EP ECON Hearing on Cross-border crisis management
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The written statement is built around 4 key questions.

1. Challenges posed by large cross-border groups

The single banking market was built on the premise that banks conduct the majority of their business at home and only branch out to other EU countries on a modest scale. This premise is no longer true. Some of the major European banks such as Deutsche Bank, BNP Paribas and UniCredit currently conduct more business cross-border than at home. The single market is now weighed down by its own success. Indeed, the single market in banking is falling apart. Following the debacle with the Icelandic banks, Glitnir, Kaupthing and Landsbanki, supervisors want to move to stand-alone subsidiaries – but this will result in significant efficiency losses. Can we save the single banking market in the EU?

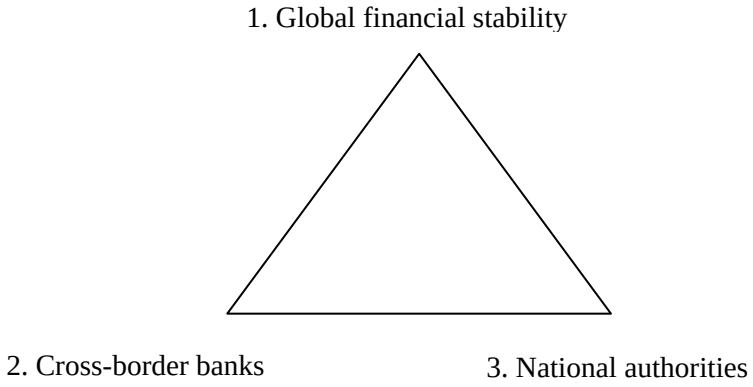
"Yes" is the answer I would argue for – if national policymakers can find the courage to give up some of their national sovereignty. This crisis has made clear that national governments are only prepared to use taxpayers' money to support domestic depositors. A prime example is Iceland providing help to depositors domiciled in Iceland. UK and Dutch depositors were literally left in the cold. Although legally the depositors in the UK and Dutch branches should have been treated on an equal footing with the depositors in the Icelandic parent banks, this was not the case. Similarly, when Fortis was falling down last autumn, the Belgian and Dutch governments each took care of the bank's separate national segments.

The logical conclusion would be that cross-border banks should be organised as a string of subsidiaries abroad (Pomerleano 2009). To establish stand alone units, each subsidiary should have its own treasury, risk management models, internal controls and so on. But even then, there is no certainty whether such stand alone subsidiaries could survive the failure of the parent bank or a subsidiary due to reputation risk. One can easily imagine a downward spiral in which supervisors increasingly ask banks to run each subsidiary as a separate banking unit, up to the point where there are no efficiency gains in being part of a wider banking group.

But there is an alternative. Figure 1 illustrates the financial trilemma, stating that the three objectives of financial stability, cross-border banks and national authorities cannot be combined; one of these objectives has to give (Schoenmaker, 2010a). The current combination of cross-border banks (financial integration) and national authorities for financial supervision and crisis management has lead to financial instability. To solve the trilemma, some supervisors propose to reverse integration by requiring cross-border subsidiaries. But another solution to the trilemma is to move away from national financial policies and to look for European solutions. This is also

stated in the Turner Review, which argues that the status quo is not stable. We need either more Europe (supranational) or less Europe (subsidiaries).

Figure 1. The financial trilemma



Source: Schoenmaker (2010a)

On the supervisory front, the new European System of Financial Supervisors is an important step towards putting financial supervision on a European footing. The new European Banking Authority will work in tandem with a network of national financial supervisors. A crucial element is that an independent chairman will have the power of binding mediation in case two or more national supervisors are in conflict. This independent chairman will have a drive to build and strengthen the role of the European Banking Authority at the centre of the system.

But on the crisis resolution front, there has been no progress so far. In particular the UK has been adamant that the European System of Financial Supervisors cannot take decisions on crisis resolution with fiscal implications - notably providing capital support to cross-border banks. Such fiscal decisions should stay fully in the realm of national governments (Pauly 2009).

To get out of this conundrum, Charles Goodhart and I have proposed binding burden sharing rules among national governments (Goodhart and Schoenmaker 2009). If a cross-border bank faces difficulties, the governments would share the costs according to some predetermined key – for example, according to the distribution of the troubled bank's assets over the respective countries. Under such a burden sharing approach, a common solution can be found upfront. By pre-committing to burden sharing, governments would give up some of their sovereignty. But in return, the single market in banking serving Europe's businesses and consumers would be saved.

2. Moral hazard

Following the 2007-2009 financial crisis, there is much concern about the massive bail-out costs of the financial sector. How can one reduce moral hazard and rein back expectations of future bail-outs? The too-big-to-fail doctrine has been reinforced, if

anything, by the handling of the current financial crisis. I believe that the authorities, under the exceptional circumstances in late 2008, had no choice but to support the financial system and thus to keep credit flowing to the wider economy. At this stage, we may draw the preliminary conclusion that the support for the financial system and the broader fiscal stimulus for the economy have averted a full-blown depression, which was a real threat at the end of 2008.

Amongst the proposals to curtail the too-big-to-fail practice, I believe that the concept of Living Wills is a promising beginning; its further development might allow systemically important banks to fail or, at least, to be unwound (Avgouleas, Goodhart and Schoenmaker, 2010). The objective is to put in place, ex ante, conditions that would allow a wider range of options other than having the whole bank rescued. A Living Will is a recovery and resolution plan to be used when a bank may get into difficulties. The G20 has requested Living Wills to be drawn up for the top 30 global banks. The Financial Stability Board is currently working on this exercise.

I see the Living Will exercise as running in tandem with the new Basel proposals to increase capital substantially, especially for large banks to internalise their systemic externalities. Higher holdings of core equity reduce the probability of failure of systemically important banks, while Living Wills reduce the impact of a possible systemic failure. Both elements can reinforce each other to rein in the too-big-to-fail problem.

Such Living Wills contain some key elements. First, there should be discussions between a bank and its supervisors about winding down its operations in crisis times, and forcing a bank to simplify its often opaque structure. A bank will also have to make contingent funding and de-risking plans to recover its own strength. Second, credible resolution plans should be drawn up to keep a bank alive, if needed. In the case of cross-border banks, these resolution plans could include a burden sharing mechanism for central banks (liquidity support) and ministries of finance (capital support). The burden sharing would then be agreed institution by institution. Third, a bankruptcy scenario might help to bring possible shortcomings in deposit guarantee schemes and inconsistencies between insolvency regimes to the forefront of attention. This would force authorities (including lawmakers) to tackle these inconsistencies. The insolvency procedure for international banks is currently a nightmare for depositors, creditors, and shareholders, but a paradise for insolvency lawyers.

Such Living Wills should be drawn up by banks and authorities. Banks would be the prime actors for developing their own recovery plans. Supervisors will challenge banks on the credibility of the recovery plan. This is typically done by the core supervisory college comprising the home and key host supervisors of a bank. The resolution plan should be drawn up by the authorities (supervisors, central banks and ministries of finance) from the countries represented in the core supervisory college. As the Living Will should cover the whole bank, it is necessary to have one overall Living Will rather than a string of national Living Wills lumped together.

The main purpose of drawing up Living Wills is the ex ante effect. The drawing up of a Living Will could act as a catalyst for thinking and taking action.

Higher capital and Living Wills can thus help to contain moral hazard. I do not expect much from structural approaches, such as reducing the size of banks and splitting commercial and investment banking. Small banks will reduce the scope for credit risk diversification, and may thus increase the vulnerability of banks (Dermine and Schoenmaker, 2010). The Volcker proposal to split commercial and investment banks may not solve the problem. In the US, problems started with the lighter regulated investment banks (Bear Stearns, Lehman).

3. Funding

There are different proposals around for funding cross-border banking crises. Implementing all these proposals at the same time would overburden the financial sector. I would make an argument for prioritising the different proposals.

First and foremost, credible deposit insurance arrangements are needed. The earlier mentioned Icelandic example, where the home country deposit insurance fund was not capable of serving host country depositors, illustrates the shortcomings of the single market arrangements. The home country principle did not work, as the Iceland deposit insurance could not serve depositors EU wide. I would argue for putting deposit insurance arrangements on a European footing and move to ex ante funding with risk based premia. At least for cross-border banks. The current situation in the EU reflects the US before the Great Depression in the 1930s. State deposit insurance schemes did not appear stable (many schemes were underfunded and unstable, similar to Iceland). In the New Deal, Roosevelt introduced federal deposit insurance (FDIC) to strengthen the stability of deposit insurance.

Deposit insurance is only credible with an implicit government guarantee. So EU member states will have to underpin such a European Deposit Insurance Fund. Although many would find such an underpinning a dangerous idea, it is already applied to the lender of last resort (LOLR) function of the ECB. The ECB can act as general LOLR flooding the interbank market with liquidity when needed. Art 18.1 of the Statute of the ESCB provides the basis for this classical central banking tool: “In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may … conduct credit operations with credit institutions and other market participants, with lending based on adequate collateral”. So, the ECB needs to take adequate collateral. During the 2007-2009 financial crisis the ECB has expanded the range of eligible collateral. As the range of collateral expands beyond safe assets such as Treasuries, credit risk increases. The ECB has made a provision of EUR 5.7 billion for the increased credit risk of its general LOLR operations. The national central banks (NCBs) have underwritten this provision according to their capital key in the share capital of the ECB. As each NCB is backed by its own government, the ECB’s expansion of collateral rules is implicitly underwritten by the national governments of the euro area.

Second, burden sharing may be needed. While implicit for general LOLR operations, burden sharing becomes explicit when moving to general capital support operations. Capital support to ailing banks can only be given by governments which have deep pockets. Currently, national governments support national banks. That is the picture throughout the 2007-2009 financial crisis. Only US head-quartered banks were

eligible for support by the programmes of the US Treasury. Similarly in Europe. In the case of Ireland for example, only Iris head-quartered banks were eligible for capital support from the Irish government, while banks from other EU countries were left in the cold. To resolve this tendency to disintegrate in Europe (and beyond), a supranational approach is needed. Goodhart and Schoenmaker (2009) propose to move to legally binding burden sharing rules for LOLR and capital support operations for cross-border banks.

Burden sharing is politically controversial (Pauly, 2009). I would like to stress that burden sharing arrangements specify how you could rescue a failing systemically important cross-border bank (similar to the domestic arrangements for rescueing a failing systemically important bank). But the decision to rescue, or not, is still at the discretion of the authorities. Central banks and finance minstries typically play a mixed strategy of constructive ambiguity, which implies that it is uncertain whether a bank in difficulties will get support. This uncertainty of public support reduces moral hazard. Finally, general burden sharing across the European banking system would be far reaching. A less far-reaching approach is to arrange specific burden sharing institution by institution. That could be done through the Living Wills. A Living Will for a cross-border bank would then specify how burden sharing would be applied in case of a potential bailout (Avgouleas, Goodhart and Schoenmaker, 2010).

Third, a resolution fund is proposed (Weder, 2010). I do not see a need for a separate resolution fund. The rationale for a separate resolution fund to maintain financial stability is twofold. The first aim is to have sufficient funds available when a crisis hits. However, the incidence and severity of crises are difficult to assess on an actuarial basis. Before the current crisis, the incidence and severity would have been calculated on a low-medium base, reflecting occasional crises over the last 30 years (since the breakdown of Bretton Woods). After the current crisis, the incidence and severity would probably be calculated on a high base, reflecting the current crisis and the Great Depression. This is the classical problem of disaster myopia. Moreover, macro-events such as systemic crises are inherently difficult to predict. So, the size of the required funds cannot be estimated in any meaningful way.

A second aim is to internalise the costs of financial crises. This can be done by a Pigouvian tax, as set out by Perotti and Suarez (2009). The levy, charge or premium on the financial sector is basically a tax, which should be set at a level to counter (i.e. neutralise) the negative externality caused by financial institutions. By its nature, this levy is not necessarily related to the required actuarial premium (insofar as such an actuarial premium could be calculated). A properly set systemic levy also addresses moral hazard as the levy is set in such a way to internalise the negative externality. In that way, the levy neutralises any incentive for risky behaviour.

Another argument against an *ex ante* resolution fund is its pro-cyclicality. Countercyclical premia suggest that levies should be higher in good times (i.e. economic upturn) and lower in bad times (i.e. economic downturn). The running of an insurance fund is typically pro-cyclical. In good times, premia tend to be lower as future risks appear benign. Even worse, premium holidays can be granted when the fund reaches its target size. This is pro-cyclicality in its extreme. Prior to a crisis, levies are reduced to zero, inducing further expansion of the financial sector and thus increasing the likelihood of a crisis. An *ex post* resolution fund to recover the costs of

the current crisis is even worse, as premiums are charged in the current economic downturn (further weakening the banking sector) and do not address moral hazard.

Financial stability is a public good, as the producer cannot exclude anybody from consuming the good (non-excludable) and consumption by one does not affect consumption by others (non- rivalness). I, therefore, consider public resolution of financial crisis as a core government task. Reviewing the arguments, I believe that the establishment of a separate resolution fund, financed *ex ante* or *ex post*, is not desirable. Although a separate fund can be helpful as a first line of defense, it can never be foolproof. Sweden, for example, has set a target of 2.5% of GDP. The current public resolution costs have been well above this target-size in many countries. It may even give a false sense of safety. Moreover, the setting of a target-size suggests that premia can go to zero when the target is reached. This is clearly pro-cyclical and counterproductive. So, a buffer based approach (i.e. the fund acts as a buffer) has major drawbacks. The general budget of the government is meant to bear the kind of macro-economic risks, such as caused by financial crises. At the same time, the government may wish to levy Pigouvian taxes on the financial system to counter negative externalities. This is a flow-based approach: cash outflows in times of crises and cash inflows in stable times. As I have argued above, the inflows and outflows need not necessarily match. As with any government task, there is no need to balance each task separately. The only constraint on governments is to achieve an overall balance of inflows and outflows over time.

In sum, I believe that setting up a credible deposit insurance scheme (with *ex ante* risk based premia) as well as burden sharing is more urgent at the European level than a resolution fund (with a separate tax to fill the fund).

4. Crisis management framework

In the 2007-2009 crisis, governments had no option than to rescue banks as a whole. A crisis management framework can help to increase the options. Such a framework needs to lay down the powers and the tools for crisis management and an agency to apply these tools effectively.

Efficient resolution plans are currently set up as part of Living Wills (Avgouleas, Goodhart, Schoenmaker, 2010). An effective resolution plan has the following tools:

Ex ante

- Simplify the structure of a bank
- Early intervention in case of emerging problems

In crisis

- Write down shareholders and unsecured creditors
- Split the bank into systemic (to be rescued) and non-systemic parts (put into insolvency)
- Apply burden sharing to rescue cross-border systemic parts
- Apply a standard insolvency regime for non-systemic parts

These powers should be put into European legislation. I would argue to combine the power of resolution and insolvency within a special resolution regime for systemically important financial institutions. See Avgouleas, Goodhart and Schoenmaker (2010) for a sketch of such a special resolution scheme.

The next question is who should be the resolution agency? Effective cross-border resolution of cross-border banks should be done at the European level (Schoenmaker, 2010b). The 2007-2009 financial crisis has proved that national supervisors have no natural inclination to share information within supervisory colleges. To the contrary, they have an incentive not to share information. As soon as one supervisor (notably the home supervisor) warns of potential difficulties, the other supervisors (host supervisors) have an incentive to ringfence the troubled bank's assets in their jurisdiction. National interests have thus been prevailing, also in the EU. To overcome this coordination failure, a European mandate overriding national mandates is needed to make the supervisory colleges work effectively.

In this context, I endorse the proposed Regulations to confer special powers on the European Supervisory Authorities (ESAs) in emergency situations. In such emergency situations, the ESAs have the power to require national supervisors to jointly take specific action. Importantly, article 10.4 of the proposed Regulations specifies that "Decisions [of ESAs] shall prevail over any previous decision adopted by the competent authorities [i.e. national supervisors] on the same matter". I propose to establish the new arrangements with the ESAs first and to make them work before setting up even more new agencies, such as a European Resolution Agency. Such a European Resolution Agency would anyway be very dependent on the ESAs providing timely information.

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