

Assonime-CEPS Task Force on Bank Crisis Resolution

Overcoming too-big-to-fail

A regulatory framework to limit moral hazard and free riding in the financial sector

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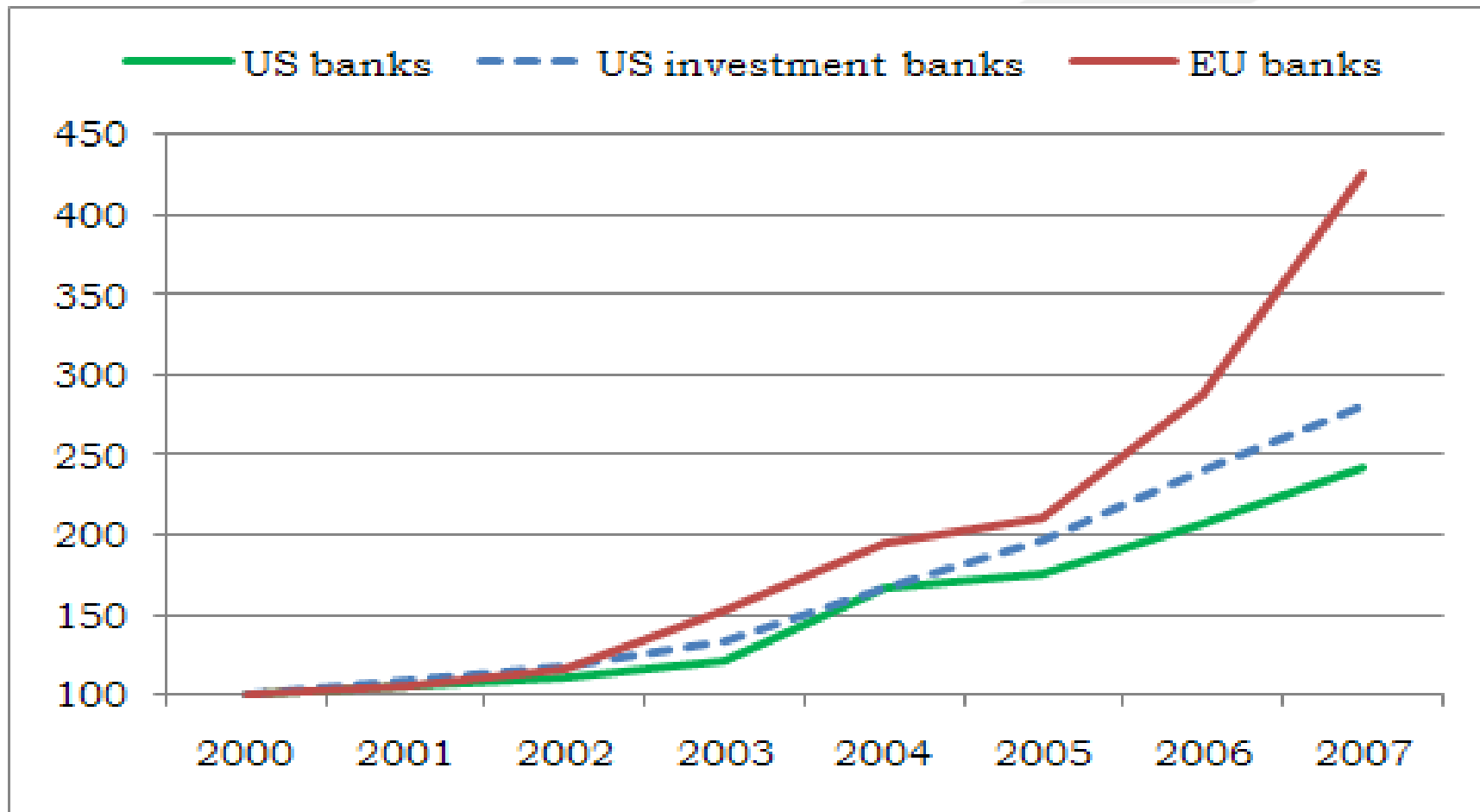
Main facts

- Asymmetric monetary policy – in an environment of stable prices and wages – as the anchor for convergent expectations of ever rising asset prices – asset bubbles
- Explosive growth of financial intermediation (Figure 1), notably wholesale money market and interbank
- Explosive growth in leverage of financial institutions
- Increased exposure of large financial organizations to high-risk assets of uncertain liquidity

→ **size, leverage, interconnectedness**

- Too-big-to-fail doctrine

**Figure 1. Growth of banks total assets, 2000-2007
(2000=100)***

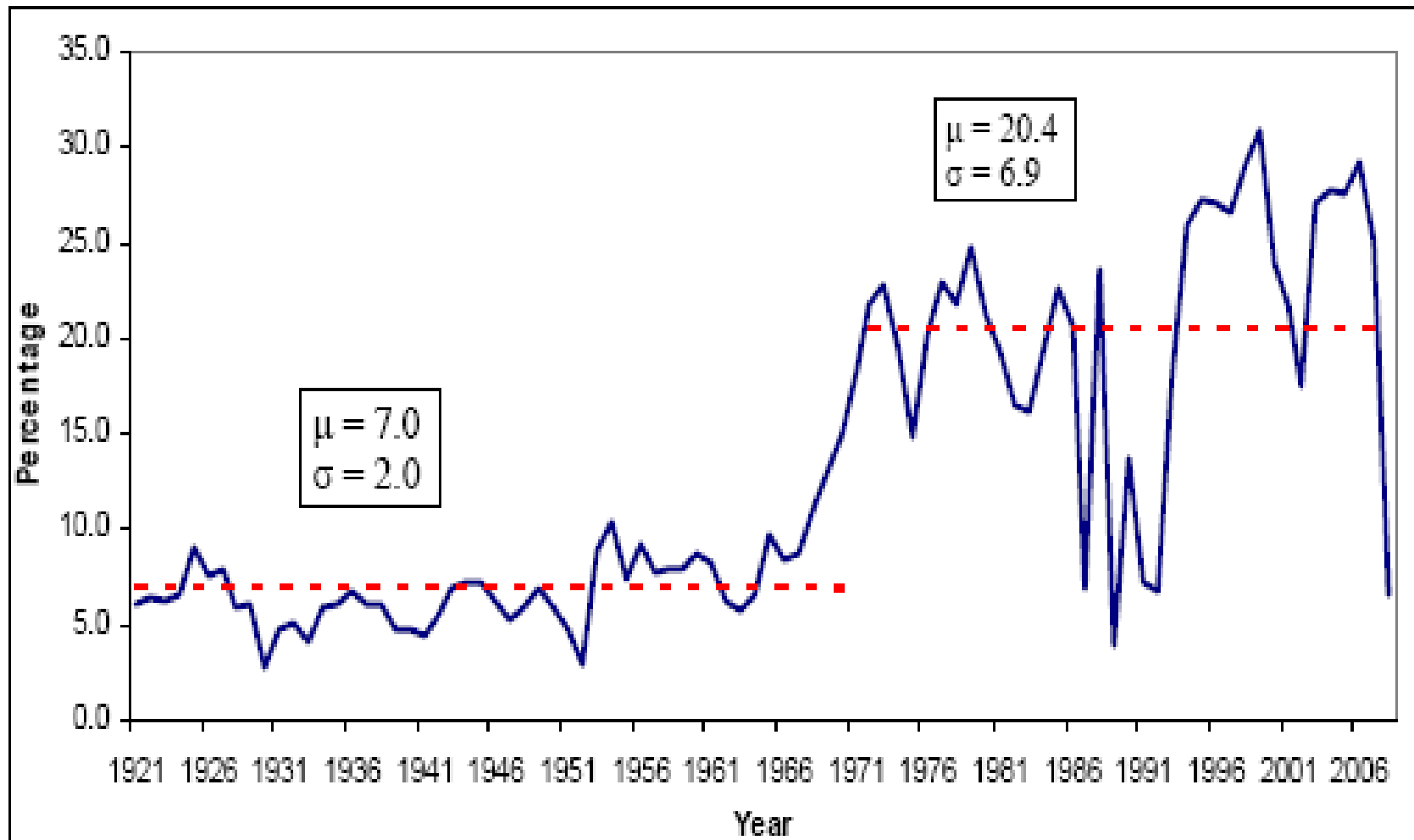


*US banks include: Bank of America, Citigroup and JP Morgan Chase. US investment banks include: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. EU banks include: BNP Paribas, Deutsche Bank, Royal Bank of Scotland, UBS.

Source: own calculations on annual reports .

Skewed incentives

- Alessandri and Haldane (2009) show that increased returns were the result of strategies based on (a) leveraging equity (b) increasing proprietary trading (c) buying diversified portfolios of risky (toxic) assets (d) placing risks into structured investment vehicles
- These strategies have in practice the effect of raising the sensitivity of returns on equity to aggregate risk – the β coefficient
- Thus, banks believed they were improving firm specific returns (“fake α ”), but they were all doing the same thing and becoming more correlated to aggregate outcomes (higher β)
- Increased returns went along with large increase in return variability – i.e. risk (Figure 2) – behaving like Tobin’s “plungers”, i.e. seeking higher returns regardless of risk – indicating distorted incentives

Figure 2. Return on equity for UK banks

Source: Alessandri and Haldane (2009)

Moral hazard

- Moral hazard problem created by asymmetric monetary policy, always ready to stop asset price falls but not counter asset price increases
- Moreover, asymmetry of return matrix aggravated by banking regulation and supervisors, due to:
 - a. **Banking charter too cheap** – creating possibility to raise cheap money with implicit public guaranty and bet it for large gains in capital market (directly and indirectly, through interbank and wholesale money-market)
 - b. **Implicit or explicit promise to bail out** large financial institutions – aggravated after Lehman mishandled failure
 - c. Supervisory forbearance, i.e. Basel capital rules, risk mitigation techniques and desire to promote national banks on world scene

Regulatory reform: key goals

- Policy task: prepare for - not merely prevent - bank failures
- Define a “fair weather” regulatory system, to maximize resiliency, make failure possible and contain systemic spillovers
- Eliminate or at least greatly reduce subsidies implicit in the banking charter
- Overcome the moral hazard due to implicit promise to bail out too-big-to-fail and too-complex-to fail financial institutions

New rules for finance

- Regulatory capital still needed as a fundamental back-stop against excessive risk-taking in a world with massive information asymmetries – but need to scrap risk-weighted capital requirements – not only easy to circumvent, but logically flawed, since risk assessment depends on market sentiment – i.e. not exogenous
- **But** this is not sufficient to remove moral hazard from banking, other tools needed, i.e.
 - (a) Transform deposit insurance into effective tool to prevent excessive risk taking rather than just pay for excessive risk taking
 - (b) Remove the implicit promise of bailout
 - (c) Put an end to supervisory forbearance

And, for pan-EU Groups ...

There is a need to adapt regulatory system to handle supervision and resolution of cross-border groups at EU level

A new European integrated system

- Three closely related components managed for large pan-EU groups on a consolidated basis:
 - a. new system of deposit insurance fully funded and risk based
 - b. a supra-national framework for bank crisis resolution at EU level, including mandated corrective action ...
 - c. ... managed by national supervisors under the law of the parent company within reinvigorated Colleges of supervisors **and** under EBA decision-making
- This is a viable alternative to breaking up large financial institutions or constraining by law their investment strategies

Deposit insurance

- Protect retail depositors, in order to preserve the system from panics and runs, but not the deposit taking institutions – creditors, shareholders and other stakeholders should be clearly told that they are not covered
- Deposit insurance fund to be financed ex-ante with risk-based fees, to ensure its adequacy
- Managed by a European Deposit Insurance Corporation (EDIC), to be set up as an European Banking Authority (EBA) arm
- Fees should reflect the risk profile of the bank (taking into account size, interconnectedness, leverage, liquidity, complexity, etc.) and its potential systemic impact
- Key feature: risk profile of financial institutions **fully priced** by regulatory system

Bank crises resolution

- Resolution as a natural follow up of mandated corrective action, with following features:
 - a. group-based resolution with universal principle – based on law of legal seat of parent company – also for subsidiaries
 - b. ban uncoordinated national interventions (ring-fencing) – delegation by host country supervisor with guarantees for protection of local interests
 - c. “living wills” to make known in advance to stakeholders and markets how resolution will work and affect various interests
- All national supervisors should have similar powers under special administrative procedures to manage **mandated** corrective action and resolution, according to principles and tools already established by Basel supervisors (CBRG)

New supervisory arrangements at EU level

- Fully consolidated supervision and resolution of pan-European banking groups, to be managed by home country supervisors under the law of the parent company
- EBA takes all key decisions (e.g. start of mandated corrective action, forced recapitalization, changes in management, assets sale, setting up of a bridge bank), based on proposals by strengthened Colleges of supervisors, with national authority of the parent company acting as lead supervisor
- EBA to supervise the procedure, resolve disputes and ensure fair treatment of interested parties

EU Mandated Corrective Action

- Insurance fund administrators obliged to order corrective action when capital weakens and leverage increases beyond certain thresholds, well before capital falls to zero
- Powers to include, as situation worsens, forced recapitalization, assets disposals, change of management, bridge bank
- Mandated corrective action to be applied at consolidated level to the entire EU cross-border financial group comprising deposit-taking units – since the entire group enjoys the implicit guaranty for deposit-taking
- Key requirements: i) same definition of capital and leverage across jurisdictions, or else arbitrage, ii) absolute leverage ratio instead of risk-weighted capital requirements

The EDIC contract

- In order to join the new EU system, EU cross-border banking groups would be required to **sign a deposit insurance contract** with EDIC
- Under the EDIC contract they would undertake to:
 - i) pay fees on an actuarial risk basis on the basis of the individual and systemic risk profile
 - ii) submit to mandated corrective action and resolution tools – key to overcome the legal hurdles stemming from heterogeneous national frameworks
 - iii) prepare “living wills”

Living wills

- All banks and banking groups required to prepare and publish on their website a document set up as a menu of options detailing:
 - a. the claims on the bank and their order of priority
 - b. the full consolidated structure of legal entities that depend on the parent company for their survival and may produce liabilities for the parent company
 - c. a clear description of operational – as distinct from legal – responsibilities and decision making, notably regarding functions centralized with the parent company
 - d. “segregation” arrangements to preserve certain functions of systemic relevance during resolution and ensure completion of contacts