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ESRB
European Systemic Risk Board
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Forbearance, resolution and deposit insurance

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Abstract

The report discusses a variety of issues involving difficulties in the banking sector, with a view to ascertaining the appropriate institutional infrastructure in the context of the European Union and the euro area.

Forbearance of banks towards borrowers: forbearance on the part of banks dealing with delinquent borrowers is unproblematic if it is simply the result of entrepreneurial judgments to the effect that patience may eventually pay off. Such forbearance is problematic, however, if it is designed to disguise problems in lending, delaying write-downs of bad loans, as a way of gaming with creditors and supervisors. Such behaviour is to be expected, in particular, if a bank has many problem loans.

Forbearance of supervisors towards banks: excessive forbearance of banks towards borrowers is a practice that supervisors should not tolerate. Supervisors may, however, be tempted to exercise forbearance themselves, because they fear the consequences of intervention. This temptation is particularly strong in situations when many banks have problems and intervention might give rise to a credit crunch. Experience has shown, however, that a failure to intervene early tends to increase the costs of the crisis. Macro-prudential concerns should not induce the authorities to delay clean-ups of banks in difficulties.

Bank resolution: to minimise the macroeconomic fallout from banking problems and to reduce the temptation for authorities to delay and hide problems in banking, it is necessary to have a viable resolution regime that leaves room for authorities to reduce the systemic fallout from resolution. Such a regime requires clear priorities, clear rules and a clear assignment of responsibilities. Priority should be given to protecting the system, rather than creditors. Rules should ensure the liability of shareholders and creditors, in particular subordinate creditors. Exceptions, e.g. for depositors, should be defined clearly and unambiguously, and should have proper funding. Assignment of responsibilities for the resolution of internationally active institutions should permit the continuation, at least temporarily, of integrated operations. For such institutions, there should also be clear rules on burden-sharing.

Bank resolution requires funding. Even if investors are held liable, funding is needed for operations that are to be maintained for purposes of protecting the system; funding is also needed if depositors are protected. The rules on funding should be clear.

The European dimension: Under both the Treaty and the Banking Directive, banking in the European Union is a cross-border business. The logic of the Single Market suggests that eventually the European financial system will have many institutions with operations extending across the whole European Union. Cross-border operations have thus far been restricted mainly to interbank borrowing and lending, and to cross-border investment. Even at this level, there are significant cross-border externalities linked to the decisions of bankers, bank supervisors and resolution authorities. These externalities can be particularly damaging if fiscal concerns prevent national supervisors from intervening quickly to resolve difficulties in their national banking systems.

Recommendation: the Advisory Scientific Committee calls for the establishment of strong European bodies responsible for banking supervision and bank resolution. A European competence is necessary to ensure that cross-border concerns are given appropriate weight in supervision and resolution. European responsibility for only supervision will not be sufficient. Bank resolution should be handled by a "European Resolution Authority", with protection of the financial system as its primary objective. Losses should be allocated in accordance with the principle that investors are liable for their decisions. The authority should have access to primary funding through a levy on the industry, with the general taxpayer serving as a backstop. Funding by deposit insurance systems should be used to finance the protection that depositors might be given against losses incurred through bank resolution.

Forbearance, resolution and deposit insurance

I. Introduction

1. Following a query from the Chair of the European Systemic Risk Board (ESRB), the Advisory Scientific Committee (ASC) has taken up the subject of forbearance and the systemic implications of forbearance in the financial sector. In the course of its discussions, the ASC has come to the conclusion that forbearance practices in relations between banks and their borrowers cannot be properly discussed in isolation, but must be treated as a matter of bank governance, taking account of, in particular, the position of such practices in relations between banks and their supervisors. Forbearance of banks towards their borrowers can be a way of gaming with the supervisors, and tolerance of banks' forbearance towards their borrowers can be a form of forbearance on the part of supervisors towards banks. This, in turn, raises issues of moral hazard on the banking side, and of control over moral hazard, all of which can have a substantial impact on systemic risk.

2. If many bank borrowers and many banks have problems at the same time, the issue of forbearance has an important macro-prudential dimension. To the extent that difficulties are seen as purely cyclical, forbearance could be regarded as a way of smoothening the lending cycle. To the extent that a debt overhang affects the viability of the financial sector, and of the economy, forbearance may simply delay the necessary adjustment and raise the overall costs thereof. Here again, issues of governance play a crucial role.

3. Supervisory attitudes and choices may depend on the alternatives to forbearance. Proper procedures and institutions for bank resolution are necessary to avoid costly mistakes in supervisory attitudes to forbearance. In particular, procedures and institutions must be in place to minimise the systemic fallout from resolution, to ensure the proper recognition and allocation of losses that have occurred and to ensure that non-viable institutions leave the market, in particular, in situations where there is excess capacity in the system. Funding must be ensured to maintain systemically important operations.

   The rules for the allocation of losses should not only be clear, but should also be governed by the principle that investors, i.e. shareholders and creditors, are responsible for their own decisions. If systemic concerns mandate exceptions to this rule, there must be provisions for funding, e.g. through a deposit insurance scheme.

4. On the basis of these considerations, the ASC has prepared the following report, which looks into the different issues and shows how they are linked. On the basis of the analysis, the report also puts forward a package of policy recommendations relating to the organisation and governance of supervision and resolution, and the role of deposit insurance in the European context.

5. In preparing the final version of this report, the ASC has benefited from comments of ESRB members on a previous version. None of the members should, however, be held responsible

for this report or any part thereof, nor should the ESRB as a whole. The ASC bears sole responsibility.

6. The European Commission's Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (COM(2012) 280/3) was published just as this report was being finalised. Therefore, this report does not take account of this Proposal, let alone comment on it. From a superficial reading of the Commission's Proposal, it seems clear, however, that the Proposal goes in the direction recommended by the ASC, but not far enough. On several important points, the suggestions contained in this report go over and beyond the Commission's Proposal.

7. The European Summit of 28 June 2012 took place after the main text of this report had been approved by the ASC. Rather than change the body of the text, the ASC has added a postscript to explain the implications of its analysis and to put forward recommendations for the implementation of the Summit's decisions, in particular the establishment of "an effective single supervisory mechanism … involving the ECB, for banks in the euro area."

II. Forbearance of banks towards borrowers

8. The notion of forbearance to borrowers covers a variety of behaviour patterns. They all have in common that one party fails to fulfil its obligations under a given contract and the other party refrains from imposing measures that could, in principle, be taken to punish the violation. A borrower does not pay on time, and the lender decides to wait and see, perhaps even to renegotiate the arrangement.

II.1 Forbearance as a result of autonomous entrepreneurial decisions

9. Forbearance is not specific to financial institutions. If a firm fails to pay for its inputs on time, the suppliers may decide to wait and see, rather than taking their deliveries back (if this is still possible) or obtaining a court injunction against the firm. Enforcement is costly, and it may be cheaper to wait for better times, when the debtor will presumably be in a position to pay again. If there are adequate prospects for better times to come, the creditor may be better off with forbearance than with costly enforcement.

10. Decisions on forbearance are a matter of judgement. When such decisions are taken, it is usually not clear whether the assessment is correct or not. Individuals and firms are usually best placed to judge matters concerning themselves. In a market economy, they are therefore autonomous in making such decisions, but they must also bear the consequences, good and bad. Because the decisions are taken under uncertainty about the future, ex post they will sometimes be seen as wrong, but that is in the very nature of decisions under uncertainty.

11. With creditors outside the financial sector, decisions on forbearance or enforcement are governed by the principle of individual autonomy in decision-making. The supplier whose bill is not paid on time decides autonomously on what he/she considers to be the best course of action. If in the end, forbearance makes him/her lose money, he/she bears the consequences of that decision.

12. In normal circumstances, the principle of individual autonomy in decision-making should also apply to forbearance decisions taken by banks. The bank is best placed to judge the prospect that the debtor will eventually pay up, and, in normal circumstances, it bears the consequences of the decision taken.

13. With hindsight, it may turn out that a decision was wrong, but that is not a reason to question the bank's right to decide, or its autonomy in taking that decision. From a regulatory perspective, the question is not whether banks are properly distinguishing between "good forbearance" and "bad forbearance", practicing the first and avoiding the second. From a regulatory perspective, the question must be whether banks have appropriate incentives in taking such decisions or whether their incentives might be distorted by extraneous considerations.

II.2 Forbearance as a result of gaming with creditors and supervisors

14. Incentive distortions and regulatory concerns arise if the forbearance decisions of banks affect the banks' relations with their own creditors and supervisors, in particular if these decisions affect the bank's actual or reported solvency and if the decisions might be a way of gaming with their own creditors and supervisors.

15. Banks' decisions on enforcement versus forbearance towards borrowers can have an effect on the treatment of loan positions in the banks' books. Forbearance may be a way of reducing or even avoiding write-offs on the loans in question. Such avoidance may be desirable to the bank as a way of gaming with its own creditors and its supervisors. The bank avoids acknowledging losses and maintains its book capital at a higher level than would perhaps be warranted. This strategy will look particularly attractive if the bank's own capital position is weak and loan collateral values are depressed. It will also look attractive if markets have little confidence in banks, so that recapitalisation would only be possible at unattractive terms if at all.

16. This is not just a theoretical possibility. Delaying recognition of losses in order to maintain book values of capital at artificially high levels is a common practice of banks in distress. In such instances, it is symptomatic that market values of bank equity will be lower than book values. As market investors become suspicious about unrecognised losses of banks, the amounts they are willing to pay for the equity add up to less than the amount that the bank says the equity is worth. Thus, in the recent sub-prime crisis in the United States, unaccounted losses kept book values of bank capital far above their true levels, which accounted for much of the decline in the market-to-book values of banks.[1] This phenomenon was also observed in many previous crises, both in developed economies (e.g. Japan in the 1990s and the United States in the 1980s) and in developing economies (e.g. Mexico and eastern Asia in the 1990s). For the current situation, the Bank for International Settlements (BIS) notes that "the coexistence of market-to-book value ratios for banks, which are generally well below one, with loan loss

[1] H. Huizinga and L. Laeven, "Accounting Discretion of Banks During a Financial Crisis", *IMF Working Paper Series*, WP/09/207, 2009.

provisions that are low despite weak macroeconomic conditions … could indicate evergreening practices."[2]

17. Forbearance decisions that are driven by a desire to delay the recognition of losses as a way of gaming with creditors and supervisors cannot be accepted as simply a result of individual autonomy in decision-making. The lack of transparency that such decisions create undermines the ability of creditors to properly assess the creditworthiness of the bank. It also undermines the proper functioning of banking supervision, e.g. the implementation of capital requirements, and must therefore give rise to supervisory concerns.

18. Apart from making matters opaque and forestalling disciplinary action by the bank's own creditors and supervisors, forbearance decisions themselves can be a form of gambling at the expense of others. Waiting to see whether the borrower might eventually pay up means taking a gamble on the borrower's ability or willingness to pay. If the gamble turns out badly and the bank's solvency is affected, some of the costs are borne by creditors and, possibly, the other financial institutions and general taxpayers contributing to the funding of the resolution of the bank.

19. Forbearance in the form of gambling is also a way of wasting additional resources if the banks continue to lend to their old debtors rather than to new firms. Continuing to lend to old debtors may be a way of "kicking the can down the road" so as to avoid having a credit event that would have to be entered into the books. Continuing to lend to old debtors may also be a case of throwing good money after bad. From the perspective of the overall economy, such a use of funds is an impediment to economic growth. Even if the old borrowers do not receive any new funds, banks with weak balance sheets may reduce new lending in order to make their balance sheets appear stronger, rather than by writing off old loans and recapitalising.[3]

20. The Japanese experience of the 1990s shows some of the dangers of such forbearance. When the Japanese banking crisis began in 1992, it was known, or should have been known, that many loans in the banks' books were worthless. However, fears of write-offs inducing open insolvencies motivated forbearance of banks towards borrowers and of supervisors towards banks. The avoidance of write-offs and the failure to acknowledge insolvencies had large economic and social costs. As banks continued to lend to problem borrowers, funds for lending to new firms were reduced and growth was lacking. In the academic community, there is a consensus that the strategy of "denial, deferral and opaqueness" was the main reason

[2] Bank for International Settlements, *82nd Annual Report: 1 April 2011 – 31 March 2012*, Basel, 2012, p. 42; see also pp. 65 and 74.

[3] The BIS has noted that aggregate deleveraging after the crisis in the United States "did not come about through writedowns of unsustainable debt. Rather, it was driven by … a reduction in new mortgage borrowing" (see Bank for International Settlements, *82nd Annual Report: 1 April 2011 – 31 March 2012*, Basel, 2012, p. 26).

why the Japanese crisis lasted for more than a decade, during which it stifled economic and social development.[4]

III. Forbearance of supervisors towards banks

21. Large-scale forbearance of banks towards borrowers is hardly possible without the acquiescence of supervisors. In Japan in the nineties, the banks could not have pursued the strategy they had chosen if supervisors had not agreed. Supervisors were guided by the same concern that large-scale write-offs would result in bank insolvencies, and that these bank insolvencies might upset the entire financial system.

22. The question is therefore how supervisors should approach the matter. How much weight should be given to concerns that full transparency about write-offs may pose dangers for the overall financial system and the economy? We address the question from both a micro-prudential and a macro-prudential perspective.

III.1 Micro-prudential concerns

23. From a micro-prudential perspective, supervisors should deal with a bank's forbearance towards borrowers in the same way as they would with any other exercise of judgment on the part of the bank. They should take into account, however, that the bank's choices may be driven by an interest in gaming with its own creditors, as well as with the supervisors.

24. Nor should supervisors or regulators regard the non-recognition of loss entailed by bank gaming as harmless. All the reasons we have for imposing regulations on banks in the first place should also be seen as reasons for not allowing them to play with the rules through forbearance towards loan customers. If the loan is bad, and if the bank is aware of this fact, then forbearance is merely a device for continuing to operate with insufficient capital without taking corrective measures such as recapitalising. In this situation, the bank has incentives to gamble "for resurrection" – a mode of behaviour that should be familiar from the US Savings & Loans (S&L) crisis of the 1980s. Allowing this to happen by failing to put hidden losses on the books is particularly insidious because this lack of transparency will also weaken the market discipline that might otherwise be imposed by the bank's creditors.

25. As mentioned above, the bank's choice of strategy towards delinquent borrowers involves an exercise of judgment about trade-offs. Similarly, the supervisor's assessment of the bank's strategy likewise involves an exercise of judgment. It is therefore difficult to define hard and fast criteria for such assessments from outside. However, it is important that supervisors themselves should develop strategies for approaching the problem and that they should be transparent about which criteria they use and how they will apply them. In developing their strategy, they should consider how to make use of extraneous information such as the information contained in the fact that the market values of banks are significantly lower than the book values. They should also develop criteria for assessing under what conditions sample

[4] T. Hoshi and A. Kashyap, "Japan's Financial Crisis and Economic Stagnation", *Journal of Economic Perspectives*, No 18, Winter 2004, pp. 3 – 26.

examinations of individual loan positions might suggest a systematic strategy of forbearance that would call for more extensive investigations.

III.2 Macro-prudential concerns

26. From a macro-prudential perspective, the matter is more complicated. If poor loan performance is a common phenomenon that affects many banks at the same time, supervisory intervention forcing banks to acknowledge losses and take write-offs will, ceteris paribus, reduce banks' willingness to provide new loans, possibly even inducing them to shed assets as a way of re-establishing their capital ratios. The reduction in lending will have adverse effects on the overall economy. Shedding assets will also put downward pressure on asset prices. The resulting decline in asset prices will cause other financial institutions to take losses and possibly force them to take further action, e.g. again to shed assets in order to improve their capital ratios.

27. Fear of such adverse macroeconomic developments may provide a rationale for exercising supervisory forbearance vis-à-vis banks, including a tolerance of the forbearance that banks show towards their own borrowers when they want to avoid substantial write-offs. In this context, many cite the example of Latin American debt in the 1980s to show how such forbearance can be beneficial.

28. If Latin American debt had been fully recognised as delinquent in 1982-83, and if the requisite write-offs had been taken at the time, many large banks would have been insolvent and losses from that debt would have been larger than they ultimately were. By repeatedly renegotiating the debt, the banks gained enough time so that, when the write-offs were effected, there was no longer a problem of insolvency. Moreover, in the second half of the 1980s, they actually received significant debt service payments from the large debtor countries.

29. However, the examples of Japan in the 1990s and the US S&L crisis in the 1980s show, as do many others, that supervisory forbearance towards banks can be problematic. Moreover, the problems are exacerbated if such forbearance takes on macroeconomic proportions.

30. In the case of the S&Ls in the 1980s, the losses did not arise from credit events, but from interest rate risk. As in the early 1980s, market rates of interest were far above previous levels, and the discounted present values of debt service payments on long-term fixed-rate mortgages were well below the book values of these mortgages. Most S&Ls were effectively insolvent, but that insolvency was hidden because the entries in the bank book do not react to changes in market interest rates (changes in funding costs). Therefore the institutions were left free to gamble. When eventually, in the late 1980s, the crisis could no longer be suppressed, the costs were far higher than they would have been if prompt corrective action had been taken earlier in the decade.

31. In Japan, forbearance led to decade-long stagnation. Here, too, the eventual costs for the taxpayer seem to have been far higher than they would have been if banks had been forced to immediately reveal their losses in 1992.

32. The above stands in contrast to the Swedish experience of the 1990s. When the banking crisis there erupted in 1992, the Swedish government immediately stepped in. While committing

taxpayers' money to fully support the banks, it also took control of them, cleaned up the books, recapitalised the banks and then, within a few years, reprivatised them. The credit crunch and recession were very sharp, but also very short, and the financial system was soon able to function properly again. Nothing is more effective for ensuring the sustainability of improvements in the financial sector than an effective clean-up and recapitalisation.

33. From a macro-prudential perspective, it is important to consider not only the credit crunch in the economy that may be induced by immediate intervention, but also the credit crunch in the economy that may be induced by later intervention when the crisis can no longer be kept under the rug. As discussed by Caprio and Klingebiel in their systematic analysis of banking crises worldwide, any failure to address banking problems in a timely and determined way may result in far more serious crises at a later date, with much tighter credit crunches than one would initially have needed to fear.[5] Ignoring banking problems in the interests of sustaining credit will, on average, lead to a more severe contraction of credit at a later stage. The resulting damage to the government budget is also far greater.

34. Even the example of Latin American debt provides an ambivalent message. In this episode, the ultimate success of forbearance was not due to banks' large sovereign debtors recovering on their own, but rather to IMF support enabling debtor countries to make large payments to private creditors, in particular large banks in the United States and Europe, in the second half of the 1980s.

35. The various experiences with forbearance around the world suggest that, in general, forbearance ultimately proves both to destabilise the economy and to be costly for taxpayers. If governments wish to intervene to assist banks so as to avoid the adverse consequences of credit crunches that would result from bank losses, they should do so explicitly by assisting banks with taxpayers' money, rather than implicitly through forbearance. Of course, any support for weak banks has adverse effects on incentives, which must also be given some weight when considering such assistance.

III.3 Policy implications

36. It is always advisable to address banking problems in a timely and determined manner when they arise, even if this is inconvenient because the economy is doing poorly and the budgetary impact is most unwelcome. If there are concerns about macroeconomic activity, supervisory forbearance towards banks, in particular supervisory forbearance towards the banks' treatment of their loan customers, is inferior to other tools of macroeconomic policy because it is a source of opaqueness and mistrust, which can itself be a source of systemic risk. Countercyclical capital requirements, with transparent procedures on when and how to relax the regulation, would be preferable.

37. The temptation to treat problems as being temporary in character, e.g., as resulting from "mere" liquidity problems, should be resisted. Most liquidity problems are indications of deeper

[5] G. Caprio and D. Klingebiel, "Bank Insolvencies: Cross-Country Experiences", *Policy Research Working Papers*, No 1620, The World Bank, 1996; and "Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking?", *Annual World Bank Conference on Development Economics 1996*, pp. 1 – 26, The World Bank, 1997.

problems since investors are afraid of insolvency. Lehman Brothers collapsed because their funding was disrupted, but underlying this breakdown of funding was the concern, which turned out to be justified, that losses on the large positions that they had taken in toxic securities would destroy their solvency. If solvency is an issue, any delay of intervention is risky and costly.

38. In the United States, these considerations provided the rationale for the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The FDICIA calls for *prompt corrective action,* with a system of graduated responses, depending on the severity of the solvency problem. The law gives the Federal Deposit Insurance Corporation (FDIC) full powers to intervene and to take control if the situation seems to require this.

39. By contrast, most European responses to banks' difficulties in the crisis have been based on a desire to avoid intervention. Banks were given capital, loans and guarantees *without* any effective imposition of control by the authorities. Much capital was provided in the form of hybrid securities, which are basically debt, except that they can be made to absorb some losses under certain circumstances; this loss absorption capacity gave supervisors a rationale for treating these hybrids as equity, even though – in fact – they are not. If capital was provided in the form of equity, governments asked for representation on the board, but did not exert sufficient control for a clean up the banks' books. Recapitalising the banks and giving them loans and loan guarantees without a clean-up of the asset side of the balance sheet, however, entails the risk that we may be on our way to a "Japanese decade".

40. The "bad bank" approach to dealing with bank difficulties is paradigmatic. Under the "bad bank" approach, the bank puts toxic assets into a special-purpose vehicle, the "bad bank" and the toxic assets are removed from the bank's books. In the German version of this arrangement, the "bad bank" is managed by the government's Financial Markets Stabilisation Authority (FMSA). In exchange for the toxic assets, the parent bank receives government debt, i.e. good assets. All future problems with toxic assets occur on the balance sheet of FMSA, off the balance sheet of the bank. For the bank, this is fine if the taxpayer is bearing the losses. Under the German law, however, there is a day of reckoning 20 years later, at which point either the bank or the bank's owners have to compensate the FMSA for losses taken on the toxic assets (with interest). Not accounting for this burden in the bank's balance sheet is as delusionary as failing to make write-offs on bad loans. To justify this accounting treatment, the German law stipulates that compensation to the FMSA should take the form of a privileged claim on distributable profits, much along the lines on which the contingency clauses in payments on silent partnerships are used as a justification for treating these titles as equity, rather than debt. From the perspectives of shareholders and shareholder-value incentivised bank managements, privileged claims on distributable profits are no different from junior debt and create the same incentives for gambling and taking risks. Disregarding the privileged character of such claims and stressing the contingent nature of payments justifies a form of deceptive accounting, which provides cover for not facing up to the real problems.[6]

[6] In practice, the clawback provision is inconsequential because the only two banks that have made use of the bad bank facility are Hypo Real Estate and West LB, one of which is owned by the Federal Government itself, while the other is also in public ownership.

41. The hands-off approach followed by European governments is aimed at preserving each bank. This is problematic if the market structure itself is a source of systemic risk. In Germany, for example, extremely low margins and excessive risk-taking by market participants provide clear evidence of excess capacity in wholesale banking and in the covered bond sector for real-estate and public sector finance. For the public banks, which are prominent in these activities, market-driven exit mechanisms are not functioning. Support from the Federal Government in the crisis came without an attempt to change the market structure; the exception is the European Commission's using its powers of control over state aid under Article 107 of the Treaty to demand a winding-up of West LB.[7]

42. If excess capacity in the business makes it difficult for banks to earn proper margins, they have an incentive to "gamble for survival". The only way to eliminate this source of systemic risk is to clean up market structures, as well as to clean up banks' books. Such a clean-up of market structures is hardly possible under a hands-off approach that aims to preserve each institution.

43. The alternative to the hands-off approach is the hands-on approach that was taken by Swedish authorities in the early 1990s. Under this approach, the authorities step in, take control, sort out the business and then restructure, recapitalise and reprivatise the good parts of the businesses. Taking control of the whole and reprivatising "good banks" makes sure that market participants after reprivatisation are no longer burdened by skeletons in the books; moreover, the authorities do not leave themselves hostage to gaming by the banks' executives and owners. A comparison of different crisis experiences suggests that this approach is generally far cheaper for taxpayers and much less risky for the financial system than either the bad bank approach or outright forbearance.

IV. The need for a workable resolution regime

44. The hands-on approach requires the authorities to take control. It also requires the government to immediately put up funds for running and recapitalising the banks, rather than spreading the losses over time.

45. Taking control means more than just telling the bank to shed this or that unit, or to refrain from certain conduct, as was done in the case of the European Commission's application of state aid control under Article 107 of the Treaty. The European Commission's state aid control was aimed at protecting competition and competitors in the relevant markets. Here, the issue is to re-establish the health of institutions that let loose in financial markets. This requires going into the banks, looking into the books and assessing the positions one by one, loan by loan, with a view to cleaning up the asset sides of the banks' balance sheets.

46. For the authorities to take charge, they must have the requisite legal infrastructure. At least some of the passivity of governments and countries in their interventions to support financial

[7] For a detailed analysis, see the Report of the Expert Group on exit strategies for crisis-related participations in banks (available in German only: Federal Ministry of Finance, *Gutachten über Ausstiegsstrategien aus krisenbedingten Beteiligungen an Banken*, January 2010 at:
http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Internationales_Finanzmarkt/Finanzmarktpolitik/2011-02-15-gutachten-gankenbeteiligung.html)).

institutions since 2008 was due to a lack of proper legal procedures that would contain the risk of another Lehman event after an intervention.

47. The issue is what legal regime governs the resolution of difficulties of financial institutions. Thus far, many countries in Europe do not have special regimes for the resolution of banks that differ significantly from insolvency law. Protection of creditors is given high priority. Decisions on freezing activities to protect assets tend to be governed by concerns about creditor protection even if such freezing has significant systemic implications.

48. The most substantial reform has taken place in the United Kingdom, with the Banking Act of 2009, which specifies the protection of the system as the main objective of the special resolution regime for banks established under that law. Even this law, however, leaves open some questions about the viability of resolution for large internationally active institutions. Cross-border issues are currently not dealt with in a satisfactory manner in any jurisdiction.

IV.1 Principles for a workable resolution regime

49. A workable resolution regime for financial institutions should satisfy various procedural and material conditions. Material conditions should be specified so as to minimise the systemic risk that arises from the bank's difficulties and the resolution of these difficulties. This may require a departure from standard principles of insolvency law, imposing requirements and burdens on creditors and owners that are not imposed on creditors and owners of non-financial firms.

50. Imposing such requirements and burdens can be justified by concerns about the protection of the public interest. If there is a fire in a house and the owner does not open the door, we generally hold that concerns about the protection of neighbours provide sufficient grounds for overruling the owner's property rights and having the police and fire brigade step in, even against the owner's will. The same underlying principle should apply to the resolution of difficulties in financial institutions.

51. Procedures should provide for transparency, accountability and flexibility. Flexibility is needed because what needs to be done is usually not clear at the time of intervention. Any notion that a resolution authority can work within a narrow framework of administrative law (or insolvency law) is illusory. An example of flexibility is to be found in the UK law, which gives the Bank of England, as the resolution authority, wide-ranging powers to choose between e.g. a sale of the bank or parts of the bank to a third party, the creation and management of a bridge bank and the initiation of insolvency proceedings.

52. Transparency and accountability are natural associates of flexibility. Transparency relates, in particular, to the procedures under which the authority steps in and the assignment of responsibilities. This includes the relations between the supervisory authority and the resolution authority, the precise point in the procedure where responsibility shifts from the bank's management to the resolution authority, the objectives under which the authority works, the rules under which certain claims are given privileged protection and the availability of funding for such protection.

53. Whether the requirement of transparency should extend to the specification of the trigger for intervention is a matter of judgment that leaves room for disagreement among even

reasonable people. On the one hand, a precisely specified trigger would reduce the scope for excessive forbearance by the authorities. Such a trigger would also reduce the legal uncertainty under which banks operate. On the other hand, any trigger is bound to capture only a part of the problem, so that leaving the authority some room for exercising judgement in the specific instances may be useful. A trigger that has been fully specified ex ante also gives rise to concerns that in the vicinity of the trigger, market participants will take action in advance of the intervention and that this action might worsen the bank's position. Investors might sell off shares, depressing the share price. Lenders might refuse to renew their loans, endangering the bank's funding. Expectations of the bank reaching the trigger may produce run-like behaviour, which would itself make the bank reach the trigger.

54. The actual resolution procedure should be handled by an authority that is independent from political interference. Given the close links that exist between many political bodies and banking institutions, political interference is likely to exhibit a bias in favour of undue forbearance. Paradigmatic examples are given by the way in which the US Congress dealt with S&Ls in the early phase of the crisis in 1980-83, and by the Japanese experience. In the present crisis, resistance of regional and national governments has also played a role in preventing necessary structural adjustment.

55. At the level of objectives, protection of the financial system should be given priority over other objectives such as creditor protection or consumer protection. In particular, the authority should have the right to continue the bank's operations, at least for a while, if this is necessary to protect the system. This may require a departure from the traditional procedures under insolvency law, namely the freezing of assets to protect creditors.

56. However, the protection of the financial system must not be confused with the protection of individual institutions. A well-functioning resolution regime must have procedures in place for the orderly exit of financial institutions from the market. Failures and exits are not only key elements of a market system, but also important for avoiding systemic risk from excess capacity in financial markets. Such systemic risk arises because excess capacities induce margin competition at a level of intensity where participants feel that they have to take high risks merely to survive.

57. If political authorities consider it necessary to give absolute protection to certain classes of creditors, e.g. depositors, this should be spelled out in the legal norms, with proper funding being provided, so that the protection of these creditors does not interfere with the protection of the system.

58. Full protection for all creditors, even all senior unsecured creditors, is undesirable for several reasons. Most importantly, a full protection of creditors eliminates all incentives for these creditors to worry about the debtor bank's creditworthiness. As a disciplining device for banks and their managers, "market discipline" may leave much to be desired, but eliminating it would be a sure recipe for further disaster. If creditors can count on being bailed out, there will be large lending flows, with insufficient assessment of borrower creditworthiness, entailing a risk of large bills to be paid by the taxpayer.

59. In particular, any special protection of subordinated debt, hybrid securities and the like, is undesirable. Such debt is intended to provide some loss absorption capacity. The buyers of such debt should know what they are letting themselves in for, and should have the strongest possible incentives to assess the creditworthiness of, and exercise discipline over, their debtors. It is rather unfortunate that in the crisis, even holders of subordinated and hybrid debt securities were bailed out through government support. By the same reasoning, with the exception of some deposits, senior unsecured debt should likewise not be protected from losses.

60. If the authorities are worried about domino effects, of haircuts and write-offs on one bank's debt causing solvency problems for other banks, it is desirable to solve these problems where they arise, i.e. at the level of the creditor banks affected. It is important not to have blanket guarantees, with zero haircuts, for all unsecured senior debt, let alone all debt. Protection of all creditors would be very expensive. Such protection also runs counter to the principle that there should be transparency with respect to the distribution of losses and costs, and it has important negative effects on incentives for ensuring market discipline for bank debt going forward.

61. Full protection of all senior unsecured bank debt, let alone all bank debt, may actually cost more than the government can bear. The examples of Ireland and Spain suggest, already at the national level, that the full protection of all senior creditors may exceed the government's fiscal capacity. As the financial system is growing further with large cross-border linkages and activities, we must fear that, at some point, the full protection of all creditors may even cost more than EU taxpayers can bear.

IV.2 Funding

62. Any resolution regime must have sufficient funding. Current regimes provide for four sources of funds:

- available assets;
- subsidies from a restructuring fund financed by a levy on the industry;
- haircuts and claw-backs from creditors; and
- subsidies from the national Treasury.

Available assets are usually insufficient to pay the bank's debts; after all, the weakness of the bank's asset position is a major cause of its difficulties. Whereas losses are usually smaller when there is time to wind up the asset positions slowly, there is no reason to believe that they will be small enough to pay all debts. In the US S&Ls crisis, for example, the total deficit after ten years amounted to USD 153 billion, significantly less than the more than USD 600 billion that some had expected in 1990, but still a sizeable amount. [8] In the Swedish crisis, the net costs for the taxpayer ultimately totalled close to 2% of GDP.[9]

63. The Dodd-Frank Act in the United States and the Bank Restructuring Law in Germany provide for industry contributions to a restructuring fund that can be drawn upon for funding.[10] The availability of funds from these institutions is useful as a way of keeping “normal” resolution activity out of political debate. However, we must not be misled by the notion that it is “fair” to ask the industry to pay for itself. The levy that is imposed on banks as their contribution to the restructuring fund is a form of taxation. As such, it gives rise to the same concerns about distortions of incentives as any other form of specific taxation. Distortionary effects are only avoided if the tax internalises the costs that the bank is imposing on the system; in that case, it might be considered a form of insurance premium. However, like any insurance scheme, such a system gives rise to the concern that solvent banks end up footing the bill for insolvent ones, which creates significant moral hazard relating to participants taking excessive risks.

64. It should be clear that such restructuring funds will not be able to underwrite bank losses in a full-blown crisis. In the case of the S&Ls in the 1980s, the industry levy ultimately contributed about USD 29 billion, while the taxpayer provided USD 124 billion. When Lehman Brothers went bankrupt, they had liabilities of more than USD 600 billion. This was far more than the funding levels considered for the restructuring fund in Germany, or for funds in any other country of the EU. However, some of the large banks in the EU are much larger then Lehman Brothers were.

65. Nor can a special industry levy at a time of crisis be relied upon to provide the missing funds. At a time of crisis, the other institutions of the industry will be under severe strain. If they are required to put up the money needed to fund the resolution of a problem bank, this obligation may push them over the brink, so that they become the next clients of the resolution authority. To provide a concrete example, if the German government had not bailed out Hypo Real Estate in the autumn of 2008, the guarantee fund of the German (private) bankers’ association would have had to compensate many of HRE’s creditors. This would have imposed a very severe burden on Commerzbank, which was already in need of government support, and on Deutsche Bank, the capital of which amounted to less than EUR 50 billion at the time.

66. The experience of the FDIC in the United States provides further evidence. For close to a decade, until 2006, the FDIC did not charge any deposit insurance premium at all, because its fund was well-capitalised, given lack of defaults in previous years. As a result of its calibrating of funding to average default rates, the FDIC is short when default rates are unexpectedly

[8] T. Curry and L. Shibut, “The Costs of the Savings and Loan Crisis: Truth and Consequences”, *FDIC Banking Review*, No 13, 2000, pp. 26 – 35.

[9] P. Englund, “The Swedish Banking Crisis: Roots and Consequences”, *Oxford Review of Economic Policy*, No 15, 1999, pp. 80 – 97.

[10] For a critical assessment of the Dodd-Frank Act, see V.V. Acharya et al., “Regulating Wall Street: The Dodd-Frank Act and the new Architecture of Global Finance”, NYU Stern School of Business, 2010, in particular Chapter 8. On the German law, see M.F. Hellwig, “The Problem of Bank Resolution Remains Unsolved: A Critique of the German Bank Restructuring Law” in P.S. Kenadijan (ed.), *Too Big To Fail – Brauchen wir ein Sonderinsolvenzrecht für Banken?* De Gruyter, Berlin/Boston, 2012, pp. 35 – 63.

high. Adapting the premium in a crisis, however, is highly pro-cyclical and exacerbates the macroeconomic impact of the crisis.[11]

67. The problem is not solved by having the government step in with loans, either to the resolution authority or to the restructuring fund, that need to be repaid by the industry. Such loans are stipulated in various laws such as the Dodd-Frank Act and the German Bank Restructuring Law. However, to repay these loans, the authority must impose a levy on the industry. The burden is thereby spread over time, but – unless tricks are played with the interest on the loans – spreading repayment over time does not reduce the burden itself. If the burden of the levy places institutions' solvency in doubt, concerns about their solvency cannot be eliminated by spreading payments over time. The critical remarks about the neglect of solvency issues under the "bad bank" approach in paragraph 40 above apply here as well.

68. Haircuts and claw-backs from creditors are important, but may have domino effects that merely shift the need for funding from the resolution of one institution to that of the next. In paragraph 60, it was highlighted that intervention involving haircuts and claw-backs, in combination with support measures for some of the creditors, rather than wholesale guarantees for all creditors, would be desirable and that the total costs for the taxpayer would then probably be lower. Even so, the total cost of restructuring in a systemic crisis can be very high.

69. Any viable resolution regime must therefore have funding from taxpayers as a backstop. At this point, hardly any legal regime entails procedural provisions for such funding. Dodd-Frank and the German law may be deemed to be introducing it through the back door, i.e. a possible default by the restructuring fund on the loans that it obtains from the Treasury, along the lines of the Federal Savings and Loan Insurance Corporation in the 1980s, but this is hardly a satisfactory state of affairs. While it is desirable to avoid taxpayer funding to the greatest extent possible, such funding may be unavoidable. Being explicit about this fact and having proper procedures in place is preferable to introducing it through the back door by having the taxpayer step in first as a creditor and then as a backstop when the funding from other sources proves to be insufficient.

70. For countries in the euro area, the backstop problem is particularly severe. As shown by the experiences of Ireland and Spain, the needs of a banking system in crisis can exceed the fiscal capacities of even a whole country. Bank resolution then is merely one part of the wider problem of how to resolve the issue of joint sovereign and banking sector debt. The problem is particularly difficult to resolve because, given a supranational and independent central bank, the simplest possible method, that of imposing haircuts by devaluing the currency, is not available. (This method is "simple" only if the implications of the currency devaluation for the population at large and for the country's wealth distribution are neglected, and if there is no foreign currency-denominated debt worth speaking about. The experiences of Argentina and Iceland show that, with significant foreign currency-denominated debt, an internal and external

[11] V.V. Acharya, J. Santos and T. Yorulmazer, "Systemic Risk and Deposit Insurance Premium", *Economic Policy Review*, Federal Reserve Bank of New York, No 16(1), 2010, pp. 89 – 99.

devaluation of the currency, without any default, may not suffice to resolve the joint problem of excessive sovereign and banking sector debt.)

IV.3 Deposit insurance

71. Deposit insurance can be an important tool in dealing with concerns about bank runs or concerns about protecting the bulk of the population from losses in bank insolvencies. If properly handled, deposit insurance also contributes to safeguarding the viability of the payments system.

72. Whereas the preceding discussion of bank resolution and restructuring, with funding at an industry level or from the general taxpayer, focused on the protection of the system, without any singling-out of specific securities, deposit insurance specifies a class of securities that enjoy a wholesale guarantee.

73. In principle, the concerns about adverse incentive effects from wholesale guarantees discussed in Section IV.1 above are also relevant for deposits and deposit insurance, as well as for other forms of credit to banks. There are, however, two major differences. First, some deposits form the basis of the payments system. Depositors are not in a position to assess whether the bank is trustworthy enough or not for each and every transaction. Second, some deposits are held by so many that it would be politically infeasible in a crisis to resist the call for deposit protection. Resistance would be even weaker if systemic implications for the payments system and the overall economy are taken into account. In the crises of the early 1930s, the breakdown of deposits and payments systems played a major role in deepening the macroeconomic depression further.

74. The difficulty of avoiding wholesale guarantees ex post is illustrated by the treatment of US money market funds in the week following the collapse of Lehman Brothers. When the Lehman bankruptcy caused Reserve Primary to "break the buck", a run of depositors on money market funds ensued, which reinforced these institutions' own runs on investment banks and, in addition, caused them to withdraw funding from European banks, so that the US Government felt compelled at the end of the week to extend deposit insurance protection to money market funds. The systemic and political damage of not intervening seemed larger than the benefits of sticking to the principle that money market funds did not enjoy the same protection as banks. In the same vein, many European governments provided state guarantees for deposits that had previously not been covered.

75. Any deposit insurance regime should be transparent and credible. Credibility has two dimensions. One relates to the claims that are covered and the claims that are not covered. The other relates to the viability of the guarantees.

76. A deposit insurance regime that is transparent and credible with respect to the claims that are protected may actually reduce the moral hazard issues raised in Section IV.1, in particular paragraph 58. If protected claims are defined clearly and credibly, the holders of unprotected claims will not try to gamble on being bailed out after all.

77. In order to make distinguishing between protected and unprotected claims viable, the law must provide for the requisite distinctions. For example, the law must provide room for giving legal

precedence to depositors over other unsecured senior creditors. Thus far, this kind of precedence does not seem to be universally enacted in Member States' legislation. However, a distinction between beneficiaries of deposit insurance and other senior unsecured creditors is necessary if we want to avoid wholesale guarantees to all creditors and to rely on haircuts and claw-backs as a basis for funding bank resolution, which itself might be useful as a way of imposing more market discipline.

78. The example of US money market funds in September 2008 illustrates the difficulty of establishing and maintaining the proper distinctions. The underlying cause of the problem was the hybrid nature of money market fund shares: as shares, they had no fixed claims, but the promise of a stable net asset value introduced a debt-like feature, the breaching of which triggered the run. Such hybrids are a means of "having your cake and eating it too", i.e. providing the fund's shareholders with a deposit-like instrument while escaping the regulatory consequences of being a depository institution, including the payment of fees for the deposit insurance. Outlawing such hybrid constructions would make it easier to establish the requisite distinctions ex ante, and to maintain them ex post.

79. Great care must be taken in determining the extent of coverage. This requires a careful calibration of the trade-off discussed in Section IV.1, in particular paragraph 58. In doing so, it may be appropriate to distinguish between different types of deposit according to the relative strengths of the different concerns.

80. The credibility of deposit insurance also requires clear provisions for a taxpayer backstop to funding. For countries in the euro area, this again raises the issues discussed in paragraph 70 above.

81. At an institutional level, there is a question of what relations should be in place between the resolution authority and the institution in charge of deposit insurance. In the US system of Federal Deposit Insurance, the two are combined in one institution, the FDIC. The German Bank Restructuring Act of 2010, by contrast, established a state-run Bank Restructuring Fund that is separate from the deposit insurance schemes that are provided by the different industry associations. It is not necessary for the two functions to be combined in one institution, although there may be synergy effects with respect to the operation of the institution. However, if resolution and restructuring, on the one hand, and deposit insurance, on the other, are kept separate, it is important to have clear rules on how they deal with each other in terms of practical procedures.

IV.4 The open international front

82. It is important, that a better harmonisation and coordination be achieved internationally. Harmonisation and coordination should be improved with respect to both procedural and material law.

83. Without an international harmonisation and coordination of bank resolution, even the best resolution regime will not be able to contain systemic risk from bank failures. For example, the UK Banking Act of 2009 scores fairly highly on most of the points raised here. However, it seems doubtful whether UK authorities would subject a large internationally active bank to their special resolution regime for banks. Apart from the sheer size and complexity of such

banks, the authorities would have to fear that international frictions would destroy any prospect of a smooth resolution. The inadequate coordination of the actions of the authorities responsible for the various entities, and the resulting destruction of corporate processes, played an important and damaging role in the bankruptcy of Lehman Brothers.

84. Who is responsible for what? Under the home country principle, the assignment of responsibilities is clear: for the parent company, and for each legally independent subsidiary, responsibility rests with the authorities of the country in which the company is located. For branches, responsibility rests with the authorities in charge of the parent company. Under a territorial principle, however, creditors in a given country might get the courts of that country to attach assets of branches located in that country. This creates the very type of competition between creditors that insolvency law was intended to prevent. The question as to which principle rules should be eliminated is important for legal certainty, not only within the EU, but also in a broader international context. (Within the EU, a lawyer might even doubt whether the principles of the Regulation on Insolvency Proceedings apply to bank resolution; after all, resolution proceedings are different from insolvency proceedings and are, indeed, intended to forestall the need for insolvency proceedings.)

85. Application of the home country principle is unproblematic and appropriate if parent companies and subsidiaries are operationally independent. However, a separate treatment of parents and subsidiaries can be harmful if the separation destroys corporate practices that may be essential for the functioning of the overall corporation. The integrated cash management of the parent company and subsidiaries would be one example. In the case of Lehman Brothers, there was no legal uncertainty as to who would be in charge of what, but the destruction of corporate practices inwhich parent and subsidiaries acted as an integrated entity contributed significantly to the ensuing turmoil. It would be desirable to avoid such destruction by having an integrated resolution procedure for parent companies and subsidiaries that operate in an integrated fashion. Alternatively, it might be appropriate to impose some form of ring-fencing on subsidiaries, forcing banks that want to operate in an integrated fashion without this encumbrance to rely on cross-border branches rather than subsidiaries. Without such ring-fencing, national authorities might even find that the destruction of integrated operations makes it impossible to keep a subsidiary operational, even though systemic risk concerns would call for such a continuation of operations.

86. For cross-border banks, it is important to have prior agreements on burden sharing, including rules for the treatment of intercompany exposures that do not reflect arm's-length contracting. The same is true for parents and subsidiaries in an integrated resolution procedure. Ex post, it will be difficult to agree on burden sharing, and the dispute about burden sharing may exacerbate the costs of resolution and the systemic fallout.

87. Concerns about legal uncertainty with a multiplicity of jurisdictions apply not just to the assignment of responsibilities and costs. They also apply to the treatment of contracts, in particular derivatives. Many such contracts involve covenants under which an intervention by resolution authorities might drastically increase the claims of the counterparties, quite often with a priority assignment to the claimants. In the absence of overriding legislation, treatment of such contractual clauses is largely in the hands of the courts. With a multiplicity of jurisdictions, this is a major source of legal uncertainty. It would be desirable to have an

international agreement on principles, so that, if the agreement is translated into the requisite legislation, it would be binding on the courts.

88. If authorities intervene to ensure that a bank's difficulties will not excessively damage the financial system, it seems unconscionable that covenants in derivatives contracts stipulate an increase in counterparties' claims when such intervention occurs. After all, the intervention does put public money at stake. Even if funding comes from a restructuring fund, rather than the general taxpayer, it must be borne in mind that bank contributions to the restructuring fund are imposed by the government, i.e. that the levy is a tax. In an international agreement on principles for the treatment of such contracts in bank resolution, covenants that would result in an increase in claims triggered by intervention should be treated as an abusive practice.

V. The European dimension

V.1 European concerns

89. Most of the issues discussed in this report fall within the competence of Member States, in some cases subject to EU Directives or, to the extent that they involve banking regulation and supervision, the provisions of the Regulations creating the European Supervisory Authorities. The European Commission's new Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (COM(2012) 280/3) strengthens the requirements for harmonisation and creates some competences of EU authorities, but otherwise retains the current format of national competence under European law.

90. There are, however, substantive reasons why the current format is not sufficient. First, cross-border bank relations are important, and likely to increase in importance in the future. This is not just a matter of genuine cross-border institutions like Nordea or Fortis or Dexia used to be. There must also be a concern about banks where the parent is clearly located in one country, but there are subsidiaries in other countries whose operations are integrated with those of the parent. With full financial integration, one might expect that, eventually, some large institutions will have EU-wide operations on this basis. As mentioned above (paragraph 85), in these cases, a strict application of the home country principle, separately for parents and subsidiaries, can be highly problematic. At least within the EU, it would be desirable to have a procedure for the integrated resolution of such parents and subsidiaries by a single authority. Improved procedures for cooperation between authorities would an improvement over the current situation. However, that would not be sufficient to maintain integrated operations that may be needed to avoid destroying the corporate entity, with damaging repercussions for the financial system as a whole.

91. Whereas we do not as yet have the kind of full financial integration under which capital exports from France or Germany, for instance, to Ireland or Spain would be handled as intrabank "lending", rather than as cross-border interbank lending, there are, indeed, such capital flows on a large scale through interbank lending. Such capital flows are fully in line with the intent of the Treaty on the Functioning of the European Union (hereinafter referred to as the "Treaty"). However, the large exposures of banks of one country as a result of lending to banks in

another country give rise to significant systemic concerns. In addition, there may be cross-border effects from information contagion. In this context, the way in which national authorities deal both with lending banks and with borrowing banks must be a matter of broad EU interest.

92. Cross-border externalities also arise from the behaviour of final investors. Depositors may move their funds from one Member State to another, depending on how they see the stability of banks, deposit insurance and fiscal backstops. In the discussion about the prospects and dangers of the potential exit of a country from Economic and Monetary Union, fears have been voiced in a country about a bank run as depositors try to rescue their euro ahead of a change of currency and potential devaluation. Even without such fears, the willingness of investors to keep funds with the banks of one country depends to some extent on the confidence they have in the different Member States' legal and institutional arrangements.

93. Cross-border externalities and EU-wide concerns cannot be dealt with effectively by legislation mandating a harmonisation of regulatory and supervisory practices. Consider the problem of forbearance: suppose that banks in one Member State exercise excessive forbearance in dealing with their borrowers, and that this is tolerated by their supervisors, all in the name of not laying open the true solvency position of the banks. If the banks in question have large-scale funding from institutions in other Member States, the lack of transparency about the situation contributes to an exacerbation of the latter institutions' exposures. To eliminate this kind of behaviour, European legislation would have to define what is, and what is not, acceptable as forbearance by supervisors towards banks in such a context. As discussed in Sections II and III of this report, however, decisions about forbearance, from banks towards their borrowers and from supervisors towards their banks, are often a matter of judgement. Exercising judgement requires some flexibility and discretion, for which the legislation must leave room.

94. It is important to ensure that decisions involving the exercise of judgement take sufficient account of cross-border externalities and EU-wide systemic concerns. Therefore, the problem must be addressed at the level of the governance of the responsible institutions, rather than in the legislation defining the institutions' mandates. For proper governance, some participation of other affected parties, or of EU institutions, in the actual decision-making is called for.

95. A second reason why current institutional arrangements are insufficient involves the entanglement of the issues discussed here with fiscal policy. The Republic of Ireland had to seek support from the EFSF because the support it had provided to Irish banks (and, indirectly, to banks from other European countries that had lent to Irish banks) overtaxed the capacity of the Irish taxpayer, at least temporarily. This experience suggests that the state of the banking system should play a role in assessments of fiscal policy risks under the Stability and Growth Pact, or under the new Fiscal Pact. It also suggests that crisis interventions involving a risk to the sustainability of fiscal policy should be coordinated with European authorities so as to ensure the consistency of policies relating to the financial sector with European rules for fiscal policy.

96. At the same time, it is important to avoid a situation where a Member State has supervisory authorities engaging in forbearance towards its banks because the fiscal implications of their stepping in, taking control and cleaning up are simply too daunting. The Japanese experience

has shown that such a strategy can end up being even more expensive for the government than had initially been feared. In the EU context, there must also be serious concerns about the cross-border effects of such a strategy on banks in other Member States and, ultimately, on taxpayers throughout the EU.

97. These concerns are particularly important in the euro area. Here, the link between banks and sovereigns has played an important role in keeping systemic risk at high levels, with risk propagation from banks to sovereigns, as well as from sovereigns to banks. Banking difficulties on so large a scale that the sovereign has difficulties acting as a backstop are one side of this link, while the other is to be found in banks holding their own sovereign's debt and encountering difficulties when the sovereign's fiscal position is unsustainable. Excessive forbearance on the part of national supervisors may tighten the link and make the crisis even more difficult to tackle. The importance of such bias at the national level has been clearly revealed by the experience gained with the European Banking Authority's stress tests, especially in 2010.

98. Finally, because banks are an important part of the monetary policy transmission mechanism, the issues considered in this report must also be of concern to central banks, in particular the European Central Bank. Such concerns arise with respect to the functioning of the existing monetary transmission mechanisms and with respect to both the solvency of banks with which the central banks do business and the quality of the collateral that these institutions provide for central bank lending.

V.2 Moving forward

99. Given the European dimension of the problems, as laid out in the preceding paragraphs, the ASC considers it important to develop a new legal and institutional framework for approaching the problems in a European context, with an appropriate division of responsibilities between EU institutions and Member States' respective national institutions.

100. The development of such a framework should take account of, in particular, the following concerns:

- An integrated resolution procedure is required for systemically important financial institutions that operate in several Member States. Ideally, such a procedure would apply to the worldwide operations of these institutions. At the very least, an EU-wide approach would take account of systemic effects inside the Union.

- Any resolution authority requires proper funding. In "normal" times, such funding could come from a levy on the industry. In a crisis, some backstop from the general taxpayer is needed. To avoid the entanglement of bank resolution with national fiscal problems, such a backstop ought to be arranged at the EU level.

- Any involvement of European taxpayers as a backstop for bank resolution requires a European competence or co-competence in supervision, in particular with a view to limiting forbearance and avoiding delays in triggering a resolution. The distribution of supervisory competences between national and EU authorities requires a judicious calibration of different concerns, taking account of the information advantages of national supervisors in dealing with their banks. However, the EU interest in avoiding systemic spillovers from national forbearance and delays in resolving banking problems must find its proper place in the governance of supervision and intervention.

- The harmonisation of legal principles and procedures for dealing with banks in difficulties, along the lines set out in this report, is absolutely necessary.

101. On the basis of these considerations, the ASC recommends that the following institutional reforms be considered by the responsible authorities:

- The establishment of a European resolution authority that would eliminate the most important concerns about systemic effects of bank resolution. When intervention by the authority is called for, it should have a mandate to take control of the bank, with wide discretion in respect of what strategy to pursue, with the ultimate aim of recapitalising and eventually reprivatising the viable parts of the business, possibly including the merging of business lines of different banks. In its actual handling of such interventions, the authority should be free from political interference.

- Resolution should adhere to the principles set out in this report. In particular, owners and holders of hybrid and subordinated debt securities should be fully liable, as should senior unsecured debt; any exceptions for depositors, for instance, should be clear and unambiguous and should be supported by special funding.

- The European resolution authority should be able to fund itself through a levy imposed on the industry. The rules governing this levy should take due account of macro-prudential concerns, e.g. those about raising the levy in a crisis.

- At the level of banking supervision, a European supervisor should be given the competence, or co-competence, to supervise banking institutions, assess their practices and solvency positions, and to call for interventions by the deposit insurance and resolution authority.

- The European competence in bank regulation, supervision and resolution should be complemented by a European competence in deposit insurance. In the course of transition from the current regime of national systems with different levels of funding, it may be appropriate to separate deposit insurance and resolution authorities in a regime in which the resolution authority calls upon competent deposit insurance institutions as the need arises without itself managing deposit insurance.

- The European resolution authority should also have access to funding from the general taxpayer. Under prevailing fiscal arrangements within the Eurozone, such funding might suitably be provided by the EFSF/ESM. If funding from the general taxpayer is needed, some form of participation on the part of fiscal authorities in decision-making and an effective form of conditionality will be called for.

- Governance and procedural rules must ensure that that taxpayer money provides a backstop, rather than a “frontstop.” In particular, losses must first be clearly determined, and shareholders and creditors must be called upon to absorb losses, only then might funds from an industry levy or the general taxpayer be used.

102. The proposal above should be seen as a package. Moreover, governance and rules for the proposed institutions should take account of the principles laid out in this report. In particular, the Europeanisation of backstops for resolution, restructuring and deposit insurance requires the establishment of credible and coordinated supervisory intervention, the credible recognition of losses and the establishment of rules for allocating losses across banks and countries. If these principles are not followed, the Europeanisation of backstops may merely exacerbate existing incentive problems in banking and bank supervision. In that case, the stipulated backstops might well be non-viable. Risks to viability might be especially high in the context of a country's leaving the Economic and Monetary Union.

103. The ASC has not considered in any detail the question of whether its proposal should be implemented at the level of the EU as a whole or at the level of the euro area. Implementation at the EU level would agree with the fact that the supranational legal norms for banking, banking regulation and banking supervision apply to the EU as a whole, which also has the jurisdictional infrastructure for settling disputes under these norms.[12] The competences of the existing European Supervisory Authorities, and of the ESRB of course, also apply to the EU as a whole.

104. Implementation at the level of the euro area would conform to the fact that, as discussed, the need for a fiscal backstop causes special problems in this context and that, at the euro area level, the EFSF and ESM are already in place and might provide the requisite fiscal infrastructure for that backstop. Moreover, the ECB is providing a liquidity backstop for the banking system. At this level, however, there is no jurisdictional infrastructure in place for settling disputes.

105. The proposal should be applied, at the very least, to large banks, especially those with significant cross-border borrowing or lending operations. One may have misgiving about applying it to the many banks that operate only regionally or locally. In shaping the legal framework for such small banks, however, it must be borne in mind that "too many to fail" can be just as dangerous as "too big to fail". Indeed the S&L crisis in the United States was a case of "too many to fail". Sometimes, many small banks can also have significant systemic cross-border implications. These considerations suggest that the proposal should, in principle, apply to all banks.

106. To the extent that supervision, resolution and deposit insurance are kept at the national level, EU legislation should still provide for the requisite coordination of authorities. It should also mandate the installation of sustainable funding, including fiscal backstops.

107. In this case, legislation should also provide for the integration of risks stemming from Member States' banks into the assessment of the fiscal stance and fiscal sustainability under EU legal norms on Member States' fiscal policies.

[12] As shown by the dispute about the treatment of euro-denominated deposits at branches of Icelandic banks in the United Kingdom and the Netherlands, this is not just a theoretical concern, but one that extends even beyond the EU and applies to the EEA.

VI. Postscript: the mandate of the Summit of 28 June

108. The European Summit of 28 June addressed some of the issues raised in this report. According to the Euro Area Statement of the Summit, “The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly. We ask the Council to consider these Proposals as a matter of urgency by the end of 2012. When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly. This would rely on appropriate conditionality, including compliance with state aid rules, which should be institution-specific, sector-specific or economy-wide, and would be formalised in a Memorandum of Understanding. The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme. Similar cases will be treated equally.”

109. The ASC welcomes this statement as an important step in the right direction, but notes at the same time that important issues have not been addressed. The ASC also notes that much depends on how the reforms for which the Summit calls are implemented.

110. The ASC is concerned that the Euro Area Statement of the Summit makes no mention of bank resolution and restructuring. As argued in this report, credible supervision must be backed by workable institutions and procedures for resolution and restructuring.

111. The ASC is also concerned that the Euro Area Statement refers to the recapitalisation of Spanish banks without referring to the need to first determine the actual losses of these banks. If losses are not determined and balance sheets are not cleaned up, EFSF or ESM funds may well be insufficient for recapitalisation. Adding capital without knowing what the assets are actually worth and how much capital is really needed entails a serious risk that the funds may simply be lost as the necessary resolution of the banks is delayed further.

112. Article 127(6) of the Treaty refers to “specific tasks … concerning policies relating to the prudential supervision of credit institutions and other financial institutions”, which may be conferred to the European Central Bank. The vagueness of this formulation should not stand in the way of a “single supervisory mechanism” that is truly effective, along the lines set out in this report. Effectiveness would require more than merely coordination at the European level. At some point, the question must be addressed whether the European institutions can close a bank or whether they can order the national supervisor to close a bank. Unless the power to close a bank is effectively transferred from national to supranational institutions, the “single supervisory mechanism in the euro area” will not be effective. In that case, the use of EFSF and ESM money for the recapitalization of banks could become very expensive without actually solving the problems.

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