italia (2017).
[1] At end-2015, reflecting the three-year horizon of the adverse scenario.
[2] Actual through 2016 and October 2017 WEO estimate for 2017.
[3] At end-June 2017.

11. Although the 2013 stress tests found that the system would be able to keep capital ratios above required minima, it also concluded that 10, 15, and 20 of the 32 banks and banking groups sampled would need additional capital under the baseline, slow growth and adverse scenarios, respectively. Combined shortfalls, however, were deemed manageable compared with

[11] Accounting for about 90 percent of banking assets.

[12] How well the FSAP stress tests projected asset quality and NPLs can only be inferred. While not separately identified in the FSAP projections, charts detailing drivers of capital ratios changed projected by the Banca d'Italia in parallel stress tests (with results similar to those of the 2013 FSAP) suggest credit losses have been smaller than were projected under the baseline and slow growth scenarios and significantly less than in the adverse scenario. Credit losses appear to have been marginally larger, however, than initial FSAP projections communicated provisionally to management in the aide memoire and the back-to-office memorandum. Much of the difference is likely to have reflecting the worsening of developments during 2012, with the final FSAP projections having been based on end-2012 data and the April 2013 *WEO* baseline, compared with the provisional ones done using end-June 2011 data and inputs from the October 2012 *WEO*.

the €40 billion of new capital raised by Italian banks from 2008 through mid-2013 (Table 3.2). Grouping the results by ownership type and size, the stress test also found shortfalls to be more pronounced among foundation-influenced banks and cooperatives and among medium-sized banks, many of which were also cooperatives.

Table 3.2. 2013 FSAP Bank Stress Test Capital Shortfalls

	Number of Banks With Shortfall	Share of System Assets	Combined CET1 Shortfall (€ billion)	Combined Tier One Shortfall (€ billion)
Baseline	10	1/7	1.1	3.4
Slow	15	1/5	5.0	10.0
Adverse	20	1/3	6.0	14.0

Source: IMF (2013c).

12. Financial surveillance issues referenced in the 2013 Article IV report paralleled those emphasized in the FSAP report. The Article IV report warned that strong headwinds from tight credit conditions were hampering recovery as Italy remained vulnerable to a renewal of Euro Area tensions and banking distress, as well as domestic policy slippages and the stalling of structural reforms. A comprehensive policy response was called for to reduce vulnerabilities and sustain a robust recovery. This included recommendations to strengthen bank balance sheets, build adequate capital and liquidity buffers and accelerate balance sheet repair via measures to offload and otherwise reduce NPLs. Measures at the European level to address financial fragmentation were judged important to ease credit conditions and funding concerns. The Article IV report and the accompanying Selected Issues Paper (SIP) gave strong emphasis to the need for market mechanisms such as those used successfully in Italy during the early 1990s (at much smaller scale) and later in Korea and Japan (at much larger scale) to dispose of NPLs, the size of which the report argued would hamper the banking system's capacity to support recovery.[13] Also emphasized were the need to strengthen governance and resolve other issues constraining the performance and resilience of foundation-owned banks and cooperatives.

13. Coverage of financial surveillance issues in subsequent Article IV reports and supporting research built upon the themes set forth in the 2013 reports.[14] Ensuring adequate capital buffers and boosting provisions, strengthening supervision and improving incentives to tackle NPLs were mainstays of annual Article IV recommendations through 2017. Also included were calls to strengthen crisis management and bank resolution and to reduce moral hazard. Reports through 2015 pressed for the full tax deductibility of new loan loss provisions,[15] which was implemented

[13] IMF (2013c).

[14] Supporting research included SIPs, Working Papers, and Staff Discussion Notes on Italy and the Euro Area.

[15] These various reports remained silent, however, on whether to allow accelerated use of deferred tax assets accumulated as a result of past limits on tax deductions for loan loss provisions.

in 2016, and for further measures to strengthen governance, especially for foundation-owned banks and cooperatives. The 2015 report also called for a "properly designed… centralized, system-wide, state-backed Asset Management Company (AMC)… consistent with the EU state aid rules and within the limited available fiscal space."[16,17] Staff also advised enhanced sharing of credit information to improve credit monitoring and support lending.

14. Advice to tackle NPLs and ensure adequate capital buffers focused on strengthening supervision and improving incentives to boost provisions. Calls in 2013 to expand Banca d'Italia (BdI) inspections were repeated in 2014 and reinforced in 2015 by advice to resolve remaining uncertainty about asset quality by applying the new EU-wide harmonized asset classification framework to all banks, subject to strict supervisory enforcement to ensure correct classification and adequate provisioning. The Fund also recommended introducing time limits on banks' ability to claim tax deductions for vintage NPLs to incentivize faster disposals. In 2016, the Fund called for additional measures to sharpen supervisory pressure to dispose of NPLs. This included giving banks detailed guidance on how to provision and restructure NPLs and requiring them to present comprehensive strategies with ambitious targets to significantly reduce NPLs over the medium term. In 2017, the supervisor was advised to assess banks' capacity to resolve NPLs using internal tools and resources, review internal workout capacity, and provide feedback on banks' approaches to provisioning and loan restructuring.

15. The focus on NPLs was accompanied by recommendations to improve insolvency procedures and expedite judicial and out-of-court processes. Detailed assessments in working papers published in 2015 and 2016 paralleled the work of an independent commission established in early 2015 to draft reforms.[18] IMF recommendations called for expanded use of special insolvency courts and online filing, the introduction of best practices and qualifications for insolvency practitioners. Later advice focused on the complexity of the system, arguing for

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[16] IMF (2015b). Privately-backed AMC-like vehicles were put in place individually by a number of larger banks and jointly in the form of the Atlante fund established in 2016, which also made recapitalization investments, and smaller "bad bank" vehicles for four small banks intervened in 2015 and the two Venetian banks intervened in 2017. A state-financed AMC was not implemented for a variety of reasons, including sizable gaps between book values and the lower "real economic value" that would have been allowed under state aid rules, differences that reflect largely the lower discount rates applied by banks to future loan and collateral recoveries under current accounting rules that allow cashflows to be discounted with contractual loan interest rates. State aid rules require impaired asset transfers at market prices or, where these are lacking or difficult to estimate from similar transactions, by discounting expected loan recoveries using higher rates that include appropriate risk premia to compensate for credit and other risks (in normal situations) in order to limit costs for taxpayers and disadvantages to competing lenders.

[17] Reports through 2015 also called for measures to support SMEs, including appropriately designed partial credit guarantees, and the removal of barriers to SME startups and scaling. Recommended as well were standard guidelines for assessing SME loans and restructuring viable but distressed firms and newer forms of alternative funding, including via fiduciary contracts that pre-assign collateral to trustees for lenders' benefit should debt service be interrupted.

[18] IMF (2015c), Garrido (2016), Garrido and others (2016).

streamlined and flexible restructuring options, in- and out-of-court, with fast-track solutions for existing NPLs, clear principles for multilateral workouts, a triage approach to indebted firms and special procedures for large enterprises. Court functioning and insolvency administrator qualifications were considered key issues, however, in a system that most observers think gives less support to creditor rights than needed to limit loan losses, increase collateral values and shorten recovery times.

16. Recommendations on bank capital and liquidity, crisis management and resolution were consistent throughout the 2013–17 period. Calls for targeted action to support bank capital as needed, prepare for the 2014 EU asset quality review and longer-termed liquidity support by the ECB were supplanted by 2016 with advice to carry out ex ante assessments of capital, liquidity, asset quality and profitability of the new banking groups emerging from consolidation and mergers, especially among the smaller cooperative banks. "(S)ubjecting banks that are not under the supervision of the SSM to a process of capital assessment following an asset quality review would clarify uncertainty," assuming "follow-up actions in line with regulatory requirements."[19] This advice was sharpened in 2017. "The supervisor should seek to ensure—through intensive and assertive supervisory challenges—that banks have realistic and coherent business model assumptions, so that capital destructive practices are recognized, streamlined, divested, or closed."[20] The Fund also advised "rigorous analysis to ensure the three emerging banking groups (from among the smaller banks) start with a clean bill of health and are profitable over the long term" based on "an asset quality review of all emerging groups, ensuring robust governance and risk management structures."[21] On resolution and moral hazard, advice transitioned from calling in 2013 for "(s)trict limits on public support for problem banks, with bail-in, management and board changes, dividend limits and private capital raising requirements" to "swift recapitalization or the timely and effective use of the resolution framework" by the 2017 report, "to avoid weaknesses from lingering too long, burdening the rest of the system, and threatening stability."[22]

17. Article IV reports in 2016 and 2017 gave considerable attention to the problem posed by retail holdings of subordinated bank debt.[23] However, Italian officials expressed greater concern in interviews than did the Article IV reports about internal contagion and deposit runs they considered likely to be triggered by the bail-in of retail investors of bank bonds. The risks seen by

[19] IMF (2016b).

[20] IMF (2017b).

[21] IMF (2017b). Also advised was "following up on issues found in the remaining smaller banks" and legislative action to address remaining gaps in "fit and proper" rules.

[22] IMF (2013b; 2017b).

[23] The 2017 report, for example, noted "(w)here burden sharing or bail-in is required, protection should be provided for vulnerable households" and "(a)ny cases of mis-selling should be addressed by the regulatory and supervisory authorities as well as the banks." This was followed in 2018 by a Working Paper on the distributional consequences of a bail-in.

the Italian authorities were noted, but the April 2016 *GFSR* was clearer in expressing concern: "State Aid rules… and the BRRD are important… but… should be implemented carefully, as public support may still be needed in a crisis. In such a situation, existing options under the BRRD could be considered, such as excluding some creditors from bail-in if there are financial stability risks…" as well as "…reducing the thresholds for direct recapitalization of European banks by the European Stability Mechanism…" if required amounts "go beyond the 8 percent bail-in requirement."[24]

18. Reports in 2016 and 2017 voiced greater urgency on bank balance sheet repair given the economy's ongoing relative underperformance and financial fragilities, which were seen to leave it vulnerable to renewed increases in policy interest rates as the Euro-area wide recovery progressed. Noting a favorable, but narrowing window for reforms and adjustment, the 2017 Article IV report wrapped its appeal for stepped-up action on banking sector clean-up into a broader call for structural reforms of product, services and labor markets and public administration as well as "growth-friendly" fiscal adjustment. Policy action as recommended on all three fronts, the report argued, would yield significant mutually-reinforcing benefits by raising growth, facilitating adjustment and easing vulnerabilities.[25]

19. Taking note of measures to resolve weak banks, consolidate others, reform insolvency procedures and issue guidance on strategies to tackle high NPLs, the 2017 report argued that "the repair of the banking system is proceeding very slowly, permitting vulnerabilities to linger and hindering monetary transmission". Avoiding direct calls for mandated increases in provisioning, the report commented all the same that the slow pace of NPL sales gives ground to "…question… whether the portfolios are adequately provisioned."

20. References to Italy in the *GFSR* have most often been in the context of broader points about the need for decisive action in Europe more generally to address long-standing weaknesses that were worsened by the global and European crises and continued to leave financial stability at risk. Messages paralleled those in the Article IV reports and supporting research. These evolved from emphasis in 2013 that much work remained to repair the credit transmission mechanism, despite eased near-term stability risks, to stepped-up calls in 2016 and 2017 for stronger supervisory measures to accelerate NPL reduction, sharpen asset quality reviews (including for smaller banks), reinforce cost-reduction and resolve unviable institutions more quickly to accelerate consolidation and reduce overbanking. These themes were part of a broader push that intensified in 2016 to address legacy banking issues in advanced economies

[24] IMF (2016c).

[25] IMF (2017b). Support for the report's recommendations was set forth in an accompanying SIP (Part 3, IMF, 2017c), which highlighted benefits from banking sector cleanup and more efficient resource allocation from more effective insolvency procedures, drawing on research by Mohaddes and others (2017) and Balgova (2017).

more generally "to deliver a more balanced and potent policy mix for improving the growth and inflation outlook and securing financial stability."[26]

21. Key *GFSR* exercises with at least partial focus on Italy included projections of European bank deleveraging updated in October 2012 and used as benchmarks in April and October 2013. Corporate debt sustainability was assessed in April 2013, focusing on whether cashflows generated by investment-grade firms were likely to be large enough to meet interest obligations. Findings of a corporate debt overhang were extended in October 2013 with firm-level projections for a broader group of companies, estimating smaller cashflows than interest bills for nearly one-third of included Italian firms and still more among included Italian SMEs.[27] Banks with weak balance sheets, the report continued, would be less able to recognize losses, more likely to forbear and end up stranding scarce credit resources with unhealthy corporates, crowding out lending to healthier, more productive firms.

IV. EVALUATING IMF FINANCIAL SURVEILLANCE

22. Interviews with Italian and European officials revealed a range of views about how well IMF financial surveillance has done in identifying key problems and risks and offering useful analysis and advice. Interviewees recognized that, in broad terms, policy messages were effectively integrated across different IMF reports.[28] This included the *GFSR*, where occasionally sharper statements helped to highlight Italy's potential for globally-relevant spillovers, given expansive cross-border trade and financial linkages and its large government bond market. Interviews also suggested substantial albeit not uniform IMF influence on official thinking, which shaped action on financial issues. At the same time, clear tensions were also evident on more difficult issues where differences of view about the analysis were often accompanied by institutional and political constraints on official action.

23. Italian and European authorities were in broad agreement that the 2013 FSAP and Article IV report highlighted the right issues, giving messages that were judged largely correct in finding the banking system to have been resilient, with adequate if diminished capital and liquidity buffers. Pressures on capital were not underestimated. The focus on capital and liquidity

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[26] IMF (2016a). Specific mention of Italian banks noted the challenge posed by low equity valuations after the bail-in of the subordinated debt of four small banks in late 2015, which "reflected investor concerns that some banks may face difficulties in growing out of their substantial NPL overhang, despite constructive steps taken by Italian authorities to facilitate balance sheet repair."

[27] IMF (2013e). This translated, the GFSR argued, into default probabilities for Italian firms of ranging from 24 percent to 33 percent during 2012 and 2013, well above those in the Euro Area core, and illustrating worrisome implications for bank asset quality. Also assessed in the October 2013 report were drivers of interest rates on bank loans to corporate borrowers, with weaknesses in banks' financial health found to be a significant driver of higher borrowing costs for Italian firms.

[28] In a few instances, however, noted below in footnotes 37 and 38, the GFSR included somewhat different messaging and analysis from Article IV reports around important details relevant to the effects of NPL disposals.

was considered useful to policymakers. Most argued that the increase in NPLs after 2012 was the result of two years of recession rather than supervisory inaction. Some maintained that a tougher report at that time would not have been actionable and seen as alarmist.

24. In this context, it is worth highlighting an internal debate within the Fund on the message on bank capitalization. One department observed that the reassuring stress test results were inconsistent with the high level of CDS spreads and that early FSAP report drafts seemed to downplay the consequences for credit supply of banking sector fragilities. Suggestions were made to strengthen calls for banking consolidation to strengthen efficiency and profitability and to note the significant number of distressed banks falling just under the regulatory minima to offset the impression given by the relatively small aggregate capital shortfall that was projected. This later concern was addressed in part by adding detail on the number of banks facing shortfalls, which is replicated above in Table 2.2.

25. Italian officials reported that the IMF's work had influenced official thinking and had helped advance needed policy actions, although there was also a sense among the Italian authorities that advice had sometimes been provided without sufficient discretion or recognition of policy actions and institutional reforms already undertaken at the national and European levels. Useful examples of influence alongside the push for adequate bank capital and liquidity included the focus on governance weaknesses impeding effective management and potential for capital support, especially among foundation-owned banks and smaller cooperative banks. Italian officials also appreciated the Fund's recommendations at the Euro-area level, calling for unconventional monetary policy and ECB liquidity support and focusing attention on the need to advance Banking Union and address effectively the many challenges involved in coordinating new, complex and evolving supervisory and regulatory structures and safety nets.

26. The focus on bank balance sheet repair was seen as important by many but was also a key source of friction. Early emphasis on the need to develop an impaired asset market helped direct attention on the need for policy action to facilitate NPL reduction, in Europe as well as Italy. This helped lay the groundwork for the later focus on insolvency reform and tax measures to lessen disincentives for banks to provision newly emerging NPLs. Advocacy of state-backed AMCs to take over and resolve NPLs helped to spur a broader debate within Europe, including recent proposals at the European level from the EBA and ECB.[29] The same can be said of redoubled focus in Article IV reports on Italy and the Euro Area and *GFSRs* in 2016 and 2017 stressing the need for stronger supervisory action to prompt deeper write-downs and faster NPL disposals.

27. At the same time, Italian officials were less complimentary about the depth of understanding of Italian and European banking and financial arrangements. One senior official shared a concern that IMF financial surveillance was not at the same level as the IMF's analytical

[29] Haben and Quagliariello (2017), and Constancio (2017).

work in other areas like fiscal policy, expressing the hope that it would improve with time. Several commented that insufficient awareness of institutional change and differences in responsibilities among national and European authorities often resulted in advice that was too generic and without due consideration to what could be done within the constraints of EU obligations. Italian officials joined EU counterparts in seeing insufficient knowledge at various points in time of the European and national legal frameworks, especially about EU rules on state aid and competition. This hampered the traction of advice on NPLs, in particular.

28. Private sector views were more skeptical on the effectiveness of IMF financial surveillance. A common concern was the slow pace of policy actions by the authorities, seen as troubling against the backdrop of a consensus financial market view (some argued, in June 2017) that high public debt and structural economic and financial weaknesses left Italy at the front end of market concerns about global financial risks, especially with ongoing Euro Area recovery bringing forward expectations of eventual ECB interest rate hikes. In this view, the IMF ought to have pressed more strongly and sooner for tougher supervisory action on provisioning and NPL disposals. The costs of not doing so, they argued, include the slower return of the banking system to full financial health and larger downside risks to be priced into borrowing costs for banks, their borrowers and the government. Of equal concern has been the depressive effect on productivity, competitiveness, output and employment of capital misallocation to financially weak "zombies" allowed to keep operating.

29. Interviews with authorities in other EU capitals suggested broad agreement with many of these private sector perspectives. Some added that progress on mutualizing fiscal backstops under European resolution and deposit insurance funds was being hampered by Italy's short-term success in avoiding giving much state aid before bail-in was required and then finding a way to do so without full bail-in afterwards, as with MPS and the Venetian banks.[30] A few expressed views also heard from market participants arguing the need for the IMF to play a more public role of "ruthless truth-teller," clarifying for voters and politicians as well as policymakers the ongoing economic and financial costs of delay and inaction.

30. One particular issue where the IMF and the Italian authorities had strongly different views was the treatment of NPLs. Italian officials were highly critical, observing that despite the IMF's global perspective and broad cross-country experience, advice to step up supervisory pressure to

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[30] Some Italian officials doubted that earlier use of state aid would have been approved by Brussels. IMF staff thought fiscal considerations ought not to have been a factor, especially after the ECB shift to monetary accommodation.

accelerate NPL disposals carried considerable risk. IMF supporting analysis, indeed, was labelled superficial by some and flawed by others.[31]

31. A March 2017 Banca d'Italia research paper by Accornero and others (2017) took direct aim at the widely-held view underpinning IMF advice that removing NPLs from balance sheets would necessarily improve banks' ability to finance the real economy.[32] Using data on individual loans from banks to firms in Italy, Accornero and others (2017) found "no evidence" of a causal relationship from NPLs to credit supply, but a strongly positive causal link between bank capital and credit. The paper concluded that since "NPLs do not seem to matter while capital certainly does, the net impact… on credit supply might be negative rather than positive" if the NPL liquidation generates losses large enough to reduce bank capital.[33] This assessment accords quite closely to views expressed by officials in Rome, who argued that the IMF's focus on reducing NPLs through supervisory action to spur their sale risked creating capital shortfalls that would have negative effects on credit, opposite consequences to those intended.[34]

32. Staff responded to this official perspective by emphasizing that the Fund had not called for fire sales of NPLs but rather a more deliberate phased approach, rather than waiting for

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[31] Public comments by a senior Fund official earlier in 2017 calling for more forceful action on NPLs were viewed as more successful in securing publicity than helpfully contributing to desired policy outcomes.

[32] An exercise in the April 2014 *GFSR* gave at least partial support to Accornero and others (2017). Using quarterly data for 1999–2013 for France, Italy, and Spain, Pillonca (2014) found that a one standard deviation decrease in the ratio of NPLs to total loans (140 basis points for Italy) had negative effects in years one and two and positive ones only after three years, limited to a central tendency of just 3 percent within five years. This compared to modestly positive initial effects in France and Spain that grew to 5 percent and 15 percent, respectively, by year five. Increases in the ratio of capital to loans, on the other hand, led to increases in credit in all three countries after five years, but not much until after two years.

[33] The additional negative effects on capital adequacy for IRB banks was also noted by the BdI in a research note (Gangeri and others, 2017), which argued that temporarily larger losses given default (LGDs) due to NPL sales should not be incorporated in risk-weight calculations for IRB banks.

[34] Accornero and others' (2017) conclusions and the arguments of the Italian authorities paralleled qualifications on the issue of NPL sales voiced in the April 2014 *GFSR*. "[P]olicies to resolve the corporate debt overhang should avoid encouraging an excessively rapid disposal of non-performing assets because there is a risk that this could drive asset prices down and destroy value." They also echoed reservations about whether provisioning was sufficient to validate simple estimates of capital relief in background research in 2015 on the Euro Area and 2016 on Italy. "If NPL disposals are substantial, a high haircut may jeopardize the capital adequacy of the ceding bank. Also, in certain countries, the anticipation of a greater regulatory push for NPL resolution might decrease the market price of collateral, imposing additional losses on disposal" (IMF, 2015d). Noting the gains if insolvency reforms shortened recovery times and reduced risk premia sought by buyers, the 2016 study (Jobst, 2016) noted that "[a]t present, immediate disposal of NPLs would not be expected to result in capital relief." "[I]llustrative calculations suggest banks would register losses" that "would outweigh any potential reduction in capital requirements … due to the removal of high risk-weight NPLs."

growth to deal with the balance sheet problem.[35] They pointed to a series of papers presented as part of Italy's Article IV consultations and to other research undertaken by IMF staff that made a broad case for reducing NPLs that was framed in an Italy-specific context.[36] They also highlighted research focusing on the long-term relationship between economic growth and changes to NPLs in Italy in the medium term.[37] Nonetheless, IMF advice did not gain traction with Italian officials. Rather than being convinced that the recommended mix of structural reforms, fiscal restructuring and banking sector clean-up could deliver the promised dividends of higher growth and reduced financial stability risks, Italian officials continued to worry that capital holes opened by newly deficient provisioning and the resulting renewal of bank-driven deleveraging would have near-term costs (from accelerated NPL disposals) that might well exceed near-term gains.[38]

33. While there were likely a variety of reasons for ineffectiveness of IMF advice in this area, greater understanding of the institutional context in Italy might have helped set the stage for broader acceptance of advice on the need for stronger actions to reduce NPLs. In addition, the IMF could have explored earlier on the potential for simplifying as well as streamlining insolvency procedures, on accelerating the usability of deferred tax assets (DTAs) generated by delayed deductibility for past provisions (before 2016). Equally helpful could have been the collection and dissemination of more information on individual loan performance, borrower finances and transactions and the value of guarantees and collateral associated with individual NPLs, especially real estate.[39]

34. Staff stressed that the increase in breakeven pricing for potential NPL buyers likely to result from shortening the time needed for legal procedures to foreclose on collateral would be the best way to narrow the pricing gaps that impeded quicker action on NPL disposals.

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[35] See "Can Italy Grow Out of Its NPL Overhang? A Panel Threshold Analysis" (Mohaddes and others, 2017).

[36] For example, IMF Working Paper "Profitability and Balance Sheet Repair of Italian Banks" (Jobst and Weber, 2016), a SIP for the 2013 Article IV Consultation entitled "Strategy for Fostering a Market for Distressed Debt in Italy" (IMF, 2013c), and, IMF Staff Discussion Note "A Strategy for Resolving Europe's Problem Loans" (Aiyar and others, 2015c). Article IV staff reports also referenced, e.g., IMF research on the effects of NPLs on credit and growth in central and southeastern Europe (Klein, 2013) and studies by others outside the IMF on Euro Area countries other than Italy (Bending and others, 2014).

[37] Mohaddes and others (2017), Weber (2017).

[38] This view was echoed by an EU official with responsibility for financial stability, who observed that the EU had worked out an approach to deal with the NPL problem in all its complexity but that this "would take time."

[39] While understandable given the prominence of banking sector cleanup in IMF advice to Italy, the relative lack of advice to strengthen reporting on real estate prices and other information needed to expand macroprudential oversight capacity generally is noteworthy nonetheless. Overlaps here ought to be considerable with information that should strengthen buying demand for collateral and therefore for NPLs, with or without needed improvements in insolvency procedures, restructuring capacity and creditor rights vis-à-vis those of borrowers.

Reasonable grounds for opposing views can be found, however, in the widely held view that insolvency reforms will reduce court times only gradually over the medium term.

35. A separate but related issue is the divergence of views within the staff and vis-à-vis Italian and EU authorities on the importance and applicability of EU state aid rules and competition law. Authorities expressed frequent frustration with staff's incomplete understanding of the rules as regards AMCs in particular and NPL resolution more generally. Staff interviewed for this study conceded that they had not always paid sufficient attention to these rules and acknowledged that stronger efforts by the Fund to respect the rules and work within them would have been better suited to build broader support for Fund advice.

36. A final point is whether sufficient consideration was given to the importance of developing capital markets and other alternatives to bank credit, including both debt and equity, and especially to whether incentives favoring equity and the broader ecosystem needed to support more of it have been properly prioritized by the Italian authorities. Regular focus on the corporate debt overhang and the need to develop more effective debt restructuring options might have provided the occasion to advocate for less contractionary deleveraging by firms and for a shift toward equity financing.[40]

V. CONCLUSION

37. IMF financial sector surveillance of Italy in recent years has succeeded in broadly fulfilling the objectives of the revised financial surveillance strategy set in 2012. Appropriate focus has been placed on strengthening bank capital and liquidity buffers, identifying and advising balance sheet repair as one of several keys to renewed economic expansion and the reduction of risks and vulnerabilities that were intensified by the crisis after many years of disappointing economic performance following the advent of the euro. The stress tests in the 2013 FSAP did not underestimate the vulnerability of Italian banks, based on a comparison of forecasts and outcome. The 2013 FSAP and Article IV reports did achieve roughly the right balance in calling for additional financial stability efforts, including on strengthening governance, creating a functioning market for impaired bank assets and pressing ahead with harmonized strong supervision and common backstops under Banking Union. Not too strident in public, but sharper in private, IMF messaging did quite well in delicate circumstances, providing a reasonably balanced warning of financial sector risks and vulnerabilities.

38. Reinforced by broader based analysis and strong messaging in the *GFSR*, bilateral financial sector surveillance after 2013 helped the Fund play a useful role at the European level, bringing

[40] Noteworthy in this respect was the absence of public comment from the IMF on the reduction of incentives for equity in 2017 under the innovative Allowance for Corporate Equity (ACE) introduced in 2012. This resulted from a cut to 2.3 percent for 2017 from 4.75 percent in 2016 in the percentage of new balance sheet equity (added since 2011) that companies are permitted to deduct taxable income. These changes and the uncertainty that they introduced were later discussed in the 2017 Article IV Staff Report and accompanying SIP.

attention to issues on how the European framework affected the resolution of Italian banking problems. Fund reporting helped focus attention on the need to shift towards bail-in to limit costs to taxpayers and to help further degrade the negative sovereign-bank feedback loop that so worried financial markets in 2011 and early 2012. Despite its potential more for medium- than near-term impact, stepped up emphasis on bolstering insolvency procedures was also appropriate, given the promised payoffs of improved buying demand for NPLs and eased pressures on bank capital, thanks to smaller LGDs. Equally important has been the potential for toughened financial discipline to support the redirection of resources from loss-making firms towards more productive ones better able to contribute to stronger growth in productivity and output.

39. One area where the IMF could have been more effective was to have more convincing analysis of the NPL problem, showing why slow resolution was a problem for the economy and how NPL disposal could be accelerated. Notwithstanding IMF advocacy and research to suggest a more aggressive approach, in both these areas officials were unconvinced that the Fund understood well enough the specific Italian environment. Unlike other recommendations, most of which were accepted by the Italian authorities, advice to press on NPL reduction triggered significant pushback and contributed to strained relations and diminished trust, a sense of which is readily apparent from discussions with Italian officials.

40. Another question worth considering is the IMF approach to EU state aid and competition rules. Finding a way to work within the rules while offering analysis and insight arguing for a less onerous interpretation and application of the rules was an area worthy of focus. In line with the judgment of one staff member long afterwards that stronger efforts to work within the rules might have built more support for Fund advice, more might have been done to recommend enhancing information about loans and borrowers and access to it with a view toward bolstering NPL buying demand and narrowing the large gaps by which NPL book values exceeded market prices. Fund analysis might equally have supported the case for less onerous interpretation of the rules by questioning whether the large discounts that state aid rules often required on the prices of NPL purchases by state-backed AMCs were well justified. This might have entailed examining the yields sought by distressed asset investors, which were taken under the rules to represent "market economy players" despite the absence of much buying and selling for most varieties of distressed credit. A key question here would have been whether and by how much the yields sought by such investors had declined since the early days of the crisis in other markets with more transactions, in line with lower market interest rates and the smaller risk premia "priced in" bank loans and bonds more generally.

41. More might also have been done, finally, to stress the need to develop capital markets and other alternatives to bank credit, including both debt and equity. A more holistic view of borrowers' financial conditions and linkages to banks' asset quality and profitability might have suggested increased attention to how to advance needed corporate debt restructurings via insolvency procedures less favorable to debtors, ensuring increases in the balance sheet equity of borrowers and developing incentives for equity-based saving and the ecosystem needed to

support it. Consideration might also have been given to both partial public sector guarantees for restructured and reduced credits, but also—in line with thinking among debt restructuring professionals—to waiving or reducing tax and social security arrears or lowering their ranking among creditor claims, where doing so would further debt restructurings and NPL resolution. Closely connected, the Fund could have advised on how best to develop markets for securitization as a step towards Capital Markets Union, reduced cross-border fragmentation and diminished dependence on banks.

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CHAPTER 4—THE EFFECTIVENESS OF IMF FINANCIAL SURVEILLANCE OF THE UNITED KINGDOM

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EXECUTIVE SUMMARY

The U.K. is deemed by the IMF to have a systemically important financial sector. Because of this, the IMF undertakes a mandatory assessment under the Financial Sector Assessment Program (FSAP) for the U.K. every five years that is detailed, resource intensive and (in terms of written output) voluminous. Financial surveillance is also conducted as part of the IMF's annual Article IV consultations, which also examine the overall U.K. economy and cover the full gamut of macro and financial policies.

IMF financial surveillance of the U.K. is detailed, well-informed and careful. The U.K. authorities definitely believe that what the IMF says about U.K. financial stability issues matters, and that this will become even more so when the U.K. leaves the EU. The U.K. authorities value the FSAP largely as a means of having its system of financial regulation and supervision given an independent health check which can be read by the wider world, more than as a source of advice on making its system better.

Some aspects of IMF financial surveillance create lots of work while the value added is not as high as it could be. One major example is stress tests of the banking sector. It may be more efficient for the IMF to assess the methodology of the U.K. bank stress tests done by the Bank of England (including giving advice on shock scenarios) rather than conduct a parallel exercise.

While risks to financial stability may vary substantially in intervals shorter than five years, it is not realistic to have more frequent FSAPs, given their wide scope and heavy burden. Therefore, it may be sensible to shift the emphasis of the FSAPs more towards assessing adequacy of the system, with more of the identification and analysis of changing risks to financial stability in the annual Article IV consultation.

Overall, IMF financial surveillance of the U.K. is impressively comprehensive and does a good job in screening the horizon for potential risks. It is testament to the quality and influence of the 2011 FSAP how many of its recommendations were implemented. Many of the judgments in the 2016 FSAP and recent Article IV staff reports also seem well founded. However, IMF recommendations are sometimes open to questions as not being sufficiently based on an analysis of specific country circumstances. For example, the criticism that supervision of smaller firms in the U.K. was insufficiently "intrusive," and not resource intensive enough, seems to reflect a view that the bank examiner model of banking supervision was the right one, but the discussion of tradeoffs of this approach was limited. Similarly, the analysis of housing sector risks was light on evidence, even though it was identified as a major domestic financial stability risk.

The 2016 FSAP concluded that U.K. banks were well capitalized in accordance with internationally agreed standards. The Bank of England in its public statements takes a similar view on the adequacy of capital to the 2016 FSAP. It is of note that the 2016 FSAP and Article IV do not assess the merit of capital levels well above Basel III requirements—as recommended by some other experts and in line with recommendations in Article IV staff reports early in this decade.

I. INTRODUCTION

1. This paper assesses the quality, relevance and impact of the IMF's surveillance of financial stability in the U.K. It focuses on the period between 2011 and Spring of 2018. It draws extensively on interviews with IMF staff, members of the IMF FSAP and Article IV missions and U.K. officials within government, the Bank of England and the Financial Conduct Authority.

2. The U.K. is a major financial center; a substantial proportion of global capital flows move through it. Financial institutions based in the U.K. have very large claims on overseas assets and generate much of their funding outside the U.K. A huge volume of transactions in foreign exchange, equities trading and derivatives take place in London each day; damage to the financial infrastructure would have serious implications far outside the U.K.

3. The U.K. is deemed by the Fund to have a systemically important financial sector. Because of this, every five years the IMF undertakes an FSAP for the U.K. that is detailed, resource intensive and (in terms of written output) voluminous. Financial surveillance is also conducted as part of the IMF's annual Article IV consultations, which also examine the overall U.K. economy and cover the full gamut of macro and financial policies. Annual Article IV staff reports now contain substantial discussion and recommendations on financial stability issues—there is far greater analysis of the financial sector, and its links to the real economy, than before the global financial crisis.

4. In this report, I consider the nature of the analysis and its effectiveness—focusing particularly on the recent FSAPs but also commenting on Article IV staff reports. This review takes place 10 years after the financial crisis when the system of financial regulation and supervision and the assessment of financial risks in the UK and globally were found to be inadequate.

5. Since the FSAP is focused specifically on financial sector risks and is the primary means of IMF financial surveillance, I structure the analysis around discussion of its effectiveness and how it relates to annual Article IV staff reports which have increasingly focused on financial conditions.

6. The rest of the report is organized as follows. Section II considers the way in which FSAP and Article IV assessments are made and the impact they have. Section III considers the quality of the analysis focusing on some specific recent policy recommendations. Section IV draws conclusions and summarizes suggestions for improvements to financial surveillance.

II. FSAP AND ARTICLE IV SURVEILLANCE

What is the nature of the FSAP program?

7. The FSAP undertakes an assessment of financial risks, a judgment on the robustness of financial institutions (particularly banks) in the face of those risks, and an analysis of the adequacy of the U.K. regulatory and supervisory system to gauge and react to such risks. Recommendations on policy—often detailed and numerous—are made. Stress testing is a central

element of the FSAP and is designed to explore the robustness of the financial system—and particularly the banking sector. Another element is a very detailed assessment of U.K. compliance with internationally agreed standards; the most lengthy of these assessments looks at compliance with the Basel Core Principles for effective banking supervision.

8. The reports produced as part of the FSAP are wide-ranging and detailed. They summarize a massive amount of information. The list of potential risks is long and covers events that could affect all parts of the financial system.

FSAP and Article IV Surveillance

9. Since the global financial crisis, Article IV surveillance has devoted considerable attention to financial sector developments with a focus on imminent risks. There is extensive analysis of the linkages between the real economy and the financial sector. This is a significant change since before the 2008 crisis, when Article IV staff reports largely focused on output, inflation, labor market and monetary and fiscal policy, and there was limited analysis of the banking sector.

10. Article IV staff reports now include a great deal of focus on banks—their funding; asset quality; exposures; balance sheets; capital; and the availability and terms of lending. Analysis of household and corporate balance sheets and exposures, and links between spending and financial conditions, are much to the fore. Analysis of monetary policy—largely conducted over the past ten years in the U.K. through credit easing and quantitative easing—has made a focus on banks and credit availability central**.** The effectiveness of monetary policy has been recognized as depending on the health of the banking system.

11. This change in focus relative to earlier Article IV staff reports came ahead of the 2011 FSAP. Analysis in the 2010 Article IV staff report was followed up in the impressive 2011 FSAP.

12. Article IV staff reports have been well aligned and integrated with both the 2011 and 2016 FSAPs. In Article IV staff reports there is now often an update on the status of the FSSA recommendations (see, for example, Annexes in the 2012 and in 2013 Article IV staff reports). The fact that there is some overlap in the staff involved in Article IV reports and FSAPs contributed to the alignment in the analysis and messages between these reports.

13. The depth of analysis of financial conditions and risks in annual Article IV surveillance is inevitably less than in the once-every-five-years FSAPs, and there seems to be greater reliance on analysis by the domestic authorities (particularly the Bank of England). Nonetheless, most of the IMF's analysis of financial risks between FSAPs is conducted via Article IV surveillance, and recommendations on financial regulation and supervision have become standard features of Article IV staff reports.

14. For example, the 2012 Article IV staff report emphasized the need for U.K. banks to build capital: "the level of capital across the banking sector is not yet at levels that would ensure resilience in the face of prospective risks" (IMF, 2012). The 2013 Article IV stressed the

importance of "an early and comprehensive treatment of banks' asset quality problems" and urged that "…the system-wide stress tests planned from 2014 should aim to cover a broad range of risks, employ sufficiently stringent scenarios, and aim for commensurately ambitious capital buffers" (IMF, 2013). The 2014 Article IV staff report also stressed a need for more capital explaining that "given the size and systemic nature of the U.K. financial system, there is a strong case to … introduce a leverage ratio requirement above Basel minima" (IMF, 2014). The 2017 Article IV, while emphasising that the 2017 Bank of England stress tests revealed a level of bank capital that seemed able to allow banks to survive a very harsh economic environment, concluded that some extra bank capital for specific risks (including that related to consumer credit exposures) might be needed (IMF, 2018).

15. Recent Article IV staff reports have also presented a risk assessment matrix with a heavy emphasis on financial sector risks and policy recommendations. The 2015 Article IV included an extended analysis of the implications on the U.K. of a stressed scenario for global asset values (IMF, 2016a). The 2016 Article IV was closely aligned with the 2016 FSAP in its assessment of, and recommendations about, financial stability risks (IMF, 2016c).

The nature of FSAP outputs

16. All U.K. officials to whom I spoke considered FSAPs to be comprehensive and based on a wealth of up-to-date evidence. The results of the FSAP are reported in several separate documents. The overall judgment is presented in the Financial System Stability Assessment (FSSA). Compliance with internationally agreed standards is reported in separate documents whose style and format are quite different (being more legalistic and mechanistic than the judgments made in the FSSA and being largely produced by different people). The largest compliance report assesses observance with Basel Principles of Banking Supervision; in 2016 this report ran to over 290 pages.

17. There is a stark contrast in readability of different outputs of the FSAP. Compliance reports are not concise; they follow a rather rigid template, and the main points can be hard to see. The FSSA tells more of a story; it paints a picture. This difference in style and readability may not be a significant problem—different FSAP outputs are directed at different people. It is also likely that much of the benefit of the FSAP is in the process of the assessment rather than in the final written reports.

18. That naturally leads on to question of who is the audience for the different FSAP outputs (and Article IV staff reports) and the nature of the interaction between the FSAP mission and the domestic authorities.

Who is the main audience for FSAP outputs and Article IV staff reports?

19. In some ways the natural answer to the question "who are FSAPs for?" is the U.K. authorities. The FSSA and related reports, which contain a long list of recommendations, are

written as if their primary audience is the domestic authorities. However, this is rather doubtful in the case of the U.K. (and perhaps for other advanced financial centers). The U.K. authorities seem to genuinely value the FSAP (with caveats noted below) largely as a means of having the U.K. system of financial regulation and supervision given an independent health check that can be read by the wider world, rather than as a means of guiding the evolution of its system to something better. My impression is that with the 2016 FSAP the U.K. authorities made an enormous effort to provide the IMF team with the material they needed with some confidence that the assessment made in the light of the facts would be favorable (which it was). Indeed, one of the reasons why the 2016 FSAP was so resource-intensive an exercise—involving an enormous number of meetings and forests of paper—was that the U.K. authorities wanted the assessment to be as full as possible and done in the light of huge amounts of information, largely provided by the Bank of England.

20. So unlike in other countries where much of the value of the IMF surveillance may be in helping improve regulatory and supervisory practice—for example by helping domestic authorities undertake stress tests—for the U.K. authorities the value lies more as an independent verification of the quality of supervision and of the scale of financial stability risks. In short, there is probably a view among the U.K. authorities that there is not a great deal for them to learn about U.K. financial developments from IMF analysis.

21. I suspect that IMF officials see rather more value in the advice they give the U.K. on how the system could be improved, but nonetheless recognize that the U.K. does have a sophisticated system of financial supervision and risk monitoring and that relatively more of the value of the IMF surveillance comes from providing an independent assessment of that to the outside world.

22. But while there is not much of an element of technical assistance (TA) in the most recent U.K. FSAP in 2016, there was more of that in 2011. In 2010 and 2011, the U.K. was effectively rebuilding its system of financial supervision (particularly of banks) and learning the lessons from past failures. The IMF knowledge of what worked and did not work so well in other countries, and also its long experience of stress tests (which were to become a central feature of the supervision of banks in the U.K.), were then valuable. The 2011 FSAP recommendations rather closely align with the path that supervision has taken since then in the U.K.

23. There is perhaps more skepticism among the U.K. authorities about the value added of annual Article IV staff reports than about FSAP outputs. In part this is because they do not provide the same score card of compliance with internationally agreed standards that the FSAP process does. They are also much briefer than the FSAP outputs and not so focused on specific issues—such as the robustness of banks to a given set of shocks. There are also many readily available assessments of the state of the U.K. macro-economy and the public finances (for example from think tanks like The Institute for Fiscal Studies, The National Institute for Economic

and Social Research and from the independent Office for Budget Responsibility).[1] In contrast there are very few independent assessments of financial stability and of the effectiveness of supervision and regulation; the FSAP outputs provide the most comprehensive and thorough alternative to reliance on assessments by the U.K. authorities (that is by the Bank of England, the Financial Conduct Authority, and the U.K. Treasury). That is a large part of its value. The Bank of England and the Financial Conduct Authority are effectively government agencies—though they are quite fiercely protective of their reputation for giving thorough, fair and comprehensive assessment of the financial system and its weaknesses. But the IMF analysis is the only wholly independent, comprehensive and authoritative assessment of the adequacy of financial supervision and regulation in the U.K.

24. The public-good aspect of IMF surveillance is therefore important. The U.K. authorities definitely believe that what the IMF says about U.K. financial stability issues matters and that this will become even more so once the U.K. leaves the European Union. Independent assessment of the extent to which the U.K. complies with internationally agreed principles of financial supervision and regulation may become critical to judgments about whether the U.K. has standards that are equivalent to (or better than) EU standards. This would affect whether firms in the U.K. can provide financial services to the European Union.

25. Because the authorities care a lot about the IMF assessment, it "keeps them on their toes" (as one senior U.K. official put it to me). This is a widespread view—I heard it from the highest levels in both the Treasury and Bank of England—even if U.K. officials are generally skeptical about the specific points of criticism (mild as they were) in the 2016 FSAP (see below). There is even greater agreement that the substantive (sometimes critical) message in the 2011 FSAP and the associated policy advice was valuable because it was well-founded and came after a financial crisis that did reveal weaknesses.

26. In the UK, the impact of FSAPs beyond the authorities is somewhat limited. The FSSA and related reports are largely ignored in the media; Article IV staff reports in contrast often get some attention—particularly if there is any hint of criticism of government fiscal or monetary policy. Few newspapers can resist a headline such as "IMF Slams U.K. Chancellor" if there are even the flimsiest grounds for it. The fact that Article IV staff reports tend to get more attention is also probably a reflection that they are relatively short, self-contained and not too technical; this is in contrast to FSAP outputs.

27. But the influence of FSAPs within the private financial sector is also rather limited. IMF views on financial stability don't seem to register very much with the private sector who look instead to the Bank of England, the FCA and the Treasury. This is natural since that is where the

[1] One advantage of having Article IV reports focus rather more on U.K. financial stability issues is that this is an area where there are currently few credible alternatives to analysis by the Bank of England. This is in marked contrast to analysis of general macroeconomic issues and of monetary and fiscal policy.

policy levers sit. So, IMF influence with private sector players in the financial market is indirect and depends upon its impact upon the U.K. authorities.

28. Executive Board members indicated that FSAPs receive less attention than they might merit because they are usually discussed at the same time as the Article IV staff report. Similarly, the Article IV staff report receives most of the attention from the press and the general public, as the reports are released together, after the Board discussion.

The FSAP process

29. The FSAP process for the U.K. is highly resource–intensive: the team is big; it is in the U.K. for lengthy periods (several weeks at a time) which stretch over several months; there is a huge number of meetings (one official suggested the figure was over 1500 in 2016); and the output is vast. As noted above, some of the scale of this is because the U.K. authorities want the assessment to be as complete as it can be. That view of the U.K. authorities is not likely to change so long as they feel the IMF judgment will be favorable (as it certainly was in 2016)—Brexit may even mean that the U.K. wishes the assessment to be even more comprehensive.

30. Some aspects of the FSAP create lots of work while the value added is not as high as it could be. One major example is stress tests of the banking sector. The IMF stress tests mean that Bank of England officials spend a great deal of time providing the FSAP team with very detailed, bank-specific data, with careful attention to protect against any possible breach of confidentiality. The IMF stress test inevitably relies upon information collected by, and judgments made by, the Bank of England. The Bank of England undertakes an annual stress test of the same banks using largely the same data and a similar methodology. The stress scenarios are different and so the IMF exercise is not aiming to produce results which can be directly compared with the Bank's assessment of the ability of the banking sector to withstand shocks. The 2016 IMF stress test scenario featured a disorderly monetary normalization in the US triggering a broad-based dislocation in financial markets and spillovers to emerging markets (IMF, 2016b). The Bank of England 2015 stress tests focused on a synchronized global downturn and hits to all risk assets while its 2016 stress test focused specifically on a hit to U.K. housing markets and to unemployment. The 2017 Bank of England stress tests involved very large falls in house prices in the U.K., a sharp rise in interest rates and a big rise in unemployment (Bank of England, 2017).

31. Despite the clear differences in the shocks applied in the IMF stress tests and those in the Bank of England tests, the tests are in some sense parallel exercises. Whether the use of alternative shock scenarios generates value added in line with the resources involved is an open question; there was skepticism in the Bank of England on that. And even if the IMF shock scenarios are different—and perhaps more informative—it does not follow that the IMF needs to undertake the stress test, at least so long as the Bank of England takes note of the IMF advice in designing shocks. (And there is every reason that the Bank should, and likely would, take IMF advice on stress test design seriously, in part because the IMF pioneered bank stress tests.)

32. The Article IV consultations that do not coincide with FSAPs draw upon the analysis in Bank of England (annual) stress tests. Using those stress test results as a way to frame the dialogue on financial stability issues seems sensible. There is little evidence that conversations around banking stability in the U.K. which drew upon Bank of England stress tests were less fruitful than those based on stress tests conducted in the context of the FSAP.

33. It may well be more efficient for the IMF to assess the methodology of the U.K. bank stress tests (including giving advice on shock scenarios) rather than conduct a parallel exercise. An assessment of methodology is likely to have lasting value whereas the usefulness of a once every five years stress test—which is a snap shot of risks at a point in time—may decline substantially between FSAPs.

34. There is however an issue as to whether it is possible to really assess the adequacy of the Bank of England approach unless you get so far into the fine details of the tests that you can (with little extra work) conduct your own stress tests and generate your own results. And if the IMF ultimately strongly favors different assumptions (either about shocks or about the transmission mechanism of those shocks through the financial system), one might not know what difference that makes unless the IMF undertakes the analysis. The question is whether the only credible way to actually assess the Bank of England stress tests is for the IMF to run its own tests. That would be a pessimistic position to take because a lot can be learned from a critical assessment of what the Bank of England does.

35. But there is another danger with a switch in emphasis away from a snap shot assessment of U.K. financial sector risks, and also away from IMF stress tests, and towards more emphasis on the way in which the U.K. authorities do their assessment. This is that the U.K. could be seen to be getting a different sort of surveillance than many other countries. That could make the job of the IMF harder ("why is the U.K. getting an easier and less intrusive form of surveillance than us") and possibly not welcome for the U.K. authorities who want the IMF assessment to be seen as being as rigorous and thorough as possible (as long as it emerges as being favorable!).

36. This discussion leads to a broader issue of what should be the relative role of FSAPs and Article IV surveillance in IMF financial surveillance.

The relative role of FSAPs and Article IV surveillance

37. The FSAP is an assessment of both the current risks to financial stability and of the adequacy of the system of financial regulation and supervision. While risks to financial stability may vary substantially in intervals shorter than five years, it is not realistic to have more frequent FSAPs, given their wide scope and heavy burden. There may be FSB Peer Reviews between FSAPs to assess steps taken by the authorities to address recommendations raised in the FSAP. For instance, an FSB Peer Review took place for the U.K. in 2013. But the FSB Peer Review is not a detailed assessment of current financial risks, and it is not based on a forensic analysis of the current position of financial institutions and markets.

38. Given the five-year gap between FSAPs, and the sometimes rapidly changing outlook for financial risks, it may be sensible to shift the emphasis of the FSAPs more towards assessing adequacy of the system, and leaving rather more of the identification and analysis of imminent risks to financial stability to the more frequent Article IV consultation. The five-year gap between FSAPs is likely to be appropriate for an assessment of the system of financial supervision and regulation and how compliance with internationally agreed standards has evolved. (It allowed, for example, for an assessment of the effectiveness of the very different system of supervision and regulation introduced in the U.K. between the 2011 and 2016 FSAPs.)

39. Anything shorter than a five-year interval provides little value added for assessment of the adequacy of the system of supervision and regulation, though it would be helpful to gauge current risks. On balance it seems unlikely to be feasible to have FSAPs more frequently. Given the very resource intensive nature of the detailed assessment, to do them more often than every five years is not very attractive; the burden placed upon IMF staff and upon the domestic authorities would be heavy. But there is a danger that assessment of current risks at a point in time in a once-every-five-year report will have limited shelf life. That risk will be heightened if there is any tendency for the FSAP teams to pay particular attention to immediate, but often transitory, risks that seem to be crystalizing at the time their mission starts (which itself is several months before the report is produced). But Article IV staff reports are prepared every year and are less resource intensive. They have also become more focused on financial conditions. This is a helpful development.

40. In this way, there may be scope to use Article IV surveillance to do more financial sector risk assessment between FSAPs and to shift the balance in FSAPs towards focussing more on the structures of regulation. The Article IV staff reports could have a somewhat enhanced analysis of imminent financial risks. There is already a good deal of that in Article IV surveillance, so this would be more a question of a slight change in emphasis rather than a wholesale change. Even so there are arguments both ways—for Article IV staff reports to dig deeper into financial risks might involve mission teams being larger or visiting for longer. That need not necessarily involve more resources being provided by the IMF or the U.K. if it is largely a switch from resources now used on the FSAP.

III. QUALITY OF ANALYSIS

41. The FSAP and Article IV teams are made up of people with a great deal of collective experience in modelling economic outcomes and assessing financial sector risks. The FSAP team benefits from the experience of people seconded to the mission who have worked on financial regulation issues in other countries and may also have experience in major financial centers—a factor seen as particularly helpful by U.K. officials. That team inevitably has less detailed knowledge of the U.K. economy and its financial sector. While there is clearly a significant benefit in having a team with a lot of experience of how supervision and surveillance is done in other countries, there is however a risk that where practice in the U.K. is different it is criticized for not conforming. For example, there is a feeling—most clearly expressed by some officials at the Bank

of England—that the criticism in both the 2011 and 2016 FSAP that supervision of smaller firms was insufficiently "intrusive," and not resource intensive enough, came from a view that the bank examiner model of banking supervision was clearly the right one.

42. Overall the IMF clearly has high quality people undertake the financial sector surveillance of the U.K., a view shared by the U.K. authorities. However, obviously, that does not mean that the assessments made have always been flawless. One way to judge quality of analysis is to see if this overall assessment is sound. Below, I examine the IMF assessments and recommendations on three key issues: the call for more resources for intensive supervision of small financial institutions, the favorable judgment made on overall levels of bank capital, and the assessment that the major domestic financial stability risk could come from a frothy U.K. housing market, where the "buy-to-let" sector was singled out. It is important to note that the Bank of England shares with the view that bank capital in the U.K. is now at a satisfactory level and that a key risk to the U.K. stems from an overly-stretched housing market where the buy-to-let sector has led the way.[2]

Treatment of oversight of small firms

43. The call for more resources to be applied to oversight of smaller firms is an implicit criticism of the U.K.'s current risk-based approach to regulation. The FSAP team took the view that focusing supervisory effort and resources on the resilience of the most important firms would reduce attention to small and mid-size companies and that relying on thematic reviews and data monitoring for these smaller firms may be inadequate. The 2016 FSSA accordingly argued that relying to a great degree on automated monitoring of small and mid-sized banks, while appropriate from a systemic perspective, may not give supervisors sufficient insight into their management, operations, and risks (IMF, 2016b).

44. There was a consistent recommendation in the 2011 and 2016 FSSAs that a more intrusive and hands-on approach be adopted for all firms (IMF, 2011b; 2016b). But the intensive supervision model—which when applied to banks might be called the bank examiner model—has hardly been proved the right approach in other countries. Advocating it for the U.K. did not seem to be the result of any cost benefit analysis, neither on the additional costs of supervision nor on the costs to the regulated firms themselves. It is not obvious that countries that historically have relied on a bank examiner approach have had a better record of banking sector stability. The U.K. model is a risk-based approach with fewer resources devoted to supervision where systemic risks are judged to be less. That approach when applied to smaller institutions generates outcomes that look very different from the bank examiner approach. But that does not mean it is self-evidently inferior. Further, there was limited discussion in the 2011 or 2016 FSSA about the trade-offs between the two approaches—yet the recommendation was made

[2] "Buy-to-let" refers to a practice of buying homes in order to rent, or let, them to other people rather than live in them yourself.

repeatedly and appeared in Article IV staff reports as well. It was justified, in part, by the argument that although smaller institutions may not appear to generate systemic risks, if they all do the same thing they become collectively systemic. While logically correct, this view was not backed up by evidence that they do in fact act in the same way and so lacked much force. The 2016 FSSA also argued that "regardless of their systemic impact, failures of even small firms can be a source of reputational risk for the supervisor" (IMF, 2016b).

Capital adequacy assessment

45. The reliance on a relatively thinly-resourced supervisory system for smaller institutions looks more justifiable the better capitalized such institutions are. In this light, it is important to consider whether the IMF's message on the adequacy of banking sector capital was correct. To a significant extent, the answer depends on whether the IMF assessment of U.K. bank capital should be made against internationally agreed standards or whether or as an absolute judgment that capital was adequate.

46. The 2016 FSSA gave a positive assessment on the level of capitalization of the U.K. banking sector.[3] The 2016 FSSA indicated that the results of both BoE and FSAP stress tests "suggest that the major U.K. banks would be resilient to a global economic downturn and to broad-based corrections in financial markets. In both tests, the global shocks have a major impact on bank capitalization, but all covered banks remain above regulatory minima" (IMF, 2016b). The 2016 Article IV confirmed the message that levels of capital of U.K. banks were adequate, citing the both strengthening bank balance sheets and the results of the BoE and FSAP stress tests.

47. The Bank of England in its recent public statements also takes the view that the capital of U.K. banks is adequate—and this is noted (with apparent agreement) in the 2017 IMF Article IV staff report on the U.K. The 2017 Bank of England stress tests were seen by the Bank as showing U.K. banks were sufficiently well capitalized to withstand large shocks. In some ways the 2016 FSSA went even further, as it included analysis to suggest that requiring more equity funding to further strengthen balance sheet resilience could have some negative effects outside the U.K. In particular, Appendix IV of the FSSA emphasized that lending by U.K. banks in several countries would be lower. These effects were described as "negative financial spillovers." No benefits of greater robustness of U.K. banks are considered in this appendix, which was called "Spillovers from U.K. Counter Cyclical Capital Buffer Adjustments" (IMF, 2016b).

48. In interviews conducted in 2017, I heard the understandable view from members of the IMF team that it would be rather bizarre if they said that U.K. banks could usefully have lots more capital, even though they satisfied Basel III rules. To use the U.K. FSAP to make a point about

[3] The only bank about which the 2016 FSSA voiced concerns regarding insufficient equity capital was the Bank of England itself—a judgment that reflected concerns about central bank independence if it needed to be recapitalized and one made quite independently of the stress tests for commercial banks.

possible weakness of Basel III rules might be strange. If the IMF wanted to take the view that Basel III needs to be made tougher, there were more appropriate ways to make that point (e.g., perhaps as part of it multilateral surveillance, or in discussions at the FSB). That takes one to the much wider issue of whether the IMF, given its status within the Basel Committee and at the FSB, can easily voice such a view even if it believes it is the right one.[4]

49. However, the 2010 and 2011 Article IV staff reports, as well as the 2011 FSSA, argued in favour of more bank capital and were explicit in criticism that Basel III rules look too weak. The 2010 U.K. Article IV staff report asserted that: "[b]anks' capital buffers should be strengthened further to prepare for tighter regulatory requirements in the future" (IMF, 2010). The 2011 FSSA and Article IV staff report indicated that the authorities and staff both supported stronger standards. The 2011 FSSA stated that: "[t]he U.K. authorities should continue to work toward an ambitious international package of regulatory reform. The authorities are rightly advocating for European legislation under the EU Capital Requirements Directive (CRD4) that enables the establishment of strong standards that (i) exceed the Basel III minima, including by setting ambitiously high capital requirements together with significantly topped-up capital demands on systemically important financial institutions …" (IMF, 2011b). The 2011 Article IV staff report stated that "the authorities … stressed the importance of having national discretion to set higher standards than the minimum levels of Basel III in specific circumstances" and that "staff have called for common standards that exceed the Basel III minima" (IMF, 2011a). This stance contrasts starkly with the 2016 FSSA, with its emphasis upon meeting regulatory minimum and the analysis of negative spillovers from U.K. banks using more equity.

50. Maybe the difference was just a matter of timing—by 2016 European financial systems were significantly more stable than in the midst of the euro area crisis in 2010–11. Nonetheless, this author believes that there is a case that could be made that the message on capital in the 2016 U.K. FSSA—and reiterated in the 2017 Article IV staff report—was too sanguine and that the IMF teams did not sufficiently question the Bank of England view. First, no space was given to considering the very clearly-articulated view of many economists (including Admati and Hellwig, 2013; Admati and others, 2010; Miles and others, 2013; Sarin and Summers, 2016; Vickers, 2017; and Wolf, 2017) that capital far above the Basel III levels was likely to be desirable. Second, significant emphasis was placed upon the costs of having U.K. banks use more equity funding—with much space devoted to analysis of supposedly negative knock on effects outside the U.K. Yet numerous studies—including by IMF staff (Dagher and others, 2016)—have consistently found these costs to be very low, at least in the long run.[5]

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[4] A separate background paper to this evaluation, Cecchetti (2018), focuses on the interactions between the IMF and the FSB and the Standard Setting Bodies.

[5] The 2016 analysis by Dagher and others says "Overall, and despite variation in data and methods used to estimate the impact of higher capital on lending rates, the literature finds extremely small effects" (Dagher, 2016).

Housing market analysis

51. If the FSSA is perhaps too sanguine on bank capital, it is arguably overly focused on housing market risks. The 2016 FSSA took the view that the buy-to-let sector in particular, but property markets more generally, pose a potential financial stability risk. On property markets the FSSA notes: "certain segments—notably buy-to-let and commercial real estate (CRE)—appear more vulnerable to price reversals, which could potentially spread to other segments. This would be a source of credit risk for banks, as well as of broader disruption for the U.K. economy…" (IMF, 2016b). The Article IV staff reports are similarly focused on housing market risks and have been for many years. The concern in the 2016 FSSA about the buy-to-let market seemed to reflect the views of the U.K. government that led to moves on tax policy in favor of owner-occupation.

52. There are three possible underlying beliefs behind the IMF's intense focus on the U.K. housing market. It may reflect:

(i) that what happened in the U.K. housing market was a major factor in the 2007–08 banking problems in the U.K. and was at the heart of the financial crisis in the U.K.;

(ii) that if U.K. house prices were out of line with fundamentals that this could cause major financial sector problems;

(iii) that rapid growth in the buy-to-let market (a major source of the rise in private rented accommodation in the U.K.) posed risks to financial stability and that this might have fueled price rises making property too expensive for first time buyers.

53. These beliefs may underlie the IMF recent focus on U.K. housing risks, but they are problematic. Proposition (i) is far from self-evident—losses on U.K. residential mortgages have been very small over the past decade; problems have been much more with commercial property. Furthermore, sales of U.K. residential mortgage-backed securities overseas are virtually zero, so any significant contagion from that route is unlikely. Proposition (ii) does not take account of the fact that the crucial factor for financial stability is the ability of households to pay interest on the mortgage and less the value of the house relative to the mortgage (where lenders have full recourse). The concern over the rapid growth of buy-to-let rental properties, proposition (iii), seems to ignore the fact that the sharp reduction in very high loan-to-value mortgages after the crash—almost certainly a helpful development in terms of financial stability—made it almost inevitable that the number of first time buyers would fall and that the time spent by young people in the rental sector would grow. The extra rental properties needed to allow this to happen had to come from somewhere.

54. The focus on housing market risks may be a case not just of fighting the last war (where there is a widespread view that housing and mortgage lending was at the heart of the 2007–08

crisis) but to some extent misdiagnosing that crisis, at least as it hit the U.K. where bad debts on U.K. mortgages had little to do with the problems.

Overall quality of FSAP and Article IV analysis

55. Overall, the 2011 and 2016 FSAPs were impressively comprehensive in assessing many types of risks and in scrutinizing adequacy of the overall structure of regulation. The Article IV analysis—which became more focused on financial risks and more closely aligned with the FSAPs—is also comprehensive, though less detailed. The IMF seems to do a good and thorough job in scanning the horizon and looking out for potential risks—though one can argue with the views taken on the relative size of different risks. It would be unfair to say that the risk assessment makes a point of mentioning as many risks as could conceivably crystallize as a defence against the criticism made later—and with the benefit of hindsight—that something was just not on the radar. The analysis of risks is more discerning than that.

56. It is also impressive how thoroughly the 2016 FSAP assesses progress against the recommendations made in the 2011 FSAP. This is essential. It is testament to the quality and influence of the 2011 FSAP how many of its recommendations were followed by implementation. But the 2016 FSAP is less impressive with respect to its specific recommendations on regulation of smaller institutions and its emphasis on housing problems where its analysis is a bit thin and light on evidence (more hunch driven).

57. There is a general tendency for the IMF reports not to engage in discussion of trade-offs of coherent views and policies that are contrary to the IMF's own views. An example is the continued push toward a more intrusive and resource-intensive approach to supervision of smaller firms but with limited assessment of the trade-offs between that view and the quite different view of the U.K. authorities. Another example is that recent Article IV reports and the FSAP 2016 did not raise the issue of whether meeting Basel III capital adequacy levels was adequate for U.K. banks (an issue raised by academics and that had been discussed in earlier staff reports). Admittedly, the experience of the past few years may have convinced both IMF staff and the authorities that capital levels were appropriate. In any case, as explained above, bilateral surveillance would not have been the right vehicle for the IMF to engage on a discussion of global standards.

58. Conceivably staff turnover might be an issue here. As far as I was able to tell there was no overlap at all between the team for the 2011 FSAP and that for the 2016 FSAP (based on the lists of team members in the introduction to each report). That might lead to insufficient understanding of the nuances of country circumstances and a tendency to fall back on long-standing recommendations that seem not to have been followed (such as "more resource intensive supervision of smaller firms is needed").

IV. Conclusions and Recommendations

59. IMF financial surveillance of the U.K. is detailed, well-informed and careful. The U.K. authorities consider that what the IMF says is important and that it may become even more important once the U.K. leaves the European Union. But some things might be done better:

(a) The amount of time and effort required of the U.K. authorities may be disproportionate to the real benefits. I got a strong sense that the U.K. accepts the cost because it is important that the IMF reach a favorable assessment of the U.K. rather than that putting in those resources yields value added to the U.K. authorities. There is a sense that the authorities don't expect to learn a lot but may need to spend a lot of time to allow the IMF to reach the same conclusions they have come to. For the U.K. authorities this is partly seen as a price to pay in part in exchange for getting this sort of analysis done on other countries where the U.K. may rely on IMF analysis. But the resource cost may still be needlessly high and a more streamlined FSAP better.

(b) It is useful for the IMF to stand back—for example, in the *Global Financial Stability Report*—and ask questions about whether overall financial regulation and supervision reforms since crisis are on track, specifically with regard to capital in the financial sector. Analysis of capital in U.K. banks in the 2016 FSAP gives a sanguine message—but this is quite at odds with much analysis by others. At the very least it would be useful to say why that analysis (a recent example of which is Sarin and Summers (2016)) is wrong. Otherwise the impression is given that compliance with Basel III means all is well.

(c) Staff turnover: Perhaps this is too high to allow mission teams to really get to grips with some U.K. specific issues that affect financial stability.

(d) Assessment with internationally agreed principles could be streamlined, at least in presentation. A 290-page report on compliance with Basel Core Principles is surely not the most effective way to deliver a message.

(e) There may be scope to use Article IV surveillance to do more financial sector risk assessment between FSAPs and to shift the balance in FSAPs towards a focus more on the structures of regulation. The Article IV staff reports could have an enhanced analysis of imminent financial risks.

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CHAPTER 5—IMF FINANCIAL SURVEILLANCE IN GHANA, KENYA, AND NIGERIA

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EXECUTIVE SUMMARY

This paper assesses the effectiveness and impact of IMF financial surveillance in Sub-Saharan Africa. Specifically, the paper examines whether IMF financial surveillance has been effective in identifying and helping mitigate financial sector risks and to what extent it influenced policies. The paper focuses on three country cases—Ghana, Kenya, and Nigeria—that illustrate many of the financial development challenges in the region. The assessment covers the period 2010–17 and is based on assessments under the Financial Sector Assessment Program (FSAP) which, as in other developing countries, were conducted jointly with the World Bank, and on the coverage of financial sector issues in Article IV staff reports and, where relevant, in program documents during this period.

The evidence suggests that IMF financial surveillance has enhanced the quality of risk assessment and has had a considerable impact on financial sector reforms and policies during the period reviewed. FSAPs introduced new analytical and diagnostic tools for financial stability assessment and their recommendations had considerable influence on the authorities' own risk assessment and policies, as well as on financial supervision. Article IV consultations provided ongoing coverage of these issues and were also effective in influencing policies and in complementing conditionality in IMF-supported programs for Ghana and Kenya. In addition, both FSAPs and Article IV consultations considered financial development issues, but this coverage was more uneven and contained less policy detail, perhaps because these issues were mainly covered by the World Bank.

Overall, a major finding that emerges from this analysis is the complementarity of surveillance, technical assistance (TA), and program conditionality. In most cases, TA provided by the Fund following the FSAP was instrumental—and, in some cases, indispensable—for implementing the policy recommendations made by FSAPs and Article IV consultations. Further, program design benefited from the knowledge developed in the context of surveillance and TA. The traction of recommendations developed in surveillance and TA was enhanced by the inclusion of related conditionality in IMF-supported programs.

Nonetheless, there is room to enhance financial surveillance for these countries. In these countries, like in other low-income countries where FSAPs are very infrequent, it is critical that the Fund strengthen financial sector expertise on Article IV teams. Tailoring Fund work more closely to country circumstances and staying ahead of emerging issues, such as the opportunities and challenges of new financial technologies, would help further enhance the effectiveness of the Fund's financial surveillance. The Fund should continue to explore ways to bring regional perspectives to bear in the bilateral surveillance of financial sector issues.

I. INTRODUCTION AND CONTEXT

1. This paper aims to assess IMF financial surveillance since the global financial crisis in Sub-Saharan Africa. In a broad sense, this paper attempts to answer the following questions:

- how effective has IMF financial surveillance been in identifying and helping mitigate financial sector risks in these countries;
- what impact has IMF financial surveillance had in shaping policy developments; and
- what has been the IMF's contribution to the analysis of financial sector deepening and financial inclusion, issues that are particularly important in Sub-Saharan Africa.

2. The paper focuses on three country cases: Ghana, Kenya, and Nigeria. In each case, the assessment focuses on the latest Financial Sector Assessment Program (FSAP) which, as in other developing countries, was conducted jointly with the World Bank, as well as on the coverage of financial sector issues in Article IV staff reports and, where relevant, program documents. This approach has two caveats. First, if a country has an IMF-supported program—as Ghana and Kenya did for part of the period covered by the evaluation—it becomes harder to evaluate the effectiveness and impact of Fund policy advice under surveillance since implementation of such advice often becomes part of conditionality. Second, IMF technical assistance (TA) activities—which have been extensive in these countries, including on financial sector issues—fall outside the scope of the assessment. But as this report makes clear, the effectiveness of financial surveillance depends partly on the availability of TA to follow up and assist the authorities in implementing the recommendations made in the context of FSAPs or Article IV consultations.

3. These three countries were selected for two reasons. Although they may not have systemically important financial sectors, they are very significant for Africa. Nigeria is the largest economy in Africa, among the 30 largest economies in the world, and a major oil producer. Kenya is the largest economy in East Africa and a leader in fintech and other financial innovations in Africa and globally. Ghana is a major destination of foreign direct investment in West Africa and a major producer of cocoa. These three countries are also an appropriately diverse sample, including a major oil producer (Nigeria), a relatively diversified economy by African standards (Kenya), and a broader commodity producer (Ghana). Given that all three are low-to-middle income countries, the findings shed light on the specific challenges that IMF financial surveillance faces in other similar countries.

4. This paper draws on a review of relevant IMF documents, notably Financial System Stability Assessments (FSSAs) and other FSAP documents, as well as Article IV staff reports for the period since the most recent FSAP and up to 2017; interviews with policymakers in relevant institutions in Ghana, Kenya and Nigeria; and interviews with IMF staff involved in surveillance in these three countries.

5. For an activity like IMF surveillance, the ultimate test of effectiveness, particularly in countries without systemically important financial sectors, is the degree to which it influences policies in member countries. For this reason, although the evaluation covered the analytics, resources, depth of discussions with the authorities, and quality of surveillance documents, the key question on which this paper is focused is the impact the Fund's financial surveillance has had on the policies in these three countries.

6. The rest of the paper is organized as follows. Section II discusses the coverage of financial surveillance in the three countries. Section III provides an overall assessment of the usefulness and impact of IMF financial surveillance in these countries. Section IV concludes.

II. COVERAGE

7. The coverage of financial sector issues in Article IV consultations has historically been more limited in African countries than in more advanced economies, both in extent and in scope, although recent years—including the period covered by the assessment—have seen a significant expansion in this coverage. Article IV staff reports and, where relevant, program documents in Ghana, Kenya, and Nigeria have focused mostly on the diagnosis and monitoring of financial vulnerabilities and on policies to mitigate these vulnerabilities drawing on FSAP recommendations. The focus is to a large extent explained by the importance of financial vulnerabilities in these countries, especially in the context of IMF-supported programs for Kenya and Ghana for part of the period covered by the evaluation. Notable exceptions are the coverage of financial deepening and inclusion in Article IV consultations in Kenya, and the effort to set the discussion of financial sector issues into a macrofinancial framework in the 2016 and 2017 consultations for Nigeria, both discussed in more detail below.

8. In these three countries, FSAPs are conducted jointly with the World Bank and are meant to provide a comprehensive analysis of financial sector issues, including financial development challenges. The most recent FSAPs in these countries took place in 2011 for Ghana (IMF, 2011), 2009 for Kenya (IMF, 2009), and 2012 for Nigeria (IMF, 2013). Consistent with the FSAP mandate, these exercises analyzed (i) current risks and vulnerabilities; (ii) the effectiveness of financial regulation; and (iii) financial safety nets, notably crisis management arrangements. They also discussed to some extent spillovers, macroprudential policies, and macrofinancial linkages.

9. Recent efforts by the Fund to strengthen the coverage of financial sector issues and the analysis of macrofinancial linkages in surveillance in Africa extend beyond FSAPs and Article IV consultations to include activities such as increased analytical work in the African Department, including papers covering cross-cutting issues (such as Pan-African banks); increased coverage of financial sector issues in the *Regional Economic Outlook* for Sub-Saharan Africa; and a number of seminars and workshops. But it is still too early to provide a thorough assessment of these efforts.

III. OVERALL ASSESSMENT

10. In general, the Fund's financial surveillance in these three countries had a significant policy impact, mostly in the areas of financial stability assessment, and on banking regulation and supervision. At the same time, in interviews the authorities identified shortcomings in a few areas that, in their view, could be addressed by strengthening FSAPs and Article IV consultations. However, as staff pointed out, there are challenges and trade-offs that need to be taken into account when trying to address some of these perceived shortcomings.

A. Strengths

Analytics and diagnostics

11. The IMF has developed and refined its analytical and diagnostic tools for identifying key financial stability concerns relevant to the circumstances of these countries. For example:

- In **Ghana**, areas of concern for financial stability include the large number of banks, high cost of borrowing, weak transmission mechanism for monetary policy, high operating costs in the banking sector, and weak capitalization of banks. All these issues were to a greater or lesser extent covered by the 2011 FSAP (IMF, 2011) and subsequent Article IV consultations. The Fund's work on developing stress test models and procedures for the banking sector in the context of the FSAP was much appreciated by the Bank of Ghana.

- **Kenya** has a crowded banking sector. Starting with the 2009 FSAP, the IMF, working together with the Central Bank of Kenya, developed stress testing tools for the banking sector as part of an early warning system (IMF, 2009). More recent Article IV consultations and program documents have also covered several times the impact of mobile banking—where Kenya is a leader—on financial inclusion and financial deepening (for example, see IMF, 2014). IMF financial surveillance and other work done in the context of the 2011 Extended Credit Facility (ECF) and follow-up 2015 Stand-By Arrangement also facilitated the identification of a number of banks that lacked adequate capital.

- In **Nigeria** recent Article IV consultations—notably in 2016 and 2017—attempted to set the discussion of financial sector issues explicitly in a macrofinancial framework.[1] Particularly notable was the 2016 Selected Issues Paper (SIP) analysing the transmission of growth stimulus from the oil to the non-oil sector through financial linkages, as well as the use of corporate sector stress tests to examine the possible banking sector vulnerabilities arising from an oil price shock (IMF, 2016).

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[1] There appears to be further progress in integrating financial sector surveillance in Article IV consultations during 2018, after the period considered in this review, for instance in Kenya.

Policy impact

12. Beyond analytics, IMF financial surveillance has had a substantial policy impact in all three countries. The impact of IMF surveillance extended beyond banking to insurance, capital market development, investor protection, and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) activities. It is important to keep in mind that in Ghana and Kenya some of the content of surveillance advice became part of program conditionality.

Ghana

- In the *banking sector*, the Bank of Ghana—with the help of IMF TA—developed stress tests for banks, introduced financial stability reviews, implemented Basel II guidelines, implemented a risk-based approach to bank supervision, and created a Financial Stability Department, all influenced by FSAP recommendations and related follow-up work by subsequent Article IV consultations. In more recent years, in the context of the 2015 ECF, the Bank of Ghana conducted special diagnostic audits of bank balance sheets, designed a road map to address weaknesses in capital and liquidity, and took a number of steps to strengthen the legal framework (IMF, 2015).

- The FSAP had an impact in the area of *pensions*. In part reflecting FSAP recommendations, the National Pensions Regulatory Authority (NPRA) worked toward aligning its supervision approach to the principles of the International Organization of Pensions principles, especially as regards governance and independence. The NPRA achieved financial independence in 2017, strengthened its governance structure and internal processes, and established a term-limit for the CEO, who is now appointed by the Board and not the Office of the President. Finally, the FSAP proposed moving NPRA pensions to a defined-contribution basis and creating new guidelines to broaden the asset base and asset allocation of pensions.

- In the *insurance sector*, the National Insurance Commission enacted reforms to strengthen its resilience in accordance with advice from the FSAP.

- The Ghana Stock Exchange also benefited from IMF recommendations covering new capitalization rules in line with international best practice and from advice on deepening the fixed income market in Ghana. IMF recommendations prompted the authorities to request TA in areas such as AML/CFT and risk-based supervision of operators, as well as guidance on the capitalization of market players. A number of regulatory reforms in these areas, introduced in 2016, arose from IMF recommendations.

Kenya

- In the *banking sector*, the Central Bank of Kenya (CBK) benefited in various ways from the 2009 FSAP and subsequent follow up in Article IV consultations (especially the 2014 consultation) and in the context of the 2011 ECF on addressing regulatory and

supervising issues arising, inter alia, from the rapid development of mobile banking. The CBK implemented most of the recommendations from the two reports. First, the authorities enhanced the regulation of mobile-banking activities (such as M-Pesa) to an extent that they consider themselves world leaders in this area. The Banking Supervision Department now has a good handle on the credit growth implications of mobile banking services and closely monitors these risks. Second, in order to comply with AML/CFT requirements in the operations of mobile payment services, the CBK introduced payments system regulations for the provision of electronic retail transfers. Third, partly reflecting the FSAP recommendations to adopt market and operational risk approaches to the prudential framework, the CBK established higher capital requirements for banks and facilitated bank mergers and acquisitions in order to create stronger institutions. Fourth, the CBK introduced regulations in 2013 that resulted in the adoption of internal capital adequacy assessment processes in banks. Fifth, the CBK strengthened the regulation of microfinance institutions and upgraded credit bureau regulations. Finally, in response to the FSAP recommendation on strengthening cross-border supervision, given the expansion of Kenyan banks in other countries, the CBK established three supervisory colleges to conduct joint assessments of the most important Kenyan financial groups. IMF staff also engaged the CBK, commercial banks, and other stakeholders on the impact of interest rate controls on financial access, economic growth, and financial stability. A staff note analyzing the issue that was shared with the CBK reportedly informed the authorities' subsequent effort to reform interest rate controls. In 2018, staff published a chapter on this "Kenya: Impact of Interest Rate Controls" in an SIP (see IMF, 2018).

- The Capital Market Authority (CMA) of Kenya benefited in various ways from recommendations in the FSAP and in the 2014 Article IV consultation, as well as from IMF TA. Specifically, the CMA elaborated a capital market Master Plan to encourage infrastructure financing and the growth of the derivatives market and moved toward automating over-the-counter trading of treasury bills. The stock market was demutualized, facilitating the entry of new investors, and cooperation with other financial sector regulators was enhanced under the auspices of the Financial Services Authority. Furthermore, the IMF conducted research on the efficiency of the bond market in 2012, provided assistance for developing a register for government securities in the Central Security Depository, and analyzed the efficiency and effectiveness of the Central Depository and Settlement Corporation.

Nigeria

- In the area of *banking*, the Central Bank of Nigeria (CBN) took several steps to strengthen oversight following the 2012 FSAP. First, the CBN enhanced supervisory oversight, including on-site inspections, over banks with international presence, as well as cooperation with other supervisors through the college of supervisors of the West African Monetary Zone and the Financial Stability Board Regional Consultative Group for

Sub-Saharan Africa. Second, macroprudential oversight and crisis preparedness were strengthened through the enhanced functioning and capacity of the Financial Services Regulation Coordinating Committee. Third, an Early Warning System was introduced and comprehensive scenario stress testing for banks is under development. Fourth, in line with FSAP recommendations, there was a review of the licensing of microfinance banks, aiming to offer different types of microfinance licenses for unit, state, and national institutions. Lastly, on the recommendation to revise and enhance the Regulatory Framework for Mobile Payment Services in order to create a more competitive environment and level the playing field, the CBN revised regulations to distinguish between bank and non-bank operators and raised capital requirements. In several of these areas, these reforms were implemented with IMF TA.

- In the *insurance sector*, partly reflecting FSAP recommendations, the National Insurance Commission upgraded the solvency regime and enhanced the reserve requirements and valuations in line with international best practice, on the back of the adoption of IFRS accounting standards in 2013.

- In the area of *pensions*, the Pensions Commission moved, in compliance with the Pension Reform Act of 2004, to establish a database of employers and to develop Nigeria-specific mortality tables for pricing annuities and programmed withdrawals.

- The *securities market* also benefited from IMF recommendations, as evidenced by the work of the regulator, the Securities and Exchange Commission (SEC). Partly in response to the recommendation to strengthen governance by expeditiously nominating new Board members of the SEC, a new board was elected. Also, risk-based supervision for broker-dealers was established and entity-level supervision and regular on-site inspections were increased. Finally, in order to centralize the monitoring of contingent fiscal commitments, the government enhanced its monitoring of fiscal activity, including identifying arrears and requiring state and local governments to report regularly.

13. A major finding that emerges from this analysis is the complementarity of surveillance, TA, and program conditionality. In most cases, TA provided by the Fund following the FSAP was instrumental—and, in some cases, indispensable—for implementing the policy recommendations made by the FSAPs and Article IV consultations. Further, program design benefited from the knowledge developed in the context of surveillance and TA. The traction of recommendations developed in surveillance and TA was enhanced by including related conditionality in IMF-supported programs.

B. Areas for Improvement

14. Despite these achievements, authorities pointed to three areas where there was room for improvement: priorities and relevance, regional perspectives, and skills. IMF staff understood the

challenges raised by authorities, but they had different perspectives and pointed to constraints they faced in addressing some of these challenges.

15. Some country authorities expressed reservations about the *priorities* of IMF financial surveillance. They argued that the IMF was excessively focused on financial stability at the expense of financial sector development. In Nigeria, for example, while acknowledging that financial stability should be the primary focus of the Fund's financial surveillance, the authorities felt the Fund could focus more on specific financial inclusion objectives, which they were pursuing through microfinance institutions; financial literacy programs; consumer protection efforts; and mobile banking services. In Kenya, policymakers noted that while Kenya was a world leader in fintech applications, such as mobile banking, the Fund had been slow to engage and was not able to give relevant policy advice on fintech. Also in Kenya, officials argued that financial surveillance could have taken more into account country circumstances, by analyzing the distortions arising from the existence of a dual banking sector, which is segmented between small and large banks and foreign and domestic-owned banks.

16. While acknowledging that financial development and financial inclusion were crucial for these countries, IMF staff pointed out that the World Bank was primarily responsible for these issues and that the Fund should avoid undue overlap and duplication.[2] IMF staff also explained that given the vulnerabilities faced by banking systems in these countries, financial stability was critical for the success of the authorities' financial inclusion agenda. In Kenya, for example, capital and liquidity weaknesses faced by some banks hamper depositor confidence and hinder financial inclusion. Still, they indicated that financial development issues had been the focus of surveillance in a number of Article IV consultations and SIPs.[3] In particular, they had examined mobile banking in Kenya, which was growing fast, and now makes up the great majority of financial transactions although it still represented a small share of transactions by value.

17. The authorities would have liked IMF financial surveillance to have a more *regional perspective*. Kenyan officials thought there was a strong argument for producing a regional FSAP for East Africa, reflecting Kenya's role in the East African Community and the intention of the whole region to move toward closer financial integration. IMF staff, on the other hand, noted they were already deeply engaged in Kenya, Tanzania, and other East African countries, as well as at the regional level, providing extensive TA and training on regulatory and financial sector issues. They pointed out that, the authorities' intentions notwithstanding, the actual level of regional financial interconnectedness was still fairly limited. Therefore, the value of a regional FSAP would be marginal, while the resource cost would be significant.

[2] For example, in Ghana, the World Bank was working with the authorities to develop a national financial inclusion strategy.

[3] One of these SIPs, on household financial access and risk-sharing in Nigeria, had been turned into a Working Paper (Carlson and others, 2015).

18. Authorities felt it was important for the IMF to increase the *financial sector skills* of staff, particularly on Article IV teams. Authorities indicated that they would appreciate if these teams regularly included staff from the Monetary and Capital Markets (MCM) Department. Fund staff acknowledged the resource limitations but pointed out that they were making efforts to address them; the Kenya team, for example, has included an MCM economist since 2016 in response to the authorities' suggestion.

IV. CONCLUSION

19. IMF financial surveillance in these three countries has been helpful to authorities and has had significant traction. FSAPs introduced new analytical and diagnostic tools for financial stability analysis and improved the identification of financial sector risks; their recommendations had a significant impact in shaping the authorities' own risk assessments and policies, particularly in the area of financial sector oversight. Article IV consultations and, where relevant, program documents were for the most part more narrowly focused on financial vulnerabilities. This was partly due to the urgency of these vulnerabilities in some of these countries. It also reflected limited financial sector expertise on Article IV teams. Still, Article IV consultations provided important ongoing coverage of these issues and were also effective in influencing the authorities' policies. In addition, both FSAPs and Article IV consultations also reported on financial development issues, notably the authorities' efforts to foster financial inclusion. This coverage was less consistent and did not go into as much detail or concrete policy recommendations, partly in deference to the World Bank on financial development issues.

20. The depth and the sophistication of the analysis of financial sector issues improved over time. While the analysis of macrofinancial linkages was weak, the 2016 and 2017 Article IV consultations with Nigeria made some progress, reflecting the Fund's efforts to mainstream financial sector analysis in surveillance, which have started bearing fruit. Indeed, staff pointed out that documents produced in the most recent months, in the context of the 2018 Article IV consultations—not examined in this evaluation—bear out this trend even more clearly.[4] Nevertheless, as staff acknowledged, these efforts are still work in progress.

21. The impact of the Fund's financial surveillance on policies was contingent on the availability of follow-up TA by the Fund or other international partners. Where such TA was made available to the countries, local capacity improved and the implementation of recommended reforms was more successful. This suggests that in developing and emerging market countries, the impact of financial surveillance cannot be assessed separately from the overall institutional involvement of the Fund with the country. Capacity building needs remain high in all three countries, especially in the areas of deepening financial markets and strengthening regulation.

[4] Among these are chapters on "Kenya's Success in Boosting Financial Inclusion" and "Macro-Financial Linkages Between Corporates and the Financial Sector in Kenya" included in a recent SIP produced for the Kenya 2018 Article IV consultation (see IMF, 2018).

22. At the same time, the authorities argued that there is room for improvement in three areas: the priorities of financial surveillance, the inclusion of regional perspectives, and the extent of financial sector expertise—especially on financial supervision—on Article IV teams. Authorities in all three countries were interested in greater emphasis on financial deepening and financial inclusion issues, and on the role of new financial technologies. Even though cross-border financial linkages among these countries are still limited, the role of Pan-African banks and the potential for cross-border contagion would justify a more regional perspective in financial surveillance. Recent initiatives of the African department suggest that the Fund has indeed started moving in this direction. As regards the scarcity of financial sector skills, especially among Article IV teams, this limitation was readily acknowledged by staff and goes beyond the teams working on Sub-Saharan Africa. Addressing this shortcoming will take time, but it is a critical precondition for a lasting strengthening of financial surveillance.

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