Discussion of Cross-border Issues – Harmonization, Burden-sharing, Failure Resolution

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Thirteenth Annual International Banking Conference of the Federal Reserve Bank of Chicago, Chicago (IL), 23-24 September 2010

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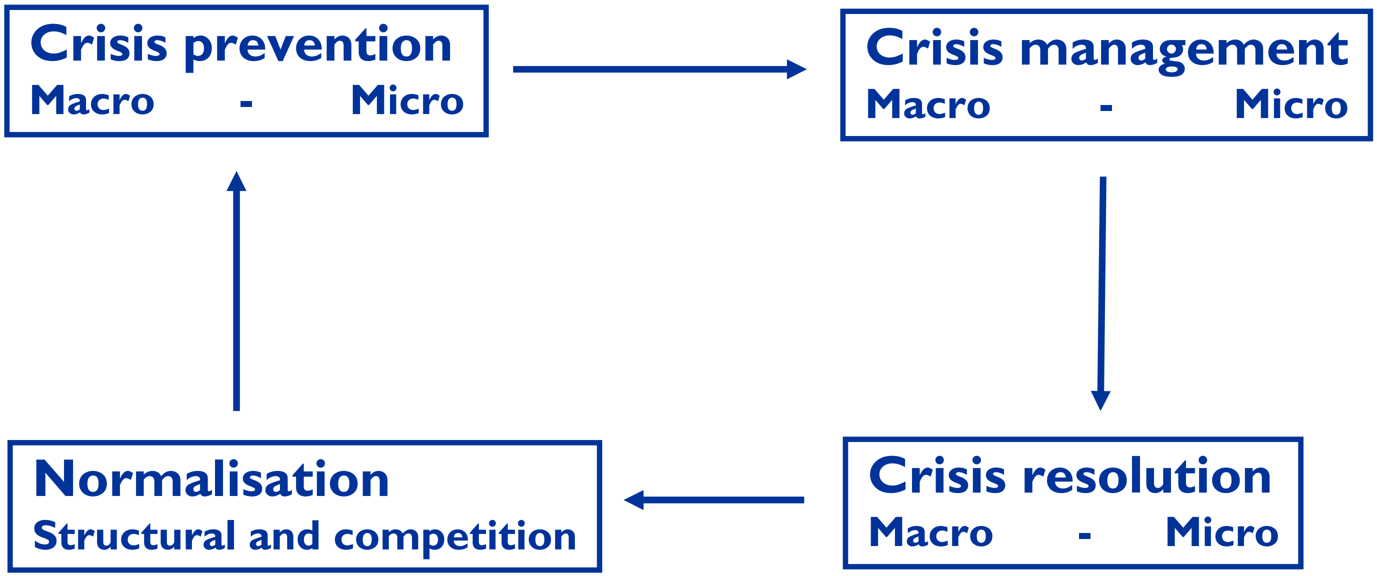
Introduction

- <u>Conference</u>
  - Macro-prudential policy (foundations, elements, governance)
  - Interaction with other policies
  - Crisis resolution and normalisation
  - Role of market discipline
- <u>This session</u>
  - André Sapir
    - Topic: Banking regulation and competition policy
    - Message: In crises stability objectives prevail over competition objectives, but institutions need to be designed that ensure a level playing field and counter moral hazard in resolution efforts
  - Peter Praet
    - Topic: International co-operation in financial stability policies, in particular recovery, resolution and harmonisation (broad)
    - Message: Resolution important for macro-pru, need harmonisation of national regimes in the EU
  - Eva Hüpkes
    - Topic: Cross-border resolution of large and complex groups
    - Message: Organise groups by function and adopt "universal" resolution approach around home supervisor preserving essential functions

Outline

- Place in the conference and overview of papers
- Process of financial stability policies (PP, EH, AS)
- Resolution mechanisms and moral hazard (PP)
- Re-segmentation, reduction in complexity and resolution (EH)
- Universality approach in resolution (EH)
- Some evidence on the importance of competition policy in banking (AS)
- Balancing competition and stability considerations in banking (AS)

Process of financial stability policies



- Define objectives, understand shocks and transmission mechanisms, define policy instruments and understand their impact

Do resolution mechanisms enhance MH?

- Yes
  - Bankruptcy risk removed/failure risk reduced
  - No termination of contracts/cross-defaults
- No
  - Closure, restructurings, management changes more likely?
  - Shareholders still cover the losses
  - Possibility of bail-in provisions for bondholders
  - Risk of managers to be removed or subordinated
  - Only essential services/functions should survive
  - Early intervention possible?
  - Implicit guarantees may be perceived to be more generous than well designed resolution mechanism
- Overall effect not clear, depends on design
- Confidence/contagion effects reduced (potential conflicts at the international level), but how important relative to other measures
- Tax payer protection argument very compelling in a democracy

Re-segmenting the financial system

- **Less international integration, reduction in wholesale funding, country-based supervisory approaches (e.g. country subsidiaries)**
- **Segmentation of financial groups: Separation of investment and commercial banking, Volcker rule, risky activities in subsidiaries (CDS business of insurers)**
- **Here: Form follows function**
  - **Each function in a single entity?**
  - **Not more entities than business lines**
- **Re-segmentation policies can result in drastic interventions in the market mechanism (European universal banking model and single market)**
- **Do we have hard evidence that tax and regulatory arbitrage reasons are so overwhelmingly important for corporate structures and complexity**
- **Knowledge of supervisors**
- **Use cautiously**

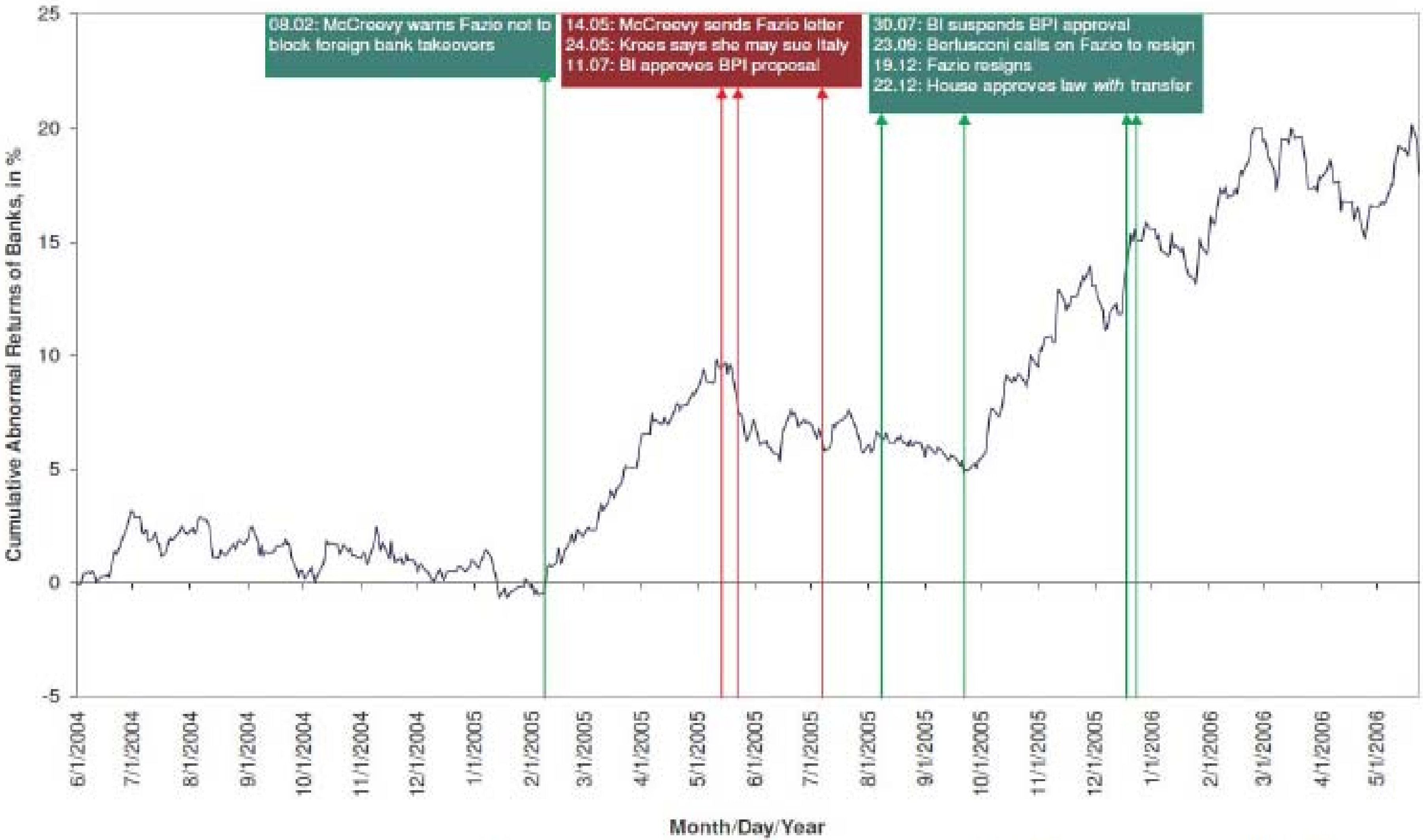
Universality

- Limited functional universality
- Home resolution authority in charge
- Lots of sources of conflict, even if shareholders not harmed
  - Non-essential functions may be closed, destroying employment in the host country
- Trust between countries, domestic resolution authorities must be high
- Citizens of a country must accept rationale of the common good
- Implicit in Praet: Unrealistic, process of harmonisation and cooperation

Importance of competition policy in banking

- Carletti, Hartmann and Ongena (2007) analyse changes in merger control legislation in 19 industrial countries between 1987 and 2004
- In banking there are two merger reviews: Supervisory and competition
- Two-step approach
  - Event study of stock prices: Strengthening of competition policy reduces stock prices of non-financial firms and increases stock prices of banks
  - Cross-section regressions of abnormal returns: Opaqueness of supervisory merger reviews is a major determinant of bank stock price increases
- Strengthening of competition policy in bank merger reviews counters inefficiencies introduced by supervisory merger reviews
- New project: Stability effects of changes in merger control legislation
- Diverse approaches across countries how conflicts between supervisory and competition reviews are resolved (Carletti and Hartmann, 2003)

Banca Populare Italiana/Antonveneta case



Competition and stability in banking

- In normal times: Competition and stability need to be balanced (not necessarily the case everywhere)
- In a crisis: Stability objectives tend to prevail, e.g. mergers irrespective of market structure (save failing banks, re-establish profitability)
- After a crisis: Competition objectives need to come to the fore (limit concentrations, avoid dominant positions)
- See e.g. Perrotti and Suarez (2002)
- Moreover, competition policies can be an indirect element in limiting too-big-to-fail problems
- Application of state-aid rules by DG Competition in the EU were rather "healthy", but imperfect and controversial, in particular in the countries affected by conditionality
- What is the optimal structure?
  - Competition and supervisory authorities conduct independent reviews
  - In case of conflict a higher authority or joint committee decides
  - Problem in the EU: No European banking supervisor – ESAs?

References

- Carletti and Hartmann (2003), Competition and stability: What's special about banking?, Mizen (ed.), *Monetary History, Exchange Rates and Financial Markets*, Proceedings of the Bank of England Conference in Honour of Charles Goodhart, Vol. II, Cheltenham: Edward Elgar
- Carletti, Hartmann and Spagnolo (2002), Implications of the bank merger wave for competition and stability, *Risk Measurement and Systemic Risk*, Proceedings of the Third Joint Central Bank Conference, Basel: BIS
- Carletti, Hartmann and Ongena (2007), The economic impact of merger control: What is special about banking?, ECB Working Paper, No. 786, July
- Perrotti and Suarez (2002), Last bank standing: What do I gain if you fail?, *European Economic Review*