EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

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DEALING WITH PROBLEM BANKS IN EUROPE

The framework of European Monetary Union has clearly addressed the importance of monetary stability in Europe, but there have been no corresponding initiatives towards the establishment of a common approach to the stability of financial institutions and markets. This is a source of concern at a time when EMU is releasing the full potential of the liberalization of financial services, contributing to the creation of a truly *European* financial market, as already witnessed by the growth of bank mergers and cross-border activities.

In its first public statement the European Shadow Financial Regulatory Committee (ESFRC) calls for a series of procedures for dealing with problem banks, based on the principle that regulation and supervision should enhance – but not replace – the discipline imposed by the market mechanism. The following procedures are suggested:

(1) Before insolvency occurs, pre-specified trigger capital ratios should initiate a progressive series of restrictions on the problem bank's activities. This general approach is known as 'Structured Early Intervention and Restructuring', or SEIR.

(2) In the event of insolvency, governments should not protect shareholders and creditors, beyond commitments pre-specified in explicit deposit insurance schemes.

(3) Banks must not be prevented from failing.

(4) National regulators and supervisors should be more independent from political influences in order to strengthen the integrity of the SEIR and liquidation processes.

We advocate a formalized gradualist response (SEIR) for several reasons. First, there is no single point in time at which a bank becomes distressed. In practice, problems build up cumulatively, and the regulatory responses must therefore follow in tandem. Secondly, it removes the potential for regulators to apply forbearance and to allow problems to become magnified. Finally, it alleviates the danger of responses which are inconsistent with competitive neutrality.

The ESFRC is also concerned that current European policy, at both the national and EU level, places insufficient emphasis on the importance of *liquidating* failed banks. If governments engineer *ad hoc* recapitalization schemes and protect shareholders and lenders from losses, dangerous incentives are provided for excessive risk-taking. Volume competition tends progressively to substitute for quality of assets competition, as in Japan, and the bail out of one bank prevents other banks from strengthening their financial position in times of depressed economic conditions. Overcapacity is also thereby encouraged, and the seeds of future crises are sown.

ESPONSES TO THE FEAR OF CONTAGION IN BANKING

The expansion of explicit deposit insurance schemes, as well as implicit guarantees with associated bail-outs, can be explained in part by governments' fears that banks may be 'too big to fail', or that a failure may be spread contagiously through interbank settlement systems (as in so-called Herstatt risk). There are also fears that the failure of one bank could lead to a general loss of confidence in the banking system as a whole, and to damaging bank runs which could force even solvent banks into liquidity crises. National governments also provide implicit bank guarantees as a means of reducing the cost of capital for favoured national institutions. The blanket guarantee of all Swedish banks' liabilities during the crisis of the early 1990s can be seen in this light. The guarantee was extended to all banks, whether in distress or not.

Many economists have argued that the fear of contagion is exaggerated, but few governments are willing to test this belief. One response has been the expansion of deposit insurance to almost complete coverage, as in the United States. Partial deposit insurance, however, as mandated by a 1994 EU Directive, only provides a level of protection for small depositors, and does not substantially reduce the possibility of contagion. Therefore governments' incentives to bail out depositors, and even shareholders, remain. As a result, the moral hazard problem remains.

RESPONSES TO CRISES

The recurrence of bank failures suggests that a combination of preventive (ex ante) and remedial (ex post) measures is needed. A regulatory authority facing an actual or perceived threat to the banking system is compelled to respond. It may bail out troubled institutions partially or fully – even nationalizing the banking sector, as in Norway in the late 1980s. Other solutions include (a) debt-restructuring, (b) a mix of government and more or less voluntary private assistance, and (c) the creation of specialized agencies to take over bad loans, such as the Resolution Trust Corporation in the United States.

Even though these solutions may assist in restoring a functioning market, they tend to be assembled by regulators in time of crises. They therefore fail to provide the sector

with clear and predictable consequences in cases of mismanagement or excessive risk-taking.

We propose that clear pre-specified insolvency procedures for banks should be designed with the purpose of reducing the probability of banks facing financial distress and, where distress occurs, preventing the insolvency from generating liquidity crises which can undermine solvent and well functioning institutions. If these objectives can be achieved, then non-competitive banks could 'exit' the market without placing the financial system at risk. Deposit insurance coverage could be partial, with the sole objective of protecting small depositors. 'No bail-out' guarantees by regulators would thereby enjoy credibility, and artificial risk-taking incentives would be reduced.

OUR PROPOSAL

The ESFRC recommends the following procedures for dealing with problem banks:

(1) SEIR regimes should be established, setting pre-specified trigger capital ratios. Regulatory action at each trigger point must be predictable, and the prospect of negotiated *ad hoc* arrangements precluded. At the first trigger point, the bank should be required to submit a realistic formal assessment of its financial position, as well as detailed descriptions of accounting systems, fraud prevention procedures and conflict of interest guidelines to the regulatory authority. At the second trigger point, specific restrictions would be placed on the banks' activities and dividend distributions. At the third trigger point, the bank might be forced to sell off assets and businesses.

(2) Once a bank's capital is depleted, it must be closed and liquidation promptly initiated. Given uncertainty about asset valuation at the final liquidation trigger point, it may be desirable to set the trigger point at a positive capital to asset ratio. Existing bankruptcy laws in some countries may make this difficult to apply.

(3) Priority rules among creditors must be pre-specified. Priority should be given to claims with high liquidity value: demand deposits should have priority over time deposits, for example, and a high priority should attach to overnight inter-bank claims.

(4) Valuation procedures should be made transparent, and to the greatest extent possible based on market valuation principles (marking to market).

(5) Since liquidation takes time, claims on the bank with high liquidity value can remain liquid only if other banks (or central banks) are organized to provide temporarily the liquidity held up during the liquidation process. This function requires careful consideration of the extent of the coverage and the range of banks or central banks involved.

(6) The central bank should be prepared to provide exceptional liquidity only under conditions where a bank failure creates systemic liquidity problems which threaten the solvency of healthy banks. This mechanism must be carefully implemented to ensure that the lender of last resort function is not extended to banks which are themselves insolvent, and not merely experiencing a short-term liquidity problem. Shareholders must never be bailed out at the expense of taxpayers.

(7) Although the public accountability of financial regulators is clearly important, the authorities must be independent of *ad hoc* political pressures. This is central to the credibility of the intervention process. The political independence of the regulatory authority should therefore be strengthened according to the same principles as those underlying the foundation of the European Central Bank.

With these procedures in place, the likelihood of the regulator actually needing to liquidate banks should be reduced and, where liquidation must occur, depositors would stand to lose only where bank's assets were seriously over-valued at the time that the trigger points were reached. Thus, depositors and participants in the payment system should be sufficiently secure in their claims that bank runs become exceptionally unlikely.