EARLY INTERVENTION AND PROMPT CORRECTIVE ACTION IN EUROPE

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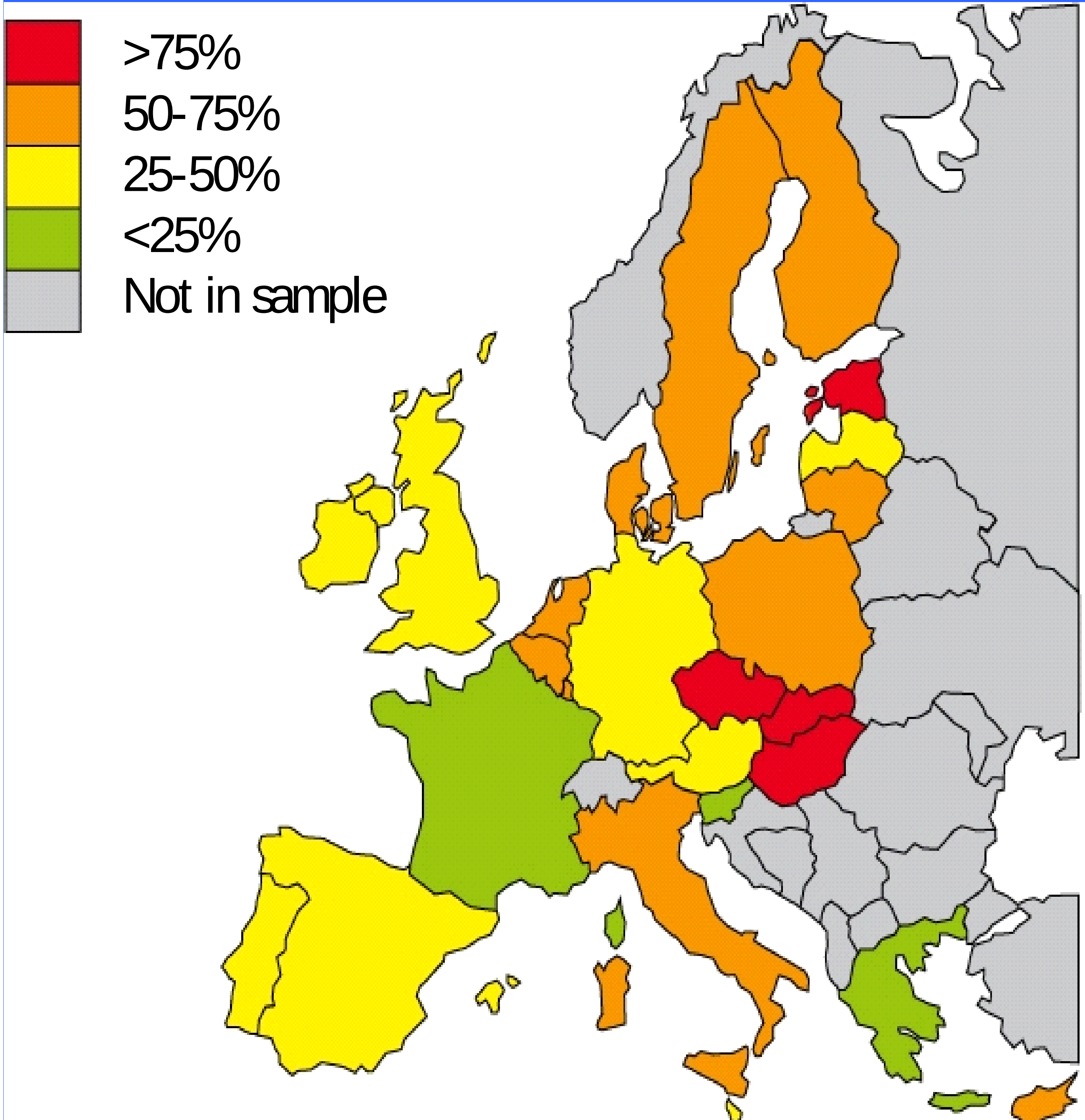
The views expressed are my personal opinion and may not reflect any held by the Bank of Finland

4 REMINDERS FROM RECENT EVENTS

- **Banks can get into trouble extremely rapidly – the authorities therefore need to have extensive 'pre-positioning' if they are to handle the difficulty efficiently**
- **Depositors need to be guaranteed almost uninterrupted access to their funds and full insurance of most deposits if bank runs are to be avoided**
- **The whole system of prompt corrective action (PCA) needs to start early, before the capital triggers are reached and hence requires a basis in risk assessment and market signals**
- **It is necessary to be able to step into a bank and take it over before its capital is entirely depleted**

‘FORTUNATELY’ MOST PROBLEMS HAVE BEEN IN ‘NATIONAL’ BANKS

- **Could the authorities have responded so rapidly for cross-border banks?**
- **Probably if the lead country were prepared to shoulder the burden and its interests were well aligned with those of the others**
- **Even so unless the various authorities have similar powers and are able to take account of problems outside their jurisdiction it would be difficult**
- **Not just a European problem, US may be involved**



*) **Cross-border Index** = outward integration + inward integration

Outward integration = The share of domestic banks' total assets held in EU25 countries outside the home country

Inward integration = Foreign banks' share of domestic banking market

WHAT CAN BE DONE IN THE CURRENT ENVIRONMENT?

- **There is a window for change while governments and parliaments are concerned**
- **Grand European institutional changes are unlikely**
- **Concentrate on the early detection and rapid resolution of problems**
- **Avoid burdens to share, limit the range of possibly contentious harmonisation**

STRUCTURED EARLY INTERVENTION AND RESOLUTION

- **Implemented under FDICIA in 1991 in the US**
- **Requires increasingly harsh measures to restore capitalisation under a timetable as capital falls**
- **4 categories of banks**
  1. **No problem**
  2. **Potential problems – intensive supervision and preparation**
  3. **Problem intensive – implementation of PCA**
  4. **Mandatory reorganization**
- **Clear dividing lines between categories**

SOME ADVANTAGES OF SEIR

- **A clear objective in the face of problems – minimising the loss to the deposit insurer**
- **A single agency in charge – FDIC**
- **It already exists and has a record of experience so it can be readily adopted and improved upon**
- **Constrained discretion**
- **Strong incentive for a private sector solution – to avoid compulsion**
- **No great additional regulatory burden**
- **Puts burden on the shareholders, avoids losses to taxpayer, creditors better off than under traditional insolvency**
- **Reduces argument about cross-border burden sharing**
- **Could be implemented in current supervisory structure**

SOME PROBLEMS

- Preconditions
- Triggers
- Information
- Prepositioning
- Institutions
- Measurement/Valuation issues

PRECONDITIONS

- **A similar toolkit**
- **Adequate authority**
  - **Can apply measures under similar conditions for benefit of those in other countries**
- **Accurate and timely information**
- **Adequate resolution procedures**
- **Market discipline needs to work**
  - **Banks can be taken over/merged**
  - **Problems finding buyers: Northern Rock, Roskilde, Lehman Brothers, Bear Stearns (now better after a failure?)**

TRIGGERS

- Capital triggers are not early enough
  - Even in US tend to act earlier: CAMELS, information, signals
- Risk assessment measures – use Pillar 2?
  - Liquidity
  - How can they be made transparent enough to avoid objections?
- Market signals
  - Pillar 3 offers a little
  - Share price or spread rules (sub debt) derivatives prices
  - Compulsory EGMs as in Norway?

Northern Rock 1 September 2006 to 30 September 2008

INFORMATION

- **For individual bank need to know as much as for a national bank**
- **For financial stability the same**
- **Need a common database not just discretionary sharing on providor’s assessment of need**
  - **Including confidential supervisory information**
  - **More than a soft law MoU**
- **Basel 2 committees help but are not enough**

PREPOSITIONING

- **FDIC is requiring more information from LCFIs to ensure that it could move in rapidly – particularly for deposit insurance**
- **Resolution authority needs access to funding, appropriate skilled staff and specialist advice – change agent and investment banker to organise sale**
- **An appropriate structure for the bank**
  - **Free standing subsidiaries would be ideal**
  - **NZ Outsourcing Policy – local incorporation, able to identify claims rapidly, apply haircuts and open on same day.**
- **Roskilde case – ability to withhold dividends, issue preference shares and intervene early**

INSTITUTIONS

- How can a large number of independent authorities work together?
- One must not be able to cause harm to the others
- National needs for financial stability
- Could delegate (Art 131)
- Supervisor of parent leads?
- College – joint responsibility as in cabinet government, rules for making decisions (deadlines)
  - Actions must be binding on members
  - Consolidating supervisor may need to decide

INSTITUTIONS

- **Would a European level institution help?**
  - **Use ECB as permitted under the Treaty (127:6)**
  - **European System of Financial Supervisors**
  - **European Organisation for Financial Supervision**
  - **Aimed at coordinating supervision**
  - **A separate European regulatory system for banks chosing to be European companies might work**
  - **Could offer lower costs in return for ability to intervene**
  - **A resolution agency would be more useful**
  - **European Deposit Insurance Corporation (EDIC)**

CONCLUDING REMARKS

- **Already seen working in other countries**
- **Can use current framework of supervision**
- **Reduces information asymmetries**
- **Ensures earlier and more rapid action**
- **Strong incentive for prior private sector solutions**
- **Limits burden on taxpayer and burden-sharing disputes**
- **BUT preconditions: resolution powers, able to act in others' interests, common tools and triggers, information sharing, decision making**
- **Only a step not a panacea**