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Europe's Solution for Too-Big-To-Fail

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1 A special insolvency law for financial institutions – context and objectives

Ladies and gentlemen,

It is always a pleasure to visit the House of Finance on the beautiful campus of Goethe University to discuss current economic policy issues with representatives from academia, economics and politics. And when such an important topic as “Effective Crisis Management in the Financial Sector” is on the agenda, I am especially happy to be here. So I thank you sincerely for your invitation and wish to present my thoughts on a legal topic, using an economic point of view.

What is it about? In the light of the financial crisis the G20 leaders agreed at the London summit in April 2009 that, in future, they will supervise and regulate “all systemically important financial institutions, financial instruments and financial markets”. Since then, a bulk of measures has been adopted at subsequent summits in Pittsburgh, Seoul and most recently in Cannes. One focal point were the SIFI rules designed to contain the “Too-Big-To-Fail” problem. The public sector often had to rescue institutions using taxpayers’ money. This implicit guarantee for SIFIs gives rise to misguided incentives, thus encouraging SIFIs to take excessive risk. Economists call this phenomenon “moral hazard”. The scale of this problem is vast!

This is borne out by the fact that, faced with the financial crisis, the governments within the European Union provided banks with assistance equivalent to 30% of the EU GDP.¹ However, the economic implications of the crisis go far beyond the fiscal burdens. They affect the real economy and therefore, for instance, every entrepreneur who relies on a bank loan to finance his investment decision. Thus, the process of adjustment within the euro-area banking sector is not over yet, particularly as the sovereign debt crisis has presented new challenges. Essentially, banks have got to remove problematic assets from their balance sheets, devise sustainable balance sheet structures and develop resilient business models. In its recent Global Financial Stability Report,² the IMF estimates that 58 major banks in the EU could reduce their aggregate balance sheet total by €2 trillion, or around 7%, by the end of 2013. The IMF fears that this deleveraging process could have a

¹ European Commission, Framework for crisis management in the financial sector, 10 January 2011; http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/mi0062_en.htm.

² IMF, Global Financial Stability Report – The Quest for Lasting Stability, April 2012.

negative impact on the credit supply within the euro area and pose a potential danger to economic development throughout Europe and beyond.

The IMF's estimate needs to be evaluated in finer detail. Nevertheless, it does illustrate the sheer scale of the problem. The point is, not least, that it must be possible in a market economy for financial institutions to withdraw from competition for economic reasons without casting the financial system into turmoil. This underlines how important it is to find a sound preventive solution for dealing with big banks.

What does the G20's solution proposal entail? The new SIFI rules are built on two pillars. First, the likelihood of a SIFI failing has to be reduced, meaning that SIFIs are to be more resilient, mainly through specific capital surcharges that go beyond the requirements of Basel III. Second, the restructuring or resolution of a SIFI is to be made possible in future without jeopardising financial stability and without having to resort to taxpayers' money.

2 A new international standard for resolution regimes

2.1 Basics of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions

For this purpose, the Financial Stability Board, FSB for short, has developed, and the G20 have adopted, a new international standard for resolution regimes: the "Key Attributes of Effective Resolution Regimes for Financial Institutions" - which I will refer to as the 'Key Attributes' from now on. This is the first time that the main features that national resolution regimes should in-

clude have been stipulated at the global level. For example, in future each of the G20 jurisdictions will have to set up a designated resolution authority for financial institutions. Moreover, specific requirements fostering cooperation between national authorities will promote crisis prevention and crisis management. Finally, institutions and supervisors alike will have to become very concrete in their planning of possible responses to an upcoming crisis. I will discuss these points in more detail later.

These Key Attributes were urgently needed, even if some financial sector commentators would have preferred a globally uniform insolvency law. It goes without saying that I, too, prefer optimal solutions, but – to put it bluntly – regulators and central banks do not live in the “land of Make-A-Wish”. The scope and complexity of the individual and mutually dependent issues which have had to be, or remain to be, solved in an overall package are sometimes like a Gordian knot. Unlike Alexander the Great in the legend, however, the G20 states have no magic sword to cut through the knot, and a reasonably timely approach that can be implemented at the global level is perhaps only a first step that may be followed by others at a later point in time.

2.2 Establishment of a designated resolution authority for financial institutions

One end of the rope forming the Gordian knot involves the institutional set-up for national resolution regimes. In adopting the Key Attributes, the G20 states committed to establish a designated resolution authority for financial institutions so that the particularities of crisis situations in the financial sector,

such as the danger of runs on banks, can be taken into consideration. This new authority will be given a strong mandate. In particular, its tasks will be to

- promote financial stability,
- ensure continuity of systemically important financial services,
- protect depositors, although this could be done – as in Germany – in coordination with the deposit guarantee schemes,
- seek to minimise the overall costs of resolution in home and host jurisdictions and
- duly consider the potential impact of resolution actions on financial stability in other countries.

To fulfil its role, the resolution authority will be equipped with far-reaching instruments. For example, it will be able to

- remove senior management and replace it with an administrator to take control of the firm,
- transfer or sell assets and liabilities to a third party or a bridge bank and
- impose a moratorium with a suspension of payments to unsecured creditors.

Implementing the Key Attributes will lead to a gradual alignment of the national legal frameworks for resolution regimes. I am convinced that this will most certainly have a positive impact on financial stability.

2.3 Strengthening international cooperation between national supervisory and resolution authorities

A further cluster of problems – the other end of the rope forming the Gordian knot – concerns the handling of crisis situations at large complex financial institutions. I don't need to explain to you that insolvency proceedings are currently carried out on a national and territorial level. However, the 30 largest systemically important banks hold on average 53% of their total assets abroad, according to data from a study carried out in 2010.³ 68% of their subsidiaries are located abroad, and they generate 56% of their pre-tax earnings from cross-border operations. In the past, if institutions like these became distressed, national supervisors regularly ring-fenced their assets. The banking groups were broken up according to national boundaries or were rescued by the respective home states as separate national entities. This meant systemic distortions and considerable cost for the taxpayer. Mervyn King once summed this up succinctly with the words: "Global banking institutions are global in life but national in death".⁴

We may not have Alexander the Great's sword, but there are two magic words which will help deal with these challenges. These words are "cooperation" and "planning". In order to systematically enhance cooperation between home and host countries, thereby improving crisis prevention, the Key Attributes contain a wide range of requirements which seek to promote cooperation. First, the competent authorities of the home jurisdictions of a SIFI are required to conclude institution-specific cooperation agreements with their

³ S Claessens, R J Herring and D Schoenmaker, *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, 2010.

⁴ Quoted from A Turner, *The Turner Review: A regulatory response to the banking crisis*, March 2009.

counterparts in the respective key host countries. Second, Crisis Management Groups are to be set up for each SIFI; within these groups, all responsible national bodies⁵ will come together at regular intervals to discuss crisis planning and crisis management. Third, in order to lay the necessary foundations for this, all impediments to sharing confidential information must be removed. I consider this last point to be especially important!

We have known for years now that the exchange of information between supervisory authorities is hampered by the lack of or an inadequate legal basis. Incidentally, this particular impediment not only obstructs resolution regimes but also affects many different areas of the G20 financial sector reform agenda. The necessary legislative changes will have to be made when the requirements resulting from the Key Attributes are transposed into European and, later, German law such as the German Banking Act. The European Commission is already aware of this problem.

2.4 Recovery and resolution planning

Recovery and resolution planning will facilitate cooperation between the authorities. This planning process consists of three mutually dependent components. First, the responsible authorities agree on an assessment on the banking group's resolvability, the aim being to examine the practicability and credibility of a resolution strategy. Any impediments to resolution should be identified and removed. In November of last year, the G20 committed themselves to carry out such assessments for all global systemically important banks by October 2012. As the second component, the institutions

⁵ The FSB Key Attributes specifically mention the supervisory and resolution authorities, the central banks, the finance ministries and the bodies responsible for statutory deposit protection.

themselves must submit plans describing how they envisage a potential restructuring and discuss them with supervisors. Ideally, the supervisory authority would be able to take these plans out of the drawer in the early stages of a crisis and restructure the institution in cooperation with the resolution authority. This planning process is useful for the institutions as well. According to a recently published survey involving 19 big financial institutions, 40% of those questioned claimed to have drawn up complete recovery plans. Despite the costs involved, the majority of the surveyed institutions see the advantages in this planning process, for example in that they provide a better operational understanding of the business structures.⁶

If restructuring is not possible or fails, the third component comes into play, namely that of resolution planning, which is to be developed by the authorities. The purpose of this is to prepare for the effective use of the resolution tools. The resolution of an institution has to be planned in such a way that

- systemically important functions performed by the institution are continued,
- the stability of the financial system is not jeopardised, and
- the use of taxpayers' money is avoided.

3 From standard-setting to the application of the new rules

3.1 The European Commission's proposal for a directive

Ladies and gentlemen, these and other standards from the Key Attributes are a milestone on the road to containing the Too-Big-To-Fail problem. On the one hand, the fact that international consensus has been reached with

⁶ Ernst & Young, Planning for all terrains – Global Banking Recovery and Resolution Planning, Survey 2012, [Interviews conducted during September and October 2011].

the backing of top G20 policymakers can be considered a success. On the other hand, a great deal of detailed work remains to be done since the FSB Key Attributes still have to be transposed into legal texts which, by necessity, have to be much more concrete than the international standard. Just how difficult this is may be seen from the fact that the publication of an EU legislative proposal originally planned for the summer of 2011⁷ has since been postponed several times, and has yet to be presented. I do appreciate the fact that, before making a publication, the European Commission wants to clarify difficult technical and political issues, such as the design of the bail-in instrument or implications for the deposit protection schemes in Europe. However, further delay in publication entails the risk that the European states each implement the Key Attributes on their own; this could create unnecessary inconsistencies and, consequently, new problems in the event of an institution becoming distressed. Moreover, it would be extremely inefficient if all EU states had to transpose standards on resolution regimes into national legal systems twice within a short space of time – first to comply with the G20 commitment and again shortly afterwards to implement the EU directive.

3.2 Germany: the Bank Restructuring Act

Notwithstanding international initiatives, German legislators responded to the financial crisis early on. On 1 January 2011, the Bank Restructuring Act⁸ en-

⁷ Press release of the European Commission of 6 January 2011, Commission seeks views on possible EU framework to deal with future bank failures.

⁸ Act on the restructuring and orderly resolution of credit institutions, on the establishment of a restructuring fund for credit institutions and on the extension of the limitation period of management liability under the German Stock Corporation Act (Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung).

tered into force, aiming to facilitate dealing with a distressed systemically important bank without jeopardising financial stability and, as far as possible, without using taxpayers' money. Moreover, the Act is intended to enable coordinated action with other responsible authorities at the European level if a cross-border banking group becomes distressed. This is why, when drawing up the Act, care was taken to ensure that the new instruments, such as stronger powers of intervention for BaFin, fitted into the already recognisable contours of the expected EU legislative proposal.⁹ In addition, with all banks contributing to a Restructuring Fund by paying a bank levy introduced in 2011, the banking industry is for the first time being made to participate in the costs of overcoming future crises – even though the amount accumulated in the fund is still far too small. The basic idea is that the money paid into the Restructuring Fund will be saved over many years until the target amount of €70 billion has been reached. Admittedly, this leaves us with a problem in the interim. However, the act in itself is a step in the right direction since it heightens what the IMF, in its last Article IV Consultation,¹⁰ called the “level of preparedness”. The fact that legislative change is also still needed in Germany before the Key Attributes and the EU directive can be fully and consistently implemented does not contradict my – in principle – positive assessment of the Restructuring Act.

3.3 Rigorous monitoring of the implementation of the new international standard

Experience over the past few years has shown that international standards can sometimes be futile if they are not implemented and applied in a consis-

⁹ Deutsche Bundesbank, Monthly Report, June 2011, Fundamental features of the German Bank Restructuring Act, pp 59-75.

¹⁰ IMF Country Report No 11/168, Germany: 2011 Article IV Consultation – Staff Report, July 2011.

tent and timely manner. For this reason, the FSB wants to rigorously monitor the progress made in implementing the Key Attributes in its member states. What makes this all the more important is the fact that the Key Attributes take us into uncharted waters. Moreover, implementation will require legislative and institutional changes – some of them extensive – in all G20 jurisdictions. Last but not least, monitoring of consistent implementation is crucial for overcoming obstacles to cross-border cooperation which will play such an outstanding role. To facilitate the monitoring process, work is currently underway, as a matter of urgency, on an assessment methodology that will make it easier to objectively assess the level of implementation in individual countries. This instrument is to be used by various bodies: a) countries will be able to perform a self-assessment in order to identify any gaps in implementation; b) the IMF/the World Bank will use this methodology when carrying out their FSAP assessments; c) the FSB is already planning a first review for 2012 as part of its peer review process, and d) the FSB Peer Review Council, which has not yet been set up, will apply this instrument to global systemically important financial institutions. Countries with a below-average performance in these assessments will be required to provide an explanation, and can expect the results to be published. I believe implementation must be monitored rigorously because the new standard closes a serious gap in the regulatory framework.

4 Conclusion

This gap illustrates perfectly that the regulatory framework before the financial crisis was not geared to the stability of the financial system as a whole. This failure to take sufficient account of the systemic stability perspective must and will be remedied. For this reason, let me draw your attention to the

German Government's draft of the Financial Stability Act, which the German Cabinet passed yesterday. This act will assign central tasks of macroprudential oversight to the Bundesbank. Among other things, the Bundesbank will be responsible for identifying risks to German financial stability as well as for proposing warnings and recommendations. The Bundesbank will present its analyses and proposals to a Financial Stability Committee, a new body that is to be established. However, it cannot be made to subscribe to analyses or proposals it does not agree with. To this end, the draft act provides that the Financial Stability Committee cannot override the Bundesbank's representatives on key decisions. I welcome this legislative initiative, it respects the Bundesbank's independence.

Difficult and complex legislative proposals can sometimes pose a problem comparable to unravelling the Gordian knot. Did you know that, according to ancient Greek mythology, the gods tied this intricate knot to the chariot of King Gordius to secure the drawbar of the chariot to the yoke? There was actually no need to cut the knot. If the peg had been pulled from the drawbar, the knot would have fallen apart on its own. To tell the truth, ladies and gentlemen, when I compare that image with the Gordian knot as represented by the resolution regime, I see neither a brute force solution nor a brilliantly simple one. Like it or not, it looks as though we will have to get on with the painstaking work of untangling the knot and work out the details of the legal contribution to solving the economic problem of Too-Big-To-Fail.