“Multiple safety net regulators and agency problems in the EU: Is Prompt Corrective Action partly the solution?”

David G. Mayes, Maria J. Nieto and Larry D. Wall

Bank of Finland
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Outline

- Background and motivation
- Preconditions for a successful implementation of PCA
  - Key conceptual aspects
  - Institutional preconditions
- Incremental issues associated with cross-border implementation of PCA in the EU
  - Adequately capitalized banks
  - Disciplining undercapitalized but viable banks
  - Bank resolution
- Conclusions

Background and motivation

- EU have multiple supervisors for cross-border groups but it also has multiple principals
  - – Multiple agents/principals for groups operating banking subsidiaries/branches across borders
  - – Safety net regulators should be expected to follow the interests of their home country
- US has multiple supervisors acting as agents but a single principal in the form of the US Congress

Background and motivation

	Prudential Supervisor	LOLR	Deposit Insurance Regulators	Reorganization and Winding-Up Authority
Banks locally incorporated				
Parent banks authorized in home country	Home country authorizing parent bank (consolidated supervision - solvency)	Home country	Home country	Home country
Subsidiaries of parent banks headquartered and authorized in another EU country	Home country authorizing parent bank (consolidated supervision - solvency) Host country authorizing the subsidiary ("solo" basis)	Host* country	Host country	Host country
Branches				
Branches of banks headquartered and authorized in other EU country	Home country of head office (consolidated supervision - solvency) Host country (liquidity)	Host* country	Home country (possibility of supplementing the guarantee by host country)	Home country

Source: Gillian G. Garcia and Maria J. Nieto (2007)

Background and motivation

- The EU safety net framework across borders not only does not have minimization of taxpayers losses as a goal but has embedded in it incentive conflicts that are likely to substantially increase taxpayer losses in case of a banking crisis
- Academics´ debate mainly focused on "centralization"
  - Single LOLR? (*Pratti and Schinasi, 1999; Khan and Santos, 2002*)
  - Single European System of PS? (*Holthausen and Rønde, 2005*)
  - Single DI? (*Santomero and Trester, 1997; Eisenbeis and Kaufman, 2007*)

Background and motivation

- Policy makers approach

Approach Safety Net	Centralized	<u>Explicit</u> cross country coordination arrangements	Decentralized
Prudential Regulation	-	o Lamfalussy architecture o More homogeneous secondary legislation	o National legislation subject to the restriction of minimum harmonization
Prudential Supervision	-	o Convergence of supervisory practices (CEBS) o Coordination via MoU (PS+LOLR)	o National on site and off site supervision
LOLR (Emergency Liquidity)	-	o Explicit coordination via MoU (PS+LOLR) o ECB Governing Council	o Implicitly decentralized NCBs
Deposit Insurance	-		o National DIs o Towards more harmonization (implicit coordination)
Reorganization and Winding-Up	-		o National Resolution Authorities o Resolution procedures are partially harmonized

Background and motivation

- Our proposals are compatible with the existing decentralized institutional framework of the EU safety net
- We believe the general approach to disciplining large cross-border banking groups advocated in our paper provides the best opportunity for an effective system in the absence of EU-level institutions
- We have intentionally avoided discussing the issue of an EU level supervisor to focus on what is needed to give the existing system its best chance of success

Background and motivation

- Our paper advocates for PS´ PCA policy to deal with cross border problem banks and the related agency problems in the EU
  - Explores the institutional setting needed in the EU if PCA is to be effective in resolving cross-border agency problems that arise in supervising and resolving cross border banking groups
    - The goal of a single financial market precludes the EU from adopting a New Zealand style solution to cross-border banking
    - But EU directives allow the EU countries to adopt multilateral cross-border arrangements that would otherwise be very difficult to adopt

Background and motivation

- Background of PCA:
  - Structured Early Intervention and Resolution (SEIR) proposed by Benston and Kaufman (1988) with a version adopted by the U.S. under the title “Prompt Corrective Action” (PCA) under FDICIA (1991)
  - Proposals for Europe: Benink and Benston (2005); and the European Shadow Financial Regulatory Committee (1998, 2005, 2006)

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Preconditions for a successful implementation of PCA

- Before PCA was adopted in the US the PS´ focus was on preventing failure rather than limiting losses due to failure
- PCA made only small changes in institutional structure but made big changes in conceptual priorities

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Key conceptual aspects

Nieto and Wall, 2006

- Prudential supervisors´ goal of minimizing tax payers´ losses
- Limiting prudential supervisors´ discretion
- Banks´ closure at positive regulatory capital

Key conceptual aspects: Prudential supervisors´ goal of minimizing tax payers´ losses

- PCA rational is to reduce
  - Losses to taxpayers
  - Resource misallocation by reducing the moral hazard incentives created by mispriced deposit insurance
- In the **EU**: The rational is in line with Directive 94/19/EC on deposit insurance schemes *"…the cost of financing such scheme must be borne, in principle, by credit institutions themselves …"* (*Preamble*) and the non-bail out clause and restrictions on monetary financing of the EC Treaty (arts. 101 and 103) are fully compatible.

Conceptual aspects of PCA: Limiting prudential supervisors´ discretion

- PCA reduces supervisory discretion to exercise forbearance by establishing a series of capital adequacy tranches with a set of mandatory and discretionary supervisory actions for each of the undercapitalized tranches
- Underlying economic rational is that, in average, forbearance does not reduce the risk of insolvency, it makes more difficult the bank's restructuring and return to the private sector

Conceptual aspects of PCA: Banks´ closure at positive regulatory capital

- Rational behind timely resolution:
  - Reduces banks´ incentives to take excess risk
  - Limits DI losses
  - PCA provides the shareholders with an opportunity to recapitalize the bank and to test their own assessment about the financial viability of the bank before it is forced into resolution.

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Institutional preconditions for PCA successful implementation

Nieto and Wall, 2006

- Supervisory independence and accountability
- Adequate supervisory measures
- Adequate resolution procedures
- Accurate and timely financial information

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Incremental issues associated with cross-border implementation of PCA: Integrated management of cross border groups

- Out of top 30 banks are ” European” : >25% activity outside home country and within the EU (*Schoenmaker and Oosterloo, 2005*)
  - **Deutsche Bank**
  - **BNP Paribas**
  - **Santander Central Hispano**
  - **HypoVereinsbank**
  - **ING Bank**
  - **ABN AMRO**
  - **Fortis Group**
  - **Group Caisse d´Espargne**
  - **Nordea Group**
  - **Westdeutsche Landesbank**
  - **KBC Group**

Incremental issues associated with cross-border implementation of PCA: Integrated management of cross border groups

- Cross-border groups increasingly operate as integrated entities:
  - Risk management and liquidity management, data processing, and loan evaluation each centralized in one part of the group
  - Not all services are necessarily centralized in the same country
  - No neat structure of a parent and free-standing locally incorporated subsidiaries but a complex interweaving of branches and subsidiaries that cannot survive on their own
  - Example: Nordea (Table 2 in *Mayes, Nieto and Wall,2007*)
- Bank supervision must also be structured for efficient cross-border supervision

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Incremental issues associated with cross-border implementation of PCA: Adequately capitalized banks

- Information sharing is critical for cross-border groups
  - US gathers and makes publicly available common quarterly financial statements for all banks and top level BHCs
  - EU should do the same (*Mayes, 2006 and Vesala, 2005)*
    - *Sharing the same info would limit PS´ self interest*
  - Proposal is limited by the professional secrecy imposed by Art. 44 of the capital requirements directive
- Market prices could help PCA
  - Directly as triggers for PCA, at least, for critically undercapitalized organizations
  - Indirectly as triggers for increased supervisory scrutiny including possible consultations with the home supervisor or a meeting of the bank’s college of supervisors

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Incremental issues associated with cross-border implementation of PCA: Disciplining undercapitalized but viable banks

- US PCA has large elements of supervisory discretion ("discretionary provisions") including <u>whether:</u>
  - To approve capital restoration plan
  - To replace certain managers and/or directors
  - To limit rates on new deposits
  - To limit growth rates
  - To divest selected nonbank activities

Incremental issues associated with cross-border implementation of PCA: Disciplining undercapitalized but viable banks

- In the EU, agency conflicts can result in supervisors of cross-border banks taking action that helps own country but hurts others
  - Home country forbearance that imposes losses on host
  - Home country supervisor demanding corrective measures where most of the costs are borne in the host country
  - Host country disciplinary measures, which impair the subsidiary’s ability to provide vital services to the group (i.e. offers brokerage services in derivative markets; act as a custodian in security settlements)

Incremental issues associated with cross-border implementation of PCA: Disciplining undercapitalized but viable banks

- The capital requirements directive (art. 131) provides for some coordination of banks supervision between home and host and allows for the delegation of some supervisory responsibilities to the home country prudential supervisor (subsidiaries)
  - This does not resolve the agency conflict
  - Indeed, delegation may worsen the principal-agent conflict between the parent’s supervisor and the subsidiary’s country’s taxpayers and voters as principal.

Incremental issues associated with cross-border implementation of PCA: Disciplining undercapitalized but viable banks

- Alternative is to form a college of supervisors to decide on discretionary actions (compatible with article 129 of the capital requirements directive)
  - College would make the **discretionary** decisions under PCA that would be binding on all supervisors
  - College must be formed no later than bank violating the minimum capital standard (previous contacts in the context of CEBS)
  - Home supervisor likely to take lead in any discussions with the bank (unless problem focuses on a particular subsidiary)
- The college provides a mechanism for all affected Member States to have a voice in the corrective measures´ decision taken under PCA

Incremental issues associated with cross-border implementation of PCA: Disciplining undercapitalized but viable banks

- The college does not completely solve the agency problem caused by the mismatch between supervisory powers and supervisory accountability to voters … but considerably improves it if there is also symmetry of information
- The college seemingly implies loss of sovereignty but loss actually occurred with formation of large cross-border groups

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Incremental issues associated with cross-border implementation of PCA: Bank resolution

- No framework of commonly accepted standards of bank resolution practice including a common definition of bank insolvency and a fully-fledged single legal framework or a common decision-making structure
- Bank resolution procedures largely depend on national laws. These national laws often fail to meet many of the requirements for a credible, efficient resolution system

Incremental issues associated with cross-border implementation of PCA: Bank resolution

- As a result, the current system in most EU countries relies heavily on (government) recapitalization of large groups
  - Difficulties in agreeing on burden sharing imply very late, very high cost resolution more likely than timely, low cost resolution
  - Crisis simulation exercise and *Schoenmaker and Goodhart (2006)* proposal
  - EU Policy makers favor least cost resolution and market solutions. No agreement on burden sharing.

Incremental issues associated with cross-border implementation of PCA: Bank resolution

- PCA *cum* closure rule at a positive level of regulatory capital would reduce or eliminate “burden sharing” problem by requiring bank closure while reported capital is still positive
- Losses will be by definition smaller than in the absence of PCA to the extent that deposits would be backed by assets of at least the same market value, except in the case of rapid decline in asset value, massive fraud or inadequate monitoring by supervisors.

Incremental issues associated with cross-border implementation of PCA: Bank resolution

- Mechanics of coordination of banks´ resolution process
  - Formation of a resolution college to decide the status of a bank should occur automatically well before resolution becomes likely (markets will look for signals of supervisory intervention)
  - Resolution college includes college of supervisors, national central banks, Treasuries and deposit insurers, ECB, EU Commission
  - Likely to involve their being operated as some equivalent of a bridge bank (or bridge banking group) pending the return of its assets to the private sector.

Incremental issues associated with cross-border implementation of PCA: Bank resolution

- Mechanics of coordination of banks´ resolution process (cont.)
  - Bridge banking group would be roughly equivalent to a governmental recapitalization except that the shareholders in the failed group would lose their claim on the group and losses may be imposed on some classes of creditors (especially the subordinated creditors)
  - Home country supervisor/authorities take lead in running the bridge bank
  - Resolution college acts as board of directors in overseeing operations
  - Resolution college approves privatization plan

Incremental issues associated with cross-border implementation of PCA: Bank resolution

- Resolution college will face conflicts in priorities for running the bank and its privatization
  - For example, is maximizing sales proceeds the sole goal of privatization process?

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- Adoption of PCA *cum* positive level of capital closure rule would substantially reduce the likelihood of a failing bank and the problems of resolving one should that be necessary

- But an effective PCA for any bank requires acceptance of its conceptual basis and an adequate institutional framework (*Nieto and Wall, 2006*):
  - Supervisors be given the same authority to take corrective measures (mandatory and discretionary)
  - Special bankruptcy provisions for banks in the EU (e.g. same closure rule) and the possibility of creating bridge banks

Conclusions

- An effective PCA for cross-border groups in the EU would also require additional coordination measures:
  - Enhanced availability of information on individual banks (supervisors and markets)
  - Supervisors´ decision process on a collegial form
  - Resolution college
- These proposals are compatible with the existing decentralized institutional framework of the EU safety net.