Crisis resolution regime and macro-prudential framework: the role of harmonization

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1. Macroprudential policy & crisis resolution framework

- Crisis resolution is an integral part of a proper macroprudential framework
  - in "good times" it impacts on market discipline (ex ante behaviour)
  - in "bad times" it impacts on the degree of stress of individual institutions of the system as a whole (spill-over/externalities).

- The ex ante impact of a crisis resolution framework is difficult to assess
  - the thesis that a crisis resolution framework that works too well weakens market discipline is not very credible
  - without a well-designed crisis resolution framework, <u>moral hazard</u> is likely to be higher in the presence of too-big-to-fail firms

- In global markets, the crisis resolution regime is a matter of common interest
  - A <u>robust</u> crisis management framework for global institutions is, however, unlikely to be achieved soon. Different sources of complexity make the crisis management process and outcome highly uncertain. They need to be understood and addressed.
  - There is a need for minimum harmonization of national resolution regimes and mutual recognition.

2. Basel 3 reforms & crisis resolution framework

- Basel 3 aims at increasing banks' capital and liquidity buffers.
  - It is unlikely to be sufficient to achieve resiliency of the financial sector as a whole
  - To which extent must additional measures be taken in conjunction?

→ a good understanding of the impact of Basel 3 reforms on risk behaviour and on industrial organization is essential.

- Without a robust resolution regime and in the presence of too-big-to-fail externalities: capital requirements and regulatory limits on maturity mismatch should be very conservative

- But, at the same time, these may imply :
  - more risk taking in regulated firms;
  - regulatory arbitrage & risk shifting to the non regulated sector

3. Crisis management institutional design

Normal situation

Pre-crisis situation

-Excessive risk building

Yes

No

Early(micro/macro) intervention successful?

Crisis situation

- Risks materialise
- Individual problem vs systemic crisis
- Private sector solution / bail in (State as broker)

Yes

No

Problem solved?

State intervention

- from orderly resolution to bail-out
- balancing act

No

Yes

State intervention successful?

Post- state intervention

-how is the end game determined?
- accountability?
- in Europe : State-aid / competition rules

- The **rules of the game** determine how the different players (should) behave in each of these different sequences

A. agree on **common objectives** of crisis management and structure the end game so as to provide the right incentives to achieve the common objective

B. define **co-operation structures** and clarify how to achieve the balancing act between different interests/objectives

C. determine **minimum harmonization** requirements of processes, practices and laws :

- as insufficient harmonization may constrain players' behaviour, and indirectly modify their incentives (e.g. if constraints prevent co-operation)
- harmonization, alone, does, however, not necessarily guarantee co-operation and so should be addresed simultaneously with the objective and the co-operation structure

4. The rules of the game
A. Common objective of crisis management

- Precondition : define <u>common</u> objectives : e.g.

... which may, however, be misaligned with objectives at <u>national</u> level

Common objectives		National objectives
least-cost solution	↔	minimize cost for the domestic tax payer
minimize systemic impact and externalities	↔	minimize impact on domestic system
minimize moral hazard	↔	Preserve national financial stability
minimize distortions of level playing field	↔	preserve industrial capacity / national champion
primacy of private sector solution	↔	preserve industrial capacity / national champion
treat equally all liability holders (across countries)	↔	preference for domestic depositors / liability holders
preserve global systemic functions	↔	preserve domestic systemic functions
...		...

4. The rules of the game :
B. Co-operation structures and balancing act

- Co-operation structures establish the channels through which the different players are supposed to interact and co-operate. This framework should
  - be sufficiently robust (danger of weak nonbinding agreements)
  - clarify how to achieve the **balancing act** between
    - financial stability, competition and moral hazard objectives
    - national and global interests

especially as :

- primacy of a particular objective is context-dependent :
- the balancing act is a continuous process ...
  - e.g. : transmission of information to counterparts and markets
- ... raising many questions
  - Which authorities are involved in the balancing act?
    - done at national or international level
    - political vs administrative authority
  - how is the balancing act assessed (accountability) and **the end game** determined?
    - for bank managers and shareholders
    - for authority in charge of supervision and crisis management
    - for ultimate political decision maker

4. The rules of the game :
C. Harmonization

- Different dimensions/concepts of harmonization
  - soft (convergence of practices, methods, philosophy, culture)
  - hard (harmonization of legal framework)

  → determine minimum harmonization requirements that are necessary (but not sufficient) to align authorities' interests

- Yet, some resistance arises because
  - it may imply a transfer of sovereignty
  - it may imply a revision of current practices (inertia may be preferred)
  - it may imply a levelling down (least common denominator)

- Areas where harmonization is possible are extremely numerous : see e.g. the EU approach

Pre-crisis situation	Crisis situation	State Intervention	Post-state Intervention
- Reinforce **resilience** of financial institutions: - Address **incentives** to excessive risk building - Improve **co-ordination** between national authorities - Improve crisis preparation	- Facilitate **early intervention** - Facilitate **private sector solutions**:	- Improve **authorities' preparation** - Facilitate **cross-border coordination** - Facilitate **orderly resolution**	- Address **accountability** of national authorities - Reinforce **influence of ex-post assesment** by DG Comp on national resolution authorities

4. The rules of the game :
C. Harmonization : the EU approach

Pre-crisis situation	Crisis situation	State Intervention	Post-state Intervention

- Reinforce **resilience** of financial institutions:
  - Improvements in capital and liquidity requirements / CRD
- Address **incentives** to excessive risk building
  - ensure sound governance, limits to remuneration packages, etc.
- Improve **crisis preparation**
  - RRP
- Improve **co-ordination** between national supervisors :
  - Joint assessment framework
  - Better delineation of home and host roles
  - Coordination structures : colleges, ESA.

*Focus on **recovery and resolution plans***

- RRP have two complementary sides :
  - how can the financial institution recover from shock
  - what could prevent an orderly resolution by authorities
- The first side allows to assess the credibility of a private sector solution and the obstacles to its potential implementation.
- The second side may shed light on minimum harmonization needs if different legal environment prevent two countries to orderly resolve the crisis.

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*Focus on **co-ordination** structures and role of home and host supervisory authorities*

-2 possibilities to better delineate the respective roles of home and host authorities (following the Icelandic and other crises)

- reinforce the power of the host with regards to the supervision of branches
- make sure that home supervisor sufficiently co-operates with host supervisor and that sufficient financial resources are available in the home to indemnify host depositors

- In terms of harmonization, each of these two options would require :

- to reinforce the consistency of supervision and supervisory methodologies : e.g.
  - common set of criteria and programs to identify risks before making inspections
- a harmonized application of a common rule book. Such rule book could e.g.:
  - specify regulatory limits in terms of maximum individual and aggregate exposures to a client or a group of clients
  - prohibit certain activities or impose constraints on size
  - define harmonized liquidity rules
- to devise a clear procedure for co-operation : e.g.
  - home provides a risk assessment to host on the basis of which a supervisory program would have to be established.
  - right for the host to alert the home and reply by the home (in case of inaction, right to require the home to take an action).

4. The rules of the game :
C. Harmonization : the EU approach

Pre-crisis situation | **Crisis situation** | State Intervention | Post-state Intervention

- Facilitate **early intervention**
  → e.g. early warning indicators, early detection of systemic risk (ESRB) and early intervention framework

- Facilitate **private sector solutions**:
  → *automatic funding* through e.g. contingent capital
  → use *group as a source of strength* through intragroup transfers
  → Improve *private sector crisis preparation*

Focus on ***risk assessment***

-Harmonized risk assessment allows to ensure that banks are assessed on a similar footing, avoiding regulatory forbearance.

-Its main elements include e.g. :

- harmonized tools allowing to identify problems at a sufficiently early stage
- common minimum thresholds to define when intervention in a cross-border bank should take place
- harmonized powers to require preparation of recovery and resolution plans

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  → Improve *private sector crisis preparation*

*Focus on authorities' **toolkit to facilitate private sector solutions***

(before insolvency)

- It is preferable for authorities to share similar powers to facilitate co-ordination. Such a toolkit could foresee administrative powers

  - to enable transfer of assets or liquidity between a group 's entities

    -may require a balancing act between private interests of shareholders and creditors (civil liabilities for directors and managers + European Convention of Human rights) and financial stability concerns (group as a source of strength)

    → defining group interest and harmonizing conditions under which such transfers could be made , as well as appropriate safeguards for creditors/shareholders interests would facilitate this balancing act

  -to require the bank to restore its capital position through

    - new capital raising
    - the conversion of debt to equity (bail in)
    - the imposition of haircuts on creditors (and especially holders of hybrid instrument)

    → harmonization of trigger events, valuation methods (to determine dilution) , and other technical features

  - to restructure its activities and operations (downsizing, divestments, etc.)
  - to change the management of the bank / appoint a representative

4. The rules of the game :
C. Harmonization : the EU approach

Pre-crisis situation | Crisis situation | State Intervention | Post-state Intervention

- Improve **authorities' preparation** through e.g. resolution plans
- Facilitate **cross-border coordination**
  - →*Coordination structures* : from cross-border stability groups to single resolution authority
  - →*Legal obstacles* : definition of a common toolkit
  - →*Incentives* to co-operate / how to finance crisis resolution? (Innovative financing / bank levy, burden sharing, and European resolution fund)
- Facilitate **orderly resolution (**DGS, winding up, insolvency laws)

EC Communication setting out an EU crisis mngment framework by Oct. 2010 and legislative proposal expected Spring 2011

*Focus on **cross-border co-ordination***

-Current situation : No single resolution authority and no harmonization of resolution authorities

- An administrative authority (subject to judicial review) seems to allow a quicker crisis resolution (compared to a judicial authority)

-Set up of common co-ordination structures at national level (domestic standing groups) and at European level (cross-border stability groups)

*Focus on authorities' **toolkit to resolve a crisis***

- An harmonized toolkit could include e.g. powers :
  - to transfer assets/operations of the failing bank to a bad/good/bridge bank
  - to suspend close out rights
  - to impose a moratorium on payments to creditors and customers
  - to suspend shareholders' voting rights .

*Focus on privately financed **resolution funds***

-The set up of privately financed resolution funds would require eg to define
- harmonised governance principles
- harmonised powers / intervention principles
- harmonised base for financing

4. The rules of the game :
C. Harmonization : the EU approach

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*Focus on **orderly resolution***

- Current situation :
  - insolvency law is country-specific
  - with different regimes (corporate insolvency laws vs special regimes)
  - and mutual recognition of insolvency proceeding for cross-border bank <u>branches</u> (single procedure iniitated in the home country)
- The EC presented several options to facilitate orderly resolution :
  - a binding framework for co-operation and exchange of information between courts and insolvency practitioners.
  - an integrated treatment of corporate groups
  - a fully harmonised insolvency regime
- Each option entails a different level of harmonization of e.g.:
  - powers and rights of the liquidator (over the group, its subsidiaries or branches)
    - e.g. : power to take over assets, to collect money owed to the group, to lead its operations, to restructure its business (liquidation, winding up, divestments, etc.)
  - conditions triggering an insolvency proceeding
  - mechanisms to exchange information
  - preference given to domestic depositors, etc.
- Similarly, DGS could benefit from more harmonization relating to e.g. their role in crisis management (paybox vs crisis management) and to their co-operation/interactions (e.g. mutual borrowing facility to allow a DGS to borrow from all other European DGS)

4. The rules of the game :
C. Harmonization : the EU approach

Pre-crisis situation | Crisis situation | State Intervention | Post-state Intervention

Focus on ***accountability***

- Crisis management authorities in Europe are accountable to different political authorities and ultimately to different taxpayers/citizens.

- Nevertheless, safeguards can be foreseen to preserve the common / European interests (see e.g. role of the EBA in crisis management)

Focus on ***ex post assessment***

- State aid must be authorised by the European Commission

  - to limit distortions in the single market

  - to avoid subsidy races

- The European Commission established a special framework to assess aids in the banking industry.

  - the framework contributed to harmonize national authorities actions as it clearly defined what would be accepted and what would not with regards to recapitalization, state guarantees on funding and the treatment of impaired assets.

- Address **accountability** of national authorities

- Reinforce **influence of ex-post assesment** by DG Comp on national resolution authorities

→Ex-post assessment of pre-crisis commitments ?

5. Conclusions

- Improving the crisis management framework would require to <u>simulatenously</u>
  - agree on common objectives for crisis management
  - define co-operation structures and clarify how to achieve the balancing act
  - and remove obstacles to co-operation / harmonize processes practices and laws as appropriate

- In the EU, these improvements are facilitated by
  - the mutual knowledge existing between authorities in different countries
  - the institutional framework with i.a. supranational competition authority and court of justice
  - the forthcoming setting up of ESRB, ESA, CBSG, and the long standing supervisory co-operation
  - but there is no European taxpayer (etc.), the agenda of reforms remains long and the areas of possible harmonization seem to be boundless

- Improvements in international coordination could parallel those in the EU :
  - and build e.g. on the IMF (2010) proposal :
    - voluntary co-operation with enhanced co-ordination framework
    - minimum level of harmonization of national resolution rules (core co-ordination standards)
    - agreement on burden sharing, on an institution-specific basis, and before a crisis occurs
  - where supranational organizations (such as e.g. IMF, WTO, International Court of Arbitration, etc.) could play an additional role
  - and this even though there remain an unescapable limit linked to fiscal sovereignty