An EU Framework for Cross-Border Crisis Management in the Banking System

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These comments are partly based on a recent report written by Thorsten Beck, Diane Coyle, Mathias Dewatripont, Xavier Freixas, and Paul Seabright for DG Competition and forthcoming as CEPR report. However, they should only be attributed to Thorsten Beck.

General comments

1. I agree with the need to complement the recent steps towards a European supervisory structure with a European-wide bank resolution framework. Only where banks can be resolved on the European level, can they also “live” on the European level. A European bank resolution framework can help provide alternatives to ring-fencing of national assets and to bail-out or liquidation, which are the only two, inefficient resolution methods, currently available. I therefore welcome this initiative while recognizing the political barriers such reform steps have to overcome.

2. The distinction between early stage, bank resolution and insolvency seems an artificial one. Only a framework that allows intervention into a bank at an early stage, i.e. before capital is exhausted and provides different options of resolution beyond liquidation, is useful and incentive-compatible. Given limited information, the supervisory authorities cannot distinguish clearly between the three stages. Consider as an example the Fortis case: there was no “early stage” and the distinction between bank resolution and insolvency depends upon how much capital the Treasuries of the involved countries stood ready to inject. So a much better distinction would be simply to consider two stages: contingency planning stage and financial distress.

3. The efficiency dimension of bank resolution should be stressed more prominently. The goal of an effective resolution framework is to minimize the external costs of bank failure in an incentive-compatible way, i.e. without providing incentives for aggressive risk taking in the expectation of a bail-out, and minimizing the likelihood and amount of tax payer support. In the context of cross-border banks, an additional goal would be to avoid national ring-fencing of assets and resolve the whole group rather than individual pieces as happened in the case of Fortis. This would require a European legal framework and institutional arrangements to implement it. Such a legal framework could come on top of the national legal framework and apply only to large European cross-border banks.

Specific comments and responses to the questions mentioned in the Communication

3.1. Early Intervention tools

A critical element would be the introduction of prompt corrective action, similarly as used in the U.S. by the FDIC. Such a framework would allow or even mandate certain supervisory actions when reported capital reaches certain threshold. These actions range from intensified monitoring over MoU and recapitalization plans over cease and desist orders to resolution of an institution. The latter would have to take place before reported capital actually reaches zero. These thresholds should serve as compulsory triggers for supervisory actions, while giving supervisors the discretion to intervene even earlier if they esteem it necessary.

Living wills are a necessary though not sufficient component of any European-level resolution framework. Not only should they make it possible where necessary for financial institutions to fail in
an orderly manner, thereby posing less of a threat to the stability of the financial system, but they should also make possible burden-sharing arrangements that are less discriminatory and less anti-competitive than in the case of those that are introduced in a hurry mid-crisis, thereby leaving a less adverse post-crisis legacy. They can help re-instill market discipline by clarifying which claim holders are the last ones to be made whole in case of failure. They should also include ex-ante burden sharing rules for cross-border banks, which would enable a quicker resolution and serve as short-cut for necessary negotiations in the case the need for quick intervention arises. Having clear ex-ante burden sharing rules might have enabled a joint resolution of Fortis instead of the break-up along national lines. Living wills might also help identify the systemically important parts of a financial institution that have to be preserved due to their importance for the payment system or financial markets and non-systemically important parts, thus avoiding the need for blanket bail-outs.

Promoting good governance in financial institutions seems a very vague goal and should be defined much more clearly, in terms of where, when and how supervisory authorities can intervene into internal governance structures of banks, balancing the need to impose discipline with the risk of supervisory intervention undermining efficiency of intermediation.

3.2. Intra-group asset transfers

The possibility to transfer assets is a critical part of any effective bank resolution framework. Designing such a framework on the European level might be made difficult by differences across different legal systems and traditions within the European Union. Concerning the necessary safeguards for shareholders’ rights, please see below.

4. Bank Resolution

The objective of an EU bank resolution framework should be to offer efficient alternatives to the current practices of either bailing-out or liquidation, mostly on the national level; alternatives that maintain the objectives of any efficient bank resolution framework (swift, maintaining access to deposits and preserving borrower-lender relationships) without necessarily sacrificing market discipline. This would also imply a reduced need for tax payer resources as we have seen it in the current crisis. A second objective should be to avoid national ring-fencing and resolution of cross-border banks. If the EU wants to foster an integrated market for financial services, universality has to be implemented and ring-fencing of national assets should be abolished. If one is to take the financial integration objective seriously, the question should not be whether we need an ex-ante arrangement for burden-sharing, but rather how it should be structured.

Being able to resolve a cross-border bank on a supra-national level widens the resolution options. Authorities in a small country might be reluctant to merge a large failing institution with another large healthy institution for competition concerns. Allowing a merger with another European financial institution, on the other hand, might not raise such concerns. A bank that is too-big-to-fail on the national level might not be on the European level, which would enhance market discipline.

The key tools for an EU resolution regime would be the possibility to intervene early in a failing institution and to undertake the options described in the communication, including purchase and assumption, good bank-bad bank and bridge bank. Conservatorship (open bank assistance) should be avoided as this would reduce market discipline, subject a bank possibly to long-term government intervention and would undermine competition.
Scope: The new EU resolution framework should apply to all cross-border banks, independent whether they operate cross-border through branches or subsidiaries. Incentive misalignments arise as soon as there is a geographic mismatch between activity and regulation/supervision of financial institutions, independent of the legal form of cross-border organization. This became most obvious in the current crisis in the case of Icelandic banks that had collected deposits through branches rather than subsidiaries. On the other hand, it might be wise to focus primarily on deposit-taking commercial banks and less on other financial institutions, given their different nature and different challenges.

Shareholders’ rights: Bank failure carries social costs higher than private costs, i.e. there is a social externality to bank failure (most prominently through contagion effects). Early intervention into banks, which includes infringement of shareholders’ rights, is therefore justified by public interest. The social externality stemming from a bank failure also underlines the need for a separate insolvency regime for banks! On the other hand, shareholders have the right to property right protection as other stakeholders and agents in the economy. Given the special nature of banks and the need for swift intervention and resolution, it is important that such protection consists of reimbursement and not reconstitution. A court review would be the most appropriate way. The case of Fortis is an important lesson in this case, where shareholders of the Belgian part held up the sale of the bank to BNP Paribas.

Institutional structure: The first-best solution would be to have a European-level resolution authority. Second-best would be legally binding procedures for the failure resolution. This could be done through living wills. The downside of this second option is that it takes away flexibility to look for the best resolution technique. The important aspect is that under either solution there must be the possibility to impose legally binding burden sharing agreements. Resolution authority or arrangements without the necessary funding are ineffective. The focus should be on private funding, with public funding only serving as back-stop.

Financing: Combining resolution with deposit insurance seems the most promising route. Previous research has shown that institutional links between resolution authority and deposit insurance is associated with more stable banking. Deposit insurance funds have the strongest incentive to minimize insurance losses and therefore to intervene early. One could envision a European Deposit Insurance Corporation model that would impose assessments on large cross-border European, while at the same time having the supervision and resolution authority for these banks. Being at the supra-national level, its political independence might be more easily guaranteed than that of national supervisors. One shortcoming might be that supranational supervisors are more distant from the supervised banks and have more limited access to ‘soft’ information about them. While financed by the banks themselves, a back-stop funding mechanism is needed to ensure confidence in such a fund, which would have to come through agreements with national government and/or the ECB.

5. Insolvency

As discussed in the introductory comments, insolvency cannot be treated separately from resolution. The need for a common European framework for resolving large cross-border banks also applies to their liquidation. It would be best to establish a separate bank resolution regime (including insolvency) for cross-border banks in Europe to thus overcome the differences across the different legal systems for this systemically important subset of financial institutions.