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?
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 provider’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 choosing 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