*Lars E. Nyberg**

# CROSS-BORDER STABILITY FRAMEWORKS[1]

## CRISIS PREVENTION AND CRISIS MANAGEMENT – TWO SIDES OF THE SAME COIN

In the previous panel, we listened to discussions on the topic of how to avoid another serious global financial crisis. This subject is, in fact, very closely related to the theme of this panel, so you will have to excuse me (or us) for any potential overlaps. Even if our focus (as I interpret the programme) is supposed to be more on crisis management than on crisis prevention, we cannot – and should not – try to separate the two subjects – because, in the end, what happens in a crisis, and the authorities' response to it, has a great impact upon the actions of financial sector participants in normal times, which, in turn, may affect both the frequency and seriousness of future crises. Therefore, I would argue that, when debating how to avoid crises, we must not only focus our efforts on discussing actual prevention tools, we must also dedicate as much – or perhaps even more – thought towards how to establish solid and credible frameworks for dealing with crises. And, most importantly, we need to consider these two subjects in conjunction. For this reason, I will take the liberty of **not** limiting my remarks to the crisis management aspects of cross-border financial stability frameworks.

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1 For the conference "Global Financial Crisis: Lessons for the Stability of the Financial Sector", Warsaw, 21 May 2010. Introductory remarks by Lars Nyberg for the panel discussion on "Cross-Border Stability Frameworks".

Before I start, I have a confession to make. Those of you who have seen (the draft of) the latest Geneva report will notice that the content of this presentation is very similar to that report. In fact, the analytical framework I use in this presentation has been "stolen" from that report. This theft has been carried out not because I lack ideas of my own, but because I think that this framework is very useful to explain and fully understand the challenges related to the regulation and supervision of cross-border banks.

Turning now to the issue at hand, I would like to focus my attention on the EU. As we all know, the recent financial crisis revealed serious weaknesses in the EU framework for financial stability. It is simply enough to mention names like Fortis and Icesave to prove the point. Of course, it would be seriously misleading to put all the blame on the EU for the problems that got us into the mess. In fact, the crisis was almost exclusively triggered by events in the US markets. Still, we cannot escape the fact the EU probably could have coped with the crisis in a much more effective way than it actually did. A fair conclusion is that the framework that the EU had, prior to the crisis, neither helped us to spot the common risks on the internal market, nor helped us to manage them. In some instances, it made problems even worse.

## THE LOGICAL INCONSISTENCY OF THE EU FINANCIAL FRAMEWORK

The heart of the EU's problem is conceptually very simple. For quite some time, we have been building a framework based on the logically inconsistent idea of having one single market controlled by 27 sovereign nations. From a financial stability point of view, this is definitely no recipe for success. On the contrary, it is a source of coordination problems and conflicts of interest among the EU countries. Furthermore, since the current framework leaves it highly uncertain who actually will have to carry the costs of failing cross-border institutions, it is potentially also an obstacle to further integration, as countries may become more reluctant to accept the concept of cross-border banking.

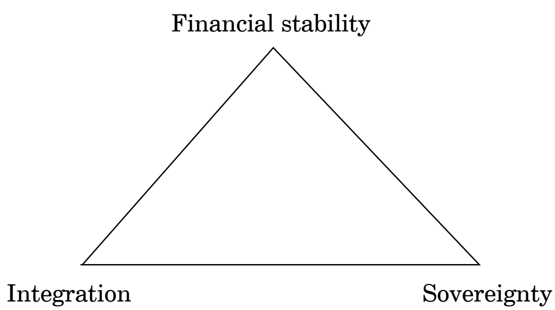
A reasonable question is why on earth the EU has chosen to build a structure that is apparently very ill-suited for delivering financial stability. The answer is simple: financial stability is not the only objective at which the member states are aiming. In the last decade or so, the main focus of the EU financial market agenda has been on integration – establishing an internal market for financial services. Carrying through this ambition, the financial stability aspects of integration were often forgotten or not given priority. Instead, the focus was on achieving a common market while maintaining next to full sovereignty for member states. However, some compromises have been made in the areas of supervision, where the EU has allowed some transfer of powers from the host to home country. As regards crisis management, on the other hand, almost all powers have remained exclusively with each member state. This splitting up of powers in supervision and crisis management has certainly not helped to create optimal conditions for financial stability in the internal market.

In many regards, these flaws came to surface in the crisis, and now, almost everybody agrees that change is needed. And while – as we all know – reform work has already come quite some way, I would say that the final outcome of this reform is still far from certain.

## SOMETHING IMPORTANT HAS TO GIVE

Basically, what this reform work is about is choosing the path at a crossroad – a crossroad that has been described by FSA chairman Adair Turner as a choice between more Europe or less Europe. But the choice is not easy, because, whichever road we take, something important has to give. What I am talking about is what has been described by Professor Dirk Schoenmaker as the "financial trilemma of Europe". We have three goals: financial stability, integration, and national sovereignty, but only two of these can be reached simultaneously. This is comparable with the trade-off in monetary policy between a fixed exchange rate, capital mobility and national independency in monetary policy, a trade-off that, in 1998, led 12 EU countries to give up their independent monetary policy to join the Euro project.

**The financial trilemma of Europe**




As I have already indicated, the pre-crisis approach to dealing with the financial trilemma was to opt for integration without giving up national independency in supervision and crisis management. Of course, all this was at the expense of financial stability. When EU financial integration picked up speed in the mid-90s, the financial stability objective came more into focus. However, the solution was not to centralise powers at the EU level, but to maintain the pace of the harmonisation process and to establish structures for *voluntary* cooperation.

## THREE OPTIONS FOR THE FUTURE

Realising now that this has not been enough, the question becomes one of what we should do instead. Broadly, we have three basic options.

- ❖ Firstly, we could go for the **federal approach**, where we allow for a full delegation of powers to the EU level, including regulation, supervision and crisis management.
- ❖ Secondly, we have the option of abandoning the idea of the internal market and returning to a system with **full national control of domestic financial systems**.
- ❖ Thirdly, we could opt for **reforms of the current model,** increasing harmonisation and co-operation to achieve a clearer and more coherent division of powers and responsibilities in supervision and crisis management.

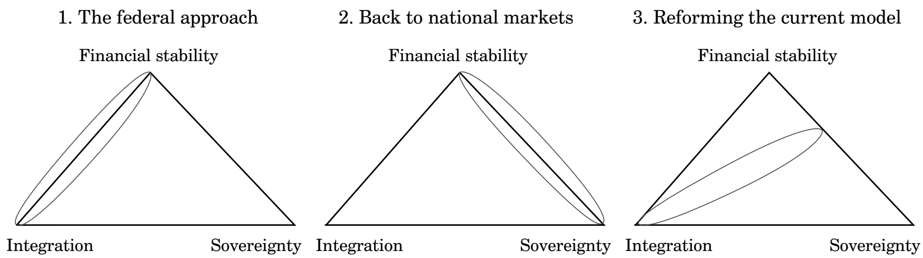
So what does each of these options imply?

The first option, **the federal approach** would mean that risks and problems that are shared by several member states or by the EU as a whole could be managed jointly at a centralised level. The potential co-ordination problems and conflicts of interest resulting from several parties being involved in supervision and crisis management would thereby be mitigated. A necessary condition for this to work would, of course, be the transfer of <u>all</u> powers, including responsibility for crisis management. Otherwise, we risk only aggravating the conflicts of interest that may occur. Following from this transfer of crisis management powers to a centralised level, the EU would have establish some kind of funding mechanism from which resources could be drawn when needed to manage crises. This is where this option gets really problematic. Despite having gone through a major crisis of global proportions, there seems to be little political support behind the idea of establishing supranational authorities equipped with powers to draw on tax-payers' funds.

The second option, a system with **full national control of domestic financial systems**, would imply a roll-back of the integration process that the EU has implemented so successfully over the years. Besides abandoning the principles of home country control and single license, it would be necessary to introduce restrictions on cross-border capital flows in order to prevent contagion. Obviously, in its pure form, this would be a very drastic manoeuvre and not something that is very likely to happen. Still, we see some tendencies in the debate in favour of a more nationally-oriented approach to supervision and crisis management. I find proposals along this line to be very worrying. It would not only be a serious violation of the fundamental idea of the internal market, it would also be highly economically damaging to the European economies. If you ask me, this is not the way to go.

The third option, **reform of the current model**, seems like the only realistic option. In terms of the financial trilemma, what this option basically entails is that we stick to integration and, at the same time, find a reasonable compromise between financial stability and sovereignty. It is all a question of strengthening the EU as the "core" within the EU financial stability framework. How to achieve this and how much of a "core" the EU will be allowed to form are the tricky parts, and the answer varies depending on who you are asking. In concrete terms, the issues at stake are how far we want to go with co-ordination and harmonisation, and what this will imply in terms of the centralisation of powers.

**The three options in terms of the financial trilemma**




## WHAT THE EU IS DOING…

This third option is also the path that the EU has chosen for reform. Before I give you my reflections on the EU's way of tackling the trilemma, let me quickly guide you through the main issues that the European Council has been able to agree on to date.

Firstly, on coordination:

- The existing – but loosely formed – European supervisory system will be significantly strengthened. **Three new supervisory authorities will be established** and given certain powers aimed at strengthening coordination. Among other things, they will be able to take certain decisions overriding the powers of national supervisors, for example in the case of a severe crisis situation in the EU or when home and host supervisors cannot reach agreement.

- ❖ Working alongside these new authorities, there will be a newly established body responsible for the macroprudential supervision of the EU financial markets, **the European Systemic Risk Board (ESRB)**. This body will not have any binding powers at its disposal, but it will be able to issue risk warnings and make policy recommendations to EU institutions and national authorities on how to address the identified risks.
- ❖ The **role of the ECOFIN and EFC in coordinating financial stability policies in an EU-wide systemic crisis will be strengthened** and explicitly integrated into the EU economic policy coordination process.
- ❖ The current EU coordination framework for crisis prevention management and resolution between EU and national financial supervisory authorities, central banks and finance ministries will be further enhanced by the establishment of **Cross Border Stability Groups (CBSGs).** These groups will operate on the basis of the procedures set out in formal agreements signed by all the involved parties, **Cross-Border Cooperation agreements (CBAs)**.
- ❖ In order to enable effective coordination in a crisis, the CBSGs should develop **operational criteria and principles for ex post burden sharing,** as well as **Recovery and Resolution Plans.**

Secondly, on harmonisation:

- ❖ The main issue on the EU's regulatory agenda is the **development of an EU regulatory crisis management framework**, providing harmonised rules for adequate 'early intervention tools' for supervisors, and resolution and accompanying insolvency measures in order to ensure that all Member States have adequate common tools and can coordinate their use, and that actions taken are legally certain.
- ❖ To strengthen harmonisation more generally, **the new supervisory authorities will be equipped with powers to develop technical standards** which could be made legally binding after endorsement by the Commission. The authorities will also be assigned with the task of promoting "voluntary" harmonisation, by issuing non-binding guidelines and developing standards for best practice supervisory methodology.

## ...IS ON THE RIGHT TRACK

Taken together, all these initiatives – if carried through – will significantly improve the financial stability framework of the EU. It will be not be perfect, but it is probably as far as we can get at the moment. In the short run, it is not realistic to aim for a pan-European structure. The political support for such a model simply does not exist. Furthermore, it would require changes to the Treaty, which we know is quite a cumbersome process to go through.

But even if the current agenda looks promising, we are not quite there yet. In the process to come, we need to stay committed to integration. The reason is simple. Financial integration brings more benefits than costs. And to achieve this, we need to address some really complicated and sensitive issues, including, for example, burden sharing and asset transfer.

However, our success in building a better framework is not only measured by how much of their own national interests countries will be willing to give up for the benefit of others or the common good of the EU, but also by how much clarity we can bring to the process of what will happen once a cross-border bank gets into trouble – because simply by bringing more certainty to the crisis management process we will come quite some way towards more efficient cross-border crisis management.

## CRISIS MANAGEMENT ARRANGEMENTS ARE THE KEY TO SUCCESS

Basically, what I am trying to get at here is that the key to an efficient stability framework, to a large part lies in crisis management arrangements. Supervision is by all means important, but, to a very large extent, it is the design of the rules of the 'end game' that matters if we want to achieve more prudent risk-taking in the financial industry. In designing such frameworks, which will also be operable in a cross-border setting, four components are particularly important:

- Firstly, all member states must have national crisis management and resolution frameworks in place. However, from a cross-border perspective, it is not only important that such frameworks exist, but also that they are built on a common philosophy of how to tackle problems when they arise. For example, it is important that countries have similar approaches with regard to issues such as the point at which authorities should intervene in a troubled institution, how owners and bondholders are treated in such cases and what responsibility lies with the governments (tax-payers) for supporting distressed institutions financially.
- Secondly, national frameworks need to be compatible. Not only in the sense that they are alike, but also that they allow for cross-border cooperation – in the meaning that the common interest of all involved parties is respected. Issues such as asset transfer and burden sharing come in here.
- Thirdly, on a similar line, responsibilities in crisis management need to be sorted out and aligned. Who does what, when and how are questions that need to be answered. Once again, the crucial aspect here is to find a model that gives

the member state responsible for supervision the correct incentives to also look after the needs and interests of other involved countries. Currently, this is not always the case.

These first three points are basically what the EU is now trying to achieve by developing a harmonised EU crisis management framework.

❖ Fourthly, and not least, effective crisis management requires preparation! As in any other area, the best way to avoid unpleasant surprises, which among other things may erode trust between authorities, is to be prepared. Plan for all types of events and do it together with those who might be involved.

The EU is also doing important work with respect to this point. The previously mentioned initiatives to set up cross-border stability groups and formal procedures for co-operation will most certainly help improve crisis preparedness.

## CONCLUDING REMARKS

However, as I said before, it remains to be seen how much of the EU agenda will eventually be delivered. My concern is that a *failure* to deliver would be a huge blow to the integration of the EU financial markets – because, without a robust cross-border stability framework with the ability to provide certain and equitable outcomes for the involved countries in a crisis situation, I am afraid that authorities would be less willing to accept the concept of cross-border banking. And, in my opinion, that would be an outcome that we cannot afford.