Banking crisis management in the EU: An interim assessment

Jean Pisani-Ferry and André Sapir

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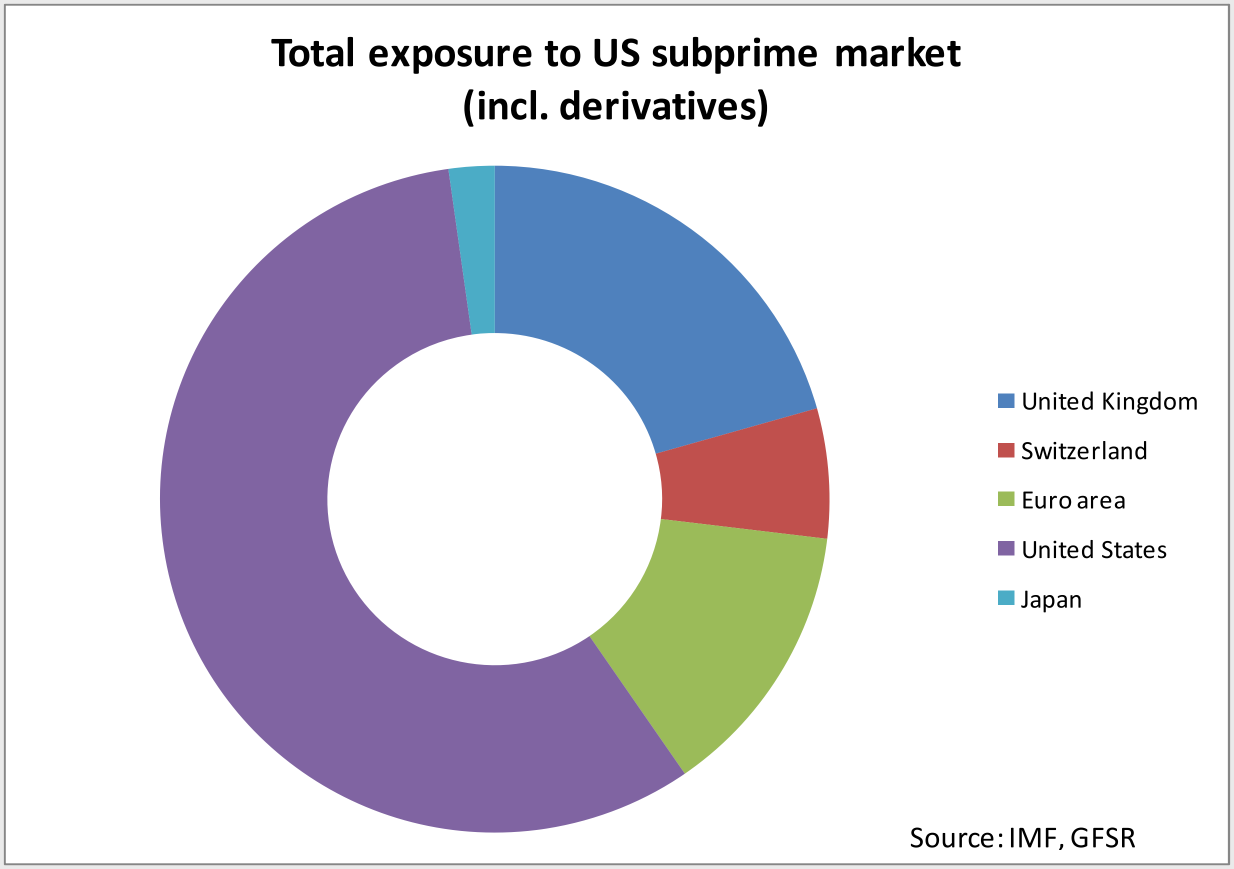
Outline

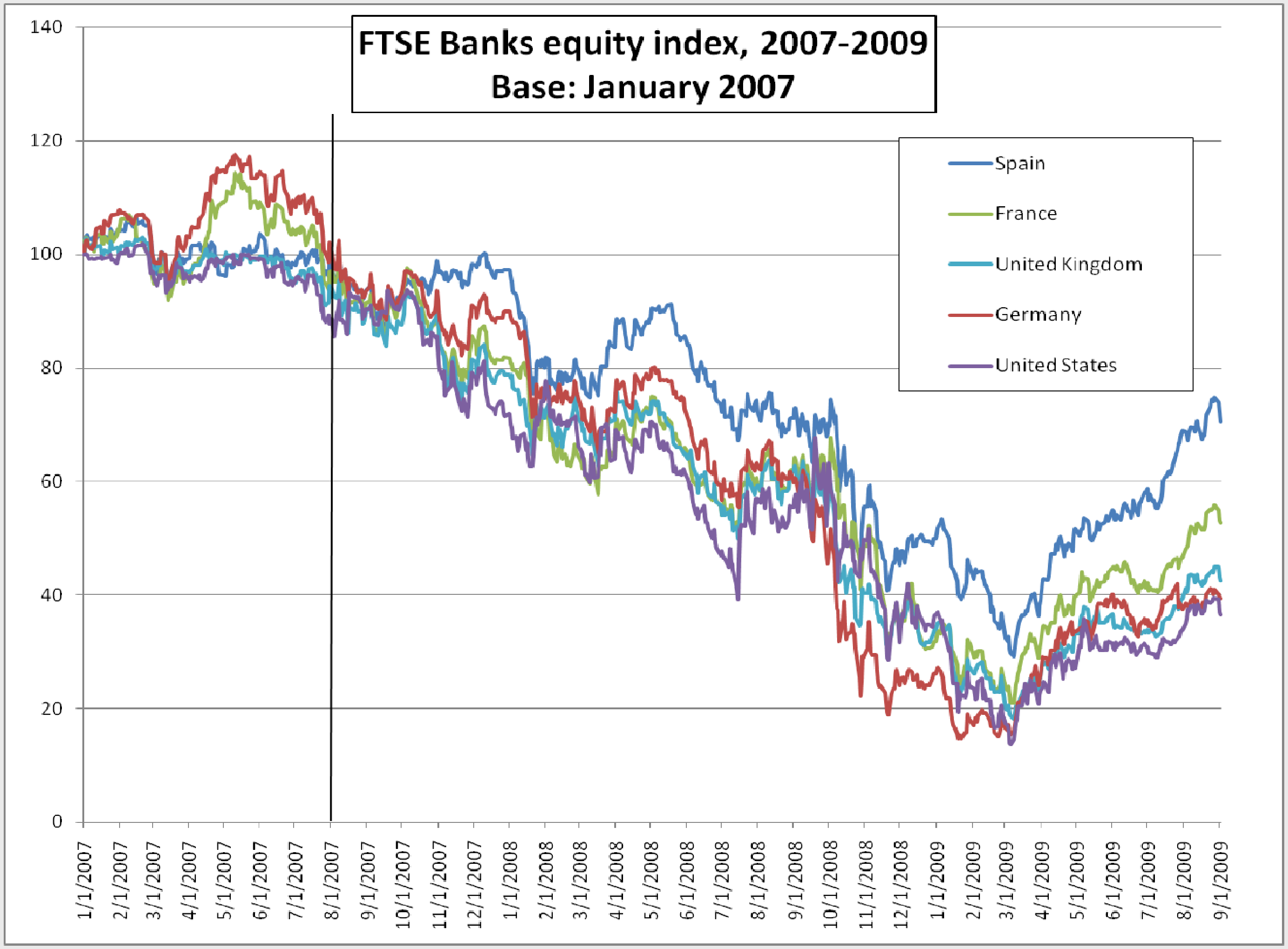
1. Introduction
2. The pre-crisis EU landscape
3. Testing times
4. Assessment and key questions
5. Lessons and choices ahead

1. Introduction

By most standards banking crises in Europe and in the US have been of roughly similar order of magnitude



Stock market data suggest crisis has been as severe as in the US



Source: Datastream

A major challenge for the EU

- **How to deal with banking crises is a challenge everywhere, but even more so in the EU where responsibility is fragmented and the policy system is still evolving**
- **Crisis has therefore raised major coordination issues**
- **But while there are accepted guiding principles for national action…**
  - Overcome asymmetric information problems, both vis-à-vis banks (stress tests) and among public authorities (through centralisation)
  - Be fast (for evaluation of future losses, treatment of weak banks) and be ready to put up large immediate support (less costly in the end)
- **… Few benchmarks for effective international coordination exist**
  - Literature generally emphasises that information and incentive problems are compounded by multiplicity of players and diversity of institutional arrangements
  - Generally sceptical on ability to overcome coordination difficulties, short of ambitious schemes (e.g. ex ante burdensharing)

The questions

- **Banking crisis (and macro crisis also) was therefore bound to be particularly testing for the EU**
- **Main questions:**
  - Given imperfections in the policy system, how have coordination problems been dealt with?
  - Have coordination failures hampered effective action in dealing with the recent banking crisis?
  - How have institutional and legal constraints determined the direction of action by the EU and national governments?
  - What are the remaining problems and the policy options?

2. The pre-crisis EU landscape

Mismatch between market and policy integration

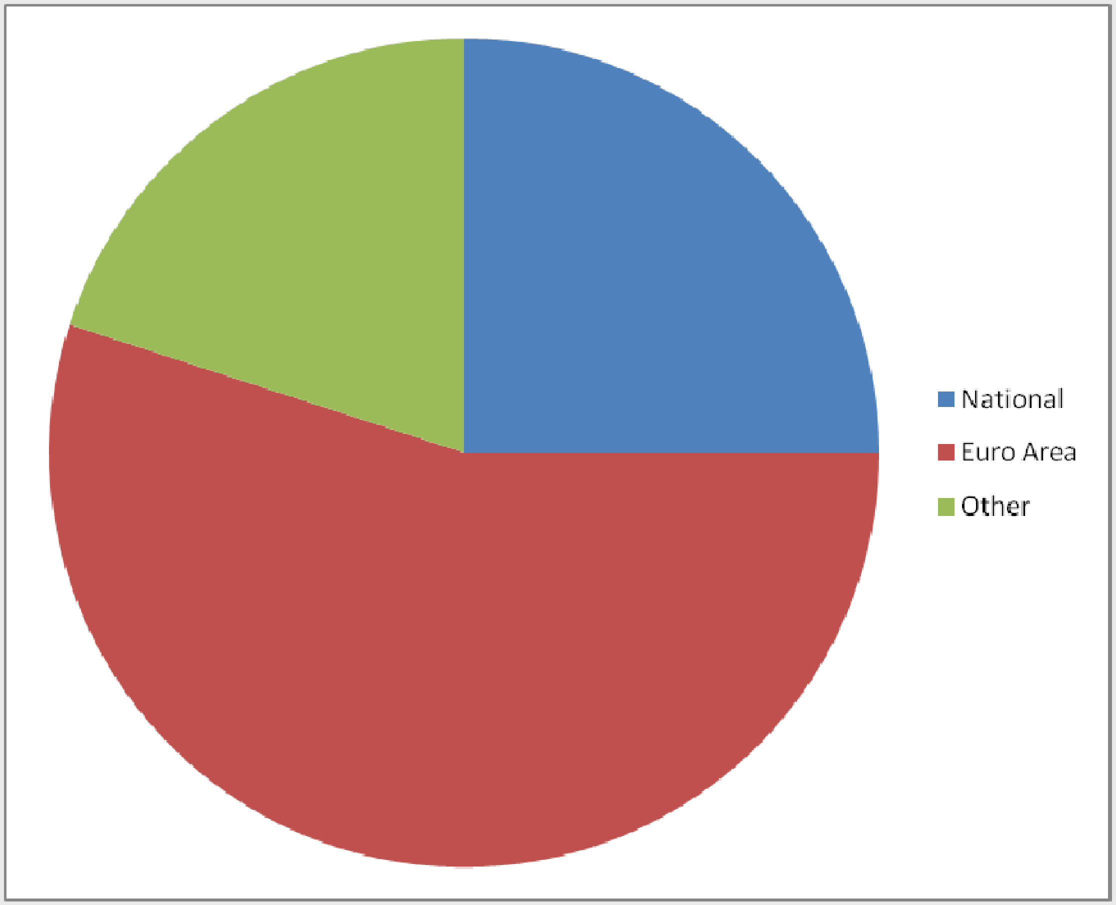
- **Rising market integration**
- **However incomplete policy integration**
- **Awareness of fragility, but motives to delay action**

Rising market integration

- **Relentless EU efforts to promote financial integration**
  - Prohibition of capital controls (Maastricht treaty)
  - Single market legislation
    - FSAP, 1999
    - Ensuing regulations and directives, 2000+
  - Market infrastructure
    - Build-up of payment systems, trading infrastructure
  - Commission offensive against banking protectionism
    - Commission’s successful infringment procedure against Portugese rejection of Champalimaud / Santander merger, 1999
  - Euro
    - Wholesale euro 1999, retail euro 2002
  - Integration of new member states
- **Effects compounded by adoption of global standards**
  - EU at forefront of adoption of IFRS, Basel 2

Evidence on market integration (1):

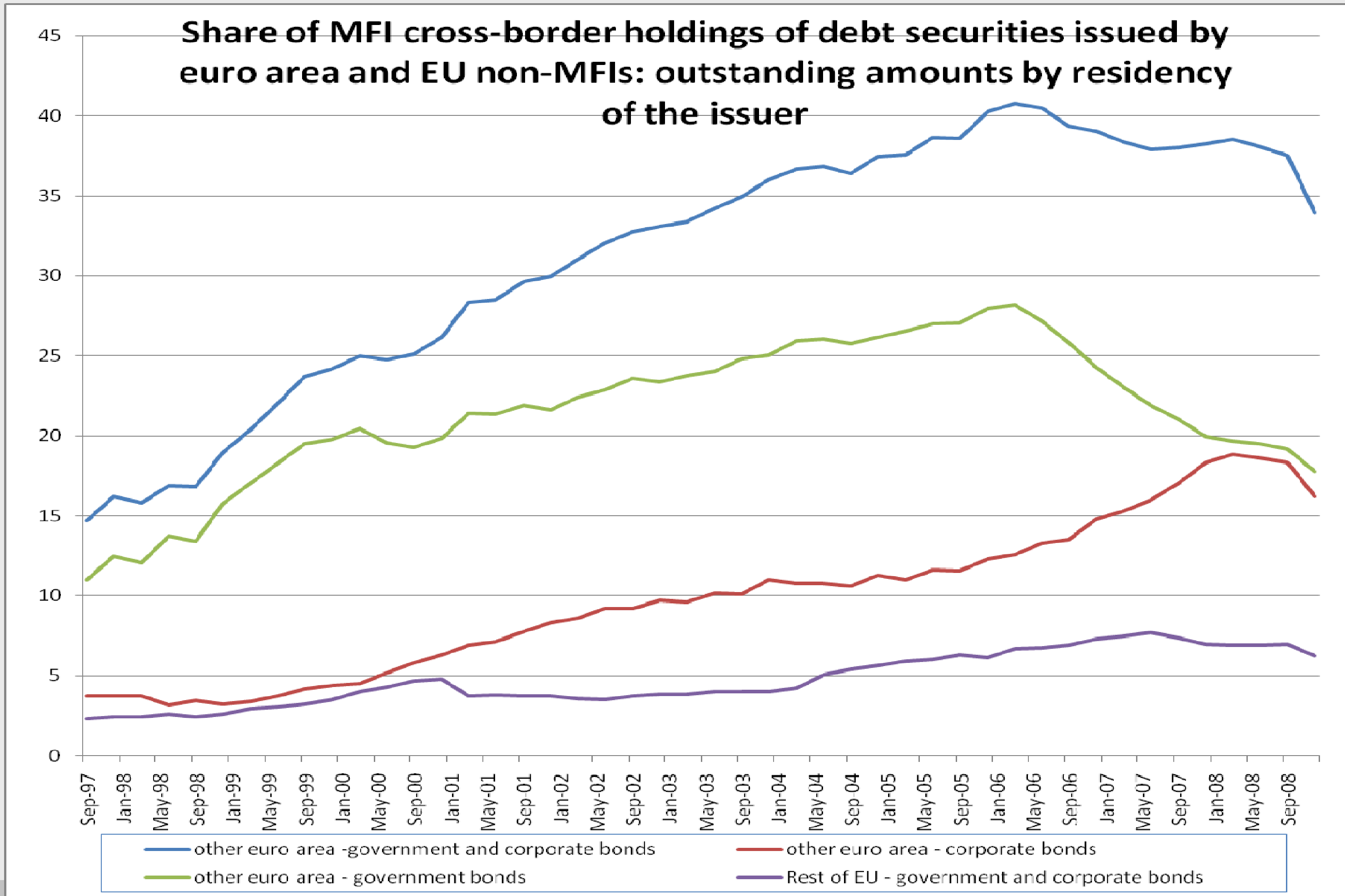
Breakdown of unsecured interbank lending in the euro area, 2006



Source: Annual Money Market Survey, 2007, ECB

Evidence on market integration (2):

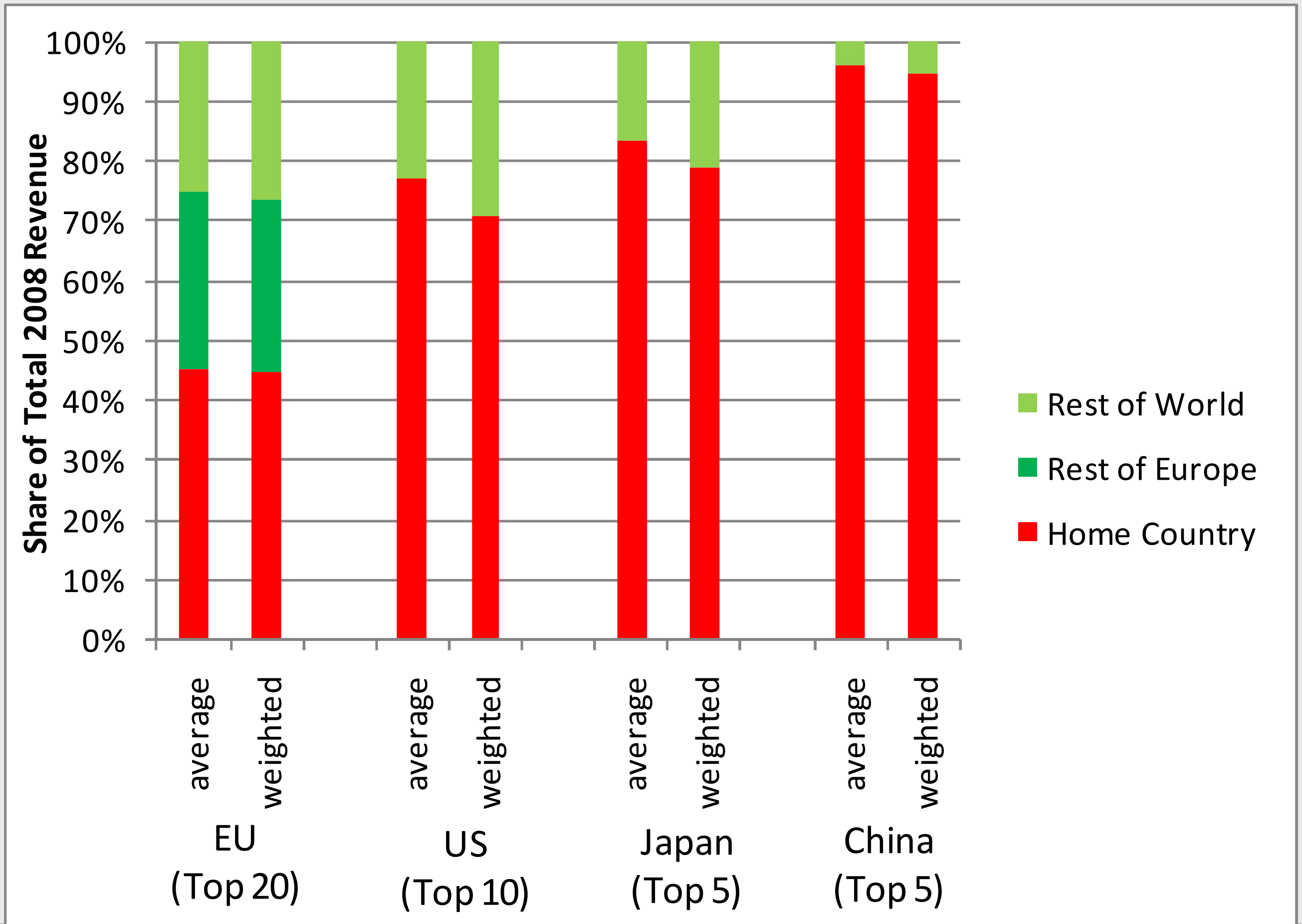
Bank’s cross-border debt holdings



Source: ECB

Evidence on market integration (3):

Internationalisation of large banks (revenue by market)



Source: N. Véron, unpublished data

Incomplete policy integration

- **Largely harmonised legislative framework**
- **Strong EU powers on competition matters**
- **But financial stability still national competence**
  - No specific EU or ECB competence for financial stability
  - Crisis prevention and management based rely on decentralisation, segmentation and cooperation (Nieto and Schinasi 2007)
    - Decentralisation to national authorities
    - Segmentation across sectors and institutions (no single template for institutional architecture)
    - Cooperation among countries and institutions
- **(another trilemma? market integration, national supervision, financial stability)**

Implications

- **Loose coordination on supervision matters**
  - Within committee of supervisors (CEBS, established 2003 with explicitly advisory role, no competence for decision nor mandatory provisions for information exchange
  - Role of ECB in supervision is vague and advisory only, (Art 105.5, Art 25 of ECB statute), unless it is unanimoulsy entrusted with specific tasks (Art 105.6)
  - No institution has competence for supervision of pan-European banks
- **Partial harmonisation of deposit insurance**
  - Home country principle, common minimal requirements, but significant variance
- **LOLR function untested in case of ECB**
  - No explicit LOLR mandate given to ECB
- **No EU competence for dealing with cross-border restructuring**
  - Unconclusive discussion on ex-ante burdensharing

Summary: pre-crisis state of play

	National	Currency area	EU	Global
Regulation (CAR..)				
Competition				
Supervision				
Deposit insurance				
Liquidity provision				
Restructuring				

Ex ante shortcomings

Information, incentive compatibility and coordination issues

A. Crisis prevention

- No incentives to information-sharing among supervisors, potential for coordination failures

B. Crisis management

- Information asymmetries
- Disparate national deposit guarantee schemes (home-country principle)
- Unspecified LOLR role of ECB
- Potential disparity in liquidity provision across currency areas
- Clashes between state support and competition concerns
- No common war chest for recapitalisation of pan-European institutions, no EU powers to tackle their restructuring

Some patches…

Developed over the years as partial responses

- Non-binding MOUs that give «a set of principles and procedures for sharing information, views and assessments »
- Crisis simulation exercises launched in 2006 by ECOFIN to test approaches to crisis resolution
- Political commitments to cooperation (e.g. ECOFIN 2004)

But none of these elicited much confidence prior to the crisis

- “in the event of a crisis involving a pan-European institution or a local crisis having systemic implications, the coordination problems faced by EMU authorities are likely to be greater than those faced before” (Prati and Schinasi 1999)
- «Suboptimal » institutional set-up « for crisis prevention (and potentially also crisis management) » (Lamfalussy, 2004)

.. and real little action

- **Why?**
  - Hope that crises would wait until integration is completed
  - National champions / regulatory capture
  - Fear of potential budgetary consequences
  - Turf war

3. Testing times

- **Timeline of events and responses**
- **Main EU initiatives**
- **Evidence**

Timeline of events and responses

Events	EU actions
7/2007 - 9/2008 **Increasing liquidity strains**	- Immediate liquidity provision by central banks
9/2008 – 10/2008 **Massive loss of confidence** Uncoordinated introduction of enhanced deposit guarantees (Sept.) Disagreement on potentially common bank rescue scheme (Sept.) Bail-out of Dexia by Be and F (30/9) Be-NL disagreement, break-up of Fortis (2/10)	- Joint declaration of heads of state and government of euro area and UK (12/10) - ECB fixed-rate allotment of liquidity with unlimited amounts
10/2008 – 7/2009 **Emergency crisis management** National bank rescue plans Rejection of harmonised bank stress tests (12/5) Crisis develops in the New Member States	- Commission principles for application of state aid rules (13/10) and the recapitalisation of financial institutions (5/12) - ECB recommendation on pricing of guarantees (20/10) - Commission principles for the treatment of impaired assets (25/2) - Examination of individual bank support measures
1/2009 – 8/2009 **Preparation for reforms**	- De Larosière report (25/2) - Directive on deposit guarantees (11/3) - European Council decisions on supervision reform (18/6)

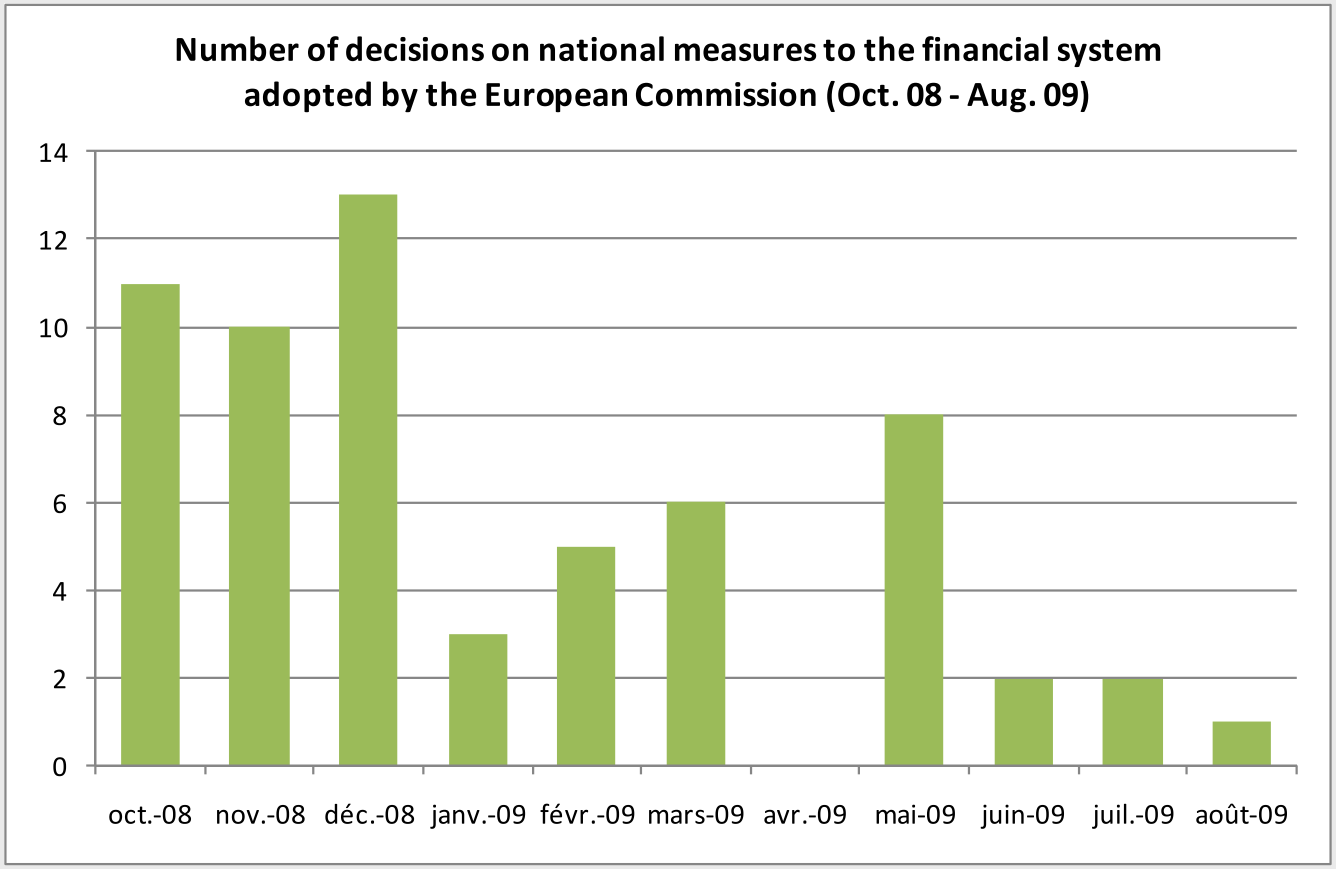
Main EU crisis management initiatives

1. **Concerted action plan of 12 October 2008 (euro area + UK)**
   - Outside the normal institutional framework
   - Outlines coordinated plan for liquidity provision + bank funding guarantees + recapitalisation
2. **Commission communication on state aid of 13 October 2008**
   - Temporary flexibility in the application of state aid rules, subject to conditions (non-discriminatory, proportionate and temporay assistance) and to Commission monitoring
   - Has served as basis for examination of national actions through expedited procedures
3. **ECB recommendation on pricing of guarantees of 20 October 2008**
   - Flat fee on short term bank debt guarantes, CDS-based pricing for longer term guarantees
   - Has served as basis for pricing of national guarantees
4. **Commission communication on recapitalisation of 5 December 2008**
   - Pricing guidelines for sound banks, conditions for recapitalisation of weak banks
5. **Commission principles for treatment of impaired assets of 25 Feb 2009**
   - Calls for coordination to avoid « subsidy race » and protect Single Market
   - Guidelines on application of state aid rules to asset relief measures (definition of eligible assets, pricing, management)
6. **De Larosière report on future financial supervision of 25 February 2009**
   - Outline of reform of supervision architecture, creation of macroprudential body
7. **Directive (EU law) on deposit guarantees of 11 March 2009**

The three pillars of EU action

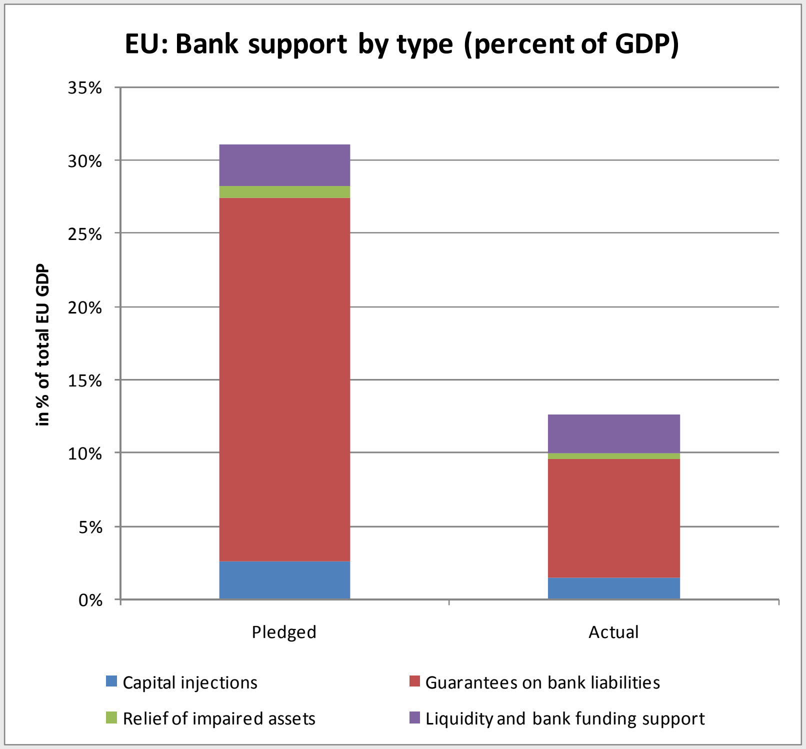
- **Common principles and guidelines for government intervention (soft coordination)**
- **Surveillance of national initiatives on competition grounds**
  - Enforcement by Commission (the competition authority): 51 decisions on national schemes and specific measures adopted between October 2008 and July 2009
- **Initiatives on the rebuilding of financial architecture**
  - De Larosière report and follow-up
  - Concerted initiatives within G20

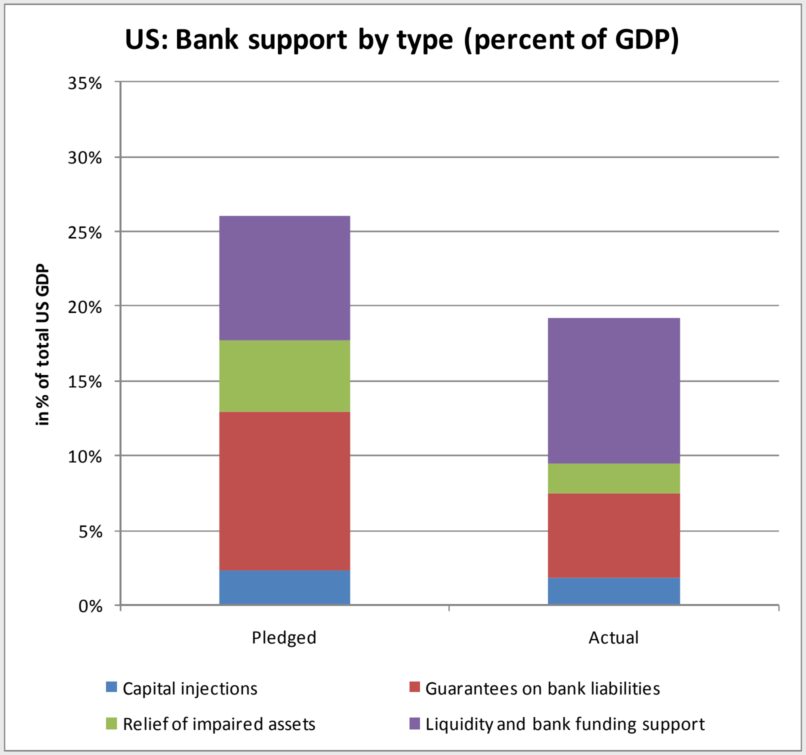
Evidence:
1. Examination of national measures has been remarkably fast



Source: European Commission

Evidence:
2. Total bank support roughly comparable in the EU and the US



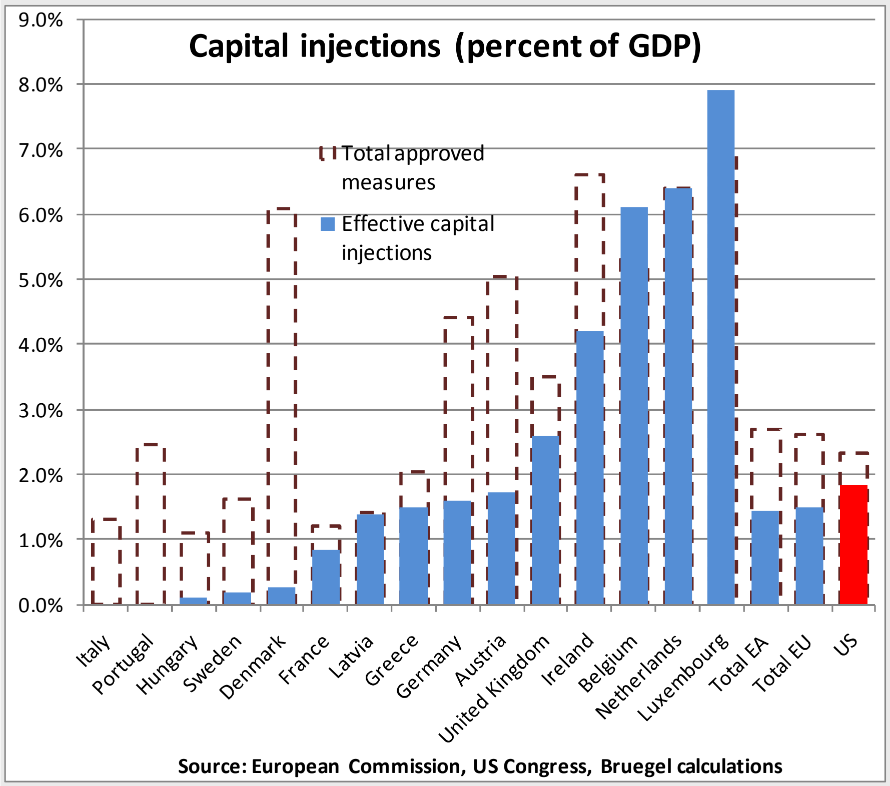


Note: « liquidity and bank funding » category includes government-managed or government-sponsored schemes only, does not include autonomous liquidity provision by central banks.

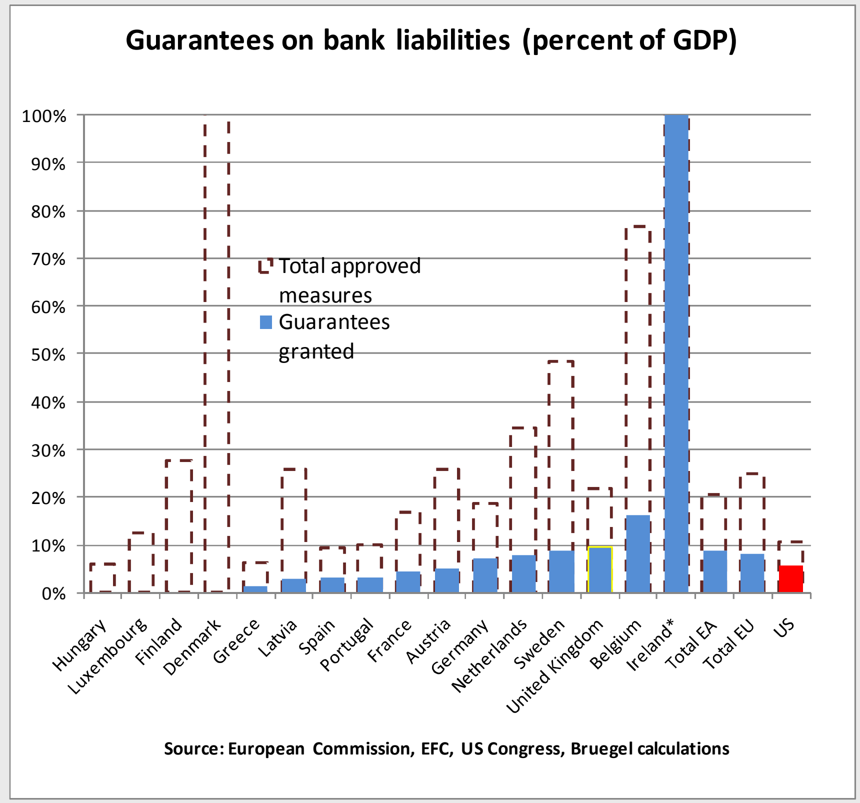
Source: European Commission, US Congress, Bruegel calculations

Evidence:
3. Large differences across member states

Capital injections (take-up rate 55%)



Guarantees (take-up rate 33%)



Note: countries where no support has been provided are excluded from graph

4. Assessment and key questions

- **Have the ex ante shortcomings hampered effective crisis management?**
- **How have problems been circumvented? What instruments has the relied on ?**

Issues

- **Information asymmetries**
  - Have they hampered proper diagnosis and/or crisis management?
- **Cross-border externalities in crisis management**
  - Liquidity support
  - Deposit guarantees
  - Support to individual banks
  - Treatment of pan-European banks
  - The case of the New Member States

Information asymmetries

- **Lingering lack of transparency**
  - Pre-Lehman assessment of problems
  - October 2008 crisis management debate
  - Spring 2009 stress-test debate
  - Exit strategies
- **System relies on national supervisors for providing information, however strong incentive problem**
  - Across countries
  - Vis-à-vis EU institutions (Commission, ECB)
- **Risks**
  - Inaccurate assessment of situation
  - Gambles for resurrection
  - Competition distorsions (financial stability as a pretext for state aid)
  - Obstacles to exit from exceptional central bank measures
- **Serious, unsolved problem throughout the crisis**

Cross-border externalities in crisis management: 1. Liquidity support

- **Pre-crisis state of play**
  - Responsibility of the Eurosystem (euro area) and the national central banks (other countries)
  - Compatible with state aid rules because:
    - Accessible to all comparable market players, or
    - If individual support decided by central bank, given to solvent financial institution, at penalty rate and against collateral
- **Assessment**
  - No evidence of coordination problems among central banks within euro area (contrary to ex ante assessments)
  - Close coordination between ECB and BoE (within global context), including through swap agreements
  - Problems however for new member states
    - Mop up of euro liquidity at time of crisis
    - Limited access to euro liquidity
  - Emerging implicit subsidisation concern
    - Access to cheap liquidity as substitute to government recapitalisation

Cross-border externalities in crisis management: 2. Deposit guarantees

- **Pre-crisis state of play**
  - Home country guarantee principle (ie a Belgian resident with an account at a French bank relies on French guarantee system) and significant cross-country differences (level, but also operation)
  - Potential spillover effects
    - Within countries (deposits move from banks with weak home-country guarantees to banks with strong home country guarantee)
    - Across countries (deposits move to provider of best guarantee)
  - Effects depend not only on nominal guarantee but also on credibility (fiscal issue – as demonstrated by Iceland)
- **Policy responses in the crisis**
  - Initially uncoordinated moves in response to crisis (unilateral Irish extension of guarantee in Sep 2008)
  - Partial coordination post-October 2008 (common blanket guarantee, increase in minimum threshold)
  - No evidence of significant problems since

Cross-border externalities in crisis management: 3. Support to individual banks

- **No ex ante coordination provisions**
- **Dealt with through combination of ad-hoc coordination and competition-based monitoring**
  - Common framework adopted after Oct 12 summit
  - Common rules for pricing of guarantees, guidelines for treatment of impaired assets
  - Monitoring of individual decisions by the Commission under competition rules
- **Assessment**
  - Significant achievement in view of lack of ex ante instruments, but:
    - Concerns over cross-country differences in pricing of guarantees (in spite of common principles), but no clear evidence on extent of competition distorsions (information is scarce)
    - Limited restructuring of European banking sector so far
    - Concern that national support was (sometimes explicitly, but also implicitly) been made conditional on extending credit to *domestic* customers, thereby leading to single market fragmentation

Cross-border externalities in crisis management: 4. Treatment of pan-European banks

- **Identified ex ante as major shortcoming of EU architecture**
  - No commonly agreed scheme for burdensharing
  - Fear that incentive problems would paralyse action
  - Significant as several banks have large cross-border operations
- **Serious concerns at early stages of crisis**
  - Economist’s warnings and suggestions fell on deaf ears
  - Dexia, Fortis crises
- **However problems have been manage at little systemic cost**
  - Fortis break-up disputable from business point of view, but in the end burdensharing was found.

Cross-border externalities in crisis management: 5. The case of the new member states

- **Central and Eastern Europe characterised by:**
  - Large, sometimes massive CA deficits financed by bank credit
  - Large market share of Western European banks (70% in Hungary) from a few countries (Austria, Sweden, Belgium, Netherlands, Italy)
  - Euroisation of domestic credit (77% in Latvia, 45% in Hungary)
- **Crisis hit in September 2008:**
  - Reluctance of banks to roll-over credit, especially when exposure was large
  - Shortage of euro liquidity
  - Significant risk for home country banks (exposure = 70% of Austrian GDP)
- **EU response:**
  - « Vienna initiative » (EU, EBRD, IMF): moral suasion to convince banks to roll-over credit
  - EU/IMF balance of payment support
  - But no swap agreements (unlike US agreement with key emerging countries)

5. Lessons and choices ahead

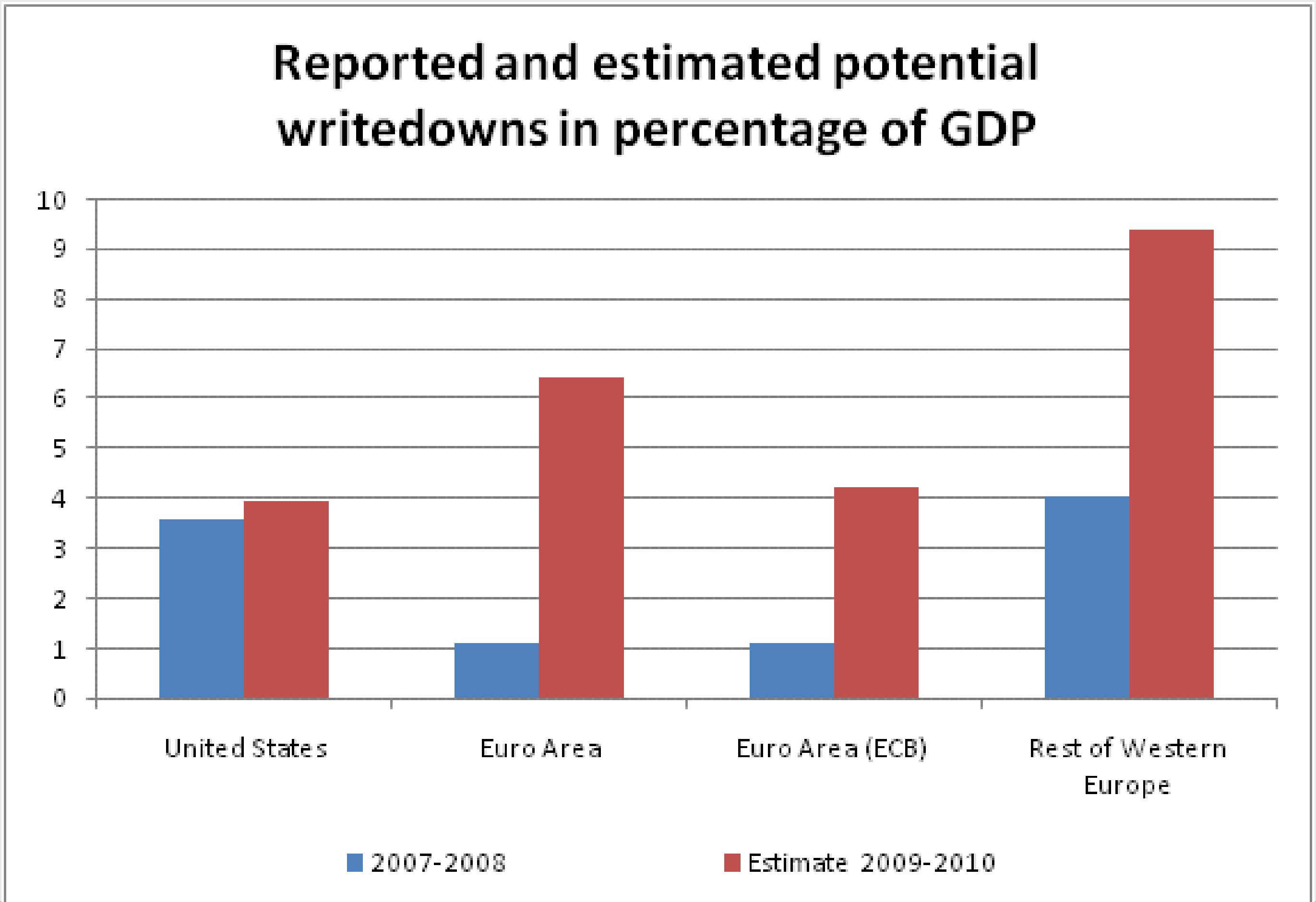
- **Crisis management has reflected competence assignment**
  - Financial stability is national competence
  - EU competence is fundamentally single market, competition
  - Specific euro area dimension: ECB liquidity provision role
- **But coordination problems have been dealt with,**
  - On an ad-hoc basis (follow-up to euro area / UK summit of 12 October)
  - Through relying on existing instruments, notably competition
- **No evidence of *major* coordination failure this far, contrary to ex ante concerns**

Risks for the future

Questions abound as regards risks down the road:

- **Distorsions to competition**
  - Temporary softening of competition rules may have been used by governments to strengthen ‘national champions’
- **‘Zombification’**
  - Lack of incentives to expedite restructuring of banking sector
  - No organised process for triage and restructuring
  - (ECB trapped in cheap liquidity support?)
  - Contrast with the US
- **Financial fragmentation**
  - Interbank market has suffered from (temporary) disintegration tendencies
  - Cross-border loans to non-MFIs have been hit by market turmoil, conditionality of state support, insufficient enforcement of competition rules
  - If banks are ‘national in death’, should they really be ‘international in life’?

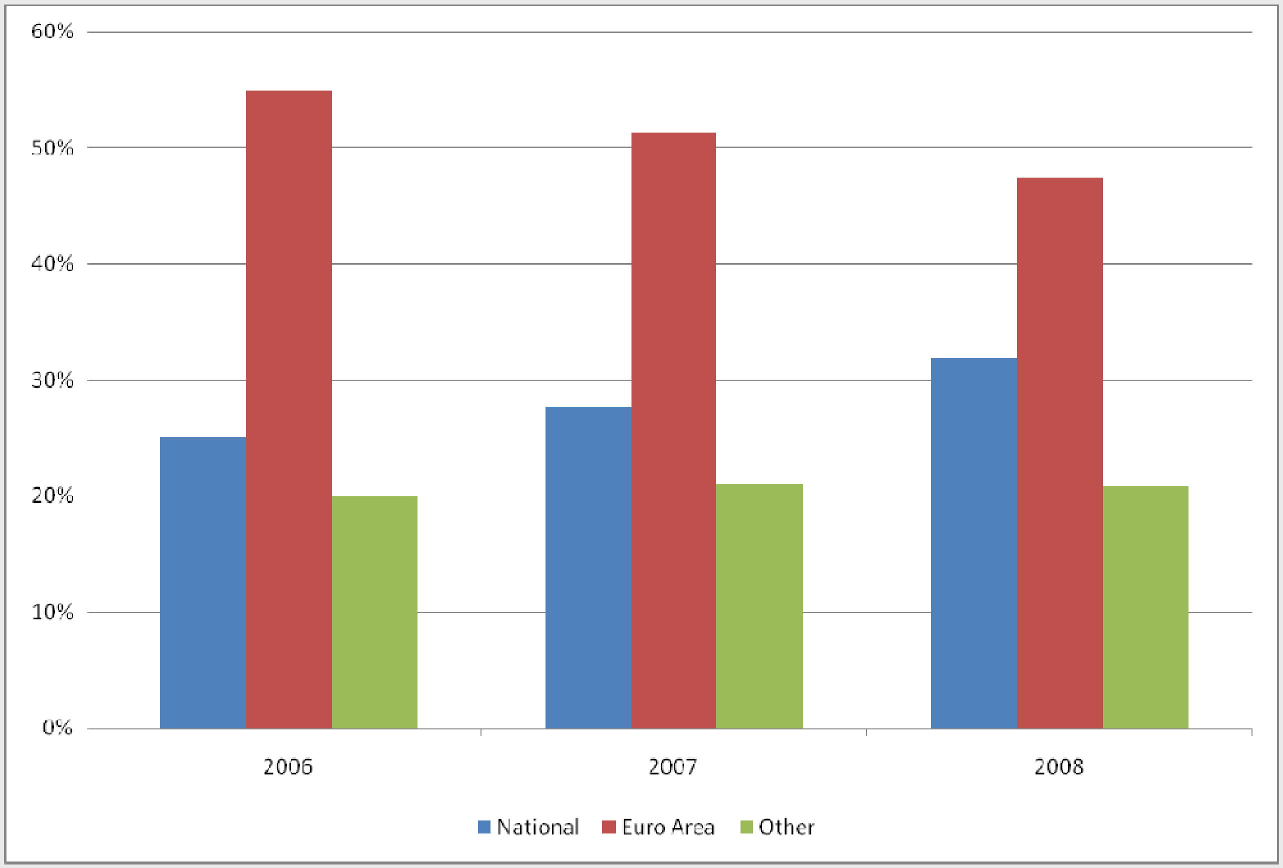
Europe does not seem to be half way through yet



Source: IMF, ECB

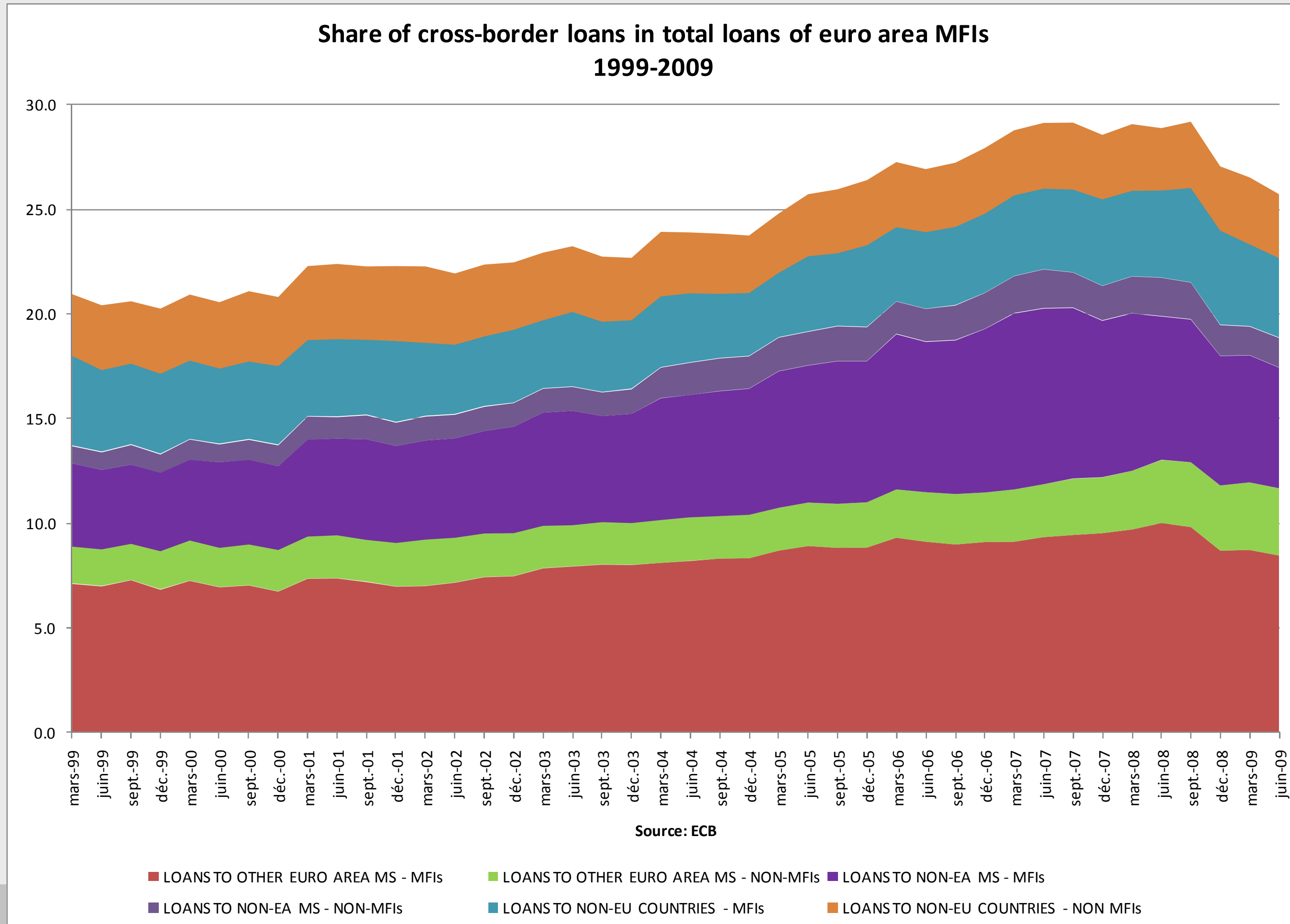
Unsecured interbank lending has become more national in the crisis, but to a limited extend

Unsecured interbank lending in the euro area



Source: ECB, Money Market Survey

Cross-border lending has not collapsed, but it has suffered



Pending questions

- **Instruments to complete cleaning up of European banking sector**
  - Country-by-country, often muddling through approach, or
  - Posen and Véron’s’ *European Treuhand* for triage and restructuring on a European scale
- **Architecture of supervision**
  - Creation of 3 European Supervisory Authorities forming jointly the European System of Financial Supervisors (ESFS). ESFS should have ‘binding powers’ vis-à-vis national supervisors, provided its decision ‘do not impinge ‘on the fiscal responsibilities of the member states.
  - Creation of ‘European Systemic Risk Board’ to monitor risk and issue warnings and recommendations for action.
  - However details remain to be determined

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