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Towards a common framework for **cross-border supervision** and **crisis management**

The increasing cross-border nature of European financial institutions' operations has created significant challenges for financial authorities, in areas of supervision as well as crisis management and resolution.[1] This paper discusses the joint nature of the challenges for cross-border supervision and crisis management[2] and the need for a common framework for addressing the challenges.

In considering the issues and the possible solutions, it is useful to distinguish between the industry perspective and the public good perspective. From the industry's point of view, present supervisory arrangements are costly in terms of compliance. Financial institutions must report to multiple supervisors, and governance arrangements must be shaped to be compatible with national systems of supervision. Current supervisory arrangements may also preclude optimal risk management from the industry's standpoint, potentially leading to excess capital or to liquidity pools which would become "trapped" in foreign subsidiaries during periods of stress. From the public good standpoint, pressing questions relate to the ability to deal with crises involving cross-border banks, the efficiency of available cross-border crisis solutions, and the potential moral hazard that current arrangements may engender.

Co-operative arrangements

It is important to keep in mind that the industry and public good perspectives are related, but distinct. Supervisors are answering to the private-sector demand for a more streamlined supervisory framework, by putting in place co-operative arrangements that were considered to be very difficult to achieve only a few years ago. This is particularly true for countries in which cross-border integration is the most advanced, such as the Nordic and the Benelux countries. Yet, despite improvements in co-operation and coordination, major challenges to the supervision and crisis management of cross-border institutions remain. A pre-condition for significant further progress would seem to be the establishment of a common framework, including objectives and principles, in which the issues of cross-border supervision and crisis management could be addressed.

This paper makes the case for joint consideration of cross-border supervisory and crisis management arrangements. It reviews the progress that has been achieved to date in the area of cross-border banking supervision and identifies some key elements of a common framework for addressing issues of cross-border crisis management. The following section first discusses conflicts of interest that underlie the difficulties with cross-border supervision and crisis management. The paper then points to advances that have been achieved with respect to cross-border supervision of financial institutions. It further lays out a set of principles which could serve as a building block for elaboration of a common framework for dealing with cross-border crises.

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Was passiert, wenn ein paneuropäisch agierendes Kreditinstitut in seinem Stammland in Not gerät? Im ungünstigsten Fall, so der Autor, ist aufgrund unterschiedlicher Rechtsrahmen und Eigeninteressen (auch der jeweiligen Aufsichten) so viel Liquidität in den Auslandsniederlassungen gebunden, dass es bis zum Zusammenbruch des Mutterhauses kommen kann. Allein deshalb gelte es, die Themenbereiche grenzüberschreitender Aufsicht und Krisenmanagement nicht isoliert voneinander zu betrachten. Zwar sieht er im Rahmen des Financial Services Action Plan (FSAP) dahingehend schon erste Direktiven umgesetzt. Mit einem weiterführenden Rahmenwerk zur Krisenbewältigung, so seine Forderung, müsse darüber hinaus der zeitnahe Informationsaustausch und die enge Zusammenarbeit der involvierten Behörden gesichert werden, damit sich Lösungen innerhalb des Privatsektors umsetzen lassen. (Red.)

Conflicts of interest

A crucial conflict of interest, now well acknowledged, lies at the heart of cross-border regulatory and supervisory concerns: in crisis times the home authorities of a cross-border institution will have the incentive to centralize assets, whereas the host authorities will have the incentive to "ring-fence" assets. The actual degree to which the interests between different national authorities may conflict in a crisis will depend upon a number of factors, including whether the financial institution is organized via subsidiaries or branches, whether the foreign unit (subsidiary or branch) is systemically important, whether the domestic unit is systemically important, whether the mandates of the home and host authorities conflict, whether public funds must be drawn upon, et cetera. The existence of potential conflicts of interest implies that the resolution policy that is chosen in a crisis may be inefficient: it may result in excessive costs, externalities that are not internalized, and outcomes where troubled banks are inefficiently continued in operation or inefficiently liquidated.

The interconnections between supervisory and crisis management arrangements and

the need for simultaneous consideration of both types of arrangements can be understood in the broader context of the three "pillars" underlying the function of safeguarding financial stability: (1) "prevention", which includes supervisory regulations and arrangements; (2) surveillance, or the monitoring of financial institutions and markets; and (3) crisis management. These pillars are inter-connected; modifications to one of the pillars will impact the other two. For this reason, the challenges of supervisory and crisis management arrangements for cross-border institutions cannot be addressed independently, without running the risk of worsening financial stability.

Given this, it is clear that the potential conflicts of interest between national authorities in crisis times can affect not only the outcome of a crisis for a cross-border financial institution but also the efficacy of supervisory arrangements in normal times. For example, the national authorities who may end up footing the bill in a crisis are unlikely to be willing to delegate supervisory powers to other national authorities in normal times. Similarly, establishing a college of supervisors may not have the intended effect if the lead supervisor is not the authority bearing the principal financial responsibility in a crisis. "De-linking" supervisory authority from crisis management responsibility can lead to phenomena such as a "race to the bottom" in regulations, authorities withholding information from other authorities, and excessive forbearance by authorities with respect to ailing banks.[3)]

Whereas the organization of financial institutions via subsidiaries or branches can influence the nature of the conflicts of interest arising between authorities in a crisis, the form of organization can also have an impact on the management of financial institutions in a crisis situation. For example, when a financial institution is organized via subsidiaries, intra-group transactions are supposed to be conducted at arms length. If the home entity faces stress, it may not be able to draw on the resources of its subsidiaries to help avoid failure. Liquidity may remain trapped in the subsidiaries. In addition, while the European Winding-up Directive stipulates that a single insolvency procedure will be used for all of the entities of a financial institution organized via branches, separate legal regimes will apply for institutions organized via subsidiaries.

Recent initiatives relating to cross-border supervision

Several recent European directives help to reduce conflicts in the EU legal framework that could impact on cross-border banking supervision and crisis management. Many of these directives have resulted from the Financial Services Action Plan (FSAP). They include the Winding-up directive, the Directive on deposit guarantee schemes, the Directive on financial collateral and the Financial conglomerates directive. The European Commission has nevertheless recently noted that transposition of Community law resulting from the FSAP is proceeding too slowly.

An important role at the European level is also being played by committees such as the Banking Supervision Committee (BSC) of the European Central Bank and the Committee of European Banking Supervisors (Cebs). These two committees have undertaken several joint initiatives, such as the Task Force on Crisis Management. In addition, Cebs has recently published guidelines on cooperation between supervisors of EU banking groups and investment firms (Cebs, 2006). By enhancing the operational networking of national supervisors, these guidelines are intended to promote an efficient supervisory framework for groups operating in several EU jurisdictions. Cebs is also in the process of improving procedures for exchange of information between authorities. This committee has also published a document on the application of the supervisory review process under Pillar 2 of the Basel II Framework, and it has published guidelines setting out a framework to deal with applications by cross-border institutions to obtain approval to use the Advanced Measurement Approach and the Internal Rating Based Approach.

Other bilateral and multilateral initiatives have recently contributed to improving supervisory networks. Authorities in several countries have negotiated bilateral and multilateral Memoranda of Understanding (MOU). These sometimes allocate supervisory responsibilities and may include practical considerations regarding the exchange of information, joint inspections, organization of contacts between supervisors, et cetera (see for instance Majaha-Jartby and Olafsson, 2005). MOU may be drafted with respect to a specific cross-border (cross-sector) group or may be more general, describing the expected behavior of authorities in specific situations. In accordance with their competencies, authorities such as central banks or treasuries, in addition to supervisory authorities, may be parties to these MOU. However, the latter do not prevail over national laws and do not modify the responsibilities of national authorities.

Networks of authorities a necessity

Reinforcing supervisory coordination and achieving convergence of supervisory practices are essential for mitigating potential conflicts of interest between national authorities. These activities also help to create networks of authorities. Creation of such networks is a necessary – although not sufficient – condition for reducing conflicts of interest in the management of cross-border crises, as trust appears to be an essential element in the management of a crisis. The economic literature on "social capital" confirms this view and suggests indeed that social connections may help agents to interact co-operatively.[4)] One of the objectives of the networks of supervisors is to create this social capital.

However, if a significant crisis were to arise, conflicts of interest could potentially take the upper hand over trust. Indeed, one of the objectives of crisis simulation exercises, such as those recently undertaken by the Economic and Financial Committee of the European Union and by the central banks of the Eurosystem, is to gauge the extent to which potential conflicts of interest between authorities might affect crisis resolution procedures. The establishment of a common framework for crisis assessment and resolution constitutes a first step towards the mitigation of these conflicts.

Devising a framework for crisis management and resolution

Defining the objectives of crisis management and resolution is essential for the establishment of a common framework for dealing with cross-border crises.[5)] Once objectives have been defined, a set of principles should be elaborated. A useful starting point might be some of the ideas ela-

borated by the CEBS/BSC Joint Task Force on Crisis Management, including:

– the need for timely exchanges of information between home and host authorities in normal times and in crisis periods,

– the need for close cooperation between home and host-country authorities in a crisis,

– the need for home and host-country authorities to take into consideration the potential impact of policy measures on the financial systems of other jurisdictions,

– the usefulness of operational networks of authorities, including supervisors and central banks, and

– recognition that operational networks do not alter the legal responsibilities of the authorities participating in the networks.

These principles could constitute a building block on which a broader set of principles might be constructed. Authorities might wish to go beyond these principles, for example, by making explicit reference to the importance of finding private-sector solutions to crises and of limiting the recourse to public funds.

To the extent that authorities' joint adoption of such principles is credible, the principles could help to reduce moral hazard, which is likely to be a more severe problem in the cross-border than in the strictly national setting, due to the costs of coordinating authorities in a crisis. Financial institutions' owners, managers, and creditors must be convinced that government-sponsored bailout of a cross-border financial institution is unlikely and, if it occurs, it would be a last resort.

Ensuring credibility

A next question that would need to be addressed would be how to make the principles effective and credible. Certain mechanisms would appear to be useful. First, mechanisms for ensuring the continuity of critical business functions could be put into place. Second, the involvement of EU competition authorities could help to ensure that government aid to ailing institutions does not lead to unfair anti-competitive practices. Third, certain types of legal structures of financial institutions might help to achieve a private-sector solution in a crisis. For example, locating certain business lines, such as investment banking, in separate subsidiaries could limit contagion to the retail portion of the bank, as well as facilitate the transfer of critical parts of the bank to new owners in a crisis.

Several observers have suggested that the design of an ex ante burden-sharing agreement should be added to this list.[6] This is a sensitive issue, however, and the presumed benefits of an ex-ante burden sharing agreement in the current institutional framework should be carefully reviewed and any potentially negative incentives, both for authorities and for individual institutions, envisaged.

In any case, a formal burden-sharing agreement would likely require cross-country harmonization of laws. At present, the powers of authorities to intervene in troubled banks and the tools available to resolve crises differ across countries. Insolvency law offers a good example. Some countries have separate laws governing the treatment of insolvent banks and non-financial firms, while other countries require insolvent banks and non-financial firms to be dealt with in the same manner. Addressing the lack of harmonization of powers to deal with troubled banks in different countries seems necessary to strengthen the crisis management framework.

Realization of private-sector solutions is the key

This paper has argued that neither of the areas of cross-border supervision or cross-border crisis management should be considered in isolation. These areas are interdependent, and both can be affected by potential conflicts of interest between home and host authorities. Several initiatives have already been undertaken to improve cross-border supervision in Europe. It is only more recently that attention has turned to cross-border crisis management.

In order to move forward, it is important, first, to agree on well defined principles and, second, to improve the framework in which private-sector solutions can be used to ensure the continuity of critical functions. Harmonization of laws may also be a part of this process.

Burden-sharing agreements might help to reduce conflicts of interest between authorities in a crisis; however, such an agreement would offer at best only a partial solution to the problem of effective cross-border crisis management.

In other words, a burden-sharing agreement is not a necessary condition for improving the prospects for cross-border crisis management in the short run. In most cases mechanisms and procedures that enable realization of private-sector solutions to crises will be key for safeguarding financial stability.

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Footnotes

[1] See Nguyen and Praet (2006) for data relating to internationalization of the activities of 20 large European banks.

[2] The terms crisis management and crisis resolution are used in this paper synonymously, to represent the process of assessing the severity of a crisis, determining the policy response, if any, and implementing the policy.

[3] For analysis of such effects in the finance literature, see Dell'Ariccia and Marquez (2006), Holthausen and Rønde (2005), Acharya (2003), and Calzolari and Loranth (2004).

[4] Glaeser et al. (2000) use experimental economics to show that trust may facilitate the co-operation necessary to achieve a public good.

[5] See Fonteyne (2006) for discussion of this point.

[6] Note that the question of burden sharing arises only in the case where a bank has been determined to be insolvent and where it has been decided to implement a resolution policy which requires public funds.