“European Banking Union: Recovery and Resolution Tools” by Charles Randell

Comments by
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General

- I share the skepticism about the likelihood that we will see a harmonized and effective EU or EMU framework for recovery and resolution in the near future.
- The general acceptance and implementation of such a framework is an important aspect of a European Banking Union wherein the supervision of a large part of the banking system is expected to become the responsibility of the ECB.

Effective resolution of distressed banks

- A number of issues must be addressed within a resolution framework*:
  - **The contagion issue**
  - The valuation issue
  - **The predictability issue**
  - The information issue
  - The coverage issue
  - The funding issue
  - **The cross-border issue**

* Based on Wihlborg, C. *Developing Distress Resolution Procedures for Financial Institutions*, SUERF Studies 2012/5

The Contagion issue

- The closure of a bank and allocation of losses to creditors should be accomplished with a minimum of contagion to other parts of the financial system.
  - Bridge bank
  - Prompt hair-cuts based on preliminary conservative valuation of assets
  - Sale of units and assets over longer period while critical operations are maintained.
- Can this be accomplished for large and complex financial institution with sufficient speed and acceptable contagion?
- Requires information and valuation; Living Will and authority (e.g. FDIC) with capability to address issues promptly.

The Predictability issue

- Includes principles for allocation of losses, as well as **credibility** that procedures will be implemented.
- Requires
  - mandatory rules for resolution rather than resplution as one alternative among many.
  - Few and well-defined principles for making exceptions.
  - Consequences if rules are not followed.
- US FDICIA mandatory procedures were not applied on large banks during the crisis (systemic risk exception)
- Current EU proposal and UK regime offers resolution as one alternative among many for dealing with distressed bank
- Can credibility be achieved for large and complex banks?

The Cross-border issue

- Harmonization of national procedures may be less important than non-discrimination between domestic and foreign creditors.
- Complexity of large cross-border banks with conflicting interests of host and home countries.
- Jurisdictional confusion and conflicting interests exacerbated by banks operating functionally integrated banks in legally separated entities (subsidiaries).
- Remedy?: New Zealand rule that subsidiary of foreign bank must be operationally separable within 24 hours.

The “too big and too complex to fail”(TBCTF) dilemma

- The main threat to implementation of effective and credible resolution procedures is the existence of TBCTF banks.
- Unless resolution procedures are credible with respect to ALL banks, the incentives for banks to remain and become TBCTF are strong (implicit subsidization).

Current proposals to deal with SIFIs

- Identification of global and national SIFIs considered TBCTF can only strengthen implicit guarantees of their creditors (especially if there is a SIFI capital requirement)
- SIFI capital requirement is a crude instrument and may encourage banks to become “near but de facto SIFIs.”
- Recovery and resolution plans (Living Wills) may discourage TBCTF but Living Wills without credible closure rules may lack teeth.

What can be done about TBCTF?

- With implementation of credible resolution procedures for ALL banks, size and complexity would be determined primarily by economies of scale and scope.
- Most likely at a lower levels than now. Markets tend to penalize complexity and non-transparency.
- **If market remedy to TBCTF cannot be achieved through effective and credible law for distress resolution, the alternative is forced division and separation.**

Volcker, Vicker and Liikanen

- Objective: Avoid having the funding of risk taking activities in securities markets subsidized by deposit insurance.
- Separate proprietary trading (Volcker) or investment banking (Vicker) from traditional commercial banking funded by deposits.
- Can fire-walls be made effective within bank-holding companies, in particular?
- Implicit protection and subsidization is not limited to traditional commercial banking since systemic risk originates as much in securities markets as in traditional banking.
- Thus, threat of no-bail outs of non-commercial banking may not be credible.