

## Bank crisis resolution procedures

### Outline for a new CEPS task force

A number of major international banks and numerous banks of lesser size in developed countries still are crippled by large amounts of “legacy” assets which they are unable to value and which impede their return to normal lending activity, while capital markets are unable or unwilling to provide them to sufficient equity capital to pull them out of their dire straits.

Government responses have greatly differed, from straight nationalization to providing capital support in forms entailing varying degrees of shareholder dilution and intervention in management, to guaranteeing banks against potential losses on certain asset classes. In the main, the problems have been rolled over rather than resolved, despite increasing capital injections and risk exposure of governments, and there has been a great deal of uncertainty as to the real situation of banks which has impeded a return to normal functioning of the interbank and credit markets. Only in one instance – that is the US FDIC crisis resolution procedures – banks have been taken over, restructured and placed back to the market fairly rapidly.

There is a real danger that, to the extent that bank losses are rolled over rather than written off, financial markets will not return to normal functioning for a long period, raising the specter of a repetition of Japan’s lost decade on a world scale. Therefore, the issue of how to resolve bank crises is central to the recovery of economic activity after the recent sharp fall.

Crisis resolution cannot be separated from crisis prevention; to the extent that crisis prevention measures can be moved to supranational level, crisis resolution measures should also move to supranational level, with adequate funding.

The key issues that the task force should examine to this end could (tentatively) be identified as follows.

- I. Crisis prevention: there is a fundamental issue to be decided preliminarily on what are the sources of systemic instability and hence what are the instruments to safeguard bank stability.
  - a. Systemic instability can be traced back to three main aspects: using bank money to finance capital market bets; excessive concentration of counterparty risks in certain markets (e.g. OTC trades, derivatives, etc.), which may endanger the payment and settlement system; the moral hazard problems stemming from the fact that certain institutions are too large to fail. General point: systemic relevance relates to certain functions performed by financial institutions, rather than the institutions themselves.
  - b. The instruments to tackle instability are in principle capital requirements (including surcharges for special functions and risks); insurance schemes to protect against systemic risks posed by systemically relevant institutions; and risk management requirements imposed on banks (including remuneration policies).
- II. Crisis resolution:
  - a. Surveying bank crisis resolution procedures existing in the main countries, notably the US and the main EU countries, and identifying existing gaps, e.g. the bank holding companies within some national jurisdictions. To the extent that this will appear feasible and desirable, propose “best practice” standards for capital injections, guarantees and overall bank rescue operations.
  - b. Lack of adequate and homogeneous procedures, and source of funding, for handling transnational crises of complex supra-national institutions; feasible alternatives.
  - c. The specific EU problem: procedures and resources for handling cross-border bank crises, including the relation between home and host country supervisory authorities, the provision of lending of last resort, notably when the liabilities of local subsidiaries of foreign banks largely exceed government resources. Also, need to review adequacy of the Directive on winding down of credit institutions.



First meeting of the CEPS Task Force on

**Banking Crisis Resolution Procedures**

**17 July 2009**

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I will attend the meeting                    { }

I will not attend the meeting            { }

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