



# Crisis Management and Resolution in the EU

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# After The Storm: The Future Face of Europe's Financial System

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# Outline

1. ECOFIN principles and roadmap
2. How did the EU fare during the crisis?
3. De Larosière proposals
4. The debate about branch-based banking
5. EU-level safety nets
6. Tackling fiscal responsibility



# ECOFIN Roadmap



# ECOFIN crisis management principles

- Protect stability in all countries involved and in EU as a whole
- Collective cost minimization
- Sharing of direct budgetary net costs on the basis of balanced and equitable criteria
- Preserving level playing field



# ECOFIN Roadmap

## 1. **Procedures and principles**

- Common principles (October 2007)
- EU-dimension in national mandates
- Voluntary Cooperation Agreements
- Crisis management MoU (June 2008)
- Common analytical framework (June 2008)
- Clarifying cooperation obligations (2007-2009)
- Crisis simulation exercise

## 2. **Review of tools for crisis prevention, management, and resolution**

- Identify obstacles to cross-border use of tools
- Streamlined procedures for State Aid
- Possible extension of Winding-Up Directive to subsidiaries
- Clarify Deposit Guarantee Schemes Directive (March 2009)
- Reducing barriers to cross-border transfer of assets

# June 2008 Crisis Management MoU

- Networks between existing institutions
  - Domestic standing groups
  - Voluntary Specific Cooperation Agreements
  - Cross-border Stability Groups
- Procedures, Communication, Contingency planning
- Common practical guidelines
- Common assessment
- Non-binding



The EU during the crisis:  
how well did things go?



# What went well?

- Systemic bank failures and disorderly cross-border bankruptcies averted (*Icelandic banks excepted*)
- Liquidity support (Eurosystem) functioned rather well
- Gradual improvements in coordination
  - Standardization by Commission and ECB
  - Menu approach to crisis management measures
  - Daily EFC conference calls
  - Summits

# What could have gone better?

- Deposit insurance and solvency support (capital, guarantees) initially uncoordinated
  - No leadership from EU-level institutions
  - Countries acted unilaterally
  - Often felt they had no choice
- Politicization of crisis management efforts
  - Coordination depended on political initiatives
  - Prime Ministers and Ministers of Finance dealt with individual cases

# What could have gone better?

- Non-binding ex ante commitments of limited value
  - Domestic political incentives
  - Lack of expertise, notably among politicians
  - Practical difficulties and stress
  - Personality-dependent
- Lack of a “referee” or “mediator” to help resolve disagreements between countries
- Information sharing was a broad problem



# What could have gone better?

- Domestic crisis resolution frameworks were inadequate
- Cross-border crisis resolution difficult
  - Dexia: burden sharing and cooperative approach, but not without difficulties
  - Fortis: burden sharing agreement fell apart after two days, break-up along national lines
  - MoU and ECOFIN crisis management principles not of obvious help

# Outcomes

- Cost of managing crisis has been high
- Negative spillover effects
- “Unleveling” of playing field
- Perceived lack of coordination damaged market confidence
- Financial protectionism
- Extensive government ownership
- Setbacks and risks to financial integration





# De Larosière proposals



# DLG on crisis management

- A transparent and clear framework for managing crises should be developed
- Appropriate and equivalent crisis prevention and crisis intervention tools

*(Commission White Paper due in June 2009)*

- Remove legal obstacles to using these tools in a cross-border context



# DLG on burden sharing

- Takes lack of pan-EU mechanism as given
- Assessment:
  - Complicated, esp. when combining public and private money
  - *Ex post* agreement more difficult than *ex ante* arrangements
- Need for **more detailed criteria**, to be embedded in June 2008 MoU, e.g.:
  - Deposits
  - Assets
  - Revenues
  - Payment flows
  - Division of supervisory responsibility

# What would this resolve?

- Leaves plenty of scope for disagreement
  - Burden =  
f(resolution approach, timing, other decisions)
  - No “pre-judging” of interventions in future cases  $\Rightarrow$  much remains to be decided ad hoc
  - No streamlining of decision-making
- MoU approach has inherent limitations: non-binding, no institutional foundations





# Branch-based banking



# Whither branch-based banking?

- DLG: existing powers of host countries in respect of branches should be reviewed
- Turner: increased national powers to require subsidiarization or limit retail deposit taking
- Implications:
  - end of single passport and single market?
  - single market only for banks of large countries?

# In defense of branch-based banking

- Important driver of market integration
- Offers large efficiencies
- Tremendous potential, especially combined with European Company statute
- Essential dimension of a single market
- Could be the future



# Saving branch-based banking

- Small scale: current arrangements OK
- Large scale:
  - Reliance on home country financial safety nets not acceptable
  - Host country interests must be safeguarded
  - Increased host country control would stand in the way of economic efficiency and integration

⇒ Need for EU-level safety nets





# EU-level safety nets



# European safety nets

- Need for consistency argues for full package at EU-level:
  - Licensing
  - Supervision
  - Regulation
  - Crisis management and resolution
  - Depositor protection



# In practice

- Licensing: 28<sup>th</sup> regime (European Banking Charter)
- Corporate form: European Company (SE)
- ESFS Authorities could be lead or coordinating supervisors
- Regulation: single rulebook (Turner)

# Key: crisis management and resolution

- Tools for early intervention
- Special resolution regime, outside normal bankruptcy legislation, with curbs on shareholder rights
- Permanent EU-level crisis management unit
- EU crisis resolution agency
- Technocratic approach, with final political approval (possibly options-approach)
- *Ex-post* judicial review only

# Do we need deposit insurance?

- Moral hazard: is threat of bankruptcy effective and cost-efficient disciplining tool?
- Does constructive ambiguity remain desirable?
  - Lehman: unexpectedly large collateral damage
  - Policymakers have committed not to let systemic institutions fail
  - Deposit insurance unsuited for systemic banks

# Alternative to deposit insurance

- Cost efficiency and systemic nature argue for going-concern approach
- Focus on institution rather than depositor
- Solvency insurance instead of deposit insurance
- Incentives to counter moral hazard
- Special resolution regime
  - “Good bank” approach (bridge bank)
  - Possibility of haircuts, also for depositors



# Tackling fiscal responsibility



# Minimizing “burdens”

- Early intervention and special resolution
- Solvency insurance (Rajan, Perotti, ...):
  - Private
  - Mutual
  - Pre-funded
- Increased prudential focus on deposit protection
  - Safeguards on asset side
  - Restrictions on risk-taking
  - Subordinated debt
  - Forward-looking provisions
  - ...
- Demand banks to organize themselves in ways that facilitate orderly resolution

# Dealing with remaining burdens

- Need for pre-financing (ECB?)
- Ex-ante agreements: incentive problems depend on resolution regime
- Options:
  - Formula / Criteria (e.g., DLG proposals)
  - EU budget
  - ECB seignorage (Goodhart and Schoenmaker)
  - EU-wide, proportionate to GDP

# Is Washington Mutual a role model?

- Systemic bank (6<sup>th</sup> largest in USA)
- Seized by the OTS, FDIC receivership
- Sale of assets, branches, deposits and secured debt to JP Morgan
- Equity and unsecured debt wiped out
- No losses to depositors
- No cost to the FDIC
- Fiscal burden = 0

# Possible drawbacks

- High cost of bank capital and unsecured debt
- Undesirably high risk aversion?
- Risk of wholesale and equity market bank runs
- Level playing field between systemic and small banks

# Guardian of the ECOFIN crisis management principles

- Need to provide greater assurance that principles will be adhered to
- Ex-ante approach:
  - Permanent EU-level crisis management cell
  - Legislation and mandates
  - Mediator (e.g., Level 3 committees)
- Ex-post approach
  - Judicial review?
  - Commission?
  - ECB?
  - ESFS Agencies?
  - ESRC?



# The End

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