EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

The Financial Crisis and the Future of Financial Regulation

Statement No. 28

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In this statement the European Shadow Financial Regulatory Committee (ESFRC) discusses the current approach to crisis management in Europe and its longer term consequences for competition and risk-taking incentives. The Committee makes four proposals with the intention to restore bank capital in the short term and a competitive financial system subject to market discipline in the longer term:

1. *Allow financial institutions to carry backward losses from write-downs for the years 2008 and 2009.*
2. *Implement binding rules for structured early intervention and insolvency procedures for banks and other systemically important financial institutions in Europe.*
3. *Make capital requirements for each financial institution depend on its contribution to systemic risk.*
4. *Raise the average capital requirement for banks to 15 percent over time.*

The almost complete bail-out of the banking systems in both Europe and the US must now be accepted as a fact. Several European governments have initiated programs for infusion of capital in order to prevent a credit crunch caused by a lack of capital in large parts of the banking systems. Fears of a complete meltdown of the financial system that were prevalent in the fall of 2008 have dissipated, but we are still far from a normal situation and bad news continues to surface. After discussing the current approach, this statement focuses on longer term consequences; competition may be reduced by current policies and, more seriously, they undermine market discipline on banks' risk-taking and increase the likelihood of future crises.

<u>Impact of the Current Approach</u>

The present crisis illustrates that prevention is less costly than the cure. During the past 10 years the ESFRC has been making a number of regulatory proposals which, if they had been implemented, would have been helpful in mitigating the severity of the current crisis, as we will detail below.

However, given the reality of this crisis drastic measures were no doubt called for. Expansion of the safety net to unsecured creditors of financial institutions, central bank lending to banks with toxic assets as collateral, and bank recapitalizations have so far succeeded in preventing runs on individual banks as well as contagion effects. The recapitalization makes it less costly for banks to satisfy capital requirements without reducing the supply of credit to firms and households. However, the fundamental uncertainty about the value of assets and the solvency of many banks remains an issue causing illiquidity in important markets.

To speed up the recovery solvent financial institutions need to restore and expand their capital and they should be encouraged to recognize losses that they have suffered from the general fall in asset values. For these purposes, financial institutions could be given expanded possibilities to "carry backward" losses caused by write-downs in 2008 and 2009. Thereby they would obtain a refund for taxes paid before the crisis.

The scheme described would be neutral with respect to the size of the bank, it would encourage the rapid write down of toxic asset values, strengthen incentives to obtain realistic values for assets and, thereby, encourage trade. The liquidity in financial markets would improve. Banks that write down asset values excessively would obtain a future tax liability.

Another problem with the current approach to the crisis is that authorities have not been sufficiently ruthless in closing down fundamentally insolvent institutions. Any government needs to spend political capital by taking on entrenched interests: shareholders and unsecured creditors of big but unhealthy banks. If banks that have behaved recklessly are not closed down with losses for groups of creditors, as well as shareholders, there is little learning in the market place. De facto insolvent banks become a drag on the better performing ones. The more distressed banks absorb capital without generating new credits while the better performing banks face greater difficulties of improving their capital base in the market place.

An important reason why governments do not allow some banks to fail is that the distressed banks are "too big to fail" and that there are no procedures in place in Europe for closing down a bank without serious disruption of the financial system as discussed further below.

Competitive Distortions

The programs for recapitalization of distressed banks have the potential to distort competition within the financial sector in several ways. Since recapitalization is a national responsibility, EU rules for state aid may be violated by recapitalization in one or more countries. There is also a risk that the bail-out of a bank in one country triggers "competitive bail-outs" in other countries since governments are unwilling to accept that other countries' banks are given a competitive advantage.

Another distortion results from the focus of recapitalization programs on large banks and on banks that have experienced relatively large losses from inferior risk control. The European Commission is aware of these potential distortions but is constrained by political realities to accept national programs. As regards to the pricing of equity purchases in banks the Commission suggests that one should take into account the degree to which banks have behaved recklessly. Shareholders in banks experiencing large losses as a result of reckless lending may have to give up majority ownership to the government in order to be recapitalized sufficiently. However, national programs have typically bailed out creditors completely. Since large banks facing large losses are the ones in the greatest need for rescue it is almost inevitable that recapitalization programs favor these banks at the expense of smaller and prudent banks.

The Commission's view that the recapitalization programs can be used as an instrument for consolidation within the banking sector suggests that it is not concerned about increased concentration in the banking sector. However, in most European countries the financial system is already dominated by large universal banks considered "too big to fail". Small financial institutions, on the other hand, are more likely to be allowed to fail. Market participants generally anticipate this bias favoring large banks. This gives large banks a competitive advantage in funding.

Crisis Management Procedures

The ongoing financial crisis provides evidence that crisis management procedures are inadequate as discussed above. Irrespective of the current situation the specification of binding, enforceable rules for dealing with distressed financial institutions should be a priority in the light of the needs of the single market in financial services and capital.

The ESFRC emphasises again the need for a system of 'Structured Early Intervention and Resolution' (SEIR) for troubled institutions as proposed in the first ESFRC statement of June 1998, and further elaborated on in later statements.[1] SEIR consists of a sequence of steps that bank supervisors must take if the health of a bank deteriorates. Before insolvency occurs, pre-specified trigger ratios should initiate a progressive series of predictable restrictions on the problem bank's activities. In case of insolvency the rules should allow the closing of the bank without severe systemic consequences and without offering a bail-out of unsecured creditors and shareholders.

A useful model is provided by the US Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act classifies banks in five categories from well capitalised to critically under-capitalised. An institution that reaches a 'critical level of under-capitalisation' 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 FDICIA is the principle of least cost resolution, which requires the

[1] Statements No. 23, Frankfurt (November 2005) and No. 25, London (November 2006). All ESFRC statements are available at www.ceps.be.

authorities to resolve problem banks in such a way as to minimize costs to the insurance funds. This approach has the advantage of being predictable and of allowing the allocation of losses to shareholders and unsecured creditors, and thereby creating incentives for these parties to carefully monitor the financial soundness of banks and to increase the funding costs of relatively risky banks.

The negative consequences of lacking procedures for distress resolution are particularly visible in the present situation. A notable example is Fortis. Had a system of early intervention been in place, Fortis might have been partially liquidated and partially sold to another large European bank (e.g., BNP Paribas, Deutsche Bank). As a result, valuable parts of Fortis' operations would have been able to continue without large capital infusions by the governments of the Benelux countries.

It is important to emphasize that SEIR would not only apply to small and medium-sized banks but also for large banks, which are at the centre of the current problems. Extensions of SEIR to non-bank financial institutions should also be considered.

Capital Requirements and ”Too Big to Fail”

The concept of “too big to fail” has long been used in the policy debate to indicate that relatively large banks are not allowed to fail for fear of systemic consequences. These systemic consequences could take the form of disruptions to the payment system through short-term interbank positions and contagious bank runs. Price effects of fire sales of assets of large institutions can also have systemic consequences. Large financial institutions thus impose negative externalities on the surrounding society.

The adverse effect of not allowing a group of financial institutions to fail is that creditors worry less about their solvency and, as a result, creditors monitor them less intensively and they gain a competitive advantage through lower costs of funds. This implicit subsidization leads to further concentration in the financial industry and implicit protection of an increasing share of the financial industry. It is well-known that financial institutions wherein creditors are largely protected have incentives to take excessive risk since part of the down-side is carried by tax payers and deposit insurance funds.

A remedy for the too big to fail problem is to require financial institutions which contribute more to systemic risk to have more equity capital relative to assets than others. Thereby, their risk of default would decrease and their lower debt funding costs would be offset by the requirement to hold more equity. Also, their incentives for risk-shifting would be reduced.

Unfortunately, there is no obvious way to measure the magnitude of the negative externalities that big financial institutions impose on society. If banks only held deposits and provided loans in the traditional sense then the contribution of each bank to systemic risk could be proxied by the bank's share of deposits within a financial system. The need to bail-out Bear Sterns in the US demonstrated that an important counter-party in particular markets may contribute to systemic risk as well. An institution holding a large share of securities of a particular type is also likely to contribute more to systemic risk than a well diversified institution of the same size.

The complexity of defining an operational definition of contribution to systemic risk implies that research is needed in this area. The Basel Committee's resources could be spent much more productively on exploring this issue than on refining overly complex schemes for assigning risk-weights of various assets.

An operational measure of contribution to systemic risk should be based on identification of what financial markets are systemically most important and on measuring the market share of each institution within this market. The capital ratio of a financial institution should increase with its market share in important markets.

A particular complication arises in cross-border banks if a foreign bank has a systemically important market share in a country. Supervisors must make arrangements among themselves to deal with this issue.

Increasing Bank Capital Ratios

Bank capital ratios were close to historically low levels when the current crisis erupted. In a recent guest article in *The Economist* Alan Greenspan showed that book equity as a percentage of assets of US commercial banks has fallen gradually from around 20% in 1900 to 10 percent in 2000.[2] Developments in Europe have been similar with capital ratios falling to a level as low as 7 percent in 2000.[3] Greenspan noted that "today, fearful investors clearly require a far larger capital cushion to lend, unsecured, to any financial intermediary. When bank book capital finally adjusts to current market imperatives, it may well reach its highest levels in 75 years, at least temporarily." Furthermore, Greenspan said that "it is not a stretch to infer that these heightened levels will be the basis of a new regulatory system."

On January 16, 2009 the Basel Committee on Banking Supervision published its consultative document "Revisions to the Basel II Market Risk Framework" without raising the fundamental question on the appropriate level of capital in the banking system as a whole. The Basel Committee notes that, since the financial crisis began in mid-2007, the majority of losses and most of the build-up of leverage occurred in the trading book, and suggests higher capital charges for products related to the trading book. The ESFRC welcomes this limited proposal but argues that banks generally will need much thicker capital cushions. The fact that many banks' capital buffers were so rapidly depleted in the current crisis supports this argument.

The ESFRC recommends that a required capital/asset ratio of 15 percent (on a non risk-weighted basis) should be introduced when the world economy has recovered from the current crisis. Assets must include off-balance sheet items expressed as the

[2] A. Greenspan, "Banks Need More Capital", The Economist, December 18, 2008.

[3] H.A. Benink and G.J. Benston, "The Future of Banking Regulation in Developed Countries: Lessons from and for Europe", *Financial Markets, Institutions & Instruments,* Vol. 14, No. 5 (December 2005).

asset equivalents of contingent liabilities, as presently calculated for the Basel capital requirement.

Requiring banks to have substantially more equity capital may be costly for the banks and create incentives for banks to manipulate their ratios unless there are unsecured creditors requiring such a cushion to lend to banks. There exist proposals to address this concern. Specifically, certain categories of long-term debt could count as part of regulatory capital (so-called "debt capital") in case it complies with certain pre-specified conditions.[4]

[4] See Benink and Benston (2005), op cit. To count as "debt capital" the debt must be explicitly and credibly uninsured and it may not be redeemed except from funds that were obtained from new issues replacing the debt capital. If otherwise redeemed, the bank would have to meet its regulatory capital requirement fully. The debt must include a provision to that effect; holders of the redeemed debt must receive legal assurance that if this provision has not been met they will be liable for the funds illegally received. Furthermore, the obligations should include a covenant that gives the banking authorities the right to suspend interest payments if the bank's capital is deficient, as specified in a structured early intervention and resolution regulation, so that funds are not withdrawn from a capital-deficient bank.