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CROSS-BORDER STABILITY FRAMEWORK: LESSONS FROM THE GLOBAL FINANCIAL CRISIS

INTRODUCTION

The essence of this subject problem reflects the challenges coming from cross-border activity of big and complex financial institutions, the systemic impact of their failure and the difficulties of cross-border crisis management.

These considerations are focused on two aspects. Firstly, the essential aspects of the cross-border stability framework and secondly the conclusions resulting from the current global financial crisis.

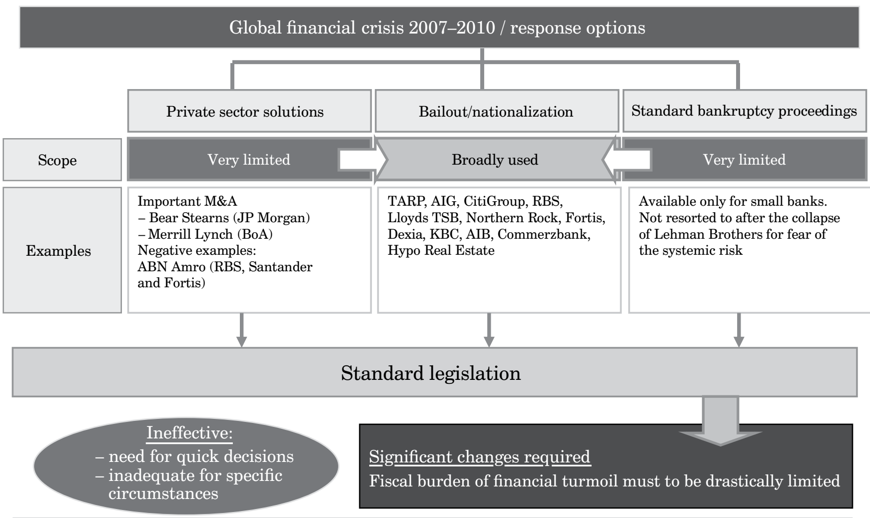
DOMESTIC FINANCIAL STABILITY FRAMEWORK: COMPLETENESS AND EFFICIENCY OF THE SYSTEM

First of all we need to assess the instruments used during the current crisis. It seems to be useful to classify these instruments into three groups, two of which are of very limited usage.

The first consists of private sector solutions. The second: standard bankruptcy proceedings. And, last but not least: bailout or nationalization.

As far as, private sector solutions are concerned, during the current global crisis, they practically haven't been applied. Only in a few cases such an option was discussed or described as private sector solution purchases. Two of them, the purchase of Bear Sterns by JP Morgan and Merill Lynch by the Bank of America, are widely considered as relatively successful. But even in these cases, the acquisitions were supported by financial assistance from the central bank or the government. One can also mention an unsuccessful example of such an acquisition, namely the purchase of ABM Amro by a consortium of the Royal Bank of Scotland (RBS), Santander and Fortis. Two out of three members of the consortium faced extremely serious problems, later on. Fortis disappeared from the market and RBS was almost fully nationalized by the UK government.

Chart 1. Low effectiveness of existing crisis management tools



The second option, which is also of very limited usage during the global financial crisis, was the standard bankruptcy proceedings. Usually, they are applied almost only for small banks, which have no systemic importance. Taking into account the fear of systemic risk, after the collapse of Lehmann Brothers (LB), this option was not resorted to.

So what kind of option was most commonly used during the financial crisis?

With some oversimplification, one may maintain that the most broadly used option was bailout. In practice, this amounted to a form of nationalization. This is the tool by which the government and some regulators started to cope with the negative consequences of the current global financial crisis.

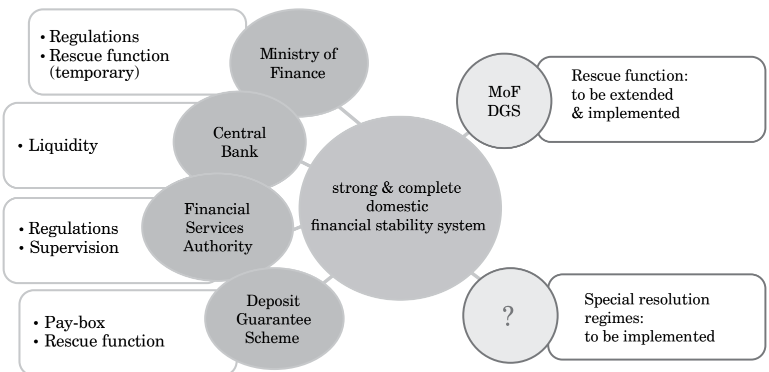
The conclusion which we should draw from the last crisis experiences boils down to saying that:

1) nationalization turned out to be an extremely costly solution,
2) the safety network revealed to be grossly inadequate to the scope and essence of the problem during the global financial crisis.

This assessment originates mainly from a domestic perspective, but if we look at it from a cross-border perspective, it is exponentially worse. Standard legislation also turned out to be ineffective under such specific circumstances as failure of banking institutions operating in cross-border regime and situations demanding a quick and straightforward decision-making process.

Let me briefly discuss what I understand to be a strong and robust domestic stability network. Traditionally, the safety net consists of four institutions, with well-defined functions. The Ministry of Finance, equipped with the authority to impose regulations. In addition to that, endowed with a temporary rescue function and, finally, reluctantly resorted to but in extreme situations broadly used bailout authority. The central bank, providing liquidity assistance with respect to individual credit institutions or the banking sector as a whole. Regulatory or financial services authority responsible for regulations and supervision. And in most countries deposit guarantee scheme equipped with a paybox function and, in limited cases in Europe , with a rescue function.

Chart 2. Robust domestic stability network as prerequisite for effective cross--border safety net

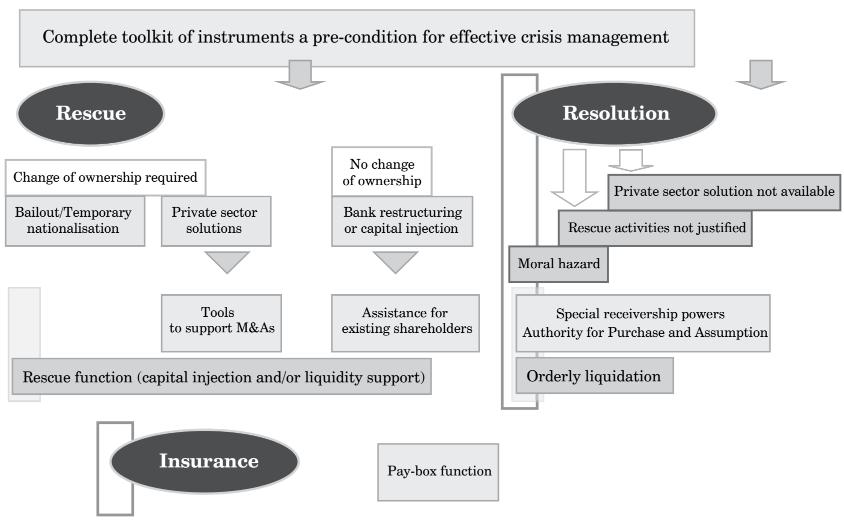


What is missing, especially in Europe? How should the safety network be enlarged?

Firstly, the rescue function should be extended. There are only a few institutions, aside from governments, which are legally established to use rescue instruments. For example in Poland there is the Bank Guarante Fund, the national DGS, designed not only with the pay-box function but under the principle of the least cost, it can serve the rescue function using the so called assistance loan, which may be provided to keep a troubled bank alive and avoid its bankruptcy and reimbursement of claims to its clients. A set of rescue instruments includes alternatively a temporary recapitalization, purchase of assets and guarantee of rights issue or bond issue. Considering the accumulated experiences, there are very strong arguments for the toolkit of rescue instruments to be attached to deposit guarantee schemes, due to its complementarity with the pay-box function, as well as due to possible synergies coming from the usage of this rescue function.

Secondly, what is especially important, there is a lack of special resolution regimes (SSR), special bankruptcy laws dedicated to banks, which allow a bank to be liquidated in an orderly way. SRR can not only mitigate crises but it also stimulates market discipline and reduces moral hazard. Quite recently, after the painful experience of Northern Rock and LB such SRR has been adopted in the UK. Without adequate rescue and resolution instruments, the domestic safety net looks like Swiss Cheese with very large holes and I do hope that there is still some milk left to contain the existing holes. Many countries in Asia, Africa, South America and North America, learning from costly experiences from previous financial crises, have already adopted the necessary regulations and they are much better prepared for the severe consequences of potential banking crises. But even in a country with a very sound and strong domestic safety network established, crises still remain inevitable in a market economy and one should not act under the illusion that any kind of domestic or cross-border stability framework can eliminate financial crises.

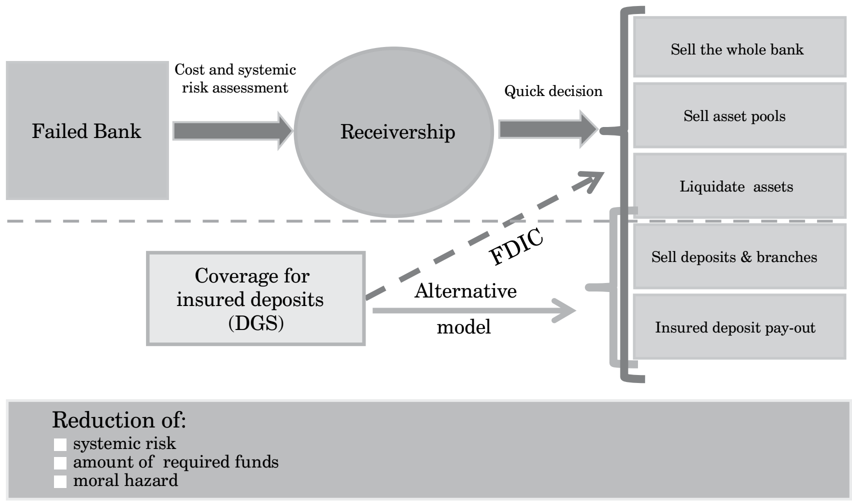
Chart 3. Need for effective rescue and resolution funtions



The rescue function can be executed in many ways, however a capital injection or liquidity support are the most frequently used ones. Rehabilitation of the problem bank with the outside rescue fund may require changing the ownership or be implemented without changing the ownership. There are good arguments to activate the rescue function mainly when a change in ownership is under way.

However, in some cases, when a private sector solution is not available and if rescue operation – using the public funds – can destroy the market discipline stimulating a moral hazard, especially connected with nationalization, there is a need for orderly liquidation of a credit institution. Therefore special receivership powers, special authority for purchase and assumption should be attached to a specific institution or institutions.

Chart 4. Resolution regime

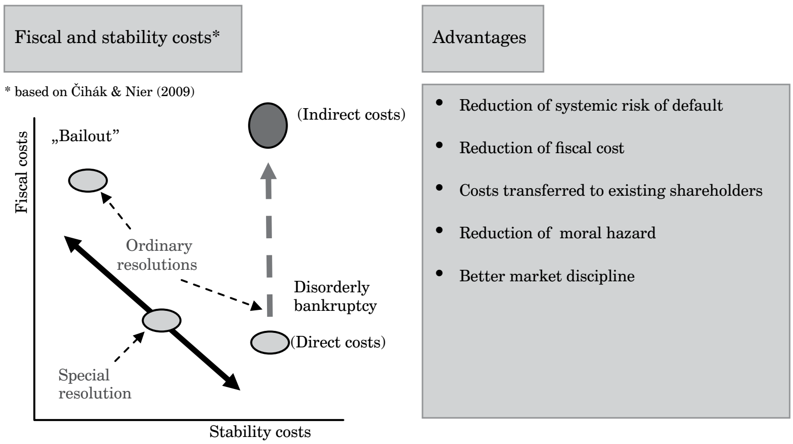


According to the best world practices, resolution instruments are majorly attached to deposit guarantee schemes. The most experienced and the best known is the Federal Deposit Insurance Corporation (FDIC). However, as mentioned before, it is not the only one. We may refer to a few examples. Resolution activities are conducted by deposit guarantee schemes in Canada, countries in Latin America (Chile, Columbia, Mexico); in Asia (Japan, Korea, Malaysia, Philippines, Taiwan, Thailand), in Africa (Nigeria and Tanzania) and some European countries (Russia, Turkey). It would appear that Europeans pretended for a long time that financial crises had been excluded from business cycles in Europe and therefore there were no reasons for implementation of resolution regimes. The current global financial crisis clearly proved that this attitude was totally unfounded. Deep crises and nationalization of the banking institutions in the UK forced politicians to adopt the so called Special Resolution Regime.

Why is this solution so important? Why should the domestic stability network be supplemented by this special resolution regime?

Briefly, we can explain it using slightly a modified, but a well-known diagram of Cihak & Nier.

Chart 5. Significance of special resolution regimes



Source: Autor's concept based on Martin Cihák Erlend W Nier, the need for special resolution regimes for financial institutions. http://www.voxeu.org/index.php?q=node/4446 (09-10-2010)

The modification relies on adding an element incorporating indirect costs.

What this diagram suggests is that even if we follow a disorderly bankruptcy, which by definition should not involve large direct fiscal costs, the costs related to the need to calm markets or to offset the negative consequences of disorderly bankruptcy turned out to be very high. It explains why even under disorderly bankruptcy indirect fiscal costs are incredibly high. In short, SRR reduces fiscal costs substantially and mitigates the negative impact on the financial stability.

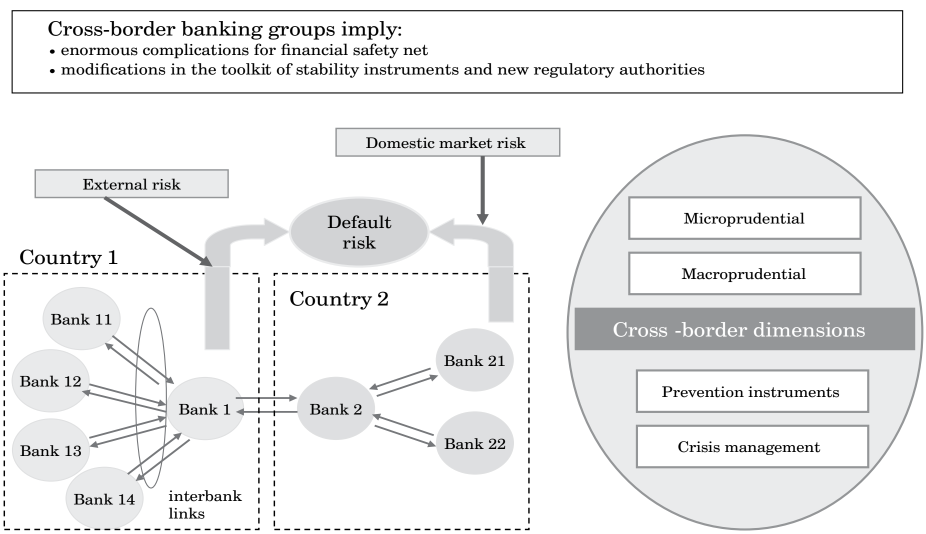
A robust stability framework almost inevitably leads to a negative side effect in the form of increased moral hazard. This problem has to be addressed. We have to diminish the fear of disorderly bankruptcy and under a special regime allow, even big and complex financial institutions, to go bankrupt. Therefore the SRR is an indispensable component of a strong domestic safety net.

The European countries, mainly EU member states, have to quickly make up for the lost time. Some countries have already launched this process. In Poland the SRR concept has been increasingly brought into general use and hopefully the needed decisions should be undertaken fairly soon.

CROSS-BORDER INTERCONNECTEDNESS – ADDITIONAL RISKS AND CHALLENGES

The need for a robust and comprehensive domestic safety net is even more urgent when we move to a global perspective from the financial and economic point of view. The benefits originating from globalization are relatively well known and there is no need to list them. However, globalization also brings some threats. In issues discussed in this paper, there are at least three negative features, resulting from financial globalization should be underlined. Firstly, globalization generates an increased risk of crisis, because cross border and international operations are accompanied by lack of sufficient information. Secondly, interconnectedness incorporates contagion effect. Both inevitably increase the risk of financial crisis which cannot be prevented under existing safety net architecture. Thirdly, crisis management is difficult even from a domestic perspective but in a cross-border environment it turns out to be highly problematic and very challenging. In a cross border perspective a domestic bank is a part of an international system, which immediately raises the question of access to information required for adequate risk assessment. If the cross-border perspective is applied, the available set of methods for macro-prudential oversight, micro-prudential supervision, prevention as well as crisis management instruments should be urgently modified. However, this is truly not an easy task to fulfil.

Chart 6. Cross-border risk management



Let me now turn from a general perspective to the available solutions for mitigation of cross-border risk. My starting point is a robust domestic safety net. I take it as a precondition of any sound cross-border stability framework. Unfortunately, in most of the European countries a robust domestic safety net is still under construction. The specific weaknesses are mainly: lack of a clearly defined and financially prepared rescue and resolution function. But these are merely preconditions.

In order to cope with a very challenging cross-border environment, harmonization and cooperation are of crucial importance. But cooperation is typically based on non-binding agreements, and such a solution could be relatively effective in terms of a fair information exchange and mostly in good times. Under emergency circumstances a non-binding framework is not sufficient and the global financial crisis has proved that such a solution simply does not work effectively.

Chart 7. A selected limitations of cross-border risk monitoring

Systemic risk

Capital surcharge to risk-weighted assets

(in % of initial risk-weighted assets)

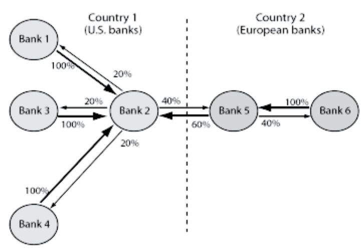
Country	Banks	Network charges	Country 1 charges	Country 2 charges
Country 1	Bank 1	0,74	0,97	?
	Bank 2	1,43	1,11	
	Bank 3	0,44	0,54	
	Bank 4	0,41	0,50	
Country 2	Bank 5	1,56	?	0,58
	Bank 6	1,06		0,34

Source – IMF

Limitations

Identification of systemically important institutions requires access to data on entire cross-border network

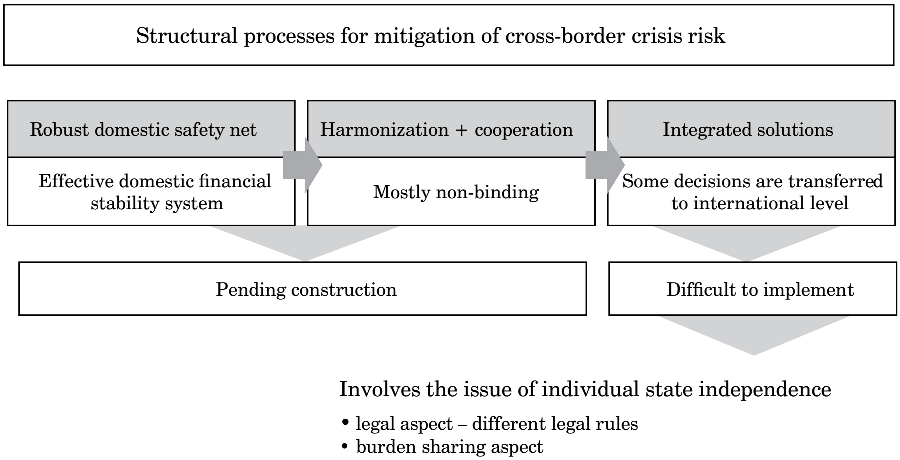
Total picture of the risk is not visible from the perspective of a single country



In addition to a local component, the risk imposed on domestic banks depends on external foreign risk, which is only partially visible

Taking into account not only potential losses, it remains unclear why two basic issues are mentioned, namely: a robust domestic safety net and an effective cross-border cooperation and harmonization which are still pending construction in the EU. On the other hand, it seems very problematic to establish any international body responsible for mitigating financial crisis without adopting adequate domestic safety net in the EU member states effectively cooperating on the basis of harmonized rules.

Chart 8. Process of reducing the risk of cross-border financial crisis



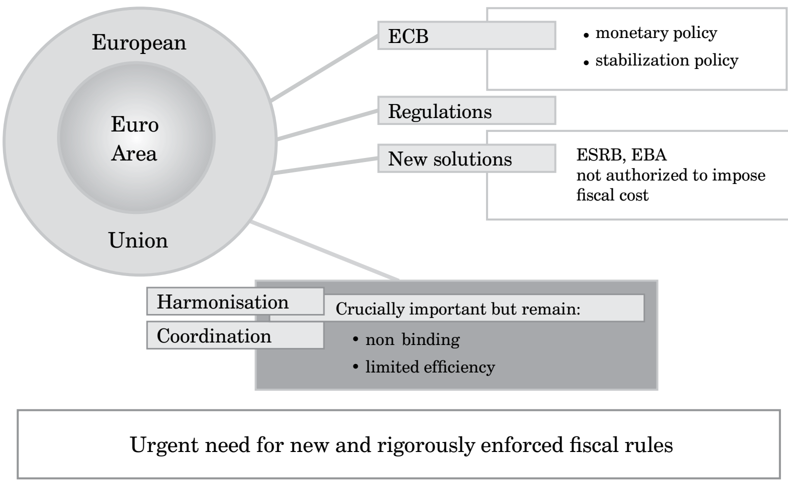
A FEW REMARKS ON THE EUROPEAN FINANCIAL STABILITY NETWORK ENHANCEMENT

First of all the heterogeneity of financial stability network in EU member states should be underlined. The only exception is the European Central Bank and the European system of central banks. The ECB has the exclusive authority to conduct monetary policy and to some extent stabilization policy. The new bodies are some recently established institutions: the European Systemic Risk Board and the European Banking Authority. However, these institutions are not authorized to impose fiscal costs on member states, so the effectiveness of these institutions may be limited. All member states obey the EU regulations; however, they mostly are dedicated to supervision. An oversight and cross border crisis management issues are hardly covered. Therefore, it should be quite clear that harmonization and coordination are of crucial importance in such a stability framework.

Cross border cooperation is not binding and has not been, at least until now, of limited efficiency. The negligible importance of MoUs signed in 2008 by ministries of finance, central bankers and supervisors has been rather evident during the current crisis. This stability network from a macroprudential perspective is supplemented by fiscal rules from the Stability and Growth Pact. And again, the European sovereign debt crisis clearly indicates the urgent need for new and rigorously enforced fiscal rules.

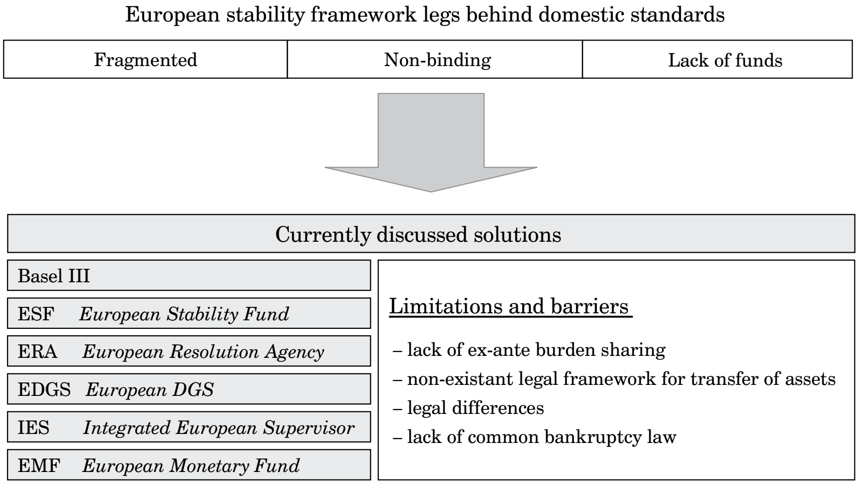
The recent cross border crisis management experience in Europe has revealed that:
– in practice, the European stability safety net has failed to be successful,
– it lags behind domestic standards,
– it is still fragmented,
– it is not binding,
– it lacks funds to intervene at the pan-European level.

Chart 9. Outlook of existing cross-border stability network in the EU



The European stability framework has to be promptly modified and improved. That is why there are many new issues which are currently being discussed, not only Basel 3 with a new set of supervisory indicators, but also the need to establish pan-European institutions like the Stability Fund or the European Resolution Fund, Professor Gross' proposal of a European Monetary Fund, pan-European Deposit Guarantee Scheme or, discussed for many years, the Integrated European Supervisor. What underpins all these institutional proposals is the hope that at a pan-European level the extremely difficult challenges of cross border crisis management may be appropriately addressed. This may be correct. But without a robust domestic stability framework, without efficient cross border cooperation, and without a strong political will to cope with ex ante burden sharing and transfer of additional authority to a European level, all these new initiatives will boil down only to discussion among economists and will never be applied in real life.

Chart 10. Proposed cross-border stability network



CONCLUDING REMARKS

Let me return briefly to the sources of the global financial crisis. Typically they are attached to weaknesses coming from macro-prudential environment, secondly, micro-prudential and thirdly, macroeconomics. We may expect that the extremely difficult problem of macro-prudential weaknesses is to be addressed by the European System Risk Board, the role of which in practice is still to be tested.

With respect to micro-prudential aspects, there are many initiatives. For example, new capital, and liquidity requirements and leverage thresholds, to cite the most widely discussed, or the latest political action to ban the naked short sell. They seem to be adopted on the assumption that the current financial crisis predominantly results from serious faults of the private sector. So the new measures are selective and focus almost exclusively on the banking sector, but their effectiveness has not been fully proved (e.g. lack of full cost-benefit analysis, and impact analysis). However there are serious doubts whether these new supervisory regulations will provide a good balance between the safety and efficiency of the financial system.

Macroeconomics can be a very important source of potential public failure and a deep state, regional or even global crisis (monetary policy, foreign exchange policy and fiscal policy). The most often cited culprit is the monetary policy. The largest central banks kept their interest rates too low for too long, which significantly contributed to building asset bubbles and global over-liquidity. If the famous Taylor rule had been applied by the Fed since 2002, the boom on the real estate market would have been quite well contained. This means that instead of an extended boom in housing industry, financed widely by Ninja credits, and subsequent dramatic bust, the economy would have followed the gently sloping pattern of a normal business cycle. In addition, the monetary policy of many central banks focused almost exclusively on the stability of consumer prices, completely neglecting asset prices, monetary aggregates or credit aggregates.

From a fiscal policy perspective it is clearly evident, especially in Europe, that it has been too expansionary, too generous, and in most countries unsustainable; without paying attention to the size of fiscal burden we are willing to impose on future generations. It should be urgently reformed.

Also foreign exchange policies contributed to global imbalances. Uncoordinated foreign exchange regimes, between countries and even continents build significant deficits in some countries with corresponding surpluses in others.

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The current discussion, on the lessons from the global financial crisis, overemphasizes the importance of the new micro-prudential tools that brings a risk of overregulation in that field. We are doing very little with respect to macroeconomics (mainly expansive monetary policy leading to suboptimal policy mix) and similarly to macro-prudential framework. Attention is focused almost exclusively on micro-prudential regulations without proving that the main sources of global financial crisis are connected with the private sector failure. For many, including myself, many serious failures resulted from the public sector as well.

Fiscal policy, in many countries, especially in Europe, has reached its limits and it is unlikely to expect any serious counter cyclical impact form it. Quite contrary, due to previous mistakes, during the current recession, the fiscal policy has to be restrictive.

Regulatory policy is clearly pro-cyclical and attention is focused mostly on new regulations and with insufficient importance attached to more effective supervision.