European Shadow Financial Regulatory Committee

Basel II and the Scope for Prompt Corrective Action in Europe

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The implementation of the Basel II Capital Accord in Europe in 2007 and 2008 through the Capital Requirements Directive (CRD) increases the need for additional safeguards for the banking system. Quantitative Impact Studies conducted by the Basel Committee show that many banks using the Internal Rating based approach to determine capital requirements under Basel II will be able to lower their capital requirements considerably. Reductions in required capital by this magnitude could increase the vulnerability of banks to major shocks and increase the likelihood of banking crises.

Prompt Corrective Action (PCA) procedures offer additional safeguards for the banking system in the new regulatory environment by mandating early supervisory intervention at pre-specified levels of capital before the banks face actual distress. The European Shadow Financial Regulatory Committee (ESFRC) has already addressed the importance of PCA and insolvency procedures for banks in its very first statement in 1998. In the present statement we propose that EU members be required to introduce legally binding PCA rules for supervisory action and we discuss how such procedures can be made effective within the new capital adequacy framework. The procedures should link the intensity of supervisory actions (including bank closure) to capital ratios in terms of both risk-weighted ratios and non-weighted capital ratios (leverage ratios).

PCA procedures should reduce the likelihood that the ultimate steps of either closing banks or bailing them out in cases of severe under-capitalization must be taken. History shows that the tendency of supervisors to allow banks with low capital to continue to operate (forbearance) is associated with considerable danger to the stability of the banking system. The introduction of PCA procedures reduces the likelihood of banking crises, enhances market discipline and helps resolve home host country conflicts in crisis management.

We emphasise that PCA rules in Europe cannot be adopted without considering the regulatory and legal environment of individual countries.

The benefits of Prompt Corrective Action rules

PCA rules classify banks based on their levels of capitalisation and they mandate supervisory action of increasing severity as the level of capitalization falls. The supervisory actions put restrictions and requirements on banks, mirroring and reinforcing market discipline. This system of trigger levels of capitalisation and associated supervisory actions provides a deterrent against regulatory forbearance, limiting the degree of discretion of the supervisor.

The Savings & Loan Association (S&L) debacle in the 1980s was the catalyst for the adoption of PCA rules within the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in the USA in 1991. The act was based on an academic proposal put forth by George Benston and George Kaufman that was adopted by the US Shadow Financial Regulatory Committee. According to FDICIA, banks are classified into five capital categories from well capitalized to critically undercapitalised with a number of required corrective actions and sanctions of increasing severity for banks that do not qualify as well capitalised. An institution that reaches a ‘critical level of undercapitalisation’ defined as 2 per cent of capital to total assets (leverage ratio) must be placed in receivership/conservatorship within 90 days. One of the major objectives of the FDICIA is the principle of least cost resolution, which requires the authorities to resolve problem banks in such a way as to minimize costs to the insurance funds.

Although the legal and institutional framework for deposit insurance and bank insolvency in Europe is different from the framework in the USA, the introduction of PCA rules in Europe would be an opportunity to establish explicit objectives for prudential supervision. The potential cost of bank failures to taxpayers is one objective but it must be assessed in relation to the objectives of stability of the financial system and the protection of depositors' and other creditors' confidence in the banking system.

The ESFRC is aware that current economic circumstances in Europe are very different from the ones in the US at the time of the introduction of FDICIA. We are enjoying benign economic times and banking systems across Europe appear relatively robust. Yet, the ESFRC considers this a good time for introducing PCA rules in Europe in view of the uncertainties associated with the implementation of Basel II and the need to have an adequate institutional framework in place to deal with a possible deterioration in banking conditions. Furthermore, PCA rules in Europe could help resolve conflicts of interest between home and host countries of international banks in times of crisis.

Uncertainties associated with the introduction of Basel II

As noted, the implementation of Basel II and its European version (CRD) increases the urgency of introducing PCA procedures for European banks. The difficult issue of defining the trigger points in terms of capital ratios for supervisory intervention is also affected by the introduction of Basel II.

The Quantitative Impact Studies conducted by the Basel Committee regarding the effects of implementing the Internal Ratings standard indicate that many banks will be able to lower their required capital as much as 25 percent while other similar banks will not be able to reduce their required capital at all. The variation in capital requirements across banks that seem to be similar in terms of risk-taking can become very large. This sensitivity of banks' required capital to their choice of assets could lead to distortions of banks' investments in risky assets. Banks will favour some assets over others in spite of similar risk and return because they can reduce the required capital without reducing the return on assets. One remedy for such distortions is to use PCA trigger ratios to introduce definitions that do not depend on Basel II risk weights. One possibility is to use simple leverage ratios (equity to non-weighted assets) as trigger ratios. Another is to use the standardized risk-weights in Basel II based on evaluations of borrowers by external rating agencies.

Using these alternative capital ratios the PCA trigger points can be designed in such a way that each of the alternative ratios must be satisfied in order not to trigger the pre-specified supervisory action. The US PCA-procedures are designed this way with a simple leverage ratio complementing the Basel ratios.

Designing an adequate institutional framework

A number of issues must be considered when defining the ratios that trigger supervisors' intervention:

(i) The PCA trigger points and supervisory actions at different ratios must be predictable in the sense that bank managers and other stakeholders can predict consequences and costs of losses at each point.

(ii) The capital ratio defining closure of the bank must be enforceable and predictable.

(iii) The trigger points before insolvency should be designed with the objective of making the likelihood of final insolvency small. Accounting procedures, risk of bank runs and risk of contagion through payment and settlement systems are factors that must be considered when defining the trigger points.

In order to achieve predictability of PCA procedures the supervisory authority in each country should be legally required to intervene at predetermined triggers based on capital ratios with mandated specific restrictions and requirements for the distressed bank.

The trigger points could be defined as in the USA with the following five capital zones:

1. Well-capitalized banks
2. Adequately capitalized banks

3. Undercapitalized banks
4. Significantly undercapitalized banks
5. Critically undercapitalized banks.

As soon as a bank enters into a capital zone below 'well capitalized' it should face restrictions and required actions by the supervisor. These restrictions should become increasingly severe and constraining on risk-taking and they should be aimed at turning around the situation. At the fifth stage the bank should be treated as insolvent according to the country's bank insolvency law.

It is important not only that the supervisor must take action at the trigger points but also that it has the legal means to impose sufficiently strong restrictions and requirements. The supervisor must also have the resources to intensify supervision of a bank as its capital declines from one zone to another.

The definition of "critically undercapitalized" and actions taken there are particularly important since incentives of shareholders and non-insured creditors depend on expected losses at this trigger. In some European countries insolvency law and constitutional provisions may prevent supervisors from treating a bank as insolvent while equity capital is positive. Thus, it is desirable that countries complement PCA procedures with a separate insolvency law for banks that lays out treatment of non-insured creditors. The existence of such insolvency law for banks --if operational and enforceable--- can enhance the credibility of the PCA procedures. Thereby they also strengthen market discipline.[1]

Home-host country conflicts in crisis management

The Banking Directive envisions that banks operate across the EU under a Single License and home country control. Yet there are no predictable procedures for crisis management. Instead host and home countries with conflicting interests face the problems of agreeing on burden sharing and guarding against discriminatory treatment of creditors from different countries. These factors in combination with the need for rapid intervention in a banking crisis imply that the most likely approach in a banking crisis is a bailout of creditors, for example in the form of a blanket guarantee. Since both home and host countries have interests at stake in a crisis, and resolution procedures are not predictable, host country supervisors cannot abstain from being involved in supervision of host country activities. The trust that home country supervisors will take host country interests into account and treat all creditors equally simply does not exist.

Predictable and effective PCA rules can be of great help in fostering trust and coping with the problematic relationships between home and host country supervisory authorities. These considerations are particularly important in countries where a large share of the banking market is foreign owned. Host authorities will feel more confident that the lead home supervisor will intervene in time if the soundness of the consolidated group deteriorates, putting at risk both branches and subsidiaries. We are aware of vast differences in national insolvency laws across the Member States of the EU and the implications of such differences in terms of the definition of the triggers for insolvency, the powers of supervisors, the rights of creditors and other issues, but yet we believe that the establishment of a system of PCA in Europe will represent a valuable contribution to the current ad hoc approach to bank crisis management in the EU.

To strengthen the incentives of the European countries to implement effective PCA and insolvency procedures for domestic banks the Single License can be made conditional on the existence of such procedures.

The need for a EU Directive

We recommend the adoption of a Directive requiring EU members to implement PCA rules incorporating trigger points for supervisory intervention and bank closure, as well as binding rules for these interventions. The interventions would specify the requirements and restrictions the supervisory authority must impose on banks at different levels of capitalization.

[1] See ESFRC Statement No 1, "Dealing with Problem Banks in Europe", June 22, 1998.

The details of the PCA rules must largely be left to the individual countries since they must be specified taking national legal and regulatory principles and practices into account. Minimum capital ratios for the sequence of trigger points could be considered.

Legally binding rules for supervisory actions need to be enforceable or there must be incentives for supervisors to abide by the rules. Thus, the nature of penalties for the supervisor not abiding by the rules should be part of the PCA rules. Incentives to bide by the rules can be provided by a requirement that a country's banks cannot obtain a Single License for operating outside the home country without effective PCA rules. In this case an EU body is required to certify the effectiveness of each country's rules.