Special Report 2011/13

New legislation intended to strengthen bank crisis management

Since the credit crisis, regulators and supervisors around the world have been making plans to minimise the likelihood and impact of new banking crises, and their impact if they happen. Strengthening the arrangements for bank crisis management is a part of this. In this Special Report we explain what this means, what its importance is and the dilemmas that may be involved. We also discuss the legislative proposal known as the Intervention Act, which should provide the Dutch government with additional powers to intervene if banks get into difficulties.

So far, a bail-out has usually been the only option

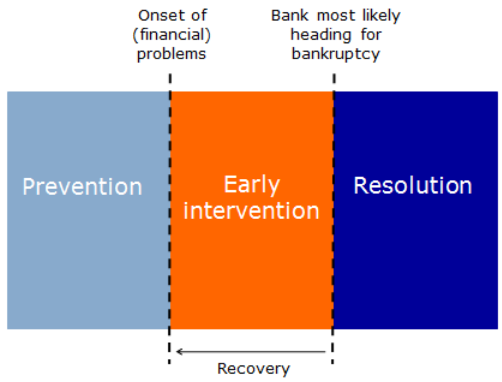
Unlike a 'normal' business, due to its size, complexity or interrelationships with other financial institutions, a systemically important bank cannot fail without this having very serious consequences for the economy and financial stability. A bank failure disrupts the continuity of important banking services that support economic activity, such as payments and lending, and can have a significant effect on other financial institutions and market participants which have relationships with the bank in question. During the credit crisis governments mostly took the view that 'saving' systemically important banks, either through financial support or nationalisation, was the only option. In many countries, the costs involved put heavy pressure on government budgets, and in some cases, such as Ireland, this actually led to a budget crisis.[1] Another issue is that of moral hazard, since systemically important banks might take on more risk if they know that they could be rescued if they encounter serious problems.

[1] The guarantees provided for the issuance of debt securities may also lead to additional costs in future.

Bank crisis management

Strengthening bank crisis management is therefore seen as one of the reforms necessary in the financial sector. But what does this mean? There are actually three phases to crisis management (Figure 1).

Figure 1: The three phases of crisis management



Source: European Commission (2011), Rabobank

The *prevention phase* primarily focuses on preventing problems at banks that are financially sound. Intensive supervision by the supervisor and the formulation of recovery and resolution plans[2] are part of this phase, and form a supplement to the stricter Basel capital and liquidity requirements (Basel 3).

The *early intervention phase* concerns the powers of the supervisor to intervene promptly when a bank gets into difficulties. The supervisor may require the bank to strengthen its equity, implement its recovery plan or hive off certain operations. In the *resolution phase*, a bank is heading for bankruptcy and the main issue is to achieve an orderly settlement, in other words, without damage to financial sta-

[2] A recovery plan consists of measures that a bank can take in various scenarios to deal with a deterioration in its financial position quickly and effectively. A resolution plan ('Living Will') describes the measures necessary to settle the affairs of a bank heading for failure in an orderly fashion.

bility. In this phase therefore, instruments are deployed that safeguard the continuity of banking services that are essential for the economy and financial stability. For example, these activities may be sold to a healthy bank or temporarily transferred to a bridge institution until a suitable buyer is found. The usage of resolution instruments should ensure that expensive rescue operations by governments, which usually have to be paid for by the taxpayer, will no longer be necessary in the future. Resolution can moreover reduce the danger of moral hazard behaviour by banks and bolster market discipline. Unlike the situation in a bail-out, in the event of intervention by the supervisor the directors, shareholders and bondholders of the bank will feel the financial pain. However the formulation of crisis management arrangements is not a simple matter. Four of the most difficult issues are discussed below.

Crisis management is complex

How can you ensure international cooperation?
In order to achieve the greatest effectiveness and a level competitive playing field for international banks, crisis management has to be harmonised at a global level. However this is not feasible at the moment, due to the wide divergence of bankruptcy laws between countries and the national sovereignty that countries wish to retain. There is therefore a risk that countries will exclusively pursue their national interest at a time when a cooperative approach to deal with a cross-border banking crisis is needed (Fonteyne et al., 2010). This is especially the case if no ex ante burden sharing agreements are in place regarding crisis management arrangements (Praet and Nguyen, 2010). One radical measure to prevent this problem would be to curtail the cross-border activities of banks. This would however lead to loss of prosperity, because all the scale and diversification benefits realised by banks through these activities would be lost (Disveld et al., 2011) and their customers would no longer have access to a cross-border service.

What are the right triggers?
Another difficult question is determining the right triggers for intervention and resolution. Broadly speaking, the choice is between a 'hard' quantitative trigger or a 'soft' qualitative trigger. The advantage of a 'hard' trigger, for example one based on a bank's capital ratio, is that supervisors will be forced to take action. Otherwise there is an incentive for them to delay (*regulatory forbearance*), partly because intervention would tarnish their reputation as a 'good supervisor' (Bijlsma et al., 2011). Another benefit of a hard trigger is the transparency it provides for banks and market participants. A disadvantage of a hard trigger is that the supervisor is denied the possibility of assessing different situations on their own merits (Fonteyne et al., 2010). This leads to a risk that, despite the fact that a trigger has been hit, intervention in a bank's affairs may occur without this being justified (Mayes, 2009). Moreover, the bank may not be given sufficient opportunity to put its own affairs in order. A final disadvantage of a publicly known hard trigger is that it may turn into a self-fulfilling prophecy for a bank in difficulties. Savers and market participants may decide to withdraw the funds they have entrusted to the bank in question as soon as they see that the bank's score based on the trigger measure is deteriorating.[3] This could actually push the bank into bankruptcy.
A 'soft' qualitative trigger allows the supervisor a measure of flexibility, thus reducing the risk of unjustified intervention. On the other hand, the risk that the supervisor will intervene too late or not at all because of the above-mentioned incentive to delay is increased. Problems will then be recognised and addressed too late, and will possibly become more difficult to resolve. A soft trigger will furthermore increase uncertainty among banks and market participants, which is normally reflected in higher risk premiums and therefore increased funding costs for banks.

[3] For savers, the deposit guarantee scheme will have a mitigating effect in this situation.

How can crisis management be implemented rapidly?

To avoid the self-fulfilling prophecy mentioned above, it is also essential that the actions taken by a supervisor with respect to a bank remain secret. It is thus important that the supervisor acts quickly so that the chance of a leak of information is reduced. However, resolution instruments such as the sale or transfer of a bank's operations require much preparation. Even in the United States, where the activities of a problem bank are seemingly transferred to another bank over a single weekend, in fact at least two to three months are needed to prepare for this operation (Mayes, 2009). The bigger the bank, the more time is needed. Larger banks usually have a more complex structure, meaning that separating their activities is more difficult. For this reason, there have been suggestions that banks should restructure themselves in operational and legal terms ex ante, so that the process will take less time. One example is the recent recommendation in the Vickers Report from the Independent Commission on Banking (ICB) in the United Kingdom. One proposal by this commission to the British government is that British banks should ring-fence their retail operations within the European Economic Area in separate legal entities. It is argued that this would make the resolution of failing banks simpler and cheaper (ICB, 2011). Full implementation of splitting up banks according to the Vickers model however has serious implications. There will be a social cost, because diversification and synergy benefits will be lost, and the availability of lending will be reduced. The latter effect will be due to the higher costs of capital and funding that will ensue. Furthermore, there is a significant chance that risks will be transferred to the unregulated 'shadow' sector (see Chow and Surti, 2011). It is thus very debatable whether the benefits of such ring-fencing would outweigh the costs.

How can you ensure credibility?

Credibility is also essential for effective crisis management (Mayes, 2009). Resolution for instance will only achieve the intended result if the public believes that systemically important banks can actually be settled in an orderly fashion. Past experience of successful cases of resolution can help to achieve this. However so far, there are few examples of instances in which the resolution of large, systemically important banks has proceeded in a controlled fashion. In most cases, the failing banks have simply been 'rescued' by their governments, they were too complex to settle or preparations for resolution were initiated at too late a stage. Also in the US, which has years of experience of resolution, only a few large banks have been settled in an orderly manner (Mayes, 2009).

What new legislation is in store?

In Europe, the European Commission is expected to put forward legislative proposals for a European framework for crisis management by the end of this year. The framework should ensure that national supervisors have the same, effective crisis management measures at their disposal and will cooperate more closely in the event of a failure of a cross-border bank. In anticipation of this, the bill for the Intervention Act has been submitted to the Lower House of the Dutch Parliament. Work is also in progress on recovery and resolution plans for internationally operating institutions in the Netherlands.

The Intervention Act bill in the Netherlands

The bill for the Intervention Act introduces two new instruments for the government to intervene when banks (or insurers) get into trouble. The first concerns the power of DNB to prepare a transfer plan *if a financial enterprise gets into difficulty without there being a sufficient or timely possibility of recovery.* If the court approves this plan, all or part of the bank will be sold to a private party or temporarily transferred to a bridge institution without the approval of the shareholders being required. This resolution instrument concerns the transfer of deposit agreements, other liabilities and assets and/or shares. Under the bill, the transfer of deposits will have to be funded by the deposit guarantee scheme (DGS), since this will prevent a bankruptcy and therefore the necessity of a pay-out to savers.

The second new instrument consists of two new powers that the Minister of Finance can apply *if financial stability is seriously and directly threatened by the situation at a financial institution*. After taking advice from DNB, the Minister can take over the internal powers of the enterprise[4] and even impose a compulsory purchase order. Expropriation will only be possible with compensation for those subject to the compulsory purchase and is the most extreme measure available on the 'intervention ladder'.

Finally, the bill contains a regulation that limits the rights of the financial enterprise's contractual counterparties after one of the new instruments has been deployed. Contracts usually contain provisions that entitle counterparties to terminate the agreement with the financial enterprise immediately or to require early settlement of claims as soon as an event of default, such as a measure imposed by the supervisor, occurs. In addition, there are notification events, which are events or circumstances that must be notified to the counterparty (Ministry of Finance, 2011). To prevent financial enterprises from getting into further difficulties, the bill contains a regulation that states that counterparties may not exercise these rights if the government imposes one of the *new* measures in the Intervention Act.

Comment

The Intervention Act will give the Dutch government additional measures for intervention when banks have actually passed through the first two phases of crisis management (Figure 1). This is a good thing. The assessment applied by the court as defined in the bill is however limited. The court will approve the transfer regime if the above-mentioned criterion is met *on a summary basis*. In other words, the court's assessment of the case will be brief and simple, and will not consider the question of whether the transfer regime is the right instrument in the situation. In addition, linking the funds of the DGS to the deposit transfer instrument could have consequences for financially healthy banks. The other banks will have to bear the burden, and there is no limit set to these costs in the bill. If the costs are too high for these banks to bear, they could also get into trouble.

Conclusion

Bank crisis management concerns both measures that banks and supervisors can take to avoid and restore problems at banks, as well as ways to achieve an orderly settlement of a bank if it can no longer be rescued (resolution). The objective of resolution is to maintain financial stability so that rescue operations by governments can be avoided. The Dutch legislative Intervention Act proposal contains two new instruments (including a transfer regime) that the Dutch government can use if banks get into difficulty. The addition to the instruments at the government's disposal is in principle a positive development. The assessment conducted by the court could however be more extensive, and in the event of a transfer of deposits the contributions of other banks should be limited to prevent them getting into trouble.

November 2011

Nicole Smolders (06 – 12993065)
N.M.P.Smolders@rn.rabobank.nl

www.rabobank.com/economics

[4] For instance, the temporary withdrawal of voting rights from shareholders, deviation from Articles of Association provisions, or suspension of an executive or supervisory director.

Literature

Avgouleas, E., C. Goodhart and D. Schoenmaker (2010), *Living wills as a catalyst for action*, DSF Policy Paper, No. 4, May.

Bijlsma, M., W. Elsenburg, G. Zwart (2011), *Een bindend interventieraamwerk voor bancair toezicht*, CPB Policy Brief 2011/04, May.

Chow, J.T.S., and J. Surti (2011), *Making Banks Safer: Can Volcker and Vickers Do It?*, IMF Working Paper WP/11/236, October.

Claessens, S., R. Herring and D. Schoenmaker (2010), *A Safer World Financial System: Improving the Resolution of Systemic Institutions, 12th Geneva report about the world economy*, ICMB, Geneva, and CEPR.

Disveld, P., M. Teunissen and H. van Voorden (2011), Een prijskaart aan systeemrelevantie, *B&E*, January/February.

EC (2011), *Consultation on technical details of a possible EU framework for bank recovery and resolution,* working document, January.

Fonteyne, W. et al. (2010), *Crisis management and resolution for a European banking system*, IMF Working Paper WP/10/70, March.

Het Financieele Dagblad (2011), *Opschudden Britse banken kost miljarden*, 13 September 2011.

Independent Commission on Banking (2011), *Final Report, recommendations*, September 2011.

Mayes, D. (2009*), Banking crisis resolution policy – lessons from recent experience*, CESifo Working Paper No. 2823, October.

Ministry of Finance (2011), *Wetsvoorstel Interventiewet*, *Memorie van Toelichting en Nader rapport Interventiewet*, Parliamentary Papers 26-10-2011.

Praet, P and G. Nguyen (2010), *Improving cross-border bank resolution in Europe: a focus on burden-sharing, pp. 73-86,* in: Crisis management at cross-roads (2010), SUERF Studies: 2010/1, Vienna.