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on Cross border crisis management in the banking sector

Committee on Economic and Monetary Affairs

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1. GENERAL CONSIDERATIONS

1.1. Context

The recent and severe financial crisis created a broad consensus across stakeholders and the political spectrum that action is urgently required to ensure the sustainability and stability of the financial system.

Unprecedented amounts of money were spent (primarily from tax payers) to rescue the system. Although the final bill is still unknown, it is clear that it had a massive impact on European growth and jobs, and represented a huge setback in the pace at which Europe is building its future.

The wide variety of approaches and tools used by governments and regulators raised serious concerns as to the:

- a.) effectiveness of the overall exercise
- b.) legal uncertainty
- c.) level playing field and distortion of competition

A robust, comprehensive approach is needed to create an effective preventive framework and safety net. The approach should focus on:

- Strengthening the international regulations
- Designing an effective EU supervisory architecture
- International discussion on overall banking system architecture

These developments will make the system more resilient and reduce the probability of crisis.

But individual or collective failures cannot be totally prevented, thus the need for a new framework for crisis management.

1.2. Moral hazard

Financial crisis cannot be always prevented. One of core concerns is to design proposals that limit and mitigate moral hazard issue when possible. The aim is to create conditions for a strong and sustainable financial system. But that does not mean a system without failures of individual institutions. It means a system where failures do not occur frequently and when they occur they are handled in an organised way limiting costs to different stakeholders and the tax payers. In some cases that will mean “euthanasia” as P. Volcker recently advocated, in others “rehabilitation”. In any case the bulk of the pain should be felt by the shareholders and the rescued institutions (in case of survival) by appropriate penalties and repayment of support. Since the existing laws on insolvency and bankruptcy traditionally focus more on liquidation and protection and fair treatment of creditors and shareholders than on financial stability, continuity of core banking services, and minimization of taxpayers' bill, setting up an EU Framework for Cross-Border Crisis Management in the Banking Sector is essential.

1.3. Importance of an EU framework for cross-border crisis management, including frameworks for early intervention and resolution

Intervention tools used by governments, central banks and regulators/supervisors across Europe to tackle individual and systemic problems in their respective banking sectors varied widely. These tools were used by local authorities with little international alignment. That raised numerous issues at different levels such as:

- Distortion of competition
- Challenges by shareholders
- Severe delays of rescue transactions
- Confusion as regards applicable legal framework and rights of stakeholders
- Protectionist measures.

It is absolutely critical, for the sake of financial stability, to create a framework that will provide necessary clarity and legal certainty in crisis situation.

Presently there is patchwork of national frameworks which are not always compatible making it difficult to deal with cross-border groups involving several jurisdictions. A sound European single financial market requires a coherent regulation across the 27 Member States.

The Commission Communication¹ focuses on three areas:

- Early intervention
- Resolution
- Insolvency

While they clearly represent separate stages and require different actions, in practical terms we think that resolution and insolvency can be dealt together. The main reason is that the early intervention phase can still be relatively invisible to the markets and therefore not necessarily triggering public concern. Both the resolution and insolvency phases imply interventions in severely wounded institutions, which are under public scrutiny and where insolvency is just a possible outcome.

THE WAY FORWARD – Issues for debate

1.4. Emerging views

The EU should aim at a harmonized set of rules across all member countries on early intervention, resolution and insolvency. The complexity of that journey should not delay the start. A phased approach may be appropriate but the timeframe and direction should be clear, along the following broad lines:

- Monitoring of financial institutions' health and triggers for intervention should be done by the regulators/supervisors (following the proposed Supervisory Architecture consisting of three layers: local, colleges, European Banking Authority)
- Regulators should also lead during the early intervention phase

¹ An EU Framework for Cross-Border Crisis Management in the Banking Sector COM (2009) 561/4

- A newly created "Resolution Agency" should lead and manage the resolution and insolvency stages for all systemic and material cross-border institutions
- All financial institutions should be covered by the new framework. However the "Resolution Agency" would target systemic and material cross-border institutions only
- The "Resolution Agency" would dispose of a fund ("Resolution Fund") funded by member banks
- The "Resolution Fund" would be in addition to local Deposit Guarantee Funds
- Such "Resolution Fund" endowed with substantial financial resources would facilitate to overcome difficulties related to intra-group assets transfers which, as the ECB concluded, are extremely challenging from a legal perspective.

A common minimum set of intervention tools would be established

1.5. Issues for further debate

- **Common framework or a pan European "law"? How far do we go? How fast do we go?** There are two options: a detailed regulation that would apply in all Member States or a generic framework with some guiding principles. A generic framework would leave discretion to country governments to adapt the guiding principles to local law. The simplicity and clarity of the first option may be offset by the difficulties in persuading countries to accept what they may perceive as a loss of autonomy. However a robust resolution mechanism is in the interest of all - home and host countries. Financial stability of the system is an important positive externality benefitting all Member States. How to reduce the vulnerability of host country interests in face of strong (home) regulators is another issue to be addressed. While some advocate "convergence", we believe the EU should go further and aim at achieving a high level of "common ruling", even if that is done in several stages.
- **Scope of the framework.** Two sets of questions:
 - a) Should the regime apply only to international (cross-border) entities or to all entities operating in the EU? Even though the Commission's guidance was to look at cross-border groups, it seems to be appropriate to extend the scope to all entities. Due to the interconnectedness of the financial system, risk easily crosses borders with financial transactions and the geographic location of an entity becomes a less important aspect to consider when assessing risk impact. Once again this could be phased: first only cross-border entities would be covered, later all.
 - b) Should the regime cover only certain type or all financial institutions regulated/supervised by central banks? Systemic institutions only? Deposit taking banks only? Also investment banks? Insurance? Asset managers?
The interconnectedness of the financial system makes it difficult to carve out types of institutions.
A solution could be a phased approach, whereby the new regime would initially apply to an identified group of institutions and later be extended to a broader group (ultimately universal).

- **Who regulates and who leads the intervention?**

The leadership from a regulatory perspective has been clarified and strengthened by the creation of the ESFS:

The remaining question is who should lead the early intervention and the resolution/insolvency actions. One alternative is:

- a) regulator monitors health of financial institutions and determines if triggers for intervention have been breached
- b) a “Resolution Agency” (disposing of a “Resolution Fund”) handles early intervention, resolution and insolvency work.

Another option is to leave the early intervention also to the regulator/supervisor and limit the “Resolution Agency’s” action to the resolution/insolvency phase. The advantage of this approach is that the risk of public concern is minimized (actions at this stage can be of preventive nature and low profile).

- **Creation of a “Resolution Agency”/Fund?**

A “Resolution Agency” should be created and have financial resources to intervene appropriately and expeditiously. Therefore, it should dispose of a “Resolution Fund”. This Fund should be private/industry funded (to minimize the impact on tax payers and to make the risk producing agent bear the external costs of its activity). Contributions should be proportional to the size, complexity and systemic impact of the institution (related to regulatory capital?). Another issue to further investigate is the structure of the Agency/Fund (centralized or with local delegations under common management?).

Examples of similar funds can be found in the USA (FDIC), Sweden or the FROB in Spain.

Such Agency/Fund could be created through a phased approach: First, a pan European Agency/Fund for certain entities (i.e. systemic institutions) while local schemes would handle pure local cases. In a second phase all local funds would merge into the pan European Agency/Fund.

- **What kind of relationship between the “Resolution Agency” and the national “Deposit Guarantee Schemes”?**

Should it be additional to the DGSs? Should it be partially funded by the DGSs?

- **Thresholds (triggers) for intervention.**

There is a tradeoff between giving authorities some leeway in terms of assessing the viability of financial institutions and reducing the legal uncertainty created by too much discretion. It seems appropriate to use a combination of hard quantitative criteria (capital or liquidity ratios) with qualitative assessment like management quality or deterioration of depositor confidence. The initial phase of “early intervention” may allow for a higher level of discretion but the decision to move into resolution/insolvency should be based on less subjective criteria.

- **Specific tools or generic guidance (giving discretion)**

Different tools are required for the different phases. At the early intervention phase

they are softer and of preventive nature.

For the subsequent phases the palette of tools is more of “heavy weaponry”. There is a debate on whether one should be prescriptive or not. However there is a need to agree on minimum set of tools (minimum toolbox) in order to avoid repeated challenges of the legality of the intervention (like in the case of Fortis/BNP).

Examples of tools:

- *Regulatory action: relax capital or liquidity requirements if a problem is short term, or where a solution is imminent.*
- *Sale to another bank*
- *Emergency Liquidity Assistance*
- *Guarantee arrangements*
- *Loans*
- *Capital injections*
- *Split “Good/Bad” bank*
- *Bridge Bank*
- *Debt/Equity swaps*
- *(Temporary) Public ownership*
- *Appointment of management*

- **Three regimes (early intervention, resolution and insolvency) or two (early intervention and resolution/insolvency)?**

See comment on 1.3

CONCLUDING REMARKS

To conclude, whereas there are still several open issues, it is clear that establishing an efficient and credible European framework for crisis management is essential. Without a credible crisis management framework single market in financial services will be at serious risk. Europe is at the turning point when decision whether "more Europe" or "less Europe" is being made. Such decisions have tremendous implications in terms of economic growth, lost opportunities, jobs and wealth. A set of important issues and open questions require further examination and debate. I count on all my colleagues, in particular the shadow rapporteurs, the Commission and Council and the different stakeholders for positive and constructive contributions in the coming weeks.