Vítor Constâncio: A European solution for crisis management and bank resolution

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at Sveriges Riksbank and ECB Conference on Bank Resolution, Stockholm, 14 November 2011.

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Introduction

Ladies and gentlemen,

It is an honour for me to speak at today's conference, which has provided a stimulating debate on the challenging topic of bank recovery and resolution.

The complexity of developing an effective framework for crisis management and resolution arises from the objective of achieving stability in increasingly integrated financial systems, where the authorities responsible for safeguarding their respective stability are still responsible towards their respective taxpayers.

This element of complexity has been taken into account in a number of policy initiatives and suggestions worldwide. Especially in the EU context, I wish to acknowledge the pivotal role played by Lars Nyberg in this domain. His long-time devotion to the design and implementation of EU crisis management arrangements, coupled with his qualities as a central banker, have made Lars a key policy-maker for crisis management in the EU.

I would also like to thank Lars for his long-standing and fruitful collaboration with the ECB in this field. Principally in the context of the work carried out by the Banking Supervision Committee, but also as Chairman of the EFC High-Level Working Group on Crisis Management, Lars has very often acted as a catalyst for coordination and cooperation among national authorities and EU institutions.

In my speech today, I would like to focus on the ongoing reforms aimed at enhancing the mechanisms with which authorities can handle problems in banks and reduce the potential impact of failures, should they occur. First, I will briefly recall the main shortcomings of the current resolution regimes. Second, I will consider the international, European and national initiatives to cope with the challenges. Finally, I would like to say a few words about the future path towards an optimal arrangement for cross-border resolution.

The main shortcomings of the current frameworks

During the current crisis we have seen several government-funded bailouts and one case where, in place of a bailout, a disorderly collapse occurred with widespread effects around the globe. There are multiple reasons why no better alternative between these two extreme solutions was available in these cases.

First, letting financial institutions fail was often not a feasible alternative from a *legal* perspective. In a majority of countries, only normal corporate insolvency proceedings were – and in many countries, *still* are – available to banks. However, limiting credit and liquidity losses in the case of failure may not be effectively ensured by using these mechanisms, because they were not designed to take into account the special nature of credit institutions.

Second, even if a well-designed special bank resolution or insolvency regime is in place in a particular country, this does not guarantee that cross-border banks can also be dealt with effectively. A cross-border crisis situation involves several national authorities, of course, each having different mandates regarding when and how they can intervene. Even more importantly, these authorities may have different objectives to pursue, but are in all cases accountable to national taxpayers and depositors.

Third, and closely linked to the previous two points, the lack of private financing arrangements also poses a significant barrier to effective resolution. Even the best resolution framework needs some funds to finance the measures. However, as long as strong inter-linkages exist between supervisory and crisis management policies on the one hand and fiscal policies on the other, cooperation will be hard to ensure among national authorities. As an alternative, there are many possible forms of private financing: one could use the funds of the deposit guarantee scheme, set up an ex ante resolution fund, or ensure that the creditors contribute to recapitalisation. The bottom line is that the lack of such a means ultimately undermines the effective implementation of resolution measures.

Initiatives at the global level

Work at the international level to address these issues is ongoing and there are some promising developments.

The Financial Stability Board's (FSB) new standard, "Key Attributes of Effective Resolution Regimes", adopted by the G20, is a point of reference for the reform of our national resolution regimes. These key attributes aim to enable authorities to resolve failing financial firms in an orderly manner and without exposing the taxpayer to the risk of loss.

This initiative addresses all the three shortcomings that I have just mentioned. The FSB standard contains a comprehensive list of tools and powers which every national resolution authority should have. This means that they aim to improve the national regimes, while at the same time providing for convergence.

The FSB key attributes also strengthen, in my view, the group resolution concept, by envisaging that recovery and resolution plans also have a global perspective. Making the national supervisors and resolution authorities plan together how the problems of their groups could be handled would already be a big step forward. In that context, the authorities will also be asked to take into consideration the effects of cross-border contagion in crisis scenarios and simultaneous stress situations in several significant markets. I would also highlight the fact that authorities will also have the right to improve the *resolvability* of large and complex groups. Let me recall here that Lehman Brothers had a presence in some 50 countries and comprised almost 3000 legal entities before the crisis. Simplifying the structure of global systemic groups could well be extremely useful in preparing for future crises, but authorities will clearly need to work very closely with one another to implement such modifications with great care.

Should the group get into difficulties, the Crisis Management Groups could indeed be helpful in promoting cooperation. With such a forum in place, there would at least be a chance of authorities reaching a consensus on how to resolve a cross-border bank. Already today we are quite advanced in this regard, as there are 14 Crisis Management Groups for which EU authorities act as coordinators. These groups are truly global, involving authorities of numerous countries, ranging from Japan to Mexico.

The issue of private financing is also addressed. The FSB standard states that jurisdictions should have in place privately financed deposit insurance or resolution funds, or a funding mechanism for ex post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of a firm.

Bail-in, a form of creditor-financed recapitalisation, is also an important element of the FSB standard. I consider bail-in as an apparently promising resolution tool. However, in many cases, in order to ensure the robust viability of the distressed bank after such a measure and to limit moral hazard, a bail-in mechanism will need to accompanied by a set of other restructuring (such as replacement of management) or resolution measures (like asset transfers, termination stays of contracts, segregation of troubled assets, bridge banks, etc...) . For cross-border institutions, international cooperation to elaborate resolution plans and implement them, it would help if other measures would be adopted like enforceable netting agreements, segregation of clients positions and, specially, the move of OTC derivatives to central counterparties (CCPs) and to organised markets.

The new bank resolution regime in the EU

Let me now turn more specifically to the EU, where a legislative proposal for a directive – in line with the FSB standard – will shortly be published by the Commission. Judging by the papers and communications previously made public, the new framework has the overall objective of dealing with failing institutions in a way that safeguards the stability of the EU financial system as a whole and minimises public costs and economic disruption. A number of innovative elements can be identified in this emerging framework.

First, it covers not only resolution, but rather all phases of a bank crisis, including preventive measures and early intervention powers. Accordingly, if problems were to arise in a bank, so that it became likely that it would breach the prudential requirements, a *harmonised set of early intervention measures* could be applied by supervisors. This area is highly important, since I strongly believe that a timely step by a supervisor to prevent things from getting worse is worth more than the best resolution efforts. The early intervention measures envisaged, such as prohibiting the payment of dividends, imposing additional reporting requirements, and requiring the replacement of managers or directors or the cessation of certain risky activities, are already in the toolkit of some Member States, but the new framework would mean that each tool would be available in each Member State, and it would be applied in a harmonised manner, based on common triggers.

Second, a forward-looking element of the new framework is the concept of *intra-group financial support*, which could reduce the current legal uncertainty that surrounds asset transferability within groups. In today's regulatory environment, group liquidity management may in some cases be suboptimal, making the survival of a group more difficult as a result of – for instance – supervisory ring-fencing measures. At the same time, some of these restrictions are in fact justified, since they serve to protect domestic creditors and shareholders from unfavourable transfers. This implies that the conditions for intra-group loans, guarantees and transfers of assets for collateral could be set out in group financial support agreements between parent banks and bank subsidiaries. However, progress in this area is extremely challenging, since group interest is not a well-defined legal concept, while national laws focus on protecting local creditors. Here I think the critical issue is whether we manage to include adequate safeguards in the framework to ensure that the financial stability of the transferring country is not exposed to undue risk as a result of the support provided according to the agreement. This means that host countries supervisors have to be involved in any solution implementation.

Third, I also consider the *involvement of the European Banking Authority (EBA)* as a very promising element of the EU plans. The EBA could play two equally important roles in the future regime. As a standard-setter, the EBA drafts binding technical standards and non-binding guidelines. This could be key to ensuring true convergence in national approaches as well as transparency vis-à-vis market players regarding the details of the possible measures to be applied. As a supervisory authority, the EBA is involved in the resolution colleges and, even more importantly, its mediation powers have the capacity to actively foster cooperation and coordination also in practice.

The new EU bank resolution regime can also draw inspiration from a number of ongoing national initiatives. These national laws already aim, in large part, to stay close to the Commission's proposals. The ECB is currently involved in supporting the implementation of new resolution frameworks in Ireland Portugal and Greece. The practical development of these regimes sheds light on some important areas. In particular, a number of critical points have emerged.

To mention just a few, the *property rights* of stakeholders constitute a legally complex issue. For instance, obligations to hold a general meeting to decide on an increase in capital could hamper the efficient and swift resolution or restructuring of a bank. For any regime, it will be important to properly balance the fundamental rights of shareholders and also creditors with the general interest in the financial system's stability. In this perspective, the example of the US FDIC´s powers should be taken into consideration.

The establishment of temporary credit institutions or bridge banks is emerging as a key resolution tool, but the new resolution frameworks need to address a number of related technical issues, such as the question of who provides the necessary capital and liquidity to the bridge institution, how the bridge bank can use the infrastructure of the failed bank, and how and when it is ultimately dissolved, since bridge banks are temporary entities needing a good exit strategy.

Finally, the design of *bank levies*, which could usefully be collected into resolution funds, is also a delicate area. Mechanisms are under examination both to recoup the losses of the crisis and to create provisions against future events. I believe that ex ante funding is a crucial element, since it may reduce moral hazard and improves the authorities' ability to react to crises earlier, thus strengthening the credibility of such actions. Levies are valuable revenue-raising mechanisms with which to finance crisis measures. Uncertainty remains as to how they would affect the particular problem of moral hazard in the financial sector, and both the rate and the base of levies need to be determined with care, especially if we want to include the aspect of systemic risk as well. However, maintaining a level playing field and coordination between Member States remains in my view paramount in order to avoid a distortion of fund contributions and resolution tools.

Challenges ahead – more integration

I am confident that the emerging EU regime will appropriately address all these challenges. As for cooperation among authorities, the new resolution regime will take the form of a coordination framework. Accordingly, national authorities will ultimately maintain their discretion in the most important decisions, although they will be strongly encouraged to try to reach joint decisions on the ways to handle bank crises in resolution colleges.

This is a realistic approach, already representing a major step forward. However, I think there may be a need for even more integration in the longer term.

As an example, *insolvency laws* are addressed by neither the FSB standard nor the EU proposal – at least not its first phase of implementation – although they may well be important in practice.

One also wonders whether there are other areas in which we could make progress. There were, and in fact continue to be, numerous proposals for the optimal European arrangement in the academic and policy sphere. Let me just mention three of them, which I find particularly inspiring.

Most of you will be familiar with the influential arguments of Charles Goodhart and Dirk Schoenmaker, who have said that, as a form of coordination among national governments to handle cross-border bank crises, legally binding burden-sharing rules should be drawn up ex ante.

Others, including David G. Mayes, have recommended adopting the prompt corrective action approach of the United States by designing a framework that would be based on stringent rules. Under such a framework, it would be clear for both banks and the authorities, that measures of increasing intrusiveness would have follow as the financial situation of a bank worsened. An important element of such a regime that limits moral hazard, regulatory forbearance and creditor losses as well, is that authorities are obliged to take over a failing bank before its capital is fully depleted.

Finally, many, including the staff of the IMF, have supported the idea of a European Resolution Authority responsible for crisis management and resolution, probably combined with a European Deposit Insurance and Resolution Fund. This is certainly the most ambitious plan of all, but was always considered as politically challenging and legally difficult to implement.

Advancing towards a truly European solution

I believe that all these proposals have important elements. In my view, the optimal arrangement for the EU would probably draw on all of these. There should be binding rules for the cooperation of Member States, and measures should be activated according to clear and transparent – although not automatic and not solely quantitative-based – triggers. Indeed, the resolution of a cross-border systemically important financial institution would probably be most efficient if the measures were at least strongly coordinated by one lead authority. Or, if we go a step further in our thinking, the ultimate long-term vision could be to establish one supranational authority, an FDIC-type entity implementing group resolution. Clearly, at the international level, this now seems to be out of reach, but one could ask whether at least in the EU such an arrangement might be feasible sometime in the future. If ever put in place, an EU-level resolution authority could act as a resolution authority responsible for all the major cross-border banks of the EU, working together with national authorities as its agents, operating on the basis of a single crisis management, resolution and insolvency framework for EU banks.

In the field of prudential regulation, something similar is already happening, since the new Basel rules will partly take the form of an EU regulation, thereby eliminating the room for national differences in transposition. In the future, the Single Rulebook could ultimately be one that also covers the crisis management, resolution and insolvency of banks. If we continue to unfold this vision, there would also be a need for robust arrangements to finance the measures of such an authority. An obvious option for that purpose would be an EU-level fund of resolution funds, or a single EU resolution fund. The benefits of such an integrated regime are most easily seen if we imagine how resolution under a loose cooperation framework would work. A previous mapping exercise by the ECB identified more than 40 banking groups with significant cross-border activities which were headquartered in the EU. Notably, 17 of them had a presence in at least ten Member States. The resolution of such a bank would involve ten national authorities, ten resolution funds and ten deposit guarantee schemes; needless to say, there would be many challenges involved in ensuring efficient coordination. The envisaged EU authority would spare us a great deal of these efforts.

And I see no reason why such a vision should be considered unrealistic. Events are moving faster now than before. Crises make us reconsider things that we would have seen as beyond the feasibility horizon. For example, of the challenges that I have mentioned here today, the financing part is probably the biggest obstacle for such a quantum leap. However, in another dimension and for the euro area we already have the EFSF in place. Such a facility would have been simply unthinkable a couple of years ago.

Similarly, I consider the setting-up of a permanent EU or euro area resolution fund to be one imaginable way to proceed. Of course, I am fully aware of the technical, legal and, most importantly, political complexities of such a move. Nonetheless, Europe could advance step by step. The euro area may be the most realistic starting point, since a stronger concept of the euro area as a legitimate entity has already been emerging. Likewise, fiscal coordination has been fundamentally strengthened during the crisis, paving the way for a specific economic governance concept for the euro area. For the euro area I will say clearly: we need for cross-border banking institutions a European Resolution Authority, including or combined with a Resolution Fund, as well as a European Supervisor. This requirement is not only a necessity stemming from the high degree of interconnectedness among euro area banks, but constitutes also a major lesson of the present crisis. Indeed, some of the major imbalances that are besetting the euro area stemmed from uncontrolled behaviour of some banking sectors that eventually contaminated the sovereign.

However, in the longer term, one can only envisage an integral EU resolution framework on a full EU basis, reflecting the highly integrated financial system in the EU. In parallel with the establishment of an EU resolution fund, we could gradually also start preparing to set up an EU-level resolution authority.

Following a pragmatic approach, we could focus on the recently established Cross-Border Stability Groups. Common practical guidelines and blueprints could be prepared for them to foster a more harmonised approach for resolution across jurisdictions. With a more forward-looking approach, on the basis of frequent peer reviews, qualitative assessments and stocktaking of best practices, we could gradually explore the possibilities of entering into more binding multilateral agreements within these groups, which in turn would pave the way for an EU-level authority.

We should not forget that the supervisory reform process based on the De Larosière proposals is not yet finished. The review of the new EU supervisory authorities is scheduled for 2014. While the optimal supervisory structure of the EU is a topic that deserves a separate speech of its own, it may suffice to say that this supervisory review may be a very good occasion to consider the suitability of moving both supervision and resolution together into an even more European set-up.

Likewise, there are already legislative proposals for a network of national EU deposit guarantee schemes, having the possibility to borrow from each other, if need be. I consider this as an ambitious plan which rightly mirrors the cross-border nature of our banks. In fact, such a mutually supportive structure of deposit insurance is not far removed from an EU-level fund of funds, nor from an EU-level deposit guarantee scheme.

Concluding words

Let me conclude by saying that the seeds of an integrated EU resolution framework are already there today, but it is an open question whether the EU will have the audacity, and, in particular, the political will, to move towards that. I firmly believe that if we wish to preserve the benefits of integrated cross-border banks in Europe and globally we must built an European resolution regime that enhances market discipline by mitigating moral hazard, maintains stability by ensuring continuity of basic services of unwinding institutions, orderly allocates losses and protects taxpayers.

To achieve this goal, we will have to make sure that our authorities speak a common language and that the thorny issue of public burden-sharing is replaced by private burden-sharing as far as possible. Based on these preconditions and building on the practical operation of cross-border stability groups, we should gradually move towards a stronger coordination of cross-border resolution, with the ultimate vision of a single EU resolution authority and an integrated EU resolution regime.

Thank you for your attention.